

**SECURITIES AND EXCHANGE COMMISSION**

**Form 20-F/A**

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

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

**for the fiscal year ended December 31, 2003**

**OR**

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

**Commission file number 1-14540**

**Deutsche Telekom AG**

*(Exact Name of Registrant as Specified in its Charter)*

**Germany**

*(Jurisdiction of Incorporation or Organization)*

**Friedrich-Ebert-Allee 140, 53113 Bonn, Germany**

*(Address of Registrant's Principal Executive Offices)*

Securities registered or to be registered pursuant to Section 12(b) of the Act.

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
American Depositary Shares, each representing one Ordinary Share	New York Stock Exchange
Ordinary Shares, no par value	New York Stock Exchange*

Securities registered or to be registered pursuant to Section 12(g) of the Act.

**NONE**

*(Title of Class)*

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

**NONE**

*(Title of Class)*

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, no par value: 4,195,081,597 (as of December 31, 2003)

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.

Yes  No

Indicate by check mark which financial statement item the registrant has elected.

Item 17  Item 18

\* Not for trading, but only in connection with the registration of American Depositary Shares.

This Amended Annual Report on Form 20-F/A dated June 29, 2004 is being filed to:

- (1) add financial information concerning certain affiliates and subsidiaries of Deutsche Telekom AG (found herein on pages A-1 to A-270) pursuant to the requirements of Item 3-09 of Regulation S-X;
- (2) amend “Item 3. Key Information — Exchange Rates” on page 8 of the Form 20-F filed on March 30, 2004 to change the reference in the table of the average noon buying rate for 2003 from “1.4111” to “1.1411”, and to change the year reference in the first sentence below the table from “2003” to “2004”;
- (3) amend “Item 5. Operating and Financial Review and Prospects — Consolidated Results of Operations — Segment Analysis — T-Com — Personnel Costs” on page 110 (page reference refers to SEC filed document) of the Form 20-F filed on March 30, 2004 to delete the words “during the year.” in the second paragraph thereunder; and
- (4) amend “Item 5. Operating and Financial Review and Prospects — Consolidated Results of Operations — Segment Analysis — T-Systems — Total Revenue” on page 111 (page reference refers to SEC filed document) of Form 20-F filed on March 30, 2004 to insert the word “million” after “EUR 10,614” in the third paragraph thereunder.

Other than the foregoing items and conforming changes related thereto, and the correction of certain typographical errors, no part of the Annual Report on Form 20-F filed on March 30, 2004 is being amended, and the filing of this Amended Annual Report on Form 20-F/A should not be understood to mean that any other statements contained therein are true or complete as of any date subsequent to March 30, 2004. This Amended Annual Report on Form 20-F/A is incorporated by reference into the registration statements of Deutsche Telekom AG on Form F-3, File No. 333-13550, and on Form S-8, File No. 333-106591, and into each respective prospectus that forms a part of those registration statements.

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## DEFINED TERMS

Deutsche Telekom AG is a corporation organized under the laws of the Federal Republic of Germany. As used in this Annual Report, unless the context otherwise requires, the term “Deutsche Telekom” refers to Deutsche Telekom AG and the terms “we,” “us” and “our” refer to Deutsche Telekom and, as applicable, Deutsche Telekom and its direct and indirect subsidiaries as a group.

## GERMAN GAAP

Unless otherwise indicated, the financial information contained in this Annual Report has been prepared in accordance with the requirements of the German Commercial Code (HGB — German GAAP). See notes (41) through (44) to our consolidated financial statements for the years ended December 31, 2003, 2002 and 2001 included in this Annual Report for a description of the principal differences between German GAAP and U.S. generally accepted accounting principles (U.S. GAAP), as they relate to us and our consolidated subsidiaries, and a reconciliation of net income and shareholders’ equity to U.S. GAAP.

## FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements. Forward-looking statements are statements that are not historical facts. Examples of forward-looking statements include:

- financial projections and estimates and their underlying assumptions;
- statements regarding plans, objectives and expectations relating to future operations, products and services;
- statements regarding the potential consequences of our debt reduction and liquidity improvement initiatives;
- statements regarding the potential impact of regulatory actions on our financial condition and operations;
- statements regarding our prospective share of new and existing markets;
- statements regarding the possible effects of adverse determinations in litigation, investigations, contested regulatory proceedings and other disputes;
- statements regarding general industry and macroeconomic growth rates and our performance relative to them; and
- statements regarding our future performance.

Forward-looking statements generally are identified by the words “expects,” “anticipates,” “believes,” “intends,” “estimates,” “aims,” “plans,” “will,” “will continue,” “seeks” and similar expressions. The “Risk Factors” discussion in Item 3, “Strategy” discussion in Item 4, “Operating and Financial Review and Prospects — Outlook for 2004” discussion in Item 5 and “Quantitative and Qualitative Disclosures About Market Risk” discussion in Item 11 in particular contain numerous forward-looking statements, although such statements also appear elsewhere in this Annual Report.

Forward-looking statements are based on current plans, estimates and projections, and therefore you should not place too much reliance on them. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement in light of new information or future events, although we intend to continue to meet our ongoing disclosure obligations under the U.S. securities laws (such as our obligations to file annual reports on Form 20-F and reports on Form 6-K) and under other applicable laws. Forward-looking statements involve inherent risks and uncertainties, most of which are difficult to predict and are generally beyond our control. We caution you that a number of important factors could cause actual results or outcomes to differ materially from those expressed in, or implied by, the forward-looking statements. These factors include, among other factors:

- risks and uncertainties relating to the benefits anticipated from our international expansion, particularly in the United States;
- risks and costs associated with integrating our acquired businesses and with selling or combining businesses or other assets;

- the progress of our domestic and international investments, joint ventures and alliances;
- the level of demand for telecommunications services, particularly for wireless telecommunications services, access lines, traffic and new higher-value products and services;
- competitive forces, including pricing pressures, technological developments and alternative routing developments;
- our ability to gain or retain market share in the face of competition from existing and new market entrants;
- our ability to secure the licenses needed to offer new services given the cost of these licenses and related network infrastructure build-outs, particularly with respect to our Universal Mobile Telecommunications System (UMTS) licenses;
- the effects of price reduction measures and our customer acquisition and retention initiatives, particularly in the fixed-line voice telephony business, the mobile telecommunications business and our other interconnection businesses;
- regulatory developments and changes, including with respect to the levels of tariffs, terms of interconnection, customer access and international settlement arrangements;
- the outcome of litigation, disputes and investigations in which we are involved or may become involved;
- the success of new business, operating and financial initiatives, many of which involve substantial start-up costs and are untested, and of new systems and applications, particularly with regard to the integration of service offerings;
- concerns over health risks associated with the use of wireless handsets and other health and safety risks related to radio frequency emissions;
- the effects of industry consolidation on the markets in which we operate, particularly with respect to our mobile and leased lines businesses;
- the progress and degree of success of our debt reduction and liquidity improvement initiatives;
- the availability, terms and deployment of capital, particularly in view of our debt refinancing needs, actions of the rating agencies and the impact of regulatory and competitive developments on our capital outlays;
- the level of demand in the market for our debt instruments and our shares and for the debt instruments and shares of our subsidiaries and associated companies, as well as for assets which we may decide to sell, which may affect our financing and acquisition strategies;
- the development of the German real estate market in view of our goal of monetizing a portion of our real estate portfolio;
- our ability to achieve cost savings and realize productivity improvements;
- our ability to attract and retain qualified personnel, particularly in light of our cost reduction efforts;
- risks of infrastructure failures or damage due to external factors, including natural disasters, intentional wrongdoing, sabotage, acts of terrorism or similar events;
- the effects of foreign exchange rate fluctuations, particularly in connection with subsidiaries operating outside the euro zone; and
- changes in general economic conditions, government and regulatory policies, new legislation and business conditions in the markets in which we and our affiliates operate.

Certain of these factors are discussed in more detail elsewhere in this Annual Report, including, without limitation, in Item 3, Item 4 and Item 5. We caution investors that the foregoing list of important factors is not exhaustive. When reviewing forward-looking statements contained in this document, investors and others should carefully consider the foregoing factors as well as other uncertainties and events and their potential impact on our operations and businesses.

Certain information in this Annual Report was provided by external sources. Due to the rapid changes in our industry, it is possible that some of this information is no longer accurate. Assessments

of market share in particular involve the use of information released or estimated by regulatory authorities, our competitors, third parties or us.

Web addresses contained in this Annual Report are for explanatory purposes only and they (and the content contained therein) do not form a part of and are not incorporated by reference into this Annual Report.

## **PART I**

### **ITEM 1. Identity of Directors, Senior Management and Advisors**

Not applicable.

### **ITEM 2. Offer Statistics and Expected Timetable**

Not applicable.

### **ITEM 3. Key Information**

#### **SELECTED FINANCIAL DATA**

The following table presents selected consolidated financial and operating information. This selected consolidated financial and operating information should be read together with “Item 5. Operating and Financial Review and Prospects” and our consolidated financial statements and the notes thereto that are included elsewhere in this Annual Report. Unless otherwise indicated, all amounts are in accordance with German GAAP.

The selected consolidated financial information as of and for each of the five years ended December 31, 1999 through 2003 are extracted or derived from our consolidated financial statements and the notes thereto, which have been audited by Ernst & Young Deutsche Allgemeine Treuhand AG Wirtschaftsprüfungsgesellschaft and PwC Deutsche Revision Aktiengesellschaft Wirtschaftsprüfungsgesellschaft in the case of the periods ended and at December 31, 2003, 2002 and 2001, and by PwC Deutsche Revision Aktiengesellschaft Wirtschaftsprüfungsgesellschaft in the case of the periods ended and at December 31, 2000 and 1999.



## Selected Consolidated Financial Data of the Deutsche Telekom Group

	<u>% Change</u> <u>2003/2002<sup>(1)(2)</sup></u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
	(billions of €, except as otherwise indicated)					
<b>Income Statement Data</b>						
Net revenue .....	4.0%	55.8	53.7	48.3	40.9	35.5
Results from ordinary business activities .....	n.m.	1.4	(27.2)	(2.5)	6.4	3.1
Net income (loss) .....	n.m.	1.3	(24.6)	(3.5)	5.9	1.3
<b>Balance Sheet Data</b>						
Total assets .....	(7.7)%	116.1	125.8	164.5	124.2	94.6
Debt (in accordance with the consolidated balance sheet) ..	(12.1)%	55.4	63.0	67.0	60.4	42.3
Shareholders' equity .....	(4.5)%	33.8	35.4	66.3	42.7	35.7
<b>Cash Flow Data<sup>(3)</sup></b>						
Net cash provided by operating activities .....	14.9%	14.3	12.5	11.9	10.0	9.6
Net cash used for investing activities .....	79.4%	(2.1)	(10.0)	(5.4)	(27.7)	(18.7)
Net cash provided by (used for) financing activities .....	(52.1)%	(5.2)	(3.4)	(4.8)	17.9	8.0
<b>U.S. GAAP Data</b>						
Net income (loss) .....	n.m.	2.9	(22.1)	0.5	9.3	1.5
Shareholders' equity .....	(0.9)%	45.0	45.4	73.7	46.1	37.6
Total assets .....	(2.3)%	145.9	149.4	180.7	135.2	97.5
<b>Ratios and Selected Data</b>						
Investment in intangible assets (excluding goodwill) and property, plant and equipment .....	21.4%	(6.2)	(7.9)	(11.2)	(23.5)	(5.9)
Capital expenditures .....	20.9%	(6.0)	(7.6)	(10.9)	(23.5)	(6.0)
Equity ratio (%) <sup>(4)</sup> .....	3.6%	29	28	39	33	36
Number of employees averaged over the year (full-time employees excluding trainees) (thousands) .....	(1.8)%	251	256	242	205	198
Revenue per employee (thousands of euro) <sup>(5)</sup> .....	5.7%	222	210	199	201	183
Earnings (loss) per share/ADS in accordance with German GAAP — basic and diluted (euro) <sup>(6)</sup> .....	n.m.	0.30	(5.86)	(0.93)	1.96	0.43
Earnings (loss) per share/ADS in accordance with U.S. GAAP — basic and diluted (euro) <sup>(6)</sup> .....	n.m.	0.70	(5.31)	0.14	3.06	0.53
Dividend per share/ADS (euro) <sup>(7)</sup> .....	—	—	—	0.37	0.62	0.62
Dividend per share/ADS (USD) <sup>(7)(8)</sup> .....	—	—	—	0.34	0.53	0.58

n.m. — not meaningful

- (1) Change from 2002 to 2003 on the basis of the more exact figures expressed in millions.
- (2) Increases in the size of negative numbers are expressed in percentage terms with negative percentage amounts, and decreases are expressed with positive percentage amounts.
- (3) In accordance with the statement of cash flows.
- (4) Total stockholders' equity divided by total assets.
- (5) Calculated on the basis of the average number of employees for the year without trainees/student interns.
- (6) Based on dividing net income (loss) by the weighted average number of ordinary shares outstanding. The share/ADS ratio is 1:1.
- (7) 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.
- (8) Dividend amounts have been converted into U.S. dollars at the noon buying rate for the relevant dividend payment date, which occurs during the second quarter of the following year.

## Exchange Rates

Beginning the first quarter of 1999, we began publishing our consolidated financial statements in euros and, unless otherwise indicated, all amounts in this document are expressed in euros. Amounts stated in euros appearing in this document for periods prior to December 31, 1998, have been converted from Deutsche marks at the official fixed conversion rate of EUR 1.00 = DM 1.95583.

As used in this document, “euro” or “EUR” means the single unified currency that was introduced in the Federal Republic of Germany (referred to as the Federal Republic) and ten other participating member states of the European Union on January 1, 1999. “Deutsche mark” or “DM” means the currency that was the lawful currency of the Federal Republic before it was replaced by the euro. “U.S. dollar” or “USD” means the lawful currency of the United States of America. As used in this document, the term “noon buying rate” refers to the rate of exchange for either Deutsche mark or euro, expressed in U.S. dollar per Deutsche mark or euro, as announced by the Federal Reserve Bank of New York for customs purposes as the rate in The City of New York for cable transfers in foreign currencies. Unless otherwise stated, conversions of euro into U.S. dollars have been made at the rate of EUR 1.00 to USD 1.2597, which was the noon buying rate on December 31, 2003.

Amounts appearing in this report that were translated into euros from other currencies were translated in accordance with the principles described in the consolidated financial statements under “Consolidation Principles — Foreign Currency Translation.”

In order that you may ascertain how the trends in our financial results might have appeared had they been expressed in U.S. dollars, the table below shows the average noon buying rates in The City of New York for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York for U.S. dollar per euro for the fiscal years presented.

The following table sets forth, for the periods indicated, the average, high, low or period-end noon buying rates for the euro expressed in U.S. dollars per EUR 1.00.

<u>Year or month</u>	<u>Average<sup>(1)</sup></u>	<u>High</u>	<u>Low</u>	<u>Period-End</u>
		<u>(in USD per €)</u>		
1999.....	1.0588	1.1812	1.0016	1.0070
2000.....	0.9207	1.0335	0.8270	0.9388
2001.....	0.8909	0.9535	0.8370	0.8901
2002.....	0.9495	1.0485	0.8594	1.0485
2003.....	1.1411	1.2597	1.0361	1.2597
2003				
October.....		1.1833	1.1596	1.1609
November.....		1.1995	1.1417	1.1995
December.....		1.2597	1.1956	1.2597
2004				
January.....		1.2853	1.2389	1.2452
February.....		1.2848	1.2426	1.2441
March (through March 26, 2004).....		1.2428	1.2088	1.2092

(1) The average of the noon buying rates on the last business day of each month during the relevant period.

On March 26, 2004, the noon buying rate was USD 1.2092 per EUR 1.00.

Since January 4, 1999, our shares have traded on the German stock exchanges in euro. Fluctuations in the exchange rate between the euro and the U.S. dollar will affect the U.S. dollar equivalent of the euro price of the shares on the German stock exchanges and, as a result, are likely to affect the market price of the Deutsche Telekom American Depositary Shares, or ADSs, on the New York Stock Exchange. If we were to declare cash dividends, they would be declared in euros, and exchange rate fluctuations would affect the U.S. dollar amounts you would receive if you are a holder of American Depositary Receipts (“ADR”) evidencing ADSs on conversion of cash dividends on the shares represented by your ADSs.

## RISK FACTORS

In addition to the other information contained in this Annual Report, investors in our securities should consider carefully the risks described below. Our financial condition or results of operations could be materially adversely affected by any of these risks.

The following discussion contains a number of forward-looking statements. Please refer to the “Forward-Looking Statements” discussion at the front of this Annual Report for cautionary information.

**An economic downturn or a substantial slowdown in economic growth could adversely affect our customers’ purchases of our products and services, which would have a negative impact on our operating results and financial condition.**

Our business depends on general economic conditions in Germany, other European countries and the United States. The climate for and values of investments in the telecommunications sector have worsened in recent years. This was reflected in particular in the restrained investment activities by key customers. Although there were signs of a moderate revival in activity in our sector during the second half of 2003, there is a risk that key customers’ willingness to invest in information and communication technology services will not increase to the extent we expect, which may adversely affect our business plan and outlook for 2004, including possibly resulting in a reduction in revenues.

If the economy remains weak and consumer behavior does not improve, the achievement of our growth targets will be endangered especially with regard to the level of demand for innovative services such as multimedia services in mobile communications and higher-value accesses in the fixed-line network. Over the medium- and long-term this could have a negative impact on our results of operations.

**Since we operate in a heavily regulated environment, decisions by regulatory authorities may impose significant limits on our flexibility to manage our business and may force us to offer services to competitors and reduce prices of our products and services, which may have a material negative impact on our revenues and our market shares.**

***T-Com (fixed-line telephony networks)***

The German Regulatory Authority for Telecommunications and Post (*Regulierungsbehoerde fuer Telekommunikation und Post*) (the “German telecommunications regulator”), considers us, through our T-Com division, to be a market-dominant provider in several markets, especially in the market for fixed-line telephony services. In 2003, many decisions of the German telecommunications regulator were implemented to increase competition in the markets for local calls and for narrow and broadband access to the T-Com fixed-line telecommunications network. These regulatory decisions have had and others that may follow are expected to have significant effects on the level of competition in the markets for regional and local calls and local access to our fixed-line network and will continue to have a negative impact on T-Com’s revenues in these markets. Risks also emanate from the possible regulatory authorization of an increase in charges for the termination of calls from our T-Com network into the networks of city carriers without a corresponding increase in charges for the termination of calls from city carriers into our T-Com network (through the elimination of reciprocity for call termination charges).

Additionally, the German government is required to amend the German Telecommunications Act to implement the new European Union telecommunications regulatory framework. We believe the proposed amendments will considerably extend regulation, particularly in the area of access service obligations, which could have a material negative impact on our revenues. Even though the new EU regulatory framework is aimed at reducing government regulation, the proposed amendments to the German Telecommunications Act may result in additional legal obligations for us and a continued reduction in pricing and market share.

We are also subject to the laws and regulations of other countries where we or our affiliates have fixed-line network operations. The business impact of increased regulation on our subsidiaries in Eastern Europe will depend on the way in which national regulatory authorities use their newly acquired powers and on whether competitors take advantage of regulatory decisions designed to foster increased competition. New telecommunications legislation has been or will be adopted in Hungary, Croatia and Slovakia in 2004, which will have the effect of reducing prices and market share in these countries.

### ***T-Mobile (mobile communications)***

Although the current draft of the German Telecommunications Act does not explicitly provide for regulation in the area of mobile communication, regulatory intervention, particularly with respect to call termination charges, cannot be excluded. Regulatorily mandated reductions in call termination charges in the United Kingdom and elsewhere have already had a negative impact on revenues for call termination.

Our mobile communications operations in the United States, the United Kingdom, the Netherlands, the Czech Republic, Croatia, and Austria are supervised by regulatory authorities. We expect possible tightening of regulatory control in the area of mobile communications by the European Union with a probable negative effect of price reductions in international roaming and call termination charges. In the United States, potential new consumer protection regulations could cause T-Mobile USA to incur considerable additional expenses in the future in the area of customer data administration.

Our telecommunications systems and operations in the United States are regulated by the U.S. Federal Communications Commission (FCC) and by various other federal, state and local government bodies. Various other federal, state and local governmental agencies may also exercise jurisdiction over mobile communications operators. Any of the aforementioned agencies could adopt regulations or take other actions that could adversely affect our business. If we fail to comply with applicable regulations, we may be subject to sanctions, which may have an adverse effect on our wireless business in the United States. FCC regulations applicable to mobile communications operators include, among other things, regulations concerning required service features and capabilities, such as number pooling and portability and emergency 911 service.

T-Mobile USA's capacity and coverage expansion is dependent on its ability to acquire additional spectrum licenses, which are granted by the FCC or otherwise regulated by the FCC if acquired from third party operators. The failure to obtain sufficient capacity and spectrum coverage would have a material adverse impact on the quality of services in the United States and our ability to provide future services in some markets.

### ***T-Online (internet access)***

Although the new regulatory framework does not provide for an extension of sector-specific regulation to the online communications market, there are some indications that the German telecommunications regulator may change its legal approach to regulation of prices for access to online services in the future. It is not yet determinable what impact, if any, such regulation may have on our T-Online division. Additionally, Internet subscribers are indirectly affected by the regulation of access tariffs, as wholesale costs include charges for telecommunications services that are regulated by the German Telecommunications Act.

For further information regarding these requirements and other aspects of the regulatory regimes to which our businesses are subject, see "Item 4. Information on the Company — Regulation."

**We face intense competition in all areas of our business, which could lead to reduced prices for our products and services and a decrease in market share in certain service areas, thereby having an adverse effect on our revenues and financial condition.**

### ***T-Com (fixed-line networks)***

Our fixed-line network voice telephony service revenues have been declining in recent years due to price reductions imposed by regulatory authorities to increase competition and also due to substitution of fixed-line usage by mobile communications. Although we expect the increasing trend towards broadband lines and other forms of upgraded access lines to continue, such increase could be affected by entry of new competitors and saturation of the market. Competition has become fiercer due to decisions of the German telecommunications regulator in 2003 (in particular, the launch of "call-by-call" and "carrier pre-selection" in the local network in Germany). This increased competition may result in a further drop in prices and continued loss of our market share. The increase in competition from mobile operators and other fixed-line carriers is expected to continue for the foreseeable future, resulting in an erosion in our market share in certain areas and also resulting in continued decrease in revenues from these markets.

For more information, see "Item 4. Information on the Company — Description of Business and Divisions — T-Com" and "Item 4. Information on the Company — Regulation."

### ***T-Mobile (mobile communications)***

Despite its disproportionately strong growth in terms of customer additions, T-Mobile USA still maintains a relatively small market share in the United States compared to other national mobile operators. Consolidation among U.S. mobile telecommunications operators, such as the recently announced acquisition by Cingular of AT&T Wireless, may have a negative effect on growth and profitability for the company over the medium- and long- term. T-Mobile USA shares a network with Cingular Wireless in California, Nevada and the New York City metropolitan area, through a joint venture. T-Mobile USA would likely have to incur significant capital expenditures or other costs to service its customers in California and Nevada and to enhance the network in the New York City market if this joint venture terminates as a result of the merger between Cingular and AT&T Wireless announced in February 2004 or otherwise. The joint venture has a two-year service tail after termination. We are monitoring the potential effects of the merger between Cingular and AT&T Wireless very closely. However, we have not as yet determined the effect, if any, that this merger will have on the operations of T-Mobile USA or its arrangement with Cingular. Unanticipated termination of the joint venture with Cingular could have a material adverse effect on our North American mobile operations.

In most of our European markets, competition based on handset subsidies has diminished, but competition based on price, subscription options offered, applications offerings, coverage and service quality remains intense. As European markets have become increasingly saturated, the focus of competition has been shifting from customer acquisition to customer retention. Since customer acquisition and retention expenses are substantial, significant customer defections would have an adverse effect on our results of operations. See also “Item 4. Information on the Company — Description of Business and Divisions — T-Mobile.”

### ***T-Systems (information and communication technology)***

In its capacity as a provider of solutions covering the entire value chain of information and communications technology, T-Systems is subject to risks associated with the general and regional economies of its customers and the willingness of its customers to invest in information and communication technology services and products. Additionally, the current economic climate has resulted in a decrease in prices and longer sales cycles, which results in lower revenues and higher costs due to under-utilization of capacity and infrastructure.

In addition, the growth potential of our T-Systems division may be limited by its limited international presence compared to some of our other competitors, especially as it relates to maintaining and increasing business with multinational companies. See also “Item 4. Information on the Company — Description of Business and Divisions — T-Systems.”

### ***T-Online (internet access)***

In addition to the risk of more intense competition as a result of possible decisions by the German telecommunications regulator with regard to broadband access, T-Online’s competitive position will be affected by pricing, network speed and reliability, services offered, customer support and its ability to be technologically adept and innovative. We expect that T-Online’s competitors will pursue new broadband customers aggressively. In the market for portal services and content, competition is intense due to low barriers to entry. Increased competition may have the effect of reducing T-Online’s market share and revenues. See also “Item 4. Information on the Company — Description of Business and Divisions — T-Online” and “Item 4. Information on the Company — Regulation.”

**We may realize neither the expected level of demand for our products and services nor the expected level or timing of revenues generated by those products and services as a result of lack of market acceptance, technological change or delays from suppliers.**

As a result of rapid technological progress and the trend towards technological convergence, there is a danger that new and established technologies or products will not only complement one another, but that they also serve as substitutes for one another. Voice over IP and W-LAN are new technologies that have the potential to replace existing technologies and products and reduce our market share and revenues.

Potential risks arise from our dependence on suppliers in each of our divisions, especially in conjunction with the launch of UMTS services (“UMTS” stands for “Universal mobile



telecommunications system” and is a next generation mobile telecommunications standard). The roll-out of UMTS services in certain markets has been delayed as a result of, among other things, technical issues relating to handsets and as a result of the unavailability of handsets in sufficient quantity and quality. Continued significant delays could adversely affect the level or timing of revenues generated by UMTS services. The lack of market acceptance of UMTS services, which could also have a negative impact on revenues and results of operations, including the possibility of impairment of the value of UMTS licenses.

In addition, there is a risk that we will not succeed in making customers sufficiently aware of existing and future value added new services and creating customer acceptance of these services. This risk exists in particular with respect to our anticipated future growth drivers in the mobile communications area (e.g. mobile data services provided via UMTS or other technologies) and in the fixed line communications area (e.g. broadband and T-DSL). If our marketing strategy is to be successful, a crucial element will be to make it possible for consumers to experience the value-added offered by our new products and services. This also applies to the area of paid content at T-Online.

**Our involvement in the Toll Collect project in Germany entails a range of risks for us which could have a considerable negative impact on our net worth, financial position, and results of operations.**

In September 2002, Deutsche Telekom AG, DaimlerChrysler Services AG, and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) (individually, the “partners” and collectively, the “consortium”) entered into an agreement with the Federal Republic of Germany (represented by the Federal Ministry of Transport) relating to a project to create and operate an innovative system for the collection of highway toll charges for heavy vehicles (the “operating agreement”). The toll collection system is to be created and operated by the joint venture Toll Collect GmbH (“Toll Collect”). DaimlerChrysler Services and we each hold a 45% stake in Toll Collect, with the remaining 10% being held by Cofiroute. Our involvement with Toll Collect includes our equity interest in Toll Collect that is recognized in our consolidated financial statements using the equity method of accounting, and certain financial guarantees. Additionally, certain of our divisions may act as sub-contractors of services to Toll Collect.

The start of operations initially was scheduled for August 31, 2003, but was delayed. On February 25, 2004, we received a 60-day notice of termination of the operating agreement. Although the consortium members reached an agreement with the Federal Republic on February 29, 2004 to continue the toll collection project, there still exist certain risks and uncertainties until the definitive details have been worked out.

Our involvement in Toll Collect entails a range of risks for us which could have a negative impact on our net worth, financial position, and results of operations. We believe our maximum exposure to loss as a result of our interest in Toll Collect could extend beyond the amounts we have invested because of other risks associated with the financial guarantees issued for Toll Collect. This includes the possibility of contractual penalties due to further postponement of the start of operations, claims for damages and losses of revenue from the project, as well as additional expenses. The termination of the agreement by the Federal Ministry of Transport would also have a considerable negative impact on our net worth, financial position, and results of operations. Additionally, it may have a negative effect on our image.

For further information about Toll Collect, see also “Item 5. Operating and Financial Review and Prospects — Liquidity and Capital Resources — Guarantees and Commitments” and “Item 8. Financial Information — Litigation.”

**Failures in the planned reduction of our staff levels could negatively affect our financial objectives.**

We are continuing with our planned reductions in the number of staff. A majority of our staff in Germany, however, are protected against dismissal as a result of their status as civil servants or under statutory provisions and collective bargaining agreements, which situation is having a negative affect on our ability to reduce staff and associated costs.

There is also a risk that individual placements of employees and apprentices transferred to Vivento, our personnel services agency, to jobs in the external labor market will not be possible to the extent originally planned due to the difficult current economic and labor situation in Germany. This would jeopardize our goal to reduce personnel costs. The transfer of employees to Vivento may

improve the cost structure of the divisions from which they are transferred, but does not immediately reduce our overall employee costs since the transferred employees remain on our payroll. It is, therefore, important to our cost reduction efforts that employees transferred to Vivento either find alternative productive employment within the group or with third parties. In the case of employees with civil servant status, however, it may be difficult to induce them to surrender their protected status for employment elsewhere in the private sector.

In order to reduce the group's personnel cost ratio, we reached a new collective bargaining agreement with the main labor unions representing employees in March 2004. This agreement includes, among other things, a reduction in wages beginning in March 2004. We intend to simultaneously implement this agreement also for civil servants. There are various risks to meet this target, especially because of the need for a required change in existing statutory regulations to accomplish this.

For further information, see "Item 4. Information on the Company — Description of Business and Divisions — Group Headquarters and Shared Services" and "Item 6. Directors, Senior Management and Employees — Employees and Labor Relations — Other Employees."

**Alleged health risks of wireless communications devices have led to litigation affecting us and could lead to decreased wireless communications usage or increased difficulty in obtaining sites for base stations and thus adversely affect the financial condition and results of operations of our mobile communication services business.**

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 transmission facilities and antennae "base stations" either or both of which could have a material adverse effect on our mobile communication services business. T-Mobile USA is involved in certain litigation relating to these issues. See "Item 8. Financial Information — Litigation — Other Proceedings."

We cannot offer assurance that legislators, regulators or private litigants will refrain from taking other actions adverse to our business based on purported health-related risks associated with radio frequency emissions, which actions may result in significant costs and may adversely affect the financial condition and results of operations of our mobile communication services business.

In addition, our mobile operations are subject to potential litigation, legislation or adverse publicity relating to damage caused by persons who use mobile telephones while driving. Such litigation, legislation or adverse publicity may result in additional costs and loss of revenues from our T-Mobile division.

For further information about health effects of wireless handsets, wireless data devices and cell sites, see also "Item 4. Information on the Company — Regulation — International Mobile Regulation — USA: T-Mobile USA."

**System failures due to natural or man-made disruptions could result in reduced user traffic and reduced revenues and could harm our reputation and results.**

Our technical infrastructure (including our network infrastructure for fixed-line network services and mobile telecommunications services) may be damaged or disrupted by fire, lightning, flooding and other calamities, technology failures, human error, terrorist attack, hacker attacks and malicious actions, and other similar events. Although we have taken certain measures to guard against such problems, we cannot be sure they will be effective under all circumstances. Damage or disruption to our infrastructure may result in reduced user traffic and reduced revenues, increased costs, and damage to our reputation.

**We are continuously involved in other disputes and litigation with regulators, competitors and other private parties. We cannot guarantee that the ultimate outcome of such legal proceedings will not have a material adverse effect on our results of operations or financial condition.**

We are subject to numerous risks relating to legal and regulatory proceedings in which we are currently a party or that could develop in the future. We cannot guarantee that the ultimate outcome

of such legal proceedings will not have a material adverse effect on our results of operations or financial condition. For information concerning some of the litigation in which we are involved, see “Item 8. Financial Information — Litigation.” For information concerning our regulatory environment, see “Item 4. Information on the Company — Regulation.”

**Future sales of our shares by the Federal Republic or Kreditanstalt fuer Wiederaufbau (“KfW”) may adversely affect the trading price of our shares and ADSs.**

The Federal Republic, together with KfW, a public-sector entity 80% of which is owned by the Federal Republic, owns approximately 43% of our shares at December 31, 2003.

The Federal Government has sold shares of Deutsche Telekom in the past and may sell additional shares in the future. Significant sales of Deutsche Telekom shares by the Federal Republic or KfW or rumors to that effect could have a negative impact on the market price of our shares and ADSs.

**Risks related to changes in exchange rates and interest rates may have an adverse effect on our financial situation**

We are exposed to currency risks due to our international business activities. Generally, our treasury department hedges currency risks that have an impact on cash flows. We are also exposed to interest risks primarily in the euro, U.S. dollar and British pound sterling currencies. Interest rate risks arise as a result of fluctuations in interest rates affecting the level of interest payments due in each of these currencies. Once per year, our Board of Management specifies the ratio of fixed and variable debt in these three currencies. Our treasury department takes appropriate measures using derivative instruments to implement the interest-risk management decisions of the Board of Management.

For further information about our hedging activities and market risks, see “Item 11. Quantitative and Qualitative Disclosures about Market Risk.”

**Developments in the technology and telecommunications sectors have resulted and may in the future result in substantial writedowns of the carrying value of certain of our assets.**

We review on a regular basis the value of each of our subsidiaries and their assets. In addition to our regular valuations, whenever indications exist (due to changes in the economic, regulatory, business or political environment) that goodwill, intangible assets or fixed assets may be impaired, we consider the necessity of performing certain valuation tests that may result in impairment charges. The recognition of impairments of tangible, intangible and financial assets could cause us to take large non-cash charges against net income, which may lead to a drop in the trading price of our shares.

In 2002, we recognized substantial impairment charges primarily related to T-Mobile USA and our UMTS licenses. The impairment charges related primarily to nonscheduled amortization of goodwill and other intangible assets of certain of our subsidiaries. Such charges were based on changes in expectations of future cash flows attributable to these assets. These nonscheduled amortization charges became necessary as we considered the fair value of these assets to be below their respective carrying values. In 2003 we did not recognize substantial impairment charges.

For more information, please refer to “Item 5. Operating and Financial Review and Prospects — Critical Accounting Estimates.”



## **ITEM 4. Information on the Company**

### **INTRODUCTION**

The legal and commercial name of our company is Deutsche Telekom AG. We are a private stock corporation organized under the laws of the Federal Republic of Germany. Our registered office is at Friedrich-Ebert-Allee 140, 53113 Bonn, Germany, telephone number +49-228-181-0. Our agent in the United States is Deutsche Telekom, Inc., 101 East 52nd Street, 17th Floor, New York, NY, 10022.

### **HISTORICAL BACKGROUND**

Historically, the provision of public telecommunications services in Germany was a state monopoly as formerly provided by the German constitution. In 1989, the Federal Republic began to transform the postal, telephone and telegraph services administered by the former monopoly provider into market-oriented businesses and divided the former monopoly provider into three distinct entities along lines of business, one of which was our predecessor. At the same time, the Federal Republic also started the liberalization of the German telecommunications market. We were transformed into a private law stock corporation at the beginning of 1995.

The operation of networks (including cable networks) for all telecommunications services other than public fixed-line voice telephony was opened to competition in Germany on August 1, 1996. The telecommunications sector in Germany was further liberalized on January 1, 1998. Since then, we have faced intense competition and have been required to offer competitors access to our fixed-line network at regulated interconnection rates.

Other important events in the development of our business include:

- the expansion and modernization of the telecommunications infrastructure in the former East Germany in the 1990s;
- the complete digitalization of our German telecommunications network in 1997;
- the expansion of our business in Eastern Europe through the acquisition in 1993 of a substantial interest in Matáv, the Hungarian national telecommunications company, and the acquisition of telecommunications subsidiaries in Slovakia, Macedonia, the Czech Republic and Croatia during 2000 and 2001;
- a joint venture with France Telecom and Sprint from 1996 through 2000 and a cooperation agreement with France Telecom from 1998 through 2000;
- the acquisition of One 2 One (now T-Mobile UK) in 1999;
- disengagement from our former strategic alliance with France Telecom and Sprint Corporation commencing in 1999;
- the acquisition of debis Systemhaus (now T-Systems IT-services) in 2000 and 2002;
- the initial public offering of T-Online International in 2000;
- the purchase of licenses allowing T-Mobile to operate UMTS wireless networks in Germany, the United Kingdom, Austria and the Netherlands in 2000 and the Czech Republic in 2001;
- the divestment of our cable assets in 2001 and 2003;
- the acquisition of VoiceStream and Powertel in 2001 (now T-Mobile USA);
- the acquisition of Ben Nederland Holding in 2000/2002 (now T-Mobile Netherlands); and
- the refocusing of our business on our core divisions and debt reduction in 2002 and 2003.

### **STRATEGY**

One of our strategic objectives for the coming years is to become the leading service company in the telecommunications and information technology industry. Another of our strategic objectives is to build on our position as one of the world's leading connectivity providers for fixed and mobile telecommunications services. We also want to capitalize on our online portal and information technology businesses. To accomplish these goals, we have organized our businesses into four main divisions:

- T-Com (for fixed-line network access and services),
- T-Mobile (for mobile communications),
- T-Systems (for data communications and systems solutions for large business customers) and
- T-Online (for Internet services).

In 2003, we reduced debt, increased cash flows and improved our liquidity position. We reorganized our headquarters to increase the operational responsibility of our divisions. For 2004, we have developed our “Agenda 2004,” program consisting of six cross-divisional initiatives:

- Broadband – expand T-DSL penetration in Germany.
- Personnel – increase personnel cost efficiencies through Vivento (our internal personnel service agency) and working hour reductions in the fixed-line segment.
- Innovation – generate new revenues from new services and supply state-of-the-art technologies.
- Quality – provide higher quality to the customer.
- Efficiency – further tighten cost controls and realize synergies in IT, platforms, and procurement.
- Corporate Customers – focus on the growth potential of domestic small and medium sized firms, as well as global accounts.

Although debt reduction remains an important part of our planning, the measures we have already taken in 2003 provide us now with additional flexibility to make capital expenditures and pursue acquisitions, joint ventures or combinations of businesses on a selective basis, where we perceive real opportunity for profitable growth. Transactions may be conducted using newly issued shares of Deutsche Telekom or shares of our affiliates, cash or a combination of cash and shares, and may individually or in the aggregate be material to us. Discussions with third parties may be commenced, on-going or discontinued at any time or from time to time.

## SIGNIFICANT SUBSIDIARIES

The following table shows significant subsidiaries, in terms of revenues, we owned, directly or indirectly, as of December 31, 2003.

<u>Name of Company</u>	<u>Percentage Holding</u>
T-Mobile Deutschland GmbH (T-Mobile Deutschland) <sup>(1)</sup> .....	100.00
T-Mobile USA, Inc. (T-Mobile USA) <sup>(1)</sup> .....	100.00
T-Mobile Holdings Ltd. (T-Mobile UK) <sup>(2)</sup> .....	100.00
T-Mobile Austria GmbH (T-Mobile Austria) <sup>(3)</sup> .....	100.00
T-Mobile Netherlands B.V. (T-Mobile Netherlands) <sup>(2)</sup> .....	100.00
T-Mobile Czech Republic a.s. (T-Mobile Czech Republic) <sup>(4)</sup> .....	60.77
T-Systems International GmbH (T-Systems International) .....	100.00
T-Systems CDS GmbH <sup>(5)</sup> .....	100.00
T-Online International AG (T-Online International) .....	73.94
DeTeImmobilien, Deutsche Telekom Immobilien und Service GmbH .....	100.00
GMG Generalmietgesellschaft mbH (GMG) .....	100.00
Deutsche Telekom Network Projects and Services GmbH .....	100.00
Magyar Tavkoezlesi Rt. (Matáv) <sup>(6)</sup> .....	59.49
Slovak Telecom (formerly: Slovenske Telekomunikacie) .....	51.00
Hrvatski Telecom HT-Hrvatski telekomunikacije d.d. (Hrvatski Telecom) .....	51.00

(1) Indirect shareholding via T-Mobile International AG & Co. KG (Deutsche Telekom share: 100%). For purposes of this Annual Report, T-Mobile USA includes T-Mobile USA, Inc. (formerly Voicestream Wireless Corporation) and Powertel, Inc.

(2) Indirect shareholding via T-Mobile Global Holding GmbH (Deutsche Telekom indirect share: 100%).

(3) Indirect shareholding via T-Mobile Global Holding Nr. 2 GmbH (Deutsche Telekom indirect share: 100%).

(4) Indirect shareholding via CMobil B.V. (Deutsche Telekom indirect share: 92.14%).  
CMobil B.V. direct share in T-Mobile Czech Republic a.s.: 60.77%.

(5) Indirect shareholding via T-Systems International GmbH (Deutsche Telekom share: 100%).

(6) Indirect shareholding via MagyarCom Holding GmbH (Deutsche Telekom share: 100%).

Please refer to our consolidated financial statements for a list of our principal subsidiaries. A list of our subsidiaries as of December 31, 2003 is filed as Exhibit 8.1 to this Annual Report.

## DESCRIPTION OF BUSINESS AND DIVISIONS

### T-Com

Our T-Com division is responsible for our fixed-line telecommunications services in Germany and Eastern Europe. Our Eastern Europe subsidiaries also provide mobile and online telecommunications services.

#### Principal Activities

The principal services offered by our T-Com division are narrow and broadband access to our fixed-line telecommunications network, and domestic and international public fixed-line network voice telephony products and services for individual and business customers (small- to medium-sized enterprises). T-Com operates one of the largest fixed-line networks in Europe with approximately 57.9 million access channels (thereof 51.1 million access channels in Germany, including 23.6 million Integrated Services Digital Network, or ISDN, channels) as of December 31, 2003.

T-Com's telecommunications products and services include:

- network communications services (products and services relating to the fixed-line network, including access and other ancillary telecommunications services, such as Internet protocol-based services and wireless local area networks (W-LAN connections));
- data communications services and solutions to business customers;
- value-added and enabling services (special purpose telephony services);
- terminal equipment sales (the sale, lease and service of telecommunications equipment to its customers and third party maintenance services);
- other fixed-line network services (i.e. installation, maintenance, educational and cable services);
- domestic carrier services (wholesale products (i.e., interconnection services)) to domestic network operators and service providers);
- systems integration and consulting;
- other domestic services, including publishing services and customer programs; and
- network communications, mobile and online services to certain countries in Eastern Europe, through its subsidiaries Matáv (Hungary), Slovak Telecom (Slovakia) and Hrvatski Telecom (Croatia).

Most of T-Com's revenues in 2003 were derived from fixed-line network telephony services (access and call revenue) provided within Germany. For more information, see "Item 5. Operating and Financial Review and Prospects — Segment Analysis — T-Com." On March 13, 2003, T-Com sold its remaining cable television operations. For more information, see "— Broadband Cable."

In August 2003, we began marketing our fixed-line network services in Germany under the "T-Com" brand to create a more distinct market profile for our fixed-line services.

#### *Germany*

##### *Network Communications*

##### *Network Infrastructure*

T-Com has made substantial investments in its telecommunications networks since 1990, including the installation of a new network in the former East Germany. T-Com has introduced asynchronous transfer mode (ATM) technology and wavelength division multiplexing (WDM) technology. ATM is a special type of technology which permits the transmission of a large amount of data (voice, text, audio and video) in high quality using a standard platform. T-Com offers it under the brand name "T-ATM." WDM technology multiplies the transmission capacity of existing fiber optic cables by allowing higher bandwidths than most other technologies.

As of December 31, 2003, T-Com's domestic fixed-line telephone network and ISDN network in Germany consisted of approximately 5,200 local networks (local exchange areas) with approximately

7,900 access areas connected by a long-distance transmission network containing approximately 600 switched network nodes. Local networks, access areas and switched network nodes are the basis for setting tariffs for the local and long-distance calls in Germany.

As of December 31, 2003, the transmission network linking T-Com's German local networks consisted of approximately 195,000 kilometers of fiber optic cable. During 2003, T-Com continued to expand the use of WDM and Synchronous Digital Hierarchy (SDH) infrastructure in its network. SDH is the transport platform upon which T-Com will base its primary digital communications services in the future.

#### *Network Access*

In Germany, T-Com offers access to its transmission network for individual customers and business customers. Typically, T-Com customers have access to the transmission network by means of a copper wire that runs from the transmission network into the home or office of a customer. These access lines can either be standard analog access lines or digital access lines. Digital access lines also are called ISDN lines. In addition, analog and digital access lines can be enhanced by increasing broadband capacity through asymmetric digital subscriber line or ADSL technology, which T-Com markets under the brand name "T-DSL." In the larger German cities, T-Com offers its customers access via glass fiber access networks capable of higher bit rates, which increase broadband capacity.

T-Com offers its customers a variety of line packages that generally consist of a monthly fixed payment for access and a variable, usage-based component for traffic volumes. With T-DSL services, T-Com offers an access connection for a monthly fixed payment to its individual customers, who — in addition — have to sign a contract with Internet Service Providers, such as T-Online, in order to get access to the Internet. For business customers using T-DSL, T-Com not only offers basic access but also ISP services.

In addition to making access lines available to our direct customers, we are also required to make access lines available to competitors at rates that are below the rates we charge to our customers.

#### *Analog Access Lines*

An analog access line — the traditional telephone line — provides a single telecommunications channel. As of December 31, 2003, approximately 27.5 million analog lines were connected to T-Com's network platform, marketed under the brand name "T-Net."

As of February 1, 2003, regulatory price cap provisions governing the prices for the provision of our fixed-line services resulted in a decrease in traffic charges and an increase in access charges. The monthly access charge for an analog telephone line increased by EUR 0.39 to EUR 13.72. The German telecommunications regulator approved a change of the price cap regime as of September 1, 2003. This allowed T-Com to make a further increase in the access charge for analog lines. Since September 1, 2003, the basic monthly access charge for a T-Net analog line has been EUR 15.66. As part of this price measure, the basic monthly charge for T-Net 100 (a T-Net analog line including an optional call plan) increased to EUR 18.45. Since September 1, 2003, the one-time activation fee has been EUR 59.95 and the charge for assuming service on an existing line is EUR 29.94. These prices apply both to analog and ISDN lines. As part of the price cap-related changes, however, there have been decreases in traffic and call charges mandated by the German telecommunications regulator. We expect this rebalancing trend to continue for the foreseeable future. For more information, see "— Regulation."

To protect our customer base and market shares in Germany, T-Com offers a range of calling plans. For example, for an additional monthly fee, customers can take advantage of particularly low tariffs for local and national calls within Germany or get an allowance of free minutes. To be eligible for most of these new rate plans, customers must have either an analog T-Net or T-ISDN line from T-Com. Some of our competitors have filed complaints relating to two T-Com rate plans ("AktivPlus xxl" and "AktivPlus basic call time 120") approved by the German telecommunications regulator. For further information, see "Item 8. Financial Information — Litigation."

The number of analog lines has decreased in the last few years, primarily as a result of the migration to ISDN. The decline in the number of T-Net lines can also be attributed, to a lesser extent, to losses of market share to other providers and substitution effects from mobile communications. We expect that the number of analog lines will continue to decline due to the migration to more advanced lines, increased competition, and substitution by mobile phones.

The following table provides information concerning the number of T-Com analog and digital access lines in Germany at the dates indicated.

	<u>At December 31,</u>			<u>% change</u>	
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	(in millions)				
Analog access lines (including public phones).....	27.5	28.9	30.3	(4.8)%	(4.6)%
ISDN digital access lines (including public phones).....	10.4	9.8	8.7	6.1%	12.6%

#### *ISDN Access Lines*

T-Com's ISDN services are marketed under the brand name "T-ISDN," and permits a single access line with 64k/bit per second to be used simultaneously for multiple products and services, including voice, data and facsimile transmission. T-ISDN also provides highly reliable connections with faster transmission of signals and increases the capacity of the access network. T-ISDN also offers various convenient features such as caller identification and T-NetBox, the network-based virtual answering machine.

T-Com offers two types of T-ISDN access lines- basic and primary. Basic T-ISDN access lines provide two telecommunications channels per access line and are offered to individual customers and to business customers. Primary T-ISDN access lines provide thirty telecommunications channels per access line and are offered primarily to business customers. In 2003, the number of basic T-ISDN access lines increased approximately 6.1% to 10.3 million as at December 31, 2003. As of December 31, 2003, T-Com had installed approximately 98,000 primary T-ISDN access lines. Through these basic and primary access lines, T-Com provided a total of 23.6 million T-ISDN channels. The number of ISDN lines has continuously grown in the last few years. We expect that the growth in T-ISDN lines will slow down as the market becomes saturated.

The following table shows the number of ISDN access lines and channels currently used by T-Com customers in Germany.

<u>Year</u>	<u>Basic connections</u>	<u>Primary connections</u>	<u>Total ISDN channels</u>
2001.....	8.6 million	105,000	20.4 million
2002.....	9.7 million	102,000	22.4 million
2003.....	10.3 million	98,000	23.6 million

Increasing T-ISDN penetration is a part of T-Com's strategy. Therefore, to attract T-ISDN customers, protect its customer base and market share, T-Com offers multiple ISDN tariff models.

#### *T-DSL*

ADSL is a telecommunications technology that permits the transmission of data at very high rates. Most T-DSL customers use 768 k/bit per second connections. T-Com offers standard analog and ISDN access lines enhanced by means of ADSL technology under the brand name "T-DSL." At December 31, 2003, there were approximately 4.0 million T-DSL lines currently in operation.

<u>Year</u>	<u>T-DSL lines in operation</u>
2001.....	1.8 million
2002.....	2.8 million
2003.....	4.0 million

One of the principal benefits of DSL technology is that it permits customers to use standard copper access lines for high-speed access to the Internet. As T-Com expects the Internet to grow in importance as a means of communication in the future, T-Com considers continued growth in the number of T-DSL access lines to be an important strategic priority. In this regard, its broadband product portfolio was expanded to meet the varying demands of individual and business customers and the marketplace through the introduction of additional T-DSL service features.

To further increase broadband penetration throughout Germany, T-Com is required by the German telecommunications regulator to make DSL resale offerings to its competitors in Germany. T-Com competitors will thus be able to market DSL products under their own brands to their customers. In addition, T-Com currently offers line-sharing at no cost. These offerings to its



competitors are aimed at strengthening Germany's position in the European and international broadband market. These line-sharing and DSL pricing measures are also a reaction to the critical view of the European Commission concerning the margin between our DSL and line-sharing tariffs.

In April 2004, T-Com expects to offer its individual and business customers "T-DSL with 1, 2 or 3 megabit/s downstream." The asymmetric T-DSL Business product variations with download speeds of 1, 2 or 3 Mbit/s are designed especially for small and medium-sized businesses. The complete Internet solution from T-Com makes it possible to search cost-effectively on the Internet, send and receive e-mails quickly and create webpages. T-Com also offers corresponding attractive flat rate offers for all asymmetric T-DSL Business product variations. T-Com is in the process of migrating its customer base to new DSL products.

Under the T-DSL Business brand, T-Com also offers a product variation using SDSL (symmetric digital subscriber line) technology that permits upstream and downstream transmission of data at the same (symmetric) high speeds. This product was introduced in 2002 and has been available nationally since 2003 in all existing T-DSL service areas.

#### *Wireless LAN*

T-Com offers to individual and business customers a range of products for wireless local area networks (LAN) and complete Internet solutions. Wireless LAN services provide wireless communications based on international broadcasting standards. Transmission rates of up to 54 Mbit/s provide customers with high levels of network performance. A number of the wireless LAN technologies offered complement T-Com's T-DSL broadband offerings. Wireless LAN was until recently an alternative only for business customers. However, recent price reductions for wireless LAN products have made wireless LAN increasingly affordable for individual customers.

In December 2003, T-Com launched a public wireless LAN service aimed at individual customers. In the pilot project, 30 T-Com "Hotspots" were launched. The primary intention is to equip buildings open to the public, such as restaurants and hotels, with wireless LAN in order to give customers wireless access to the Internet. T-Com offers maintenance and equipment to the location owners. Through attractive customer tariffs and simplicity of use, T-Com wants to achieve a high level of acceptance. T-Com intends to introduce a standard tariff with a monthly fee and usage-based pricing. In addition, credit card vouchers will be offered for "try only" use. For the implementation of this service, T-Com cooperates with T-Mobile. Both, T-Com and T-Mobile will offer a networked public wireless LAN service to their customers based on one common network. This means that T-Com customers can also use T-Mobile's Hotspots. T-Com views wireless LAN as another broadband service and an extension of its T-DSL product offerings.

#### *Calling Services*

T-Com provides comprehensive local and regional calling services as well as national and international long-distance calling services for individual and business customers that have access to T-Com's fixed-line network.

In the market for long-distance and international calls, T-Com's competitors have made considerable inroads into the market since 1998. Fixed terms for interconnection, which particularly favor competitors that have not invested heavily in infrastructure, enabled competitors to benefit from our infrastructure investments. In Germany, individual and business customers have been free since 1998 to choose providers either through pre-selection (selecting one long-distance carrier to handle all domestic long-distance and international calls on a default selection basis) or through call-by-call selection (selecting a carrier when such a call is made by dialing the carrier's numeric prefix before dialing the telephone number) for long-distance and international calls.

Pre-selection and call-by-call selection for local calls commenced in 2003, which inevitably led to reduced market share for local calls.

We have countered the challenge posed by competitors and alternative networks with reduced tariffs and innovative, customer-oriented and reliable products and services. The introduction of calling plans (calling plans provide customers with attractive, reduced call charges for a monthly fee) was an important element, particularly with regard to call charges, of the response to the competitive environment.

Under the regulatory framework applicable to the German telecommunications sector, T-Com's tariffs for fixed-line network calling services are subject to regulatory approval for as long as we are

considered to be a market-dominant provider. Furthermore, competitors have taken legal action against the new rate plans. For further information, see “— Regulation.”

#### *Data Communications*

T-Com offers business customers a full portfolio of data communications services, including:

- Leased lines (marketed under the brand names “SFV” and “DDV”) — SFV and DDV are trunk lines offering high levels of security and predefined bandwidths for the construction of corporate networks.
- Ethernet products — The new Ethernet product line, including DDV-M Ethernet 100 and HSE (High Speed Ethernet), provides business customers with innovative, low-priced plug-and-play products for interconnecting customer sites in line with the worldwide Ethernet standard and with high transmission rates (up to 1,000 Mbit/sec).
- VPN products — which connect customer sites as if they were in a private closed network. Many attractively priced or individually tailored services are possible, from standard solutions to large, individually configurable ATM or IP networks, offering high-speed transmission rates and elevated security standards.
- Internet communications applications (marketed under the brand name “CompanyConnect”) — CompanyConnect is a professional broadband Internet connection with numerous line variants, such as high availability, guaranteed bandwidth and fixed IP addresses. In addition, IP-Transit, a professional paid peering service, offers worldwide Internet connectivity for Internet service providers. Intranet communications applications are also part of our data services.
- TDN (installation and operation of customized voice and data communications networks for individual and business customers).

#### *Value-Added Services*

In Germany, T-Com offers a range of value-added telephone services for business and private use. These services include toll-free numbers and shared cost numbers for customer relationship management as well as directory assistance numbers and public telephones.

T-Com provides contact routing solutions, primarily to large call center operators. In the media sector, TV and radio stations use T-Com’s services, such as “T-VoteCall,” to enable viewers and listeners to participate actively in programs and to extend audience loyalty. T-VoteCall and the “Mass Calling Platform” are used to process a large volume of calls. In the entertainment sector, T-Com’s premium rate services (0190 and 0900 exchanges) enable information and entertainment packages to be sold and billed by telephone or via the Internet.

#### *Terminal Equipment*

Through its terminal equipment business, T-Com distributes an extensive range of telecommunications equipment under its own brand. Products range from individual telephone sets and facsimile machines, targeted at individual customers, to more complex telephones, private branch exchanges (PBXs) and complex network systems (including DSL access devices), targeted at business customers.

T-Com’s terminal equipment can be purchased or rented.

#### *Other Fixed-Line Network Services*

T-Com also provides installation, maintenance, hotline, customer education, software installation and network management services. Product-related maintenance service levels are offered to individual customers under the brand names “Compact-Service” and “Comfort-Service.” Tailored services are available to business customers.

#### *Broadband Cable*

On March 13, 2003, T-Com sold its interest in the six remaining regional cable companies in Hamburg/Schleswig-Holstein/Mecklenburg-Western Pomeranian, Lower Saxony/Bremen,



Berlin/Brandenburg, Rhineland-Palatinate/Saarland, Bavaria and Saxony/Saxony-Anhalt/Thuringia. In July 2003, T-Com also sold its remaining 40% interest in the regional cable company in Baden-Wuerttemberg.

#### *Domestic Carrier Services (Wholesale Services)*

T-Com's business with other telecommunications carriers is conducted through T-Com and T-Systems. Since January 1, 2002, T-Com has had business responsibility for services for domestic network operators and service providers. T-Systems has been responsible for the international carrier services business.

Wholesale Services not only provides the products and services for domestic network operators and service providers (or carriers), but also supplies — subject to regulatory constraints — Deutsche Telekom's other divisions. Wholesale services consist primarily of interconnection services for operators of fixed-line networks and mobile communications networks, carrier-specific transmission paths, access to the unbundled subscriber lines that run into an end-customer's premises (the "unbundled local loop") and IP-services, these being the transport of broadband and narrowband internet traffic to Internet service providers.

In the domestic market, the German telecommunications regulator determines the terms on which T-Com provides interconnection to competitors as well as access to the unbundled local loop so that competitors have direct access to customers. The terms for interconnecting T-Com's telephone network with the networks of other national network operators and service providers are contained in bilateral contracts. At December 31, 2003, T-Com had 93 interconnection partners; interconnection agreements existed with 61 of these partners, while in 32 cases interconnection was conducted on the basis of an interconnection order from the German telecommunications regulator.

There was slight growth in leased lines provided to other carriers. Our method of determining the number of leased lines changed within Wholesale Services during 2003. Prior to 2003, the number of leased lines was calculated in accordance with the total number of channels provided over all lines. In 2003, we began a new method of counting only the lines (products) irrespective of the number of channels. For more information, see "— Regulation — Regulation in Germany — Special Network Access and Interconnection — Fixed-Fixed Interconnection."

#### *System Integration and Consulting*

##### *T-LAN*

T-Com offers local area networking and communications services to increase planning and operation services for computer networks.

##### *E-Business*

T-Com offers e-business products to business customers. Revenues from e-business services have been increasing in recent years. T-Com offers business customers web hosting products and solutions designed to provide our customers with an Internet presence (websites) and facilitate e-business for T-Com's customers. T-Com provides the platforms and manages the software needed for integration into the relevant communications networks. The e-business products and solutions provided to T-Com's customers are modular in structure, affording flexibility and ease with respect to the incorporation of additional modules and features. We see particular potential for growth in the areas of eHealth (an introduction of patient records management in Germany in 2004), eGovernment (a solution for local and state governments targeted at public administration), and eTraffic (a solution targeted at integrated traffic control from technology and freight carriers).

#### *Other Domestic Services*

##### *Publishing Services*

Our business activities focus on the marketing of advertising in paper and online telephone directories and the publication and distribution of telecommunications directories in Germany in cooperation with small and medium-sized publishing companies. These products are published in a

variety of media formats, including print, online and CD-ROM. We receive most of its revenues from advertisements contained in these products. In recent years, our products have been subject to increasing pressure from competitors.

### *Sales Channels*

T-Com provides toll-free numbers where customers can obtain information and order products and services. This sales channel is mostly used by individual customers. Additionally, T-Com markets its products and services to individual and business customers through its network of "T-Punkt" retail outlets. The T-Punkt outlets offer an extensive product portfolio including T-ISDN and T-DSL business products, as well as products from T-Online and T-Mobile. Furthermore, products from leading IT manufacturers are offered. At December 31, 2003, T-Com had 412 T-Punkt outlets in Germany, of which 102 were business outlets. T-Com also markets its products and services in Germany via its website.

T-Com also serves business customers through a direct sales force. For targeted customer canvassing geared to specific business needs, business customers are assigned to three defined sales units. Within these sales units, the customer approach ranges from telephone support/canvassing (outbound/inbound) to personal calling and direct meetings with customers.

Furthermore, T-Com markets its domestic carrier services, as well as individual and business products and services to network operators and service providers (and internal divisions) through a special sales unit with six regional offices. Specific managers maintain a customer relationship with carrier customers.

In addition, T-Com offers its products and services through a broad range of sales partners.

### *Eastern Europe*

#### *Matáv*

We hold a 59.5% equity interest in Matáv, the leading (in terms of revenues) full service telecommunications provider in Hungary. Matáv also owns Westel, a Hungarian mobile communications provider. Westel maintained its leading position in an expanding mobile market characterized by intense competition. Westel's customer base was 3.8 million subscribers at December 31, 2003, an increase of 10.8% as compared with 2002. In addition, in 2000, Matáv acquired a 51% interest in Stonebridge, a company that owns 86.5% of the Macedonian telecommunications company Makedonski Telekomunikacii (Maktel). On June 30, 2003, Matáv's share in Stonebridge was increased to 89.51%. Maktel is the sole fixed-line and the leading mobile operator in Macedonia with 0.6 million fixed-lines (including ISDN channels) and 0.5 million mobile customers.

In 2003, Matáv's fixed-line network penetration and the total number of access channels marginally declined. The total number of access channels decreased by 1.8% from 2.88 million to 2.83 million year over year due to increased competition mainly from mobile services. However, the number of ISDN channels increased to approximately 528,000, a 3.2% increase year over year. At December 31, 2003, approximately 18.6% of Matáv's total fixed lines were ISDN channels. Matáv was successful in broadband applications, with the number of installed ADSL lines growing from 34,127 in 2002 to 103,803 in 2003.

Matáv's Internet subsidiary, Axelero, maintained its leading position among ISPs in the Hungarian dial-up market with a market share of approximately 44% and almost 211,000 Internet subscribers at December 31, 2003.

Although T-Com has the power to appoint a majority of Matáv's board of directors, the Republic of Hungary retains significant influence over Matáv's activities as the holder of the Series B share, the regulator of the Hungarian telecommunications sector and Matáv's largest customer. The Series B share gives the Hungarian state certain rights exercised through the Minister of Informatics and Telecommunications. These rights include, among others, the right to nominate and have elected one member of the Management Board, one member of the Supervisory Board, and to require the Ministry's consent for certain decisions (listed in the Articles of Association) taken at the general shareholders' meeting.

Matáv's monopoly in the Hungarian market for long-distance and international telecommunications services expired at the end of 2001. Even though alternative carriers emerged,

Matáv retained its leading role in the voice services market. Matáv's data transmission services continue to be subject to strong competition since a number of Hungarian companies have set up private data transmission networks.

#### *Slovak Telecom*

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 fixed-line telephone services, data communications services, distribution and broadcast radio and television signals and mobile communications services via its majority-owned subsidiary, Eurotel, which is not fully consolidated within T-Com. Although, pursuant to Eurotel's Shareholders Agreement, Slovak Telecom has a 51% economic interest in the profits and net assets of Eurotel, control of Eurotel is shared between Slovak Telecom and another company (Atlantic West B.V.) and neither party has unilateral control over major decisions affecting Eurotel. Therefore, this investment is considered a joint venture.

In May 2003, the other Slovak Telecom shareholders and T-Com signed an agreement relating to further cooperation, including providing for the extension of the deadline for the fulfillment of the initial investment commitments from the year ending 2003 to the year ending 2005.

Fixed-line network penetration and the total number of access channels declined in 2003. Due to the increased competition from mobile services, the number of access channels decreased by 4.9% year over year from 1.4 million to 1.3 million at the end of 2003. While analog access lines decreased by 7.2% from 1.3 to 1.2 million, the number of ISDN channels increased by 42% to approximately 75,600 from 53,000. Since July 1, 2003, Slovak Telecom has offered broadband applications and at December 31, 2003, had installed approximately 4,200 ADSL lines.

Slovak Telecom is the leading provider of online services in Slovakia through its subsidiary, ST Online. As of December 31, 2003, ST Online had a 56.2% market share of dial-up traffic and approximately 91,620 customers, a 35.8% increase year on year.

A new Slovak Telecommunications Act based on the European regulatory framework became effective on January 1, 2004. Slovak Telecom had a 99% market share of local and national calls in 2003. We expect that Slovak Telecom will be subject to increased regulation and that revenues and market share with respect to calls and interconnection will decline significantly as a result of the new Slovak Telecommunications Act. For more information, see "— Regulation."

#### *Hrvatski Telecom*

In October 1999, T-Com acquired a 35% equity interest in the then state-owned Hrvatski Telecom, the leading (in terms of revenues) full-service telecommunications service provider in Croatia for USD 850 million. In October 2001, T-Com acquired an additional 16% interest in Hrvatski Telecom for EUR 500 million and increased its aggregate ownership to 51%.

Hrvatski Telecom operates mainly digitalized fixed-line and mobile networks. Hrvatski Telecom pursued restructuring and market repositioning projects in 2002 and 2003, including the transformation of telecommunications centers, the continuation of the outsourcing of non-core business activities and defining a "go to market" strategy in order to counter erosion of market share by competitors. The mobile business was separated out into a self-supporting wholly owned subsidiary of Hrvatski Telecom.

The number of access channels increased by 2% from approximately 1.8 million in 2002 to approximately 1.9 million in 2003 due primarily to a shift of customers from analog access to ISDN lines. HT Mobile's subscriber base increased from approximately 1.19 million in 2002 to approximately 1.34 million in 2003, with a mobile market share of approximately 52.5% in 2003, a slight increase as compared to 2002. Hrvatski Telecom's online subscribers increased to approximately 480,000 in 2003 from approximately 370,000 in 2002.

A new Telecommunications Act in Croatia based on the European regulatory framework became effective on January 1, 2003. We expect that Hrvatski Telecom's will be subject to increased regulation, which will have an adverse effect on revenues and market share. For more information, see "— Regulation."

#### ***Toll collection system***

As previously reported, in September 2002, Deutsche Telekom AG, DaimlerChrysler Services AG, and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) (individually, the

“partners” and collectively, the “consortium”) entered into an agreement dated September 2002 and last amended in November 2002 (the “operating agreement”) with the Federal Republic of Germany (represented by the German Federal Ministry of Transport, Building and Housing) relating to a project to create and operate an innovative system for the collection of toll charges for the use by heavy vehicles of the German high-speed highway system. We refer to this project as the “Toll Collect project.” The toll collection system is to be created and operated by the joint venture Toll Collect GmbH (“Toll Collect”). DaimlerChrysler Services and we each hold a 45% stake in Toll Collect, with the remaining 10% being held by Cofiroute. Our involvement with Toll Collect includes our equity interest in Toll Collect that is recognized in our consolidated financial statements using the equity method of accounting, and certain financial guarantees. Additionally, certain of our divisions may act as sub-contractors of services to Toll Collect. We believe our maximum exposure to loss as a result of our interest in Toll Collect could extend beyond the amounts we have invested because of other risks associated with the financial guarantees issued for Toll Collect.

Pursuant to the provisions of the operating agreement, we, together with our partners, have, on a joint and several basis, guaranteed that Toll Collect will duly perform its duties in line with the operating agreement for the period of one year after the agreed start of operations.

The start of operations initially was scheduled for August 31, 2003, but has been delayed. Commencing on December 2, 2003, the consortium, or Toll Collect (provided it joins as a party to the operating agreement) has become liable for contractual penalties of EUR 250,000 per day until the end of February 2004 and EUR 500,000 per day thereafter until the toll collection system is operational.

Specific circumstances may entitle the parties to terminate the operating agreement. For termination to be effective, notice of termination must generally be given at least two months before the termination takes effect. This period may be used to rectify the reasons for termination. Termination of the operating agreement may have significant consequences for us as financial guarantor of certain obligations of Toll Collect. On February 17, 2004, the Federal Ministry of Transport sent us a letter advising that a notice of termination of the operating agreement was imminent. On February 25, 2004, we received such notice of termination of the operating agreement, dated February 19, 2004. While the notice of termination has not been formally retracted, on February 29, 2004, the consortium members reached an agreement with the Federal Republic to continue the Toll Collection project on the basic terms described in “Item 5. Operating and Financial Review and Prospectus — Liquidity and Capital Resources — Guarantees and Commitments.”

Toll Collect and the consortium are currently in discussions with the Federal Ministry of Transport to implement the agreement reached on February 29, 2004.

For information relating to possible arbitration proceedings with the Federal Republic, see “Item 8. Financial Information — Litigation — Other Proceedings.”

### **Seasonality**

The business of the T-Com division is not materially affected by seasonal variations.

### **Suppliers**

The principal types of equipment purchased by the T-Com division are network components such as switching systems, transmission systems, access network components and customer premises equipment, such as telephones and fax machines, T-DSL modems and similar items. Although we do not believe that T-Com is dependent on any single supplier, due to the multiple supplier strategy that we have implemented, there may be occasions when a particular product from a particular supplier is delayed or back-ordered. Major suppliers of T-Com are Alcatel SEL AG, Cisco Systems International B.V., Corning Cable Systems GmbH & Co. KG, ECI Telecom GmbH, Lucent Technologies Network Systems GmbH and Siemens AG.

### **Dependence on Patents, Licenses, Customers, Industrial, Commercial or Financial Contracts**

We do not believe that T-Com is dependent on any patent or other intellectual property right. For a description of patent infringement litigation that is relevant for T-Com’s business relating to ATM technology, see “Item 8. Financial Information — Litigation — Other Proceedings.” We do not believe that T-Com is dependent on any individual third party customer, or on any industrial, commercial or financial contract.

Similar to other fixed-line operators, T-Com is dependent on telecommunications licenses from the governments of the countries in which it operates. For more information, see “— Regulation.”

## **Competition**

### ***Fixed-Line Network Voice Telephony and Local Access***

Since the full liberalization of the German telecommunications market in January 1998, we have faced intense competition, based primarily on price, in the market for fixed-line network voice telephony. During the last three years, the competition has intensified, particularly in the local and broadband markets.

### ***Effect of Regulatory Decisions***

In the market for international and domestic long-distance calling services, the level of competition is influenced by the fact that we are required to permit other telecommunications companies to interconnect with our fixed-line network at rates that are set by the German telecommunications regulator. As a result, decisions of the German telecommunications regulator regarding the maximum rate that we are permitted to charge for interconnection have a very significant impact on the level of competition in the market for fixed-line network voice telephony. When the maximum permitted interconnection rate is below the price charged by us for calling services, competitors can interconnect with fixed-line network and offer calling services for a lower price, forcing us to lower our prices for calling services or to lose market share or both. The price structure for interconnection rates particularly benefits those competitors that have not made substantial investments in their own infrastructure. As a result of several decisions of the German telecommunications regulator between 1998 and 2003 that reduced the maximum permitted interconnection rate, we reduced our tariffs substantially from 1998 on, particularly in the areas of international and domestic long-distance calls. After large-scale price reductions in the standard rate at the start of 1999, we introduced optional tariffs that enable the customer to make inexpensive local, regional and international calls for a monthly fee. In 2003, we further reduced our prices of city calls as a result of mandatory (regulatory) price-cap targets. T-Com's fixed-line network market share as measured by call time in minutes declined from approximately 67.2% in 2001 to 61.2% in 2002, and continued to fall to 57.6% in 2003.

Future decisions of the German telecommunications regulator could require us to lower our prices further, cause us to lose additional market share, or both. The German telecommunications regulator has issued a decision that reduced the permitted fixed-fixed interconnection rate by an average of approximately 14% in 2002 and by an additional average of 9.5% in 2003. A reduction in interconnection rates means more advantageous advance payment costs for competitors and thus the opportunity to reduce end user prices or to increase their margins. Some competitors have used the reduction to increase their own margins on calls, and other competitors have passed these reductions on to end users. As part of the current price cap regime (2002–2004), we will again be required to reduce charges for long distance calls. In order to meet requirements of the EU Commission relating to an alleged unfair pricing practice in connection with the provision of local access to our fixed-line telecommunications network, we requested that the German telecommunications regulator approve a modification of the price cap regime that would allow us to increase the monthly fee for basic charges for analog access. On July 28, 2003 the regulator approved our application. For further information regarding actions of the German telecommunications regulator and the new price cap, see “— Regulation.”

Regulatory decisions also play a critical role in the level of competition in the markets for regional and local calls and for local access. We are required by law to rent subscriber access lines to competitors at prices determined by the German telecommunications regulator. We are required to permit “line sharing,” which means renting to a competitor only that portion of the subscriber access line that is required for high-bandwidth services, such as high-speed Internet access. As a result of a decision by the German telecommunications regulator, we are also required to offer local access and local call minutes to competitors at wholesale prices for purposes of resale. In addition, we were implemented local carrier selection alternatives for our customers commencing on April 25, 2003, as well as preselection of local call carriers by our customers beginning from July 9, 2003. For further information in this regard, see “— Regulation — Regulation in Germany — Special Network Access and Interconnection — Fixed-Fixed Interconnection.”



Further regulatory initiatives in Germany or the European Union aimed at increasing competition in the markets for local calls and for access may be expected in the coming years, which may have an adverse impact on our operations and our competitive position. For further information on these regulatory requirements and initiatives, see “— Regulation.”

### ***Effect of Investments by Other Companies***

We also face significant competition in the markets for international and domestic long-distance calls, regional calls and access lines from competitors that have made investments in their own infrastructure, such as Arcor AG & Co., Colt Telecom Group Plc., MCI Worldcom Inc. and BT Group Plc. In addition, national network operators, such as Arcor AG & Co., and local network operators, such as HanseNet Telekommunikation GmbH, KomTel GmbH and NetCologne Gesellschaft fuer Telekommunikation mbH, have made substantial investments in local network infrastructure and compete with us in major urban centers throughout Germany. Furthermore, as prices for mobile telephony decline, our local and other calling services, as well as access services, face increasing competition from mobile telephone operators. Additionally, as alternative technologies, such as voice-over-IP and use of the Internet, gain market acceptance, our fixed-line network telephone usage may be adversely affected.

### ***Other Fields of Business Activity.***

Although we do not manufacture our own equipment, we do resell telecommunications equipment under our own label that has been manufactured for us. The terminal equipment sector has been open to full competition since 1990 and is characterized by falling prices, low margins, rapid technological innovation and intense competition. The basis for competition in this field is primarily price. T-Com's most significant competitors in this area are Siemens AG, Alcatel S. A., Philips Electronics N. V. and Tenovis GmbH & Co. KG (formerly Bosch Telecom GmbH/Telenorma AG). Most of these competitors are also suppliers to T-Com.

## **T-Systems**

T-Systems International GmbH provides information and communication technology (ICT) services worldwide to large German and international accounts, non-profit organizations and governmental agencies. T-Systems commenced operations under its reorganized structure in 2000 by combining a number of Deutsche Telekom business units, including debis Systemhaus (50.1% of which was acquired in October 2000 and the remaining 49.9% was acquired in the first quarter of 2002).

During 2003, T-Systems continued its strategy of divesting non-core businesses, including TeleCash Kommunikations-Service GmbH, T-Systems SIRIS S.A.S., T-Systems MultiLink SA and T-Systems Card Services AG. For further information, see “Item 5. Operating and Financial Review and Prospects — Segment Analysis — T-Systems.”

### **Principal Activities**

T-Systems' ICT services and solutions are targeted primarily at large national and international corporations. The servicing of major national and international accounts also benefits other divisions of the Deutsche Telekom group with respect to the provision of additional services to these customers. In this way, T-Systems plays a key strategic role within the Deutsche Telekom group.

T-Systems uses advanced information technology and telecommunications expertise to supply the required ICT infrastructure to its customers, to provide tailored ICT solutions and, if required, to take over complete business processes based on these solutions. T-Systems provides support for customers through its global telecommunications network in more than twenty countries.

T-Systems' international business units support many German-based multinational customers as well as customers headquartered outside of Germany. Although the majority of T-Systems' customers are headquartered in Germany, as of December 31, 2003, roughly one quarter of T-Systems' 40,833 employees are based outside of Germany. T-Systems' primary markets are in Western Europe, North America and Asia. In 2003, German-based operations contributed approximately 73% of total revenues. For the year ended December 31, 2003, the telecommunications (TC) services group contributed approximately 47.4% of T-Systems' total revenues and the information technology (IT)

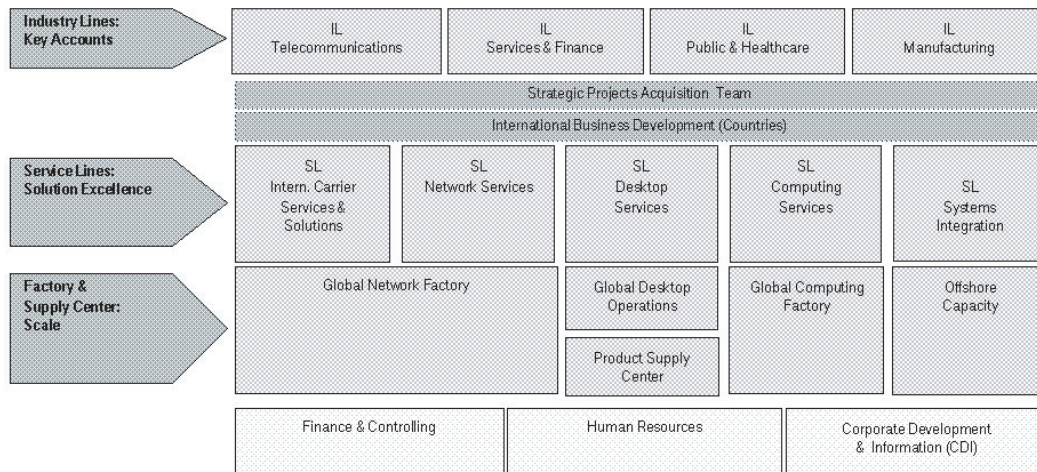
services group contributed approximately 52.6% of T-Systems' total revenues. Total revenues include inter-segment revenues from other Deutsche Telekom divisions and affiliates. For more information, see "Item 5. Operating and Financial Review and Prospects — Segment Analysis — T-Systems."

**Business Model**

In 2003, T-Systems established and implemented a strategic program referred to as "Focus & Execution." Through this program, T-Systems focused on both its structure and its go-to-market model in four industry sectors or Industry Lines (ILs). T-Systems combines competencies in the ILs: Telecommunications, Services & Finance, Public & Healthcare and Manufacturing.

Sales and service teams assigned to these ILs are responsible for supporting high-revenue customers, focusing on key account management, and ensuring that customers receive ICT services that are oriented to their specific industry-sector requirements. Innovative solutions form the basis for long-term business relationships with these customers, not only for T-Systems but for the entire Deutsche Telekom group. All other customers, who for the most part use disparate as well as combined T-Systems services, are maintained by sales and service teams assigned by Service Lines (SLs).

T-Systems' Service Lines include International Carrier Sales & Solutions, Network Services, Computing and Desktop Services and Systems Integration. These Service Line teams have the ICT expertise to develop top-quality solutions for both the customers they service directly, as well as to the Industry Lines' key accounts. The following graphic illustrates this new business model.



Another important component of the strategic program is the establishment of Strategic Project Acquisition Teams (S-PAT), responsible for winning large orders. These project groups possess all the skills needed to win large orders in the national and international markets.

Additionally, T-Systems restructured its service offering in the fourth quarter of 2003. This new portfolio addresses three increasing value-added levels:

- **ICT Infrastructure Management:** customers receive tailored and cost-optimized services through flexible management of ICT infrastructures, such as complete management of SAP applications, including operating and maintaining mainframe computers and desktop systems.
- **Business Solution Design & Implementation:** Customers are provided with complete ICT solutions for their business processes. These applications contribute to optimizing their specific processes and raising their value added, such as providing turnkey applications and systems that permit efficient operation and oversight of entire supply chains (supply chain management) for the automotive industry.
- **Business Process Management:** T-Systems assumes responsibility for customers' complete process chains, enabling them to concentrate on their core business while at the same time benefiting from improved processes and cost optimization. For example, complete responsibility for management and operation of invoicing and payroll accounting functions on behalf of a customer, including equipment and personnel.

These value-added levels or Focus Solutions are the primary drivers of the T-Systems solutions portfolio. They offer customers a high degree of flexibility and enable them to concentrate on their core business. Thus they contribute significantly to a customer's success.

Also in 2003, T-Systems' decided to align international expansion more closely to providing services to globally active customers. The focus is not on global physical presence, but on global reach and deliverability. T-Systems provides this through international account management in each of the Industry Lines and Service Lines.

### **Telecommunications Services (TC)**

Telecommunications Services encompass a global network infrastructure for voice and data communications and a range of related solutions and consulting services, including "Network Services" (NWS), which consists of "Hosting and ASP Services" (H&ASP), "Global Synergy, Strategy and Solutions" (GSSS) and "Media and Broadcast" (MB). Telecommunications services also include "International Carrier Sales and Solutions" (ICSS) and "Global Network Factory" (GNF).

The Deutsche Telekom group (other than T-Systems) accounted for approximately 18.3% of the total revenues of the TC services area in 2003 and 25.7% in 2002. For further information, see "Item 5. Operating and Financial Review and Prospects — Segment Analysis — T-Systems."

### ***Network Services (NWS)***

The Service Line, Network Services, is responsible for the installation and operation of customized voice and data communications networks for T-Systems' customers, including large corporate accounts, non-profit organizations and governmental agencies. NWS provides fast, secure and reliable communications solutions for customers worldwide, with a special focus on Western Europe and North America.

The services offered by NWS include the IP/VPN (Internet Protocol-based Virtual Private Networks) and voice VPN solutions combined with hosted services such as:

- "Global Frame Relay/Global ATM" – a high-speed communications technology that provides businesses with a cost-effective, flexible way to connect local area networks, system network architecture, voice and Internet protocol-based applications.
- "Global Business Link" – an international private leased circuit ("private" = point to point connection for retail customers at the customer location) service with a bandwidth range from 64/56 Kbps to 622 Mbps that provides high-speed, high-quality leased-line connectivity between two endpoints.
- "IntraSelect MPLS" (Multi Protocol Label Switching) – a virtual private network (VPN) solution for any-to-any connectivity (each location in a network can communicate with the other), Internet access, dedicated firewall services, encryption services and remote dial-in services with standardization class of services (class of services = differentiated quality parameters for different applications, such as voice, data and multimedia) backed up with cross services level agreements (connectivity, IP access, firewall, etc.)
- "Global Internet" – Internet connectivity at a range of access speeds which complements the "IntraSelect MPLS" service by extending it to provide public Internet services, such as e-mail and file-transfer, together with private Intranet services within a VPN.

NWS also offers a broad range of services, including customized voice communication networks and complex call center solutions that assist customers with management of their incoming calls, faxes and e-mails.

Contracts relating to NWS have an average duration of approximately three years. Voice services provided are billed on a per minute basis, while data services are billed in terms of bandwidth provided per month.

### ***Hosting and ASP Services (H&ASP)***

Hosting and ASP Services (H&ASP) enable customers to employ Internet technologies in their businesses. H&ASP services provide the underlying infrastructure that enables a customer's business to operate more efficiently and seamlessly.

The H&ASP services group arranges (or "hosts") the Internet presence of customers by providing a reliable connection to T-Systems' network and manages the customer's website. In addition, H&ASP services provide the software necessary to maintain a reliable Internet connection.



The collaborative services provided by the H&ASP group also enable electronic marketplaces and portals to conduct business transactions electronically, either within a single industry or between enterprises from different industries. With these electronic marketplaces and portals, customers can enhance their relationships with suppliers (“supply chain management”) or with their customers (“customer relationship management”).

T-Systems is one of the market leaders in Germany for hosted solutions. Internationally, T-Systems has expanded its footprint for hosted solutions to Austria, Switzerland and Spain. In 2004, T-Systems will introduce its hosting solutions products and services to the North American market.

In Germany, T-Systems’ H&ASP services are also marketed by the T-Com division to business customers not directly addressed by T-Systems. Outside Germany, these services are also marketed through arrangements with third parties.

Contracts involving H&ASP services have an average duration of approximately three years.

#### *Global Synergy, Strategy and Solutions (GSSS)*

In January 2003, T-Systems established the Global Synergy, Strategy and Solutions (GSSS) unit, which is responsible for the growing and innovative business of telecommunications outsourcing. Since July 2003, GSSS is also responsible for indirect sales of retail telecommunications products through reselling arrangements with other telecommunications operators.

The GSSS mission is to leverage T-Systems to become the leading global telecommunications outsourcing partner and synergy provider.

In furtherance of its mission, the GSSS team is responsible for obtaining and managing outsourcing (transfer of operation of networks and network services to T-Systems) and outtasking (transfer of business functions such as international traffic routing to T-Systems) arrangements with telecommunications operators. GSSS also manages the implementation of these agreements and provides partner sales management and sales support.

Benefits to customers of outsourcing and out-tasking include a reduction in capital expenditures (i.e., decreased investment in infrastructure) and a reduction in operating expenses (i.e., decreased personnel maintenance and network costs). T-Systems benefits through increased utilization rates (scale effects) of existing capacity and equipment and improved coverage of the global network.

Additionally, GSSS contracts and manages the relationship with telecommunications operators relating to the resale of T-Systems’ retail telecommunication products and services. Through this arrangement, telecommunications operators and system integrators can offer many more products and services to their customer base and expand their reach by leveraging T-Systems’ global operations. This indirect sales channel is a strategic complement to T-Systems’ international direct sales force and strengthens the relationship with outsourcing and outtasking customers.

#### *Media and Broadcast (MB)*

In Europe, T-Systems is one of the largest service-providers of broadcast services, including analog and digital terrestrial broadcasting, satellite broadcasting and innovative digital applications. As of December 31, 2003, the broadcast network of T-Systems in Germany included more than 8,000 analog television and radio transmitters and 97 digital television and radio transmitters. T-Systems has expertise in providing systems equipment technology and digital radio transmitters.

Media and Broadcast provides services, such as broadcast contribution networks, distribution networks and studio and production solutions, to public broadcasters and private companies that provide content for broadcast media, including traditional (analog and digital) terrestrial broadcasting, satellite broadcasting and innovative digital applications. Media and Broadcast also provides services relating to planning, building and operating multi-media platforms for customers. In order to provide optimal service and retain customers, Media and Broadcast emphasizes the maintenance of a dedicated service and sales staff.

T-Systems’ Media and Broadcast customers consist of public and private broadcast companies in Germany, as well as television production companies and international audio broadcasters. Customers pay for media and broadcast services corresponding to the use of the services offered. Most contracts have an average duration of four to six years.

### ***International Carrier Sales and Solutions (ICSS)***

ICSS provides wholesale customers – typically other fixed-line and mobile carriers as well as Internet service providers (ISPs) – with direct access to T-Systems’ international telecommunications networks, including those networks that are leased from other carriers. During 2003, ICSS managed total worldwide voice traffic of more than 14 billion minutes. In addition, ICSS provides innovative solutions based on IP. For example, IP Transit provides the customer with a transport medium for worldwide access to Internet content, and Carrier Managed Network Solutions provides voice and wireless access to telecommunications carriers (including former incumbent or dominant regional/national carriers, emerging regional and long-distance carriers, Internet service providers and mobile carriers).

Competitive rates and individual leases allow ICSS to provide customized solutions targeted to individual carriers’ needs. The primary responsibility of ICSS is its bilateral business, where T-Systems and another carrier agree to terminate international voice traffic into Germany on Deutsche Telekom’s network and to purchase termination arrangements of outgoing traffic to international destinations from these same carriers. ICSS also provides carrier termination and transit services to other fixed-line and mobile carriers for calls that originate outside Germany and are routed through T-Systems International’s networks for termination in Germany or a third country. ICSS purchases termination services from foreign carriers for termination of T-Systems’ outbound international traffic. ICSS offers international carriers wholesale solutions via T-Systems International’s networks. These solutions are offered to fixed and mobile carriers, ISPs, ASPs (Application Service Providers), content providers and cable TV operators. In 2003, ICSS had arrangements with approximately 900 major international carrier customers in 192 countries.

Supporting this range of solutions and services is a modern network infrastructure that connects major international business centers over a fiber optic network (more than 150,000 kilometers) worldwide. Network operators can access T-Systems’ global backbone network from all over the world. As T-Systems continues to build its international network infrastructure, ICSS will be able to offer expanding global network coverage.

### ***Global Network Factory (GNF)***

The Global Network Factory unit (GNF) plans, builds and operates the global telecommunications platforms of T-Systems and the national and international corporate networks of many of our customers. Through T-Systems’ global network platform and through the operation of our customers’ networks, the GNF unit is responsible for providing equipment and services relating to the planning, implementation and operation of telecommunications networks and other related telecommunications services. For further information about the GNF unit, see “— Description of Property, Plant and Equipment — Cable and Satellite Transmission Infrastructure.”

### ***Information Technology Services (IT)***

The information technology (IT) services group has broad expertise relating to computer software and hardware and information technology systems solutions. The IT group provides information technology services, including both Systems Integration (SI), including consulting services, and Computing and Desktop Services (CDS), to large and multinational enterprises. CDS encompasses three delivery units, called “factories” — the “Global Computing Factory” (GCF), the “Global Desktop Operations” (GDO) and the “Product Supply Center” (PSC).

In 2003, other divisions of the Deutsche Telekom group accounted for approximately 45.0% of total revenues of the IT services group as compared to 41.4% in 2002. For further information, see “Item 5. Operating and Financial Review and Prospects — Segment Analysis — T-Systems.”

### ***Systems Integration and Consulting (SI)***

The Service Line, Systems Integration (SI), which includes consulting services, provides customers with consulting, implementation and applications support relating to systems solutions in the areas of information and communications technology (ICT). SI develops software solutions customized for the needs of individual customers and integrates those solutions into the customer’s ICT infrastructure. Examples of the services offered include security solutions, migration services, application management, software development, as well as solutions that assist users in managing their business processes (e.g., supply chain management solutions that enable businesses to use ICT to organize and optimize their relationships with suppliers).

In cooperation with other Service Lines, SI supports T-Systems' "Plan-Build-Run" process. This process covers with individually tailored end-to-end solutions the entire value chain from strategic business consulting ("Plan") to systems development and implementation ("Build"), right through to the on-going management of entire application and network systems ("Run"). "Plan-Build-Run" means a turn-key solution for the customer's planning, construction and operating ICT needs on a global basis. Based on cutting-edge project-management methods, projects of any size and level of complexity can be managed successfully.

In order to improve its ability to service customers' core processes and secondary business processes such as billing, SI has recently consolidated its 22 business units in Germany. These consist of technology and software development centers, as well as branch offices. SI will continue reorganizing its structures and process model in 2004.

Contracts involving SI services have an average duration of approximately one year and are charged on the basis of hourly rates or a fixed payment agreed upon in advance.

Through its wholly-owned subsidiary, Detecon International GmbH, T-Systems also offers customers comprehensive management consulting services. This unit focuses on providing services to the telecommunications markets worldwide and related sectors such as media, regulation and suppliers. Detecon provides services to software and hardware suppliers of telecommunication systems and to the fixed and mobile carriers that use such systems.

### ***Computing and Desktop Services (CDS)***

CDS is responsible for the operation of complete or partial customer IT infrastructures. Externally, CDS consists of two service lines, Computing Services (CS) and Desktop Services (DS). However, internally, both service lines are managed as one due to the overlap and bundling of services provided by these two service lines. CDS manages centralized and distributed information systems, infrastructure components, applications and business software solutions.

CDS is represented in a considerable number of locations throughout Germany and throughout the world. It has a total of about 17,000 employees, approximately two-thirds of whom are based in Germany. It is organized centrally and consists of five customer service units that are organized around industry sectors and regions and the three delivery units – GCF, being the CS delivery unit, and GDO and PSC, being the DS delivery units.

### ***Computing Services (CS)***

The IT unit provides our customers with the ability to outsource their entire information technology operations. The services offered include the operation of data centers, applications management, user support and network management. CS can also facilitate the transfer of information technology assets and personnel from the customer to T-Systems. The primary goal for such outsourcing of complete IT solutions and data centers to T-Systems is the creation of a competitive advantage for customers. Services offered by CS also include the installation, operation and administration of central computer systems (mainframes), open computer systems (UNIX, Windows NT) including billing-services, data center infrastructure services and business applications on behalf of the customers.

Generally, contracts involving computing services have an average duration of four years or more. Customers pay for computing services based on contractually agreed service levels. These agreements describe the quantity and quality of services to be provided (for example, 99.9% reliability) and the extent of services to be provided. Customer contracts are serviced by customer service units.

### ***Desktop Services (DS)***

The Service Line, Desktop Services, provides the services of its delivery units, GDO and PSC, to T-Systems' customers. These services include development and implementation of complete office systems solutions for customers with wide-ranging responsibility for the IT infrastructure. Other core competencies are office systems solutions, including desktop operations, call center and help-desk services, as well as the operation of computing services infrastructures, consulting and IT design. These services may include sales or leasing contracts of desktop computer hardware produced by third parties.

In general, desktop services contracts have an average duration of two years. Customers pay for desktop services based on contractually agreed service level agreements. These agreements describe

quantities of goods (i.e., the number of computers leased and maintained) as well as customer-specific availability and quality requirements for the services provided.

#### *Global Computing Factory (GCF)*

T-Systems operates a very large computer network, called the “Global Computing Factory,” as a platform for the information technology services offered to customers. The primary responsibilities of the GCF include the operation of mainframe computers, open system servers and storage arrays for outsourcing projects, including operating systems, database software, data communication software, systems automation. The Global Computing Factory provides the personnel, servers and infrastructure necessary to operate the information technology resources of its customers. For further information about the Global Computing Factory, see “— Description of Property, Plant and Equipment — Global Computing Factory.”

#### *Global Desktop Operations (GDO)*

The business mandate and objective of GDO is to provide desktop services that are cost-effective and meet market demands primarily for large customers and nationwide orders. Services provided by GDO cover the entire life-cycle of the workstations provided to the customer. GDO ensures the proper operation of the workstations and services hardware and software products. More than 300,000 workstations in Germany are serviced by GDO.

GDO is responsible for providing help-desk services primarily through a services office platform and call center platform management (CCPM). The services office platform supports one of the largest and most sophisticated Microsoft exchange applications worldwide with more than 230,000 mailboxes and file, fax and SMS services. CCPM includes services that are required for the smooth operation of a call center platform. In addition to constantly monitoring essential components, GDO provides all operating and support relating to help-desk services.

#### *Product Supply Center (PSC)*

Desktop Services also provides Product Supply, Product Life Cycle and E-Supply services through its Product Supply Center. PSC is the central IT hardware purchasing unit for customers and also for divisions and affiliates within our group. PSC is responsible for the logistics of delivery of products (product supply) and for the transportation of desktop hardware and software from the supplier to the customer (product life cycle). In this way, PSC is able to achieve significant efficiencies and cost savings with regard to product purchasing.

To minimize supply chain costs, PSC provides an electronic link between customers and suppliers so that orders can be routed directly to the manufacturer or dealer (E-Supply), thereby reducing manual work and improving efficiency as well as enhancing error prevention.

#### **Principal Markets**

T-Systems’ business model is primarily focused on large business customers, German and non-German multinational corporations, and international telecommunication carriers and broadcasters (including companies that provide content for broadcast media). During 2003, T-Systems provided services to more than 1,500 large business customers (and approximately 10,000 subsidiaries of such customers) in Germany. T-Systems services customers according to T-Systems’ Industry Lines: manufacturing, public and healthcare, services and finance and telecommunications. Most of these customers are German or European-based with operations in various countries around the world.

- **Manufacturing** — includes manufacturers of automobiles, aircraft, electronics and manufacturers of component parts used by other manufacturers. T-Systems provides electronic supply chain management, product life cycle management and information technology outsourcing services.
- **Public and Healthcare** — includes government agencies, state pension funds, the armed forces of the Federal Republic of Germany, research and teaching institutions, as well as international organizations. T-Systems enables public entities (e.g., Federal Ministries and state agencies) to establish innovative business processes, such as services to individuals through the Internet and the management of data and voice networks.

- Services and Finance — includes banks and insurance companies as well as services business such as wholesale distribution, air transport, rail transport, logistics and retail industry. T-Systems develops a variety of solutions, including sales support systems for banking and insurance companies, electronic banking solutions, billing solutions, shops for direct sales via the Internet, Internet-based reservation and booking systems and data management systems.
- Telecommunications — includes other network operators and companies offering fixed-line, mobile and Internet telecommunications services. T-Systems provides, among other services, customer relationship management systems, customer care and call center systems and billing systems.

### **Seasonality**

The revenues of the T-Systems division are not materially affected by seasonal variations. However, T-Systems' revenues may be subject to quarterly fluctuations depending upon sales cycles (currently ranging between six and eighteen months) and purchasing patterns and resources of customers, which are subject to general economic conditions and are difficult to predict. Accordingly, revenues received in a particular quarter may not be indicative of future revenues to be received in any subsequent quarter.

### **Suppliers**

The principal goods and services purchased by the T-Systems division are computer hardware for client servers and mainframes, computer standard and applications software, network capacity and network services, telecommunications network components and IT consulting services. T-Systems manages, on behalf of customers, the risk in the supplier relationship as well as quality and cost considerations. We do not believe that T-Systems is dependent on any single supplier.

### **Dependence on Intellectual Property**

T-Systems does not believe that it is dependent on any individual patents, licenses or industrial, commercial or financial contracts. However, T-Systems is subject to third party software licenses in connection with the services provided to customers. Any breach, violation or misuse of any of such third party software licenses could result in additional costs with respect to the particular project that is the subject of such licenses.

### **Dependence on Material Contracts**

T-Systems aims to become less dependent on internal customers and to improve its market position with external customers. In 2003, other operating divisions of Deutsche Telekom (primarily T-Com and T-Mobile) accounted for approximately 32% of total revenues of T-Systems. No other customer accounted for a significant portion of T-Systems' total revenues in 2003.

### **Competition**

T-Systems operates in markets that are subject to intense competitive pressures. T-Systems faces a significant number of competitors, ranging from large IT and telecommunications providers to an increasing number of relatively small, rapidly growing and highly specialized organizations. T-Systems believes that its combination of service, performance, quality, reliability and price are important factors in maintaining its strong competitive position.

The principal competitors of T-Systems in the telecommunications area include AT&T, MCI, France Telecom/ Equant, British Telecom, Cable & Wireless and Colt. The principal competitors of T-Systems in the information technology area include IBM Global Services, EDS, CSC, Cap Gemini Ernst & Young and Siemens Business Services (Siemens SBS).

T-Systems holds different market positions in different regions of the world. In Germany, T-Systems is the market leader in the IT and TC areas. In Western Europe, T-Systems is one of the five largest vendors, together with IBM Global Services, EDS and Siemens SBS in IT, and with BT Global Services, FT/ Equant and Telefonica in the telecommunication industry. Globally, T-Systems ranks among the top ten IT and TC companies. IT competitors include IBM, EDS, CSC, Cap Gemini Ernst & Young and Siemens SBS. In the TC area, T-Systems competes with AT&T, MCI, NTT, FT/ Equant and BT-Global Services.



Competition in the telecommunications area (including IP services, network services, voice and data communications) is very intense. The competitive landscape in 2003 was characterized by suppliers attempting to reduce their indebtedness and increase profitability by a strategic refocusing and concentrating on their core businesses, increased efficiency and processes. In the marketplace, customers view financial stability as important criteria for choosing a supplier. In addition to the concentration on core businesses, all global competitors, including T-Systems, developed a portfolio of IP-based (Internet Protocol) business solutions on a quality-of-service platform (IP-MPLS). The IP-based solutions are more efficient and cost-effective and provide a high level of flexibility.

In the information technology area, competition is intense and the current market is characterized by strong pricing pressures, reduced IT budgets of customers and an extension of customers' sales cycles. As a result of these competitive pressures, many companies, including T-Systems, are attempting to maintain or expand market share through improved productivity, cost-cutting and efficiency measures, reliance on IT expertise and maintenance of existing customer relationships. This situation has also led to consolidation of the IT sector, which is expected to continue for the foreseeable future. T-Systems believes, based in part on independent market analyst reports, that global IT services markets during 2004 will recover slowly with higher market growth rates thereafter. However, T-Systems believes that markets will not achieve growth rates of the past and that competition will remain intense.

Like many of its competitors, T-Systems provides outsourcing services to large enterprises and therefore must allocate significant resources to projects for these customers. Although the allocation of resources in this way has not adversely affected T-Systems' business in the past, it is possible that intensified competitive and cost reduction pressures may result in reduced profit margins and/or loss of market opportunities.

T-Systems believes that it can compete effectively, largely due to its strategy of providing comprehensive solutions (planning, building and operating) to its customers' needs across a broad spectrum of IT and telecommunications activities. T-Systems believes that through its focus on solutions with higher margin potential and in which the company has substantial industry specific expertise, it can respond to customers' requirements acting as a telecommunications and information technology partner able to support customers in the most effective and efficient manner possible.

## **T-Mobile**

### **Principal Activities**

The principal services offered by the T-Mobile division are digital mobile telephony services based on the mobile telecommunications technology known as GSM (or Global System for Mobile Communications) and non-voice services such as SMS (Short Message Services), MMS (Multimedia Messaging Services) and other data services to residential and business subscribers based on CSD (Circuit Switched Data) or GPRS (General Packet Radio Service) technologies. T-Mobile also operates "HotSpots" (wireless local area networks or W-LAN) which can be used currently by customers in more than 4,500 public locations in Germany, Austria, the Czech Republic, the United Kingdom, the Netherlands and the United States.

Our T-Mobile division offers international roaming services for GSM and GPRS to subscribers through a large number of international roaming agreements with third-party operators, so that subscribers can access mobile services while they are outside their home network service area. The T-Mobile division also sells mobile handsets to subscribers in conjunction with its service offerings.

Mobile voice and data services are offered both on a prepay basis and on a contract basis. Subscribers purchase contract services on the basis of fixed monthly fees and pay time-based airtime, or per message, fees. Some contract service offerings include a limited amount of airtime, data volume or messages in the monthly fee. Prepay services are purchased on the basis of monetary increments that are recorded on the subscribers' cards and then deducted based on airtime or messaging usage fees as the cards are used. W-LAN services are sold on both a monthly subscription basis and on various usage based plans.

Usage fees can vary according to the tariff plan selected by the customer, the day and time of day when a call is made, the destination of the call, the location where the call originates and, in some cases, other provisions applicable to the tariff plan and whether the called party is also a customer of the same network.

## **Global Branding, Integration and Alliances**

Following the introduction of the T-Mobile brand across international markets in 2002 and 2003, the key focus for 2003 has been to achieve a strong and uniform brand positioning and customer experience in all of the markets where T-Mobile has a majority shareholding.

T-Mobile is implementing a strategy intended to make its national operations function more like a single integrated business across borders. We call this the “One Company Strategy.” In addition to rebranding the division’s majority-owned mobile telecommunications subsidiaries with the T-Mobile brand, we have developed a functionally integrated business organization in Europe that features a single shared approach to marketing, technology and network, and sales and service.

In July 2003, T-Mobile entered into an alliance with Telefonica Moviles, Telecom Italia Mobile (TIM) and Orange S.A. The alliance came into effect with the establishment of an association as legal entity in the Netherlands in December 2003. It is open to other mobile communication companies. The alliance aims to make mobile services more widely available and seamless in all countries in which the alliance members operate. Alliance members seek to cooperate in several key areas, including the development of joint services relating to roaming, voice, data and the development and purchasing of handsets. Initial products of the alliance include seamless services across markets like GPRS, Virtual Direct Interconnect and MMS, and the alliance focuses on multi-national customers across Europe.

## **New Services**

T-Mobile launched its mobile data services across our European markets and in the United States between 2000 and 2003. In April 2003, T-Mobile’s mobile multimedia services, such as surfing, messaging, and downloads, were bundled and branded as “t-zones.” Messaging (SMS and MMS), Internet browsing and downloads are the main portion of mobile data services.

SMS is still the most widely used data service with 22 billion SMS sent worldwide in 2003. Within the t-zones, the entertainment channels (t-news, t-sport, t-games, t-movies and t-music) are the most frequented zones and account for over 70% of the t-zone traffic across all European markets.

Mobile data services can be used through handsets using GSM/GPRS and in the future also Universal Mobile Telecommunications System or “UMTS.” T-Mobile, as an international network operator, has various technologies in place that all support the network evolution. We aim to provide mobile broadband access across these and other relevant technologies. In the United States, the company is upgrading its network with Enhanced Data Rates for Global Evolution (with EDGE) capabilities. In addition, T-Mobile uses W-LAN to offer mobile data services.

T-Mobile has made substantial investments in the next generation mobile communications standard known as UMTS. T-Mobile invested EUR 8.5 billion in UMTS licenses in Germany, EUR 171 million in Austria, EUR 395 million in the Netherlands, EUR 6.6 billion in the United Kingdom and EUR 103 million in the Czech Republic. These investments in licenses do not include the costs of UMTS network build-out in these countries. Through 2003, T-Mobile has invested over EUR 300 million in UMTS networks. We expect to invest amounts in excess of our 2003 investments during each of the next three years. The investments should enable us to meet the minimum coverage requirements established under our UMTS licenses. To reduce costs and increase efficiency, T-Mobile has entered into network sharing agreements with other operators.

T-Mobile has met or exceeded all regulatory requirements with respect to its UMTS licences in the United Kingdom, Germany and Austria. Regarding regulatory approval and for further details with respect to roll-out requirements and network sharing, please see “— Regulation.” For information regarding tax refund proceedings relating to the purchase of UMTS licenses, see “Item 8. Financial Information — Litigation — Other Proceedings.”

## **Principal Markets**

The T-Mobile division’s principal markets include Germany, the United States, the United Kingdom, Austria, the Czech Republic, the Netherlands, Poland and Russia.

T-Mobile Deutschland and our other mobile communications subsidiaries count contract customers as subscribers for the length of their contracts and count prepay customers as subscribers as long as they continue to use our service and then for a prescribed period thereafter, which differs

according to the particular market. Generally, at the end of this time, or in the case of payment default or voluntary disconnection, the subscribers are canceled or “churned.” The churn rate for any given period represents the number of subscribers whose service was discontinued during that period, expressed as a percentage of the average number of subscribers during that period, based on beginning and period-end figures. Our competitors may calculate their churn rates using methods different from ours. In addition, because we use different calculation methodologies in different jurisdictions, our own churn figures are not comparable across all national operations.

### *Germany*

Through T-Mobile Deutschland, we offer mobile communications services to individual and business subscribers in Germany. At December 31, 2003, T-Mobile Deutschland had approximately 26.3 million subscribers as compared to approximately 24.6 million subscribers at December 31, 2002. Of the total subscribers at December 31, 2003, approximately 12.6 million were contract subscribers, as compared to approximately 11.5 million at December 31, 2002. T-Mobile Deutschland had approximately 13.8 million prepay subscribers at December 31, 2003, as compared to approximately 13.1 million at December 31, 2002.

T-Mobile Deutschland’s average churn rate for 2003 was 1.4% per month compared to 1.5% per month in 2002. In 2003 for the first time, the average prepay churn rate did not exceed the average contract churn rate. This is mainly due to the fact that, after years of fast prepay growth, the portfolio of prepay subscribers has become more stable.

Generally, a prepay customer in Germany is churned after a period of 15 months if the customer has neither originated nor received a data or voice communication in that period.

### *North America*

In May 2001, we acquired all of the outstanding equity securities of VoiceStream Wireless Corporation and of Powertel, Inc., two formerly independent U.S. mobile operators, in exchange for an amount of our shares having a market value on the acquisition date of EUR 28.7 billion plus EUR 4.9 billion in cash. As of May 31, 2001, these companies became fully consolidated within the T-Mobile division. VoiceStream Wireless Corporation was renamed T-Mobile USA, Inc. in August 2002. Shortly thereafter, both T-Mobile USA and Powertel began marketing their services under the T-Mobile brand. On December 31, 2003, Powertel, Inc., became a wholly owned subsidiary of T-Mobile USA, Inc. As used in this Annual Report, T-Mobile USA refers to both T-Mobile USA, Inc. and Powertel, Inc.

Through T-Mobile USA, we offer mobile communications services to individual and business subscribers in the United States. At December 31, 2003, T-Mobile USA had approximately 13.1 million subscribers, as compared to approximately 9.9 million at December 31, 2002. Of the total subscribers at December 31, 2003, approximately 11.7 million were contract subscribers, as compared to approximately 8.6 million at December 31, 2002, and approximately 1.4 million were prepay subscribers, approximately the same as at December 31, 2002.

T-Mobile USA’s average churn rate for 2003 was 3.1% per month, down from 4.0% per month in 2002. The improvement reflects lower churn of prepay subscribers as the average churn rate for contract subscribers was stable at 2.5% in both 2003 and 2002. During 2003, T-Mobile USA introduced a number of changes in its prepay service offering that were successful in extending subscriber tenure and thereby reduced the prepay churn rate. One such change, introduced in September 2003, was the extension of expiry periods for certain denominations of prepay vouchers. Prior to September 2003, vouchers with a value of USD 10 expired 15 days after activation and vouchers with a value of USD 25 expired 30 days after activation. Vouchers with a value of USD 10 now expire 30 days after activation and vouchers with a value of USD 25 expire 60 days after activation. As a result, prepay churn rate decreased in the fourth quarter to 6.8%, compared to the 2003 annual average of 7.6%. This decrease in the prepay churn rate in the fourth quarter caused the annual churn rate for prepay and contract combined to decline from 3.2% to 3.1%.

Generally, the churn result in 2002 was negatively affected by the integration of Powertel, whose subscriber base was mainly prepay. The higher average churn rate of our U.S. operations compared to our European operations is primarily a reflection of a higher average churn rate for the U.S. wireless industry compared to Europe. Competitive differences, differences in features and services due to the



use of multiple wireless technologies and general differences in consumer behavior between the United States and Europe factor in to the higher industry churn rate seen in the U.S. The churn rate of our U.S. operations is higher than the U.S. industry average due in part to the higher proportion of prepay subscribers in T-Mobile USA's customer base relative to its U.S. competitors. Prepay subscribers in the United States typically churn at substantially higher rates than contract subscribers.

Wireless Local Number Portability (WLNP) was started in late November 2003 for the 100 largest markets in the United States. WLNP enables customers to keep their number when changing their wireless provider and when changing from fixed-line service to wireless service. T-Mobile, the other U.S. wireless carriers and the fixed-line carriers have all experienced technical and other execution problems in implementing this process, which prevented or slowed a significant number of porting transactions. These problems are being addressed by the carriers and the other parties supporting the porting process and significant progress has been made toward their resolution, as evidenced by significant improvements in porting execution. To date, T-Mobile has experienced fewer problems than other carriers based on published reports of the number of complaints received by the FCC. To date, WLNP has had a positive net effect on T-Mobile because more customers have ported their numbers to and signed up for service with T-Mobile, than have ported from T-Mobile to other carriers. For more information see “— Regulation.”

T-Mobile USA entered into an agreement with Cingular Wireless LLC (“Cingular”) in November 2001 to share in the ownership and operation of certain GSM network infrastructures. We contributed our network assets in the New York City market, and Cingular contributed its network assets which cover most of California and parts of Nevada (the “California/Nevada market”), to a newly formed joint venture entity, GSM Facilities. Both parties retained the ownership and control of their spectrum licenses. T-Mobile USA and Cingular manage and maintain the assets previously owned by each company on behalf of the joint venture. The monthly cash operating expenses of GSM Facilities are shared by T-Mobile USA and Cingular based on the proportionate minutes of use by each party's subscribers in each market. Non-cash expenses, including depreciation on the network assets and interest charges on capitalized tower leases, are not recovered by GSM Facilities and result in net losses to the entity. These losses are shared by T-Mobile USA and Cingular based on their relative economic interests in GSM Facilities and are reported as loss from companies accounted for under the equity method. Capital expenditure requirements of the joint venture are funded through capital contributions from T-Mobile USA and Cingular based generally on incremental minutes of use by each parties' subscribers in each market.

Contractual termination provisions provide for an orderly unwinding of GSM Facilities over a two year period in the event of notice of termination by either party following a change in control of a party, material breach or at the discretion of either party. In an unwinding, the New York City market network assets would be returned to T-Mobile USA and the California/Nevada market network assets would be returned to Cingular, with a settlement between the parties to adjust for contribution differences. Under some circumstances, an unwinding would also include the exchange of certain predetermined spectrum licenses between Cingular and T-Mobile USA, although the spectrum licenses are not held by GSM Facilities. Additionally, an unwinding caused by certain actions of either party may result in a substantial cash termination payment by that party. In the event of such termination, T-Mobile USA would incur substantial capital expenditures or other costs to service its customers in the California/Nevada market and to enhance the network in the New York City market which could materially impact the company's operating results and debt levels. In February 2004, Cingular announced an agreement to acquire AT&T Wireless. We are not able to judge if and when this transaction will close. Such transaction may be deemed a qualifying consolidation event permitting Cingular to exercise its right to terminate the GSM Facilities arrangement, as noted above. Thus, as further noted above, such proposed acquisition by Cingular of AT&T Wireless may require T-Mobile to incur substantial capital expenditures or other costs to service its customers in the California/Nevada market and to enhance the network in the New York City market which could materially impact the company's operating results and debt levels.

### ***United Kingdom***

In October 1999, we purchased T-Mobile UK (formerly One 2 One) in the United Kingdom, for a purchase price of EUR 10.9 billion (including the assumption of outstanding shareholder loans).

Through T-Mobile UK, we offer mobile communications services to individual and business subscribers in the United Kingdom. At December 31, 2003, T-Mobile UK had approximately 13.6

million subscribers, as compared to approximately 12.4 million at December 31, 2002. Of the total subscribers at December 31, 2003, approximately 2.7 million were contract subscribers, as compared to approximately 2.2 million at December 31, 2002, and approximately 11.0 million were prepay subscribers, as compared to approximately 10.2 million at December 31, 2002.

Of the total number of T-Mobile UK subscribers at December 31, 2003, approximately 3.6 million were subscribers of Virgin Mobile, a joint venture between T-Mobile UK and the Virgin Group. Virgin Mobile is a so-called mobile virtual network operator (MVNO) established jointly by T-Mobile UK and the Virgin Group. As a virtual network operator, Virgin Mobile purchased airtime minutes and basic mobile services from T-Mobile UK and resells these minutes and services under the "Virgin Mobile" brand name. On January 29, 2004, T-Mobile UK, Virgin Group and Virgin Mobile entered into a new agreement pursuant to which Virgin Group acquired T-Mobile's stake in Virgin Mobile. At the same time, all outstanding litigation are settled and a new telecom supply agreement was signed running for a minimum of 10 years, including improved access to GPRS and UMTS services for Virgin Mobile and the end of the monthly marketing support contribution by T-Mobile. Under the new agreement, Virgin Mobile will receive inbound and outbound call revenues. In addition, in the event Virgin Mobile consummates a public offering of its equity securities, we will receive a specified amount of the proceeds up to certain limits.

T-Mobile UK's average monthly churn rate during 2003 was 2.9%, as compared to 2.2% per month in 2002. The increase in churn was predominantly caused by a significant clean up of the inactive prepay customer base. Prepay churn rate was 3.1% on average in 2003 compared to 2.0% in 2002. Contract churn decreased to 2.3% in 2003 compared to 2.7% in 2002.

### ***Austria***

Through T-Mobile Austria, the T-Mobile division offers mobile communications services to individual and business subscribers in Austria. At December 31, 2003, T-Mobile Austria had approximately 2.0 million mobile communications subscribers, essentially unchanged as compared to the number of subscribers at December 31, 2002. Of the total subscribers at December 31, 2003, approximately 1 million were contract subscribers and approximately 1 million were prepay subscribers.

T-Mobile Austria's average churn rate during 2003 was 1.7% per month, as compared to 2.3% in 2002. The churn rate in 2002 was significantly affected by the disconnection of a high number of prepay subscribers. T-Mobile Austria churns prepay subscribers twelve months after their last charged data/voice communication and last reload of their prepay cards.

### ***Czech Republic***

T-Mobile International holds an equity interest of approximately 92% in Cmobil, which owns an equity interest of 61% in the Czech mobile communications network operator T-Mobile Czech Republic. Until April 2001, Cmobil owned 49% of T-Mobile Czech Republic (then RadioMobil). T-Mobile Czech Republic has been fully consolidated in our financial statements since April 1, 2001. As of May 2003, RadioMobil was rebranded to T-Mobile Czech Republic.

At December 31, 2003, T-Mobile Czech Republic had approximately 3.9 million subscribers, as compared to approximately 3.5 million at December 31, 2002. Of the total subscribers at December 31, 2003, approximately 0.9 million were contract subscribers, as compared to approximately 0.7 million at December 31, 2002. T-Mobile Czech Republic had approximately 3.1 million prepay subscribers at December 31, 2003, as compared to approximately 2.8 million at December 31, 2002.

T-Mobile Czech Republic's average churn rate during 2003 was 1.0% per month, as compared to 0.9% in 2002. The overall rise was driven by an increase in the prepay churn rate, while a lower contract churn rate partly compensated for this effect. Generally, a prepay customer is churned after a period of twelve months if no originating or receiving communication is recorded.

### ***The Netherlands***

In October 2000, T-Mobile International acquired an equity interest of 50.0% minus one share in Ben Nederland Holding, B.V., whose wholly-owned subsidiary, Ben Nederland B.V. was one of five operators in the Dutch mobile communications market. In September 2002, T-Mobile acquired the remaining share in Ben. T-Mobile Netherlands (formerly Ben) has been fully consolidated in Deutsche Telekom's financial statements since October 1, 2002.

At December 31, 2003, T-Mobile Netherlands had approximately 2.0 million subscribers, as compared to approximately 1.4 million at December 31, 2002. At the end of 2003, about 0.9 million subscribers were on contract and 1.1 million on prepay compared to 0.6 million contract subscribers and 0.8 million prepay subscriber end of 2002.

The average churn rate for 2003 was 2.6% per month, as compared to an average churn rate of 2.8% in 2002. Improved network quality in the Netherlands is the main reason for this reduction. If they have not originated or received a call for a period of 180 days, prepay subscribers at T-Mobile Netherlands are churned and removed from the subscriber base.

#### ***Minority Shareholdings: Poland***

T-Mobile International holds a 49.0% equity interest in Polska Telefonia Cyfrowa Sp. z o.o. (“PTC”). At December 31, 2003, PTC had approximately 6.2 million subscribers, as compared to approximately 4.9 million at December 31, 2002.

On August 25, 2003 we made the other shareholders of PTC a cash offer to acquire the remaining shares of PTC. A general agreement was reached on September 14, 2003 concerning a revised offer for EUR 1.1 billion. On September 26, 2003 we announced that no definite agreement on increasing our stake in PTC had been reached. For a discussion of a dispute concerning our investment in PTC, please refer to “Item 8. Financial Information — Litigation.”

#### ***Minority Shareholdings: Russia***

T-Mobile International currently holds an equity interest of approximately 25.1% in Mobile TeleSystems OJSC (“MTS”), a Russian mobile telecommunications company. On April 15, 2003, T-Mobile sold a 5% stake in MTS as part of a block trade. In addition, on April 21, 2003, T-Mobile’s co-shareholder of MTS, AFK Sistema JCSC (Sistema) exercised a call option granted in March 2003 to purchase approximately 10% of the MTS shares held by T-Mobile. The total proceeds from these two transactions amounted to approximately EUR 500 million.

At December 31, 2003, MTS had approximately 16.7 million subscribers, as compared to approximately 6.6 million at December 31, 2002. The large increase in subscriber base was primarily attributable to several acquisitions made in 2003 and organic growth.

#### **Seasonality**

T-Mobile’s business in some markets is affected by seasonal factors, with a general increase in sales of products and services during the fourth calendar quarter due to holiday purchases. As a result, T-Mobile’s performance during the fourth quarter can have a significant influence on its performance for the full year.

#### **Suppliers**

T-Mobile purchases IT and network components, as well as mobile handsets for purposes of resale, from a number of different suppliers. T-Mobile seeks to address the risk of delays in the supply of equipment and other technologies by using multiple suppliers where appropriate and by negotiating contractual penalties to be enforced if the supplier does not meet the agreements in time and quality. Such penalty provisions, even if obtained, may not fully mitigate the harm to our business by such delays or poor quality.

T-Mobile believes it has reduced its technological risks by contracting with multiple suppliers who have a significant market share in UMTS infrastructure and handset business.

#### **Marketing**

Each of the principal subsidiaries in our T-Mobile division uses its own combination of distribution channels to market products and services to customers. In each of the principal markets, third-party distributors, who typically market the products and services of multiple mobile phone network operators, play a significant role in marketing. Our mobile communications subsidiaries use a variety of incentives to encourage third-party vendors to sell T-Mobile products and services, such as payment of marketing expenses and special commissions. In addition, T-Mobile markets its products and services to retail customers through direct sales outlets, particularly in Germany and Austria, and

markets products and services to business customers through a direct sales force. The T-Mobile Internet pages being predominantly used for customer relationship management are also access routes to sales and services. T-Mobile also sells products and services through its Internet pages. In Germany, an important distribution channel is our group's T-Punkt retail shops. Mobile telecommunications re-sellers are also an important distribution channel. Mobile telecommunications re-sellers purchase network access at wholesale conditions as well as handsets at a discount from network operators, resell packaged services and handsets under their own brand through their own distribution channels, charge their customers at rates that they set independently and provide customer service and technical support.

T-Mobile provides access to third party content services to its customers through its mobile data service called "t-zones." Content provided to customers is either standard content, in which case the customer only has to pay the normal transportation charges to view or surf the content, or it is premium content, where a customer pays a specific charge through the customer's mobile phone bill for the content.

### **Dependence on Patents, Licenses, Industrial, Commercial or Financial Contracts**

T-Mobile owns a large number of registered patents and has a number of patent applications outstanding for technical innovations in the area of mobile telecommunications applications resulting from its development activities. Patent protection activity is focused on countries with T-Mobile operations. We do not believe that our T-Mobile division is dependent on any one patent or group of patents.

To offer mobile telecommunications services in the different jurisdictions in which we operate, we require and therefore are dependent on licenses from the relevant authorities in each of these jurisdictions. For further information, please refer to "— Regulation."

We do not believe that our T-Mobile division is dependent on any third party industrial, commercial or financial contract.

### **Competition**

#### ***General***

Competition in mobile communications is generally intense and conducted on the basis of price, subscription options offered, offers of subsidized handsets, coverage, range of services offered, innovation and quality of service.

In the past, competition in the European mobile communications market has been conducted at the national level. Increasingly, however, competition in this market is being conducted on a more international basis as international services are being introduced and as the number of mobile brands in Europe is shrinking.

In Germany, the United Kingdom, Austria, the Czech Republic and the Netherlands, the rate of mobile phone penetration is quite high. As a result, growth in the number of T-Mobile subscribers in these markets is expected to be significantly lower than in past years, and the focus of competition will shift from customer acquisition to customer retention and to increasing average revenues per user by stimulating demand for voice usage and new data products and services. In this connection, the timely introduction of new technologies that permit faster data transmission and enhanced services is highly significant. Churn rates could rise as mobile network operators seek to acquire subscribers of other mobile network operators. While the focus of competition is shifting, we expect that competition will intensify. Large numbers of subscribers in Europe have taken advantage of prepay tariff packages. Since these prepay subscribers are not bound to T-Mobile or other operators by contract, this trend may generate additional competitive pressure in the future.

The global mobile communications industry has been undergoing consolidation in recent years, which may increase competitive pressure and it is expected that consolidation will continue in the coming years.

In addition, new technologies, whether introduced by us or by others, can be expected to draw subscribers from existing technologies, including those of Deutsche Telekom. The competitive dynamics of the mobile telecommunications industry therefore could change in ways that we cannot predict and that could adversely affect our results of operations and thus our financial position.



## *Germany*

In Germany, T-Mobile Deutschland faces intense competition from the network operators Vodafone D2 (formerly Mannesmann D2), E-Plus and O2 (formerly Viag Interkom). In 2003, T-Mobile Deutschland maintained its market leadership position in terms of number of subscribers, although our competitors gained some ground.

We believe T-Mobile Deutschland had a subscriber market share of approximately 40.6% at December 31, 2003, while Vodafone D2 had a subscriber market share of approximately 38.1%, E-Plus had a subscriber market share of approximately 12.7% and O2 had a subscriber market share of approximately 8.6% at that date. The penetration rate in the German mobile communications market was approximately 78.3% at December 31, 2003.

In 2003, T-Mobile and Vodafone tended to focus on subscriber growth and increasingly on the improvement of subscriber quality. E-Plus offered prepay and contract products comparable to those of T-Mobile and Vodafone. O2 emphasized niche products, such as O2Genion. As a result of its strategy, O2 is the only German mobile network operator having more contract than prepay subscribers.

In the retail market, in addition to competition from other network operators, T-Mobile Deutschland faces significant competition from resellers.

In August 2000, six UMTS licenses were awarded to the four existing mobile communication network operators, the reseller Mobilcom and Quam, a joint venture owned by Telefonica and Sonera. On December 23, 2003, Mobilcom returned its UMTS license to the German telecommunications regulator. For further details, see “— Regulation — Regulation in Germany.”

## *North America*

T-Mobile USA faces intense competition in the United States mobile telecommunications market from the other five national mobile providers, Verizon Wireless, Cingular, AT&T Wireless, Sprint PCS and Nextel, and from various regional operators. The six national carriers are estimated to represent over 80% of the total U.S. mobile telephony subscriber base. T-Mobile USA's subscriber market share measured against the other nation-wide operators was approximately 10.3% at December 31, 2003, as compared to approximately 8.9% at December 31, 2002. Most of these competitors had been operating in the U.S. mobile telecommunications market for a considerable time prior to the entry of T-Mobile USA's predecessors into the market.

In February 2004, Cingular announced an agreement to acquire AT&T Wireless. Although we are not able to judge if and when this transaction will close, the completed transaction would create the largest wireless services provider in the United States based on the number of subscribers. A combined Cingular/AT&T and Verizon Wireless, our largest competitors in the United States, have potential advantages of size and scale that could allow them to deliver services in a more cost efficient manner and thereby negatively affect our competitive situation. As described above, the potential unwind of our network sharing joint venture with Cingular may also negatively affect our competitive situation.

The U.S. mobile telecommunications market is quite different in a number of respects from the European telecommunications mobile markets. The nationwide network operators use no single communications standard. T-Mobile USA was the only national mobile provider using GSM, prior to the initiation by Cingular Wireless and AT&T Wireless of the overlay of their existing networks with GSM networks. Licenses to provide wireless services cover numerous localities, rather than the entire nation. It can be difficult for network operators to obtain the spectrum needed in some localities to expand subscriber bases, upgrade the quality of service and add new services, particularly in densely populated urban areas. Low population density in other areas can cause problems with network efficiency and result in large geographic areas with no or limited coverage. For these and other reasons, including the extremely high penetration level of reliable, low cost, fixed-line telephony services, penetration levels for mobile telephony services in the United States are generally lower than penetration levels in Western European countries, with an estimated 55% mobile penetration rate as of December 31, 2003. As a result, operators in the United States market generally continue to invest heavily in order to encourage and capture growth in subscriber numbers.

Usage and pricing practices in the U.S. mobile market also differ significantly from those typically seen in European markets. Average voice usage per subscriber per month is generally much higher in

the United States than in Europe. Contract pricing in the United States is typically in the form of a fixed monthly charge at various price points for specified bundles of features and services which permit usage up to prescribed limits with no incremental charges. Usage in excess of the limits results in incremental charges. Prepay usage is generally priced solely on a usage basis. Typically both inbound and outbound usage counts against the contract usage limits and are subject to incremental charges for excess contract usage and prepaid usage. Average revenue per user is typically higher in the United States. Average revenue per minute of use is substantially lower in the United States than in Europe.

The differences between the U.S. and European mobile telephony markets result in different competitive pressures in the markets. In the United States, coverage is a key competitive factor as is the perceived value of bundles of minutes, features and services at the popular price points. To the extent that the competitive environment requires us to decrease prices or increase service and product offerings, our revenues could decline, our costs could increase and our customer retention could be adversely affected.

### ***United Kingdom***

In the United Kingdom, T-Mobile UK faces intense competition, principally from Vodafone, mmo2 and Orange, a subsidiary of France Telecom. We believe T-Mobile UK had a subscriber market share of approximately 25.0% at year end 2003 compared to 24.0% at the end of 2002. Compared to its competitors, T-Mobile UK's customer base, including customers of Virgin Mobile, has a lower proportion of business subscribers. The penetration rate in the British mobile communications market was approximately 86.2% at December 31, 2003.

In the retail market, in addition to competition from other network operators, T-Mobile UK faced significant competition from resellers and virtual network operators.

In addition to the existing mobile operators, T-Mobile UK faces competition from "3" (a brand name of Hutchison 3G UK Limited), which started operation in 2003, aiming mainly at customers for UMTS services.

### ***Austria***

In Austria, T-Mobile Austria faces competition from Mobilkom (A1), Connect Austria (One), tele.ring, H3G and tele2. We believe T-Mobile Austria's year-end 2003 subscriber market share to be 31%, decreasing from 32% at the end of 2002 mainly due to strong and price aggressive competition from tele.ring and due to the entrance of H3G and tele2 in the Austrian mobile market. We believe the subscriber market shares of A1 to be 40%, 20% for One and 9% for tele.ring. The penetration rate in the Austrian mobile communications market was approximately 83% at December 31, 2003, compared to approximately 80% at December 31, 2002.

### ***Czech Republic***

In the Czech Republic, T-Mobile Czech Republic faces competition from Eurotel Praha, spol s.r.o. and Cesky Mobil. We believe T-Mobile Czech Republic had a subscriber market share of approximately 41%, which is the same as in 2002. Eurotel Praha, spol s.r.o. had about 43% compared to 45% in 2002 and Cesky Mobil had 16% compared to 14% at the end of 2002. The penetration rate in the Czech mobile communications market was approximately 94% at December 31, 2003, up by approximately 10 percentage points in comparison to December 31, 2002.

### ***The Netherlands***

In the Netherlands, T-Mobile Netherlands faces intense competition from KPN Mobile, Vodafone, Telfort (formerly O2) and Orange (formerly Dutchtone). We believe KPN Mobile and Vodafone had subscriber market shares of 38% and 26% at the end of 2003, compared to 42% and 27% at December 31, 2002. The subscriber market share of T-Mobile Netherlands increased to approximately 15% at December 31, 2003, compared to approximately 12% at December 31, 2002. Compared to its competitors, T-Mobile Netherlands has a higher proportion of contract subscribers, generally leading to a more stable subscriber base, and higher average usage and revenues per user. The penetration rate in the Dutch mobile telecommunications market was approximately 78% at December 2003, compared to 76% at December 31, 2002.



In the Dutch retail market, in addition to competition from other network operators, T-Mobile Netherlands competes with an increasing number of MVNO's.

## **T-Online**

### **General**

We offer Internet services in Europe for residential customers and for small- and medium-sized business customers through our majority-owned subsidiary, T-Online International AG. T-Online provides its customers access to the Internet and, through its own Internet portal, an extensive range of products and value-added services, such as e-mail, online chats, web hosting, web organizer and international Internet access.

T-Online International AG was first listed on the Neuer Markt segment of the Frankfurt Stock Exchange in April 2000 through a public offering of newly issued shares representing approximately 10% of its then equity capitalization. Our interest was subsequently diluted through new share issuances to approximately 81.7%. In December 2002, we sold an additional 9.81% of our T-Online shares. As of December 31, 2002, we had a controlling ownership interest of approximately 71.9% in T-Online. On November 12, 2003, we acquired the 2% stake (approximately 24.9 million shares) in T-Online previously held by Commerzbank under the terms of a contractual agreement between Commerzbank and us. Pursuant to the terms of the agreement, Commerzbank was required to offer these shares to us if Commerzbank wanted to sell them. Accordingly, as of December 31, 2003, we had a controlling ownership interest in T-Online International AG of approximately 73.9%.

On March 24, 2003, T-Online's stock was incorporated into the TecDAX index established in the course of segment restructuring by the operator of the Frankfurt Stock Exchange, Deutsche Boerse AG.

On December 10, 2003, the supervisory board of T-Online International AG approved the acquisition of 100% of the shares of the Internet portal operator Scout 24 AG from Beisheim Holding Schweiz. Subject to agreed closing adjustments, the total purchase price for Scout 24 AG is expected to be approximately EUR 180 million, including the purchase price of a shareholder loan.

### **Principal Markets**

The T-Online division includes the activities of our majority-owned T-Online International AG subsidiary in Germany, which contributes almost 90% of the revenues of the division. T-Online also operates through wholly owned subsidiaries in France, Spain and certain other European countries.

With more than 13.1 million subscribers at December 31, 2003, T-Online is one of the largest European Internet service providers, or ISPs, based on revenues and number of subscribers. T-Online estimates that approximately 3.6 million, or 27.2%, of its total customers had broadband access to the Internet in 2003.

Broadband refers most commonly to the new generation of high-speed transmission services, which allow users to access the Internet and Internet-related services at significantly higher speeds than traditional dial-up service is capable of supporting. T-Online uses the term "broadband" to refer to high-speed access to the Internet based on ADSL technology ("Asymmetric Digital Subscriber Line"). Broadband access is generally fast enough to support new applications, such as high quality streaming video. T-Online, like other ISPs, defines broadband as any ADSL connection for which the data rate is greater than 128 kbit/s. The Deutsche Telekom T-DSL service offering starts at 768 kbit/s. Deutsche Telekom T-DSL service offering is expected to migrate to a minimum of one Mbit/s during 2004. Narrowband usually refers to a dial-up connection and offers a transmission rate of up to 128 kbit/s (ISDN with channel bundling).

## Subscribers

	December 31,		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(in thousands)		
<b>Broadband</b>			
Germany .....	3,308	2,642	1,358
Rest of Europe .....	<u>264</u>	<u>156</u>	<u>28</u>
<b>Group</b> .....	<b>3,572</b>	<b>2,798</b>	<b>1,386</b>
<b>Narrowband</b>			
Germany .....	7,477	7,320	7,406
Rest of Europe .....	<u>2,084</u>	<u>2,127</u>	<u>1,867</u>
<b>Group</b> .....	<b>9,561</b>	<b>9,447</b>	<b>9,273</b>
<b>Total</b> .....	<b>13,133</b>	<b>12,245</b>	<b>10,659</b>

### *Germany*

In the past year, T-Online International AG retained its leading position in the German ISP market with 10.8 million subscribers at December 31, 2003. By the end of 2003, T-Online's broadband customer base in Germany had increased to approximately 3.3 million, representing over 30% of T-Online's total customer base in Germany. These customers generally use the Internet more frequently and for longer periods of time than narrowband users. They are also heavier users of e-commerce. T-Online considers broadband customers one of the key growth drivers in the Internet industry.

The high level of demand for the T-DSL flat rate plan — unlimited usage for a monthly fee — continued during 2003. The T-DSL flat rate subscriber base increased by 21% to approximately 2.0 million at the end of 2003 as compared to the end of 2002. Narrowband access continued the trend of slower growth in 2003 compared to broadband access due to increasing demand for broadband access.

T-Online continues to offer Internet access via wireless local area networks (W-LANs) in specific public places. The focus of the W-LAN strategy is cooperation with strong regional and national partners, with T-Online relying on these partners' existing technologies rather than setting up its own W-LAN infrastructure. T-Online's W-LAN partners include MainSurf, the leading local W-LAN supplier in the Rhine-Main region, and BerlinNet. In the future, T-Online plans to cooperate with T-Com and T-Mobile to provide greater W-LAN coverage. Customers of all three divisions will be able to use HotSpots branded with the "T-HotSpot" logo.

Since 2000, T-Online has focused on becoming Europe's leading Internet media network. In this context, T-Online developed its own portal into a multi-access theme portal. Numerous content offers of T-Online are available not only through personal computers, but also on mobile devices such as mobile phones, smart phones and PDAs. Themed content with respect to news, sport, finance, entertainment and games are available for mobile users as well.

In August 2003, T-Online presented the new structure and graphic design of its homepage to conform to T-Online's combined business model, which focuses on access, content, services, and e-commerce. T-Online's Internet portal now combines new product areas for current topics, services, and shopping, offering information and entertainment, services and access products, and a variety of e-commerce services.

The goal of these measures is to increase the amount and quality of the content provided on T-Online's portal and thereby to increase the time spent on the portal by visitors. Accordingly, T-Online seeks to provide attractive content and new services through its portal network. T-Online's content partners include ZDF television, Axel Springer publishers and the Burda People Group. In 2003, T-Online expanded its media network strategy and benefited from the increase in paid content and service offers.

The product portfolio of the broadband portal, T-Online Vision, was expanded to include for the first time productions of the major U.S. film studios Dreamworks, Metro-Goldwyn-Mayer and Universal, as well as Germany's Constantin Film AG. Through the broadband portal, T-Online Vision — ([www.t-online-vision.de](http://www.t-online-vision.de)), T-DSL users can access films in streaming mode and view them for a fee.

T-Online believes that e-commerce is going to become more important over the next few years and is therefore a key element in its strategy. For direct trading with consumers, T-Online established its T-Online Shop in December 2002, which offers a range of computer and multimedia products. T-Online will be seeking to increase the value-creation potential of its T-Online Shop by trading directly in a few selected areas. As a pure marketplace activity, T-Online offers its e-commerce partners the opportunity to reach their targeted groups through its shopping portal for a prearranged fee.

With the launch of the new [www.musicload.de](http://www.musicload.de) portal, T-Online has its own offering for the legal downloading of digital music. With musicload, T-Online provides its users in Germany with a product range from the catalog of major record companies, such as Sony Music, BMG EMI, Warner, Kontor and EDEL, and is strengthening its position in the e-commerce sector and lending important momentum to the digital distribution of music products.

T-Online also offers e-mail, online banking, chatting and international access, among other services. The strategic importance of these services is to strengthen customer relationships. During 2003, the existing service portfolio was expanded and new Internet services were developed and launched, such as web-hosting, office applications, security and business information.

### ***Rest of Europe***

The T-Online division took a significant step in the development of its international business in March 2000, when T-Online acquired a 99.9% equity interest in T-Online France, the online service business of the French Lagardère group, in exchange for 5.69% of T-Online's shares (after giving effect to the listing of T-Online shares that took place in April 2000 and to the acquisition of an interest in comdirect). In May 2003, T-Online acquired the remaining 0.1% of T-Online France's shares from Lagardère.

T-Online France, operating under the name of Club Internet, has continued to develop its Internet business beyond simple Internet access. In September 2002, Club Internet was the first ISP in France to present a live portal with ADSL-specific content ("Club Haut Débit"). The product range of this portal includes video-on-demand, music download and games-on-demand, and has been expanded with products such as web-radio and live streaming TV channels. Club Internet's cooperation with the Internet shopping platform "Best of micro-Buy-central" is intended to grow its e-commerce revenues. This shopping platform encompasses the product range of more than 300 retailers. Club Internet also launched a range of new services on a pay-per-use basis, such as firewall software, antivirus software, mobile e-mail, paid services (horoscopes, IQ-tests) and photo services.

In October 2000, T-Online acquired Ya.com in exchange for cash and approximately 1.25% of T-Online shares. Ya.com is one of the three leading ISPs in Spain. Besides providing narrowband and broadband Internet access in Spain, Ya.com develops content, services and e-commerce offerings for Internet users in Spain and Portugal. In addition to its main portal ([www.ya.com](http://www.ya.com)), the Ya.com network in Spain is comprised of several integrated portals, such as travel ([Viajar.com](http://Viajar.com)), music and DVDs ([Discoweb.com](http://Discoweb.com)), finances ([Finanzas.com](http://Finanzas.com)), automotive ([supermotor.com](http://supermotor.com)) and computer sales ([TiendaPC.com](http://TiendaPC.com)), aimed at generating revenues from Internet traffic.

Through its Ya.com Travel S.L. subsidiary, operating under the name [Viajar.com](http://Viajar.com), Ya.com has already become one of Spain's top three online travel agencies in terms of revenues. During 2003, Ya.com also extended the scope of its paid services. The introduction of downloadable cell phone logos, for example, was very popular among Spanish users.

T-Online France and Ya.com also capitalized on the expansion of the broadband market in their respective countries to increase their customer bases. At December 31, 2003, the broadband customer base in our activities in the rest of Europe was approximately 264,000 subscribers, compared with approximately 156,000 at the end of 2002. T-Online France increased its base of ADSL subscribers by approximately 67% compared with the same period last year, while Ya.com's ADSL customer base increased by more than 72% in 2003 compared with 2002.

### **Competition**

The German and European markets for Internet access and portal services have been and will continue to be highly competitive. In the market for Internet access services, competition occurs in several areas, including pricing, brand recognition, network speed and reliability, customer support and

timely introduction of new products and services. The regulatory environment can also exert a significant influence on the level of competition. For Internet access providers, the terms on which they and their customers are able to secure telecommunications network services from carriers are important factors in the development of the market, and these services are generally regulated to promote competition. In the market for portal services, T-Online faces competition from websites maintained by Internet service providers, Internet information retrieval services, online community websites, home page services, e-commerce retailers and shopping portals, among others, as well as from traditional media, including newspapers, magazines, radio and television.

### **Group Headquarters and Shared Services**

As part of our four-pillar strategy, we assigned our telecommunications industry activities to our four corresponding divisions. Our internal reorganization was completed, both in terms of organization and staffing, in the first half of 2003. Accordingly, although our T-Com division and a number of our departments do not have legal identity separate from that of Deutsche Telekom AG, we manage them as though they are separate legal entities or assigned to specific divisions. As part of our strategic reorganization, many of the central departments (e.g., treasury, legal and accounting) were included in “Group Headquarters and Shared Services” (formerly “Other Activities”). Managing our group headquarters in this way is intended to enhance the competitive strength of all divisions in our group. Under the division of responsibilities between Group Headquarters and Shared Services and the operating divisions, the latter assume full responsibility for managing operational businesses, while Group Headquarters and Shared Services is now primarily responsible for strategic and cross-divisional management functions. Group Headquarters and Shared Services, through various departments, focuses on administrative, governance, treasury and finance matters relating to the group as a whole. Operating activities not directly related to the core businesses of the divisions, such as the administration of our real estate within Germany, domestic billing services, domestic fleet management, Vivento (formerly known as the Personnel Services Agency (PSA)) and our domestic training center, are also included in Group Headquarters and Shared Services.

#### **Activities in Germany**

The real estate unit is, based on revenues, the largest shared service within Group Headquarters and Shared Services. The real estate unit is responsible for renting and selling commercial real estate and for providing facility management services for our group in Germany. Our real estate unit was restructured in 2002 by reassigning responsibilities of the unit into four companies. Such real estate operations are carried out on our behalf by the following entities:

- GMG Generalmietgesellschaft mbH (GMG), which is responsible for the internal and external group leasing and rental business;
- DeTe Immobilien, Deutsche Telekom Immobilien und Service GmbH (DeTe Immobilien), which is responsible for providing facility management services;
- Sireo Real Estate Asset Management GmbH (Sireo), a joint venture of Deutsche Telekom AG (51%), Corpus Immobiliengruppe GmbH & CO KG (24.5%) and Morgan Stanley Bank AG (24.5%), which is responsible for the administration and disposition of our real estate interests; and
- DFMG Deutsche Funkturm GmbH (DFMG), which was established at the beginning of 2002 to act as the service provider for all of our radio towers and transmitter masts in Germany and manages such towers and transmitter masts (the towers and transmitter masts are primarily used in mobile, radio, and satellite communications as well as for television broadcasting).

For more information about our real estate management activities and portfolio, please refer to “— Description of Property, Plant and Equipment — Real Estate.”

The Billing Services unit provides billing services for our divisions (except T-Mobile) within Germany. In 2004, the Billing Services unit intends to broaden its service portfolio by integrating our accounts receivable department, our debt collection business (SAF Forderungsmanagement GmbH), and our risk and credit rating provider (Solventec GmbH). This will enable the Billing Services unit to operate as a full service provider with end-to-end capabilities in business process management for the billing and management of accounts receivable.

Our fleet management company, DeTeFleetServices GmbH, was established in July 2002 to capitalize on synergy effects throughout our company. It manages fleet operations with approximately 39,000 vehicles throughout all our divisions in Germany. It operates as a full service provider of fleet management and mobility services.

With the goal of efficiently implementing our staff restructuring measures in a socially responsible manner, we established the PSA in the fourth quarter of 2002. In the second half of 2003, the PSA was repositioned under the name Vivento, with new management and a new business mandate. The agency employs displaced workers, and trains and equips them with other employment qualifications for redeployment within the Deutsche Telekom group or other companies, or for project or temporary assignments. In addition to individual placements, Vivento staffs major projects and workforce-intensive operations and services. In 2004, Vivento took over the call center unit operations of T-Com and intends to expand this operation as a new service within the group and externally.

Through December 31, 2003, approximately 19,240 of our employees had been transferred to Vivento. Approximately 75% of our employees transferred to Vivento originated from T-Com, and were transferred as part of that division's program to increase efficiency. The remaining transferred employees were primarily apprentices who had finished their professional training within the group.

Through December 31, 2003, of approximately 3,710 employees had left Vivento, of which approximately 2,200 were placed outside the group. As of December 31, 2003, approximately 3,300 additional employees had been given temporary employment within the group, and a further 700 outside the group. At the end of 2003, approximately 15,530 employees were in Vivento, and a further 440 were Vivento's permanent staff.

	As of <sup>(1)</sup>			
	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Number of transferred employees <sup>(2)</sup> . . .	5,150	8,240	11,770	19,240
Number of employees leaving <sup>(2)</sup> . . . . .	250	860	2,000	3,710
Actual number of employees in				
Vivento . . . . .	4,900	7,380	9,770	15,530
Operational staff of Vivento . . . . .	200	310	350	440

(1) Figures are rounded.

(2) Including 2002 figures.

For more information on Vivento, please refer to "Item 6. Directors, Senior Management and Employees — Employees and Labor Relations — Other Employees."

In the second quarter of 2003, the activities of the Telekom Training Center and T-Systems Deutsche Telekom Trainings GmbH were merged and renamed Telekom Training. The Telekom Training unit is responsible for providing professional training and qualification services for our employees within Germany. It trains existing staff and employees of Vivento, and provided training for approximately 10,000 apprentices during 2003.

The treasury unit is primarily responsible for cash management, investments in securities, leasing arrangements and the refinancing of indebtedness through a variety of financial arrangements, including, among other things, bank loans and other credit arrangements, as well as the issuance of debt in the capital markets, the handling of payments and clearing transactions, and foreign exchange and hedging activities.

T-Venture Holding GmbH ("T-Venture") is also included in the Group Headquarters and Shared Services. T-Venture's mission is to scout for new products, technologies and services and to acquire access to them. Accordingly, a corporate venture capital investment fund has been established to make investments beyond those made directly by our divisions.

Group Headquarters and Shared Services also includes the establishment and maintenance of international intellectual property rights for the Deutsche Telekom group, including the T-Com, T-Mobile, T-Online and T-Systems brands.

### **International Activities**

In 2003, we continued to sell certain of our minority and non-core shareholdings. In December 2003, we sold our interest in the satellite operator Inmarsat Venture Plc. In October 2003, we sold most of our interest in Globe Telecom in the Philippines. The remaining shares of our interest in Globe Telecom were sold in February 2004. In June 2003, we sold our remaining interest in Celcom (Malaysia) Berhad. Additionally, in February 2003, we sold our interest in Eutelsat S.A. and the UMC (Ukrainian Mobile Communications) joint venture. The sale of those minority interests generated aggregate proceeds of approximately EUR 0.7 billion.



## INNOVATION MANAGEMENT (RESEARCH AND DEVELOPMENT)

Innovation management focuses on innovation strategy, research and development, innovation transparency throughout our group, intellectual property rights, asset management and T-Venture. Our research and development activities are performed primarily in the divisions and are coordinated centrally. Corporate innovation was repositioned within our headquarters and works closely with corporate strategy and corporate technology under the responsibility of our CEO.

### Research and Development Expenditures

In 2003, we incurred approximately EUR 0.9 billion of innovation expenditures. As in the preceding years, the majority of such expenditures was invested in the development and upgrading of the necessary software systems and architectures relating to our T-Com and T-Mobile divisions. This amount was similar to the expenditures invested in 2002. In 2003, central innovation management focused on restructuring and reorganizing the central research and development project portfolio. The time horizon for these research and development projects was refocused from 5-10 years to 2-5 years. The divisions are responsible for product roadmaps and the research and development pipeline for the next two years. All projects and activities combined involved approximately 6,400 employees.

### Intellectual Property

More than 400 patent applications were submitted in 2003 in Germany. The number of assigned patents (intellectual property rights), which have been filed increased by approximately 70% in comparison to the previous year (2003: 308; 2002: 182). At the end of 2003, we held approximately 5,000 intellectual property rights. Many of these intellectual property rights have been strategically implemented within our company and the marketing of others to third parties has been successfully continued.

## ACQUISITIONS AND DIVESTITURES

As part of our strategic plans, we have been selling certain non-core assets to reduce our indebtedness and improve liquidity. We have announced our intention to sell, in whole or in part, certain other non-core assets, including various real estate holdings in Germany. The following list contains each of the principal acquisitions and dispositions made by us since January 1, 2000.

<u>Year</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2003	T-Systems	Sale of shares in TeleCash . . . . .	0.1
2003	GHS	Sale of shares in Inmarsat . . . . .	0.1
2003	GHS	Purchase of additional shares of T-Online International AG ..	0.2
2003	GHS	Sales of shares in Celcom . . . . .	0.1
2003	GHS	Sales of shares in Globe Telecom . . . . .	0.4
2003	T-Systems	Purchase of PragoNet . . . . .	0.01
2003	T-Com	Sale of interest in Kabel Baden-Wuerttemberg . . . . .	0.1
2003	T-Systems	Sale of SIRIS, Multilink, T-Systems Card Services . . . . .	0.04
2003	GHS	Sales of shares in Eutelsat and Ukrainian Mobile Communications . . . . .	0.2
2003	T-Mobile	Sale of receivables in an asset-backed securitization transaction . . . . .	0.5
2003	T-Mobile	Sale of shares in MTS . . . . .	0.5
2003	GHS	Sales of real estate . . . . .	0.8
2003	T-Com	Sale of six regional cable companies . . . . .	1.7
2002	GHS	Sales of real estate. . . . .	1.3
2002	GHS	Sale of shares in T-Online International AG to institutional investors . . . . .	0.7
2002	T-Systems	Sale of receivables in an asset-backed securitization transaction. . . . .	0.3
2002	GHS	Sale of interest in Satelindo. . . . .	0.3
2002	GHS	Sale of interest in France Telecom. . . . .	0.3

<u>Year</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
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 debis Systemhaus . . . . .	(4.7)
2001	T-Com	Sale of receivables in an asset-backed securitization transaction. . . . .	1.4
2001	GHS	Sales of real estate. . . . .	0.7
2001	T-Com	Sale of interest in regional cable television company for Baden-Wuerttemberg . . . . .	0.9
2001	GHS	Sale of interests in Sprint, FON and PCS . . . . .	3.4
2001	GHS	Sale of interest in WIND (net of withholding tax) . . . . .	2.1
2001	T-Com	Acquisition of interest in Hrvatski Telecom (Croatia) . . . . .	(0.5)
2001	T-Mobile	Acquisition of T-Mobile USA and Powertel . . . . .	(33.8)*
2001	T-Mobile	Acquisition of interest in RadioMobil . . . . .	(0.6)
2001	T-Com	Acquisition of interest in Macedonia Telecom (Maktel) . . . . .	(0.3)
2000	GHS	Sale of logistic center . . . . .	0.4
2000	T-Com	Sale of interest in the regional cable television companies for North Rhine-Westphalia and Hesse . . . . .	3.0
2000	GHS	Sale of interest in Global One . . . . .	2.9
2000	T-Mobile	Acquisition of UMTS licenses in Germany, UK and Austria . . . . .	(15.3)
2000	T-Mobile	Initial investment in T-Mobile USA . . . . .	(5.6)
2000	T-Com	Acquisition of interest in Slovak Telecom . . . . .	(1.0)
2000	T-Mobile	Acquisition of interest in Ben Nederland Holdings BV . . . . .	(1.1)
2000	T-Com	Acquisition of interest in Matáv . . . . .	(2.3)
2000	T-Online	Acquisition of Club Internet . . . . .	(1.9)*
2000	T-Online	Acquisition of interest in comdirect . . . . .	(0.7)*
2000	T-Online	Acquisition of ya.com . . . . .	(0.4)*
2000	T-Mobile	Acquisition of interest in PTC . . . . .	(1.1)
2000	T-Com	Acquisition of interest in Westel 900 (Media One) . . . . .	(1.0)

\* amount invested includes market values of shares exchanged.

## **REGULATION**

### **Regulation in Germany**

Our T-Com division, in particular, is influenced by the decisions of the Regulatory Authority for Telecommunications and Post (*Regulierungsbehoerde fuer Telekommunikation und Post*) (the “German telecommunications regulator”), a supervisory body established within the German Economics Ministry (*Bundesministerium fuer Wirtschaft und Arbeit*) to carry out regulatory functions under the German Telecommunications Act. The German telecommunications regulator considers T-Com to be a market dominant provider in several markets, especially in fixed-line networks calling services. In 2003, many of the decisions of the German telecommunications regulator were implemented to increase competition in the markets for local calls and for narrow and broadband access to the T-Com fixed-line telecommunications network. These regulatory decisions have had and will continue to have significant effects on the level of competition in the markets for regional and local calls and local access to our fixed-line network.

The other divisions and affiliates of the Deutsche Telekom group within Germany are also influenced by the German regulatory regime relating to telephone services and data transmission services, and a number of them are also directly or indirectly subject to the regulatory provisions and decisions of the German telecommunications regulator.

### **Liberalization**

The legal framework for the regulation of the telecommunications sector in Germany was completely transformed through the German Telecommunications Act, which became effective on August 1, 1996. The German Telecommunications Act required the complete liberalization of the German telecommunications market by January 1, 1998, as mandated by the directives of the EU Commission. This represented the final step in the liberalization effort that began in 1989.

In March 2004, the Federal Parliament approved a draft bill relating to amendments to the German Telecommunications Act to take into account the changed market conditions in Germany and the new EU regulatory framework. For further information on the EU framework see “— The European Union Regulatory Framework—The New Regulatory Framework.” These proposed amendments to the German Telecommunications Act are likely to affect our business materially. The future regulatory and competitive environment for Deutsche Telekom in Germany will be largely determined by the implementation and interpretations relating to the proposed amendments to the German Telecommunications Act, which are difficult to predict. The draft bill has yet to be approved by the Chamber of Federal States. The amended German Telecommunications Act is not expected to become effective prior to mid-2004.

The following sections refer primarily to the present telecommunication laws in Germany. However, where appropriate, we will also refer to the recently proposed amendments to the German Telecommunication Act.

### **The Regulatory Framework**

The German Telecommunications Act allows virtually unrestricted market access by qualified entrants. The principal objectives of the German Telecommunications Act are to promote competition in the telecommunications sector through regulatory measures, to guarantee appropriate and adequate telecommunications services throughout Germany and to provide for the regulation of frequencies. The German Telecommunications Act aims to achieve these objectives principally by requiring licenses for the carrying out of certain telecommunications activities, allocating frequencies, securing universal service and subjecting enterprises having dominant positions in particular telecommunications markets (so-called “market-dominant providers”, such as Deutsche Telekom) to a special regulatory framework.

### **Regulatory Supervision**

The German telecommunications regulator has various powers under the German Telecommunications Act, including the authority to grant and revoke licenses, control network access and interconnection, and approve or review the tariffs and tariff-related general business terms and conditions of market-dominant providers. It also has the authority to assign and supervise frequencies and to impose universal service obligations.

### ***Licensing and Notification Requirements; Allocation of Frequencies***

As of July 25, 2003, the German telecommunications regulator abolished the requirement to obtain special licenses for telecommunications services. However, approvals are still required to obtain scarce telecommunications frequencies. Prior to July 25, 2003, licenses were required for the following activities:

- the operation of transmission lines for mobile telecommunications services for the public (Class 1 licenses),
- the operation of transmission lines for satellite services for the public (Class 2 licenses),
- the operation of transmission lines for public telecommunications services (Class 3 licenses), and
- the provision of voice telephony services to the public on the basis of self-operated telecommunications networks (Class 4 licenses).

Any entity providing telecommunications services is required to notify the German telecommunications regulator of its operations. Frequencies are to be allocated upon request on a non-discriminatory basis according to objective and verifiable criteria. Frequencies may be awarded by auction or competitive bidding if the German telecommunications regulator determines that frequencies are not available in sufficient quantity for all applicants or if multiple applications are submitted for the same frequency. The German telecommunications regulator may exclude a company from taking part in an auction or competitive bid for licenses or frequencies if the success of that company in an auction or bid would endanger competition based on principles of equal opportunity. The German telecommunications regulator may also deny approval of an application to transfer frequencies on the same basis if scarce frequencies are involved.

Payment of an initial frequency fee is required in connection with the grant or allocation of frequencies. In addition, annual contributions to cover the costs incurred by the German telecommunications regulator in planning and administering efficient and interference-free frequency usage are also required.

Under the proposed amendments to the German Telecommunications Act, regulatory fees may be imposed based on the revenues of telecommunication companies. Although still under discussion, this proposal, if adopted, may have a disproportionate effect on large companies like Deutsche Telekom, and may have a material adverse effect on our results of operations.

Since 1992, T-Mobile Deutschland has held a mobile (class 1) license to establish and operate a public digital telecommunications network based on the GSM standard with 2x12.5 MHz spectrum in the 900 MHz band. This license was originally awarded to Deutsche Telekom (then called Deutsche Bundespost Telekom) in 1990. Following an auction in 1999, T-Mobile Deutschland's GSM license was extended by 2 x 5 MHz in the 1800 MHz band. The license will expire on December 31, 2009. Procedures relating to the extension of this license beyond its current expiration date have not yet been established.

In 2000, T-Mobile Deutschland acquired a UMTS/IMT-2000 license with a frequency allocation of 2 x 10 MHz paired spectrum and 5 MHz unpaired spectrum in the 2 GHz band. This license will remain in force through the end of 2020, provided that T-Mobile Deutschland complies with the general requirements of the German Telecommunications Act and the specific conditions of the license. T-Mobile Deutschland's population coverage obligations under the license is 25% by December 31, 2003 (which has been achieved) and 50% by December 31, 2005.

The proposed amendments to the German Telecommunications Act contain rules relating to spectrum trading. It is not known at this time whether and how this will affect the use of spectrum rights under 2G and 3G licenses by us and our competitors.

One of the six UMTS licenses that were allocated in 2000 was returned to the German telecommunications regulator at the end of 2003. The relevant spectrum (2 x 5 MHz paired spectrum and 5 MHz unpaired spectrum) will be reallocated in the future. However, it is not yet known under what timeframe and conditions such reallocation will take place.

### ***Special Requirements Applicable to Market-Dominant Providers***

#### *General*

Market-dominant providers and their affiliates are subject to special rules and obligations, including the following:

- The prior approval or retroactive review of tariffs and tariff-related general business terms and conditions by the German telecommunications regulator, insofar as such tariffs and conditions relate to a market in which the provider is dominant. See “— Pricing.”
- The obligation to offer competitors unbundled special network access (including interconnection) as well as access to essential services and facilities used by the market-dominant provider internally on a non-discriminatory basis. See “— Special Network Access and Interconnection.”
- Potentially, the obligation to provide universal services in a market. See “— Leased Lines — Universal Services.”
- The possible inclusion of restrictive conditions in licenses, such as, in the case of scarce frequencies, a condition not to cooperate with another provider in the same market or the rejection of bids for licenses and frequencies in case of scarce frequency capacity to the extent that equal competition on the relevant market is endangered.

In addition, market-dominant providers must maintain segregated accounting systems to allow for transparency with respect to various licensed telecommunications services, and between such services and license-free services, in order to prevent, among other things, the cross-subsidization of services. In this regard, the German telecommunications regulator may specify the structure of internal accounting for particular telecommunications services subject to licenses. Furthermore, under general competition law principles, market-dominant enterprises may not abuse their dominant position. See “— Competition Law.”

Market dominance under the German Telecommunications Act is determined by reference to the German Act Against Restraints of Competition (*Gesetz gegen Wettbewerbsbeschränkungen*). See “— Competition Law.”

Current law provides that a company is presumed to have a dominant position if its share of a particular market equals or exceeds one-third of such market. The determination of the product and geographic markets affected and the criteria relating to market-dominance under the German Telecommunications Act are made by the German telecommunications regulator in agreement with the German Federal Competition Authority.

Pursuant to the proposed amendments to the German Telecommunications Act, the concept of market dominance will likely be replaced by the EU concept of significant market power. Accordingly, if this concept is adopted, the German telecommunications regulator and those companies affected will have to look to European law and practice for additional guidance in this area. The question of which telecommunications markets the German Telecommunications Act applies will for most aspects not be governed in the act itself anymore but will be subject of a market analysis procedure which shall be revised on a two years cycle. The starting point for this market analysis procedure is the “EU recommendation on relevant markets” that specifies a list of telecommunications markets which shall be subject to sector specific regulation. The first recommendation concerns retail markets for fixed public telephone service and leased lines and wholesale markets for unbundled local loop, fixed network interconnection, broadband access, mobile termination/access + origination/international roaming and broadcasting transmission services (see also “— The European Union Regulatory Framework — The New Framework.”). The German telecommunications regulator is in the process of reviewing these markets with the results expected by the end of 2004.

We believe that for the foreseeable future, the German telecommunications regulator is likely to view us as holding a dominant position in the German market for public voice telephony services in the fixed network and in other markets, including most of those in which we held monopoly rights in the past. As a result, we expect that the provisions of the German Telecommunications Act relating to the regulation of market-dominant providers will be applied to our activities in those markets. Considering that in many markets our competitors are unlikely to reach dominant positions in the near future, we expect that we will have to compete in significant markets with providers not subject to the requirements applicable to market-dominant providers (or those with significant market power). These competitors may therefore have more flexibility than we have in terms of the selection of services offered and customers served, pricing and the grant of access to their networks.

At the end of 2003, the German telecommunications regulator and the Monopoly Commission (*Monopolkommission*) reported to the German federal legislature on the developments of competition in the German telecommunications market. Although both reports state that overall competition is developing positively in the German telecommunications market, they conclude that promotion of competition through regulatory intervention continues to be necessary.

### *Pricing*

Under the German Telecommunications Act, tariffs and tariff-related business terms and conditions for the telecommunications services of market-dominant providers and their affiliates are subject to regulation insofar as they relate to a market in which such dominance is determined to exist. Other tariffs are essentially unregulated under the German Telecommunications Act. The tariffs of all providers in Germany are, however, generally subject to European and German law, including competition and consumer protection laws and ordinances. In addition, tariffs for universal services must be set at an “affordable price.” See “— Leased Lines — Universal Services.”

The German Telecommunications Act distinguishes between tariffs that require prior regulatory approval and tariffs which do not require prior approval but are subject to retroactive review. Prior approval is required for the tariffs of a market-dominant provider in the areas of public voice telephony services, the operation of transmission lines for telecommunications services to the public, and access and interconnection services. All other tariffs, including tariffs in respect of mobile telephony, subscription fees for cable transmission services and fees for satellite services, may be established without prior approval. However, in markets in which a provider is considered to have a market-dominant position, such tariffs are subject to retroactive review to the extent that facts become known which indicate that the tariffs are inconsistent with the German Telecommunications Act.

With regard to pricing issues regulatory, changes are likely to occur according to the draft for a new telecommunication law. In the future, prices for end-customers are in general likely not to require



prior approval anymore. Nevertheless, the regulatory authority may oblige market dominant providers to notify new end-customer prices two months before they become effective. Any such price change will also remain subject to retroactive review by the German telecommunications regulator. Finally the draft embodies an obligation for market dominant providers to simultaneously offer with the introduction of end-customer prices corresponding wholesale products to competitors.

#### *Prior Approval of Tariffs*

The German Telecommunications Act provides for two basic approaches to prior approvals of tariffs: a price-cap approach and an approach involving individual approvals based on an assessment of the costs of providing a particular service (the “cost-based approach”). The Tariff Regulation Ordinance (*Telekommunikations-Entgeltregulierungsverordnung*) requires that priority be given to the price-cap approach. The cost-based approach generally applies to tariffs for services that may not be, or are not, combined in a “basket” or “bundled” together with other services in accordance with the price-cap approach.

Tariffs may not be approved if they (1) contain surcharges which prevail solely as a result of the applicant’s market-dominant position, (2) include discounts which prejudice the competitive opportunities of other companies in a telecommunications market or (3) discriminate among customers for the same or similar services in a telecommunications market, unless such surcharges, discounts or discriminatory features are objectively justified.

#### *Price-Cap Approach*

The price-cap approach to tariff regulation has been applied to voice telephony services to the public. Under the price-cap approach, the German telecommunications regulator establishes baskets or bundles of services, establishes an initial price benchmark for each basket or bundle and limits tariffs for the blend of services within that basket or bundle through the use of a price-cap formula. This formula allows for price increases or requires price decreases from the initial benchmark level, based on the difference between the general inflation rate and a factor that reflects expected productivity improvements. In establishing the price-cap formula, the German telecommunications regulator is required to consider a range of factors, including the relationship of the initial tariff levels to the costs of efficient service provision and the productivity improvements being achieved by other enterprises in similar markets. The price-cap formula has the effect of requiring the affected company to reduce, or limiting the extent to which it can increase, the aggregate tariffs for services within a basket or bundle.

In December 2001, the German telecommunications regulator established the second price-cap regime that was intended to be applicable to the years 2002 through 2004, being divided into three one-year periods. On December 19, 2002, the German telecommunications regulator approved (amongst other pricing measures) price increases as to the monthly retail charge for analogue lines from EUR 11.49 (excluding VAT) to EUR 11.82.

In July 2003, the German telecommunications regulator approved a modification of the price-cap regime that increased our scope for pricing measures within the access basket substantially. In the same month Deutsche Telekom applied for allowance to further increase the monthly fee for analog access by EUR 1.68 (excluding VAT) to EUR 13.50 in addition to increases in one-time charges. These measures became necessary because of a decision of the EU Commission alleging that we abused our dominant position of local access to our fixed-line telecommunications network. The European Commission obliged us to end the allegedly unfair pricing practices immediately. For further information in this regard, see “The European Regulatory Framework — Competition Law.” On July 28, 2003, the German telecommunications regulator approved the above mentioned measures with effect from September 1, 2003.

On December 15, 2003, we applied for new pricing measures to take effect on April 1, 2004. These pricing measures generally include an extension of the currently approved tariffs, except with respect to long-distance calls, which are subject to a price reduction of 1% in 2004. The regulator approved our application without any changes on January 29, 2004.

#### *Cost-Based Approach*

Tariffs requiring prior approval that are not subject to the price-cap approach are based on the costs of efficient provision of the relevant service. The German telecommunications regulator bases its



determination of the costs of efficient provision of service on the long-run incremental costs of providing a particular service, with an additional amount in respect of overhead costs (including an appropriate return on capital employed), to the extent such costs are necessary for the provision of the service. The applicant is required to submit extensive documentation as to its costs and the methods and parameters on which its determination of costs is based in respect of the service. The German telecommunications regulator has broad discretion in deciding whether to accept an applicant's attribution of costs to a particular service. In recent years, in determining tariffs under the cost-based approach, the German telecommunications regulator has declined to take into account costs that we believe were properly attributed to certain services. Discussions continue concerning the appropriate methodology to be used in the calculation of the long-run incremental costs of the services subject to cost-based pricing. In the proposed amendments to the German Telecommunication Act, service prices are not only to be based on the costs of efficient provision of the relevant service, but are also not allowed to exceed the costs of efficient provision of the relevant service.

#### *Retroactive Review of Tariffs*

All tariffs of market-dominant providers in markets in which such dominance occurs are subject to retroactive regulatory examination, even if the tariffs were initially subject to prior approval. The German telecommunications regulator must initiate examination proceedings if it becomes aware of facts indicating that tariffs that were initially subject to prior approval contain discounts or discriminatory features that are not objectively justified. In addition, with respect to tariffs not subject to prior approval, the German telecommunications regulator may initiate examination proceedings if it becomes aware of facts indicating that such tariffs contain surcharges, discounts or discriminatory features that are not objectively justified. The German telecommunications regulator may object to such tariffs and declare them invalid.

In 2001, the German telecommunications regulator decided that the rates for external telecommunications services for closed user group members are subject to regulatory approval. We initiated legal proceedings seeking to enjoin this decision and for other relief. The Cologne Administrative Court granted the requested injunction, which was affirmed by the Appellate Court in Muenster. The proceedings in the main action are still pending. For further information in this regard, see "Item 8. Financial Information — Litigation."

In December 2002, the German telecommunications regulator imposed on us the obligation to raise our contractually-agreed rates with two closed user groups. The German telecommunications regulator decided that part of the tariff structure does not comply with cost-based standards. The application of such standards could affect the competitiveness of our services in this market and could lead to a material loss in market share. We initiated legal proceedings seeking to enjoin this decision and for other relief. The Cologne Administrative Court granted us injunctive relief, which decision was affirmed by the Appellate Administrative Court. The proceedings in the main action are still pending. For further information in this regard, see "Item 8. Financial Information — Litigation."

#### **Special Network Access and Interconnection**

The German Telecommunications Act imposes specific obligations concerning access to networks and interconnection. The Network Access Ordinance (*Netzzugangsverordnung*) under the German Telecommunications Act provides details concerning these obligations and specifies the manner in which special network access (including interconnection) is to be accomplished.

#### ***General Principles and Practice***

Every operator of a public telecommunications network, irrespective of the operator's market position, is obligated, upon request, to make an offer to other network operators for interconnection to its network. If the parties cannot reach an agreement on such interconnection, the German telecommunications regulator will order the interconnection upon application of one of the parties. To date, numerous interconnection orders have been issued. The contents of all agreements on special network access must comply with certain requirements of the Network Access Ordinance. Under the proposed amendments to the German Telecommunication Act, the Network Access Ordinance will be integrated into the German Telecommunication Act which will, among other changes, enumerate specific access obligations (for example resale, billing and collection).

#### ***Provisions Applicable to Market-Dominant Providers***

A network operator that offers telecommunications services to the public and is market-dominant in a particular market must allow every user access to its network or parts thereof. Such access may

be granted via connections provided for all users (general network access) or via special connections (special network access), which includes the interconnection of networks. Limitations on access may be based only on the “essential requirements” set forth in the Open Network Provision Directive of the European Union, which include the preservation of the security of network operations, the maintenance of network integrity, the interoperability of services and the protection of data.

A provider that is dominant in a market for telecommunications services to the public must also grant to competitors active in the same market access to essential services that it uses internally for the provision of such services. Such access must be provided under the same conditions it applies to itself, unless the offer of different conditions can be objectively justified.

A market-dominant provider generally is required to unbundle its services for special network access, and must therefore offer its internally used essential services, including transmission, switching and operational interfaces, in such a way that other users need not purchase services they do not want. In addition, a market-dominant provider generally is obligated to allow other network operators to use transmission, switching and operational interfaces to its network on its premises on the same conditions it applies to itself.

Agreements on special network access (including interconnection) must be provided to the German telecommunications regulator immediately following their execution. Conditions in such agreements must be based on objective criteria, be comprehensible and guarantee equal access.

#### ***Fixed-Fixed Interconnection***

Since January 2002, we have in Germany an “element-based” interconnection tariff system, which is the international norm. Under this system, the tariff for transmission of traffic is based on the number and type of network elements used in transmission and not on the distance over which the traffic is transmitted. As a result of the implementation of the element-based tariff system, we had to lower our interconnection rates by an average of approximately 14%, enabling our competitors to lower their prices for fixed-line international and domestic long-distance calls. We initiated legal proceedings against the implementation of the element-based tariff system, which proceedings are still pending. For further information, see “Item 8. Financial Information — Litigation.”

The German telecommunications regulator approved the current interconnection pricing level in November 2003. The tariffs are valid from December 1, 2003 until May 2006. The decision has required us to lower our interconnection rates by an average of approximately 9.5%. For more information, see “Item 8. Financial Information — Litigation.” The decision of the German telecommunications regulator favors those competitors who do not invest in their own infrastructure. See “— Description of Business and Divisions — T-Com.”

Additionally, 15 local carriers have applied to the German telecommunications regulator to increase their call termination charges. Deutsche Telekom pays these charges for calls that terminate in the network of the other carrier. These charges were always billed on a reciprocal basis, i.e. at the respective rate approved for Deutsche Telekom. A unilateral increase in termination charges by the local carriers would mean a potentially significant rise in Deutsche Telekom’s costs for such services without a corresponding rise in price for the local carriers for the reciprocal service. Accordingly, Deutsche Telekom’s costs would increase. On December 5, 2003, the German telecommunications regulator approved the application of the 15 local carriers for higher termination charges. With effect from December 15, 2003 until October 31, 2004 local carriers would be allowed to charge 0.5 cent per minute more for their termination calls than Deutsche Telekom can charge such carriers for the same service. We filed a complaint seeking to enjoin this action and for other relief with respect to this decision. The Cologne Administrative Court granted the injunction in February 2004. In case the injunction will be withdrawn in the main action, we will examine whether price increases for our end-customers will become necessary. For further information, see “Item 8. Financial Information — Litigation.”

#### ***Fixed-Mobile Interconnection***

Following major price cuts in 1998 and in 2000, national termination rates of the German GSM mobile network operators have remained stable since the beginning of 2001. Termination rates of T-Mobile Deutschland are among the lowest in Europe. Further price cuts may be required as a result of the ongoing market analysis procedure currently being conducted by the German telecommunications regulator. For more information see “— Provisions Applicable to Market-Dominant Providers.” Such regulatory intervention may have a material impact on our termination revenues.

T-Com is required to offer interconnection partners access to all German mobile operators at regulated rates. These rates consist of the termination rate paid to the mobile operator plus an amount for transport within the fixed network at the level of fixed interconnection rates. Since mobile operators have interconnected with each other and allow for direct termination of alternative fixed network operators, we consider T-Com's transit service for interconnection no longer to be an essential facility for competitors. However, the German telecommunications regulator still insists upon prior approval of these rates.

### ***Local Loop Access***

As indicated above with regard to special network access, market-dominant providers are obligated to unbundle their service offerings to the extent demanded by their competitors in a public telecommunications market unless the market-dominant provider can demonstrate that unbundling is not objectively justified under the particular circumstances. In light of this obligation, various competitors have asked us to provide unbundled access to our subscriber lines (i.e., the local loop). By allowing competitors to connect to customer access lines in local networks, unbundling of the local loop allows competitors to gain direct access to subscribers without having to build local networks of their own. In this way, competitors are able to use our customer access lines to offer a wide range of local services directly to the customer. The proposed amendments to the German Telecommunications Act do not appear to change the general obligation to offer competitors fully unbundled access to the local loop.

There are a number of legal proceedings pending relating to decisions of the German telecommunications regulator concerning access charges to the local loop that resulted in severe reductions of our charges for such access. We believe that the German telecommunications regulator did not take into account a number of costs that were justifiable costs for these services. For more information, see "Item 8. Financial Information — Litigation."

On April 29, 2003, the German telecommunications regulator reduced monthly line rental charge to competitors from EUR 12.48 to EUR 11.80. The new charges are valid from May 1, 2003 until March 31, 2005. Furthermore, on June 30, 2003, the German telecommunications regulator decided upon the one-time charges that we may collect from competitors with respect to customers switching out of our network. With effect from July 1, 2003, the one-time basic fee we may charge to competitors when German fixed-line customers switch from using Deutsche Telekom to another carrier for certain telephone services (switching without installation or access work performed at the customer's point of access) was reduced from EUR 70.56 to EUR 56.60. Also with effect from July 1, 2003, the fee we may charge to competitors terminating use of the local loop was reduced from EUR 34.94 to EUR 31.21 (from EUR 50.71 to EUR 47.09 if there is no concurrent switch to another carrier).

Since January 2001, we have been making line sharing offers (i.e. using a single access line for multiple purposes, including sharing access with competitors), in accordance with European Union requirements. In September 2003, the German telecommunications regulator approved our application for the extension of the current monthly line sharing tariff of EUR 4.77 while at the same time requiring us to slightly reduce certain one-time tariffs. In 2002, following a competitor's complaint with respect to an alleged price squeeze between line sharing and T-DSL tariffs, the EU Commission approached us with several requests for information. The EU Commission requested extensive data on the tariffs for cost of line sharing and T-DSL services. On the basis of the provided data, the EU Commission came to the conclusion that there was a negative margin between our line sharing and T-DSL tariffs. The Commission informed us that in its preliminary view the charging of those tariffs was abusive pursuant to Article 82 of the EC Treaty since they would not allow our line sharing customers to effectively compete with us in the DSL-retail market. In order to remedy the EU Commission's concerns, we committed ourselves vis-à-vis the EU Commission to close the alleged price squeeze by (i) refraining from charging the line sharing fees from April 1, 2004 until December 31, 2004, (ii) restructuring our T-DSL tariffs and (iii) applying at the regulator for a reduction of our (monthly and/or one-off) line sharing fees effective as of January 1, 2005. In return the EU Commission informed us that it would not open formal proceedings provided that we comply with the commitments.

In July 2002, the German telecommunications regulator set rules for fair access to the unbundled local loop within our network. Among other things the regulator introduced penalties in order to enforce the time limits set for the provision of local loop access and required us to give competitors

access to certain elements of our electronic information systems. We initiated legal proceedings in order to cancel a few of the obligations the regulator imposed upon us (especially the contractual penalties). We obtained injunctive relief, but the proceedings in the main action are still pending. For more information, see “Item 8. Financial Information — Litigation.”

### ***Local Carrier Selection***

Commencing on April 25, 2003, we were required to implement local carrier selection alternatives for our customers (referred to as “call-by-call”). In addition, pre-selection of local call carriers by our customers commenced on July 9, 2003. On June 4, 2003 the German telecommunications regulator approved a fee of EUR 4.40 for the service of pre-selection for local calls, pre-selection for long-distance calls and for a service where pre-selection for local and long-distance calls are ordered together.

### ***Leased Lines***

In May and July 2002, the German telecommunications regulator imposed upon us the obligation to modify our contractual conditions for the provision of leased lines. We are required, among other things, to include in our contracts clauses to pay penalties in the case of delays, to expand wholesale supply, and to warrant certain delivery periods. We initiated legal proceedings. Our request for an injunction was granted by the Cologne Administrative Court and affirmed by the Appellate Administrative Court in Muenster. Both courts confirmed explicitly that Deutsche Telekom’s leased line provisioning practices are not discriminatory. The proceedings in the main action are still pending. For more information, see “Item 8. Financial Information — Litigation.”

### ***Resale***

The German telecommunications regulator decided in 1999 that regulatory approval is required for our offers of services for purposes of resale. In May 2001, the German telecommunications regulator issued an order requiring us to offer subscriber network services (i.e., access and local services including DSL) to a particular competitor for purposes of resale. We initiated legal proceedings with respect to this decision. In July 2002, the Cologne administrative court corroborated the regulator’s position towards the obligation of Deutsche Telekom to offer wholesale products for the purpose of resale in the main legal proceeding. We appealed this decision before the German Federal Administrative Court, which confirmed our obligation on December 3, 2003. Accordingly, we now must offer our access and local call services, including DSL access, for resale by our competitors.

On July 18, 2003, in response to an impasse in discussions with a competitor regarding the resale of telecommunications services, the German telecommunications regulator imposed on us the formal obligation to submit an offer that would permit telecommunications services resellers in Germany to acquire from us line access services (including DSL) unbundled from conveyance services. On December 1, 2003, we submitted the offering containing the demanded features to the competitor. The offering is still being scrutinized by our competitor. In the end, the possible reduction of revenues and margins for us will depend on the discount we will have to grant our competitors on the prices of our retail products. The amount of the discount is likely to be determined in the course of a regulatory proceeding.

These decisions relating to resale allow our competitors effectively to engage in the risk-free arbitrage of price differentials in a market where Deutsche Telekom and other network operators have made considerable investments in telecommunications access infrastructure. The decision may therefore provide a disincentive to further investment in infrastructure and future technologies.

Although the demand for resale products is small today, this may change as a result of proposed amendments to the German Telecommunications Act. As currently proposed, the German telecommunications regulator would be authorized, at its option, to require us to offer to our competitors conveyance services or line access services bundled with conveyance services for purposes of resale by those competitors. It is possible that in the ongoing parliamentary process a provision requiring us to provide such services to resellers will be reintroduced into the draft legislation. We would expect that the financial consequences of our becoming required by statute or regulatory order to provide such services would be significant, because resale enables our competitors without their own networks to compete quickly with our retail products by offering one of our products at a lower cost.



### ***Tariff Packages***

There were no requirements concerning prior approvals of tariff packages by the German telecommunications regulator in the past (packages including tariffs, access charges and additional features). The German telecommunications regulator is currently considering complaints from our competitors that call for the regulatory prior approval of certain tariff packages in the future. We believe that regulator is questioning whether the additional features and hardware bundles that are included in some of packages are actually being priced based on cost, and so is questioning whether the tariffs are cross-subsidizing these elements of the packages. A misuse of market-dominant power is in the future likely to be presumed if products are packaged unreasonably. According to the proposed amendments to the German Telecommunication Act, prices for end-customers are likely no longer to require prior approval.

### ***Internet Access***

On December 15, 2000, we began offering access to our public switched telephone network to Internet platform providers at flat (“unmetered”) rates in response to a decision of the German telecommunications regulator requiring us to offer such a flat rate product. In March 2001, we successfully applied for a preliminary injunction against the obligation to offer a flat rate to Internet platform providers, with the effect that we are currently not obliged to offer such a flat rate product. We still offer unmetered access to our public switched telephone network to Internet platform providers voluntarily. The German telecommunications regulator has suspended the related proceeding at present. The proposed amendments to the German Telecommunications Act contain an option for the German telecommunications regulator to obligate market dominant providers to offer access using certain tariff arrangements (for example, flat rate tariffs).

Apart from access to the unbundled local loop and shared access/line sharing, we are currently offering several DSL wholesale products which provide competitors different opportunities for their own individual DSL-offers depending on their own network structure. To meet market demand, we plan to introduce further wholesale DSL products this year, such as DSL-Resale and Bitstream Access. A DSL resale offer is already being negotiated with competitors. Bitstream Access will be a combined product including T-DSL resale (as the access part of Bitstream Access) and one of the existing wholesale products.

T-Online is not subject to the regulation of its tariffs under the German Telecommunications Act. However, Internet subscribers are indirectly affected by the regulation of tariffs, including wholesale costs and charges for telecommunications services. In June 1999, the German telecommunications regulator ruled that the Internet access charges of T-Online are not subject to price regulation because the dominant feature of online services is not telecommunications, but so-called “tele-services” (*Teledienste*). Nevertheless, there are some indications that the German telecommunications regulator may change its regulation of prices for access to online services in the future. In the new regulatory framework, an extension of sector-specific regulation to online communications markets cannot be ruled out.

### ***Universal Services***

The German Telecommunications Act includes provisions to ensure the availability of certain basic telecommunications services (referred to as “universal services”) throughout Germany. Additional details concerning universal service requirements are provided in the Universal Service Ordinance and in the Telecommunications Customer Protection Ordinance. For more information, see “— Customer Protection Ordinance.”

The Universal Service Ordinance defines “universal services” to include public fixed-network voice telephony with certain ISDN features, directory services, telephone books, public pay phones and certain categories of transmission lines. These services must be universally available to all customers at a price determined by the German telecommunications regulator to be an “affordable price.”

Under the German Telecommunications Act, if a universal service in a particular product and geographic market is not being appropriately and adequately provided, or where there is reason to believe that such provision will not be accomplished, each licensee with a share of at least 4% of the product market for such service or a dominant position in the relevant product and geographic market



can be required to contribute through payments to the cost of providing such universal service. Contributions are required if the provider of a universal service proves that the long-term additional costs of providing the service efficiently in the relevant geographic market, including adequate interest on capital employed, exceed the revenues from providing that service at an affordable price.

Under the Universal Service Ordinance, which came into effect at the beginning of 1998, market-dominant providers in the relevant markets may be required to provide universal services. We provide customers with voice telephony and other universal services within the framework of the law and our General Terms and Conditions. We currently provide the universal services specified by the Universal Service Ordinance without compensation. If we decide to stop providing any of the services referred to in the Universal Service Ordinance, we must give at least one year's advance notice. We expect that we will, for some time to come, be the only provider considered suitable to be subjected to the obligation to offer universal services. Accordingly, it may prove difficult for us to cease providing universal services in some markets, although we may be able to claim special compensation.

If we become required to offer a universal service, and if the revenues from providing that service are insufficient to cover its additional costs, the compensation granted under the German Telecommunications Act may be insufficient to cover our full costs of providing that service. This results from the fact that we, like other licensees, are required to contribute to the cost of providing these services in proportion to our market share.

Amendments to the German Telecommunications Act that change the scope of universal service obligations are a possible outcome of the ongoing legislative process. Currently, however, we do not expect such changes, since the current draft of such proposed amendments does not materially extend or curtail the scope of universal service obligations.

### ***Customer Protection Ordinance***

The Telecommunications Customer Protection Ordinance (“Customer Protection Ordinance”) covers the special rights and obligations between providers of telecommunications services to the public and their customers, who may be either end customers or competitors to the extent that they have concluded a contract or intend to conclude a contract with the relevant telecommunications provider. As a result, nearly all our products and services, with only a few exceptions, such as the marketing of telephones, are subject to the provisions of the Customer Protection Ordinance.

Under the provisions of the Customer Protection Ordinance, market-dominant providers must make their services available to everyone on the same terms. Exceptions must be objectively justified. Further, although telecommunications providers generally have some flexibility in determining whether to offer services in “bundles,” the dominant provider is required to offer individual services on an unbundled basis when there is a “general demand” for those individual services in the market. This requirement applies to the description of individual services and the relevant service specifications, as well as the billing for such services. However, offering individually listed services as a package is still allowed.

In addition, the market-dominant provider must, upon request, eliminate or repair any malfunction immediately, including at night or on Sundays or holidays. Customers can request a free itemized statement of their calls, which must be detailed enough to allow them to check and monitor the accuracy of their bills. In the event that a customer has made no other arrangements with another provider, the customer will receive a combined bill from his local carrier. In such cases, the charges for all calls that the customer has made via other providers must be listed separately. Finally, as of January 1, 2001, telecommunications service providers have been under an obligation to ensure that any customer who has set a ceiling for its calling charges does not exceed it. The Customer Protection Ordinance also allows for certain limitations on the liability of telecommunications service providers.

The Customer Protection Ordinance is currently under legislative review. In April 2003, the Ministry of Economics published a first draft of a revised Customer Protection Ordinance. Upon review of this draft legislation it is possible that the new Customer Protection Ordinance will expand certain customer rights, such as the right to receive free itemized bills for services beyond voice telephony calls.

The Federal Government enacted separate legal requirements in response to the misuse of certain value-added and premium rate services by some of our customers, who offer such services under specific prefixes within our network. Such services are billed directly to the customer. The

new law adopted in the summer of 2003 gives expanded monitoring powers to the German telecommunications regulator and imposes strict and potentially costly requirements on network operators and providers. In view of the forthcoming amendment of the German Telecommunications Act, and the lobbying of consumer protection associations, further tightening of existing legal regulations in the coming months cannot be ruled out.

### **Billing and Collection**

Contrary to our view that mandatory billing services under the Customer Protection Ordinance do not include the collection of bills on behalf of competitors, the German telecommunications regulator ruled on February 21, 2000 that we must continue to offer billing and collection services for dial-up voice telephony, directory inquiry, value-added services and dial-up Internet-by-Call. According to these rulings, however, we were no longer obligated to manage customer complaints, send late payment warnings or enforce late payments on behalf of competitors after January 1, 2001. We initiated legal proceedings, which are still pending. For more information, see “Item 8. Financial Information — Litigation.” The proposed amendments to the German Telecommunications Act provide an explicit option for the German telecommunications regulator to require us to offer billing and collection services. The proposed amendments to the German Telecommunications Act are likely to clarify the range of the obligation to offer billing and collection services and to deliver customer data for accounting purposes. The draft explicitly excludes an obligation to send and enforce late payment warnings. It expands the range of billing services to products that are only based on telecommunication services and sets upper Euro-limits for the billing and collection of unmetered services. According to the proposed amendments to the German Telecommunications Act, prices for billing and collection are not regulated if an agreement is concluded with the predominant part of the relevant market.

### **Use of Public Rights of Way**

Under the pre-German Telecommunications Act laws, we were entitled to utilize the Federal Republic's rights of way over public property free of charge. Pursuant to the German Telecommunications Act, the Federal Republic's right to use such rights of way free of charge was transferred to licensed operators of transmission lines for public telecommunications services. Our right to utilize such rights of way has been carried over under our license. The German Telecommunications Act requires that operators of transmission lines obtain the consent of the authority responsible for the maintenance of the relevant public ways before laying new transmission lines or modifying existing transmission lines. We have agreed on a cost-saving and delay-avoiding procedure with federal associations of municipal authorities to simplify the process of obtaining the required consent.

Under the German Telecommunications Act, if the establishment of new transmission lines by an operator through the use of public rights of way is not feasible or technically possible or if the cost is disproportionately high, an operator of an existing transmission line using those public rights of way may be obligated to grant to the operator of those new transmission lines the joint use of its installations, such as ducts, for adequate compensation, provided no major construction work is required and such joint use is economically feasible.

### **Competition Law**

The requirements imposed upon us by German competition law should also be viewed in the context of European Union competition rules. For more information in this regard, see “— The European Union Regulatory Framework — Competition Law.”

The German Act Against Restraints of Competition prohibits the abuse of a market-dominant position as well as the distortion of competition through agreements or collusive behavior by market participants.

Notice of mergers, including the creation of joint ventures, must be provided to the German Competition Authority before they can be executed if the concerned undertakings' turnover reaches a certain threshold but remains below the threshold above which proposed mergers must be notified to the EU Commission. The German Competition Authority will prohibit mergers if they create or strengthen a market-dominant position. The German Competition Authority is empowered to enforce these laws and may impose sanctions if their orders are contravened. Before taking action against

abuses of a market-dominant position in the telecommunications sector, the German Competition Authority must consult with the German telecommunications regulator. Market participants damaged by abusive practices on the part of a market-dominant provider may sue for compensation under the German Telecommunications Act as well as under the German Act Against Restraints of Competition.

On August 8, 2003, the German federal competition authority opened formal proceedings against us following a complaint by Vodafone D2 and info.portal. The German telecommunications regulator opened parallel proceedings. We provided the complainants and other parties with access to the “NDIS” online directory information database. The operators of Vodafone D2 and info.portal use this database for providing voice directory services. In June 2003, we installed a filter in NDIS that grants access only to external users for whom the German Telecommunications Act obliges us to make directory services openly available. Hence, directory information that we do not obtain in our function as a carrier but from other sources is not being provided to external NDIS users. The complainants assert that this practice limits their possibilities to provide operator-based voice directory services and thus constitutes an abuse of a dominant position. Seeing that most companies providing operator-based voice directory services use the NDIS technology or comparable software of at least two other companies we have argued that we do not have a dominant position in the first place. Furthermore, we contend that the filter complies with the relevant article of the German Telecommunications Act. If the complainants succeed, we would be obliged to adapt the filter in accordance with the regulator’s decision and deliver value added data to third parties.

### **The European Union Regulatory Framework**

#### ***General***

Germany is a member state of the EU. As such, it is required to enact EU legislation in its domestic law and to take EU legislation into account in applying its domestic law. EU legislation can take a number of forms. Regulations have general application, and are binding in their entirety and directly applicable in all member states. Directives are also binding, but national authorities may choose the form and method of implementation.

Over the past fifteen years, the EU Commission has opened the telecommunications markets to competition through a series of liberalization directives that gradually abolished the monopoly rights of state-owned telecommunications operators. Public voice telephony services became open to full competition in the majority of EU member states, including Germany and Austria, with effect from January 1, 1998, and had been open to full competition in the United Kingdom before 1998.

Between 1989 and 2001, the European Union adopted a number of directives and recommendations regarding open and efficient access to, and use of, public telecommunications networks and services. These were intended to harmonize technical interfaces, usage conditions, mandatory minimum service standards for all fixed-line users, and a general framework for tariffs throughout the European Union. Specific measures have been adopted in a number of areas including licensing and interconnection. Additional obligations in relation to special network access, interconnection charging, accounting separation and cost accounting, publication and non-discrimination are imposed on operators which are designated by the national regulatory authorities (NRAs) in the telecommunications sector as having significant market power in a telecommunications market.

#### ***The New Regulatory Framework***

At the end of 1999, the EU Commission initiated a review of the European Union telecommunications regulatory framework focusing on the development of competition in the European telecommunications sector and the increasing convergence of media, telecommunications and information technology. In February and July 2002, legislative measures were adopted consisting of a general framework directive and four specific directives regarding (i) access to and interconnection of electronic communications networks, (ii) mandatory minimum service standards for all users (“universal service”) and users’ rights, (iii) authorization and licensing regimes and (iv) telecommunications data protection as well as a decision on a regulatory framework for radio spectrum policy in the European Union. Member states are under an obligation to implement the directives into their domestic law within 15 months of adoption. So far, the directives have been adopted in 8 of 15 member states. All other member states, including Germany, are expected to implement these directives in the course of 2004. See “— Provisions Applicable to Market-Dominant Providers — General.”

The directives of the EU Commission are intended to:

- establish the rights, responsibilities, decision-making powers and procedures of the NRAs and the EU Commission, including an NRA's obligation to submit to the EU Commission and the NRAs of other European Union member states, prior to adoption, proposed regulatory measures relating to market definition and significant market power, and the EU Commission's power to require NRAs to withdraw such proposed measures to the extent the EU Commission considers such measures to form a barrier to the single European market or are incompatible with EU law.
- identify specific policy objectives that NRAs must achieve in carrying out their responsibilities (namely, to promote an open and competitive European market for communications services, to promote the interests of European citizens and to consolidate the European Union's internal market in a converging technological environment).
- provide that operators with significant market power in relevant communications markets can be subject to certain obligations, such as obligations relating to the cost-orientation of prices, transparency, non-discrimination between their own subsidiaries and competitors, accounting separation and mandated access to, and use of, network facilities as set out in the directives on universal service and access. Significant market power is defined on the basis of the concept of dominance as developed in the case law of the European Court of Justice and the Court of First Instance of the European Communities.

A European Union regulation on unbundled access to the local loop entered into force in January 2001. It contains the obligations to provide full unbundled access to the copper paired wire lines and at the same time unbundled access to the high frequency spectrum (line-sharing).

The EU Commission issued a recommendation on relevant product and services markets in February 2003. The recommendation identifies certain markets having characteristics which may justify the imposition of regulatory obligations. The first recommendation concerns retail markets for fixed public telephone service and leased lines and wholesale markets for unbundled local loop, fixed network interconnection, broadband access, mobile termination/access + origination/international roaming and broadcasting transmission services. NRAs are obliged to carry out new market analyses on all communications markets included in the EU Commission's recommendation or that NRAs have decided to include in the scope of sector-specific regulation with the agreement of the EU Commission. The EU Commission will regularly review its recommendation. The preparation of the first review may start at the end of 2004.

Whether the new regulatory framework will increase or decrease our regulatory burden will largely depend on the manner in which the directives are implemented in member states, how the new framework will be applied by the EU Commission and NRAs and how the newly established European Regulators Group (ERG), a body composed of representatives of NRAs, will influence the NRAs' decisions.

In the context of the new regulatory framework, pressure is also rising to regulate wholesale broadband access as the EU Commission has identified "wholesale broadband access" as a separate market. The EU Commission has also stated that "bitstream access," which is considered as one alternative of the wholesale broadband access market, has not been made available to all participants in Germany. The ERG is currently investigating whether a harmonized approach by the NRAs is necessary. In November 2003, the ERG determined that bitstream access is essential to the development of competition in the wholesale broadband access market and that the NRAs should mandate a bitstream access product. The German telecommunications regulator is in the process of reviewing bitstream access, thereby commencing the process of market analysis in the German broadband access market. The findings of the ERG, to be finalized in the second half of 2004, may result in additional pressure on the German telecommunications regulator to adopt further regulation relating to bitstream access and products. Any such actions may have negative effects on our operations and market share in this area.

The new regulatory framework will result in increased co-operation between the EU Commission and the ERG and NRAs, with the EU Commission taking a lead role in determining key regulatory issues, such as market definition and market power analysis. The ERG assists in establishing a joint approach with the EU Commission relating to the application of specific regulatory remedies to operators with significant market power. This will in turn influence NRA decisions on the imposition



of regulatory obligations for specific market failures. The currently discussed joint proposal of the EU Commission and the ERG contains several specific recommendations (e.g., relating to mobile termination rate regulation and wholesale access regulation) that would result in a more rigid regulatory regime.

The new telecommunications data protection directive allows member states to adopt legislative measures concerning traffic data retention where it is proportionate and necessary to, among other things, safeguard national and public security and to prevent and prosecute criminal offences or unauthorized uses of electronic commerce systems. An obligation to retain traffic data could, depending on scope and duration of the retention, result in significant costs for us as a network operator. The proposed amendments to the German Telecommunications Act — as proposed by the Federal Parliament — do not currently contain data retention obligations. However, European Union member states as well as the federal states in Germany are currently discussing whether to adopt legislation on traffic data retention for law enforcement purposes.

In March 2004, the European Parliament and Council reached a compromise agreement on a directive on measures and procedures to ensure the enforcement of intellectual property rights. The proposal contains a number of measures aimed at facilitating the prosecution of copyright infringements in the context of file-sharing of music and video files via peer-to-peer platforms. These measures need to be applied only for breaches committed on a commercial scale, i.e., consumers acting in good faith will be excluded. Although the directive provides for wide-ranging claims against third parties such as ISPs and network operators, no further obligations or liability claims against ISP and network operators were established on the EU level. However regulatory requests to ISP and network operators for data concerning customers who are linked to alleged infringements might increase and cause further costs. The requests for information are, however, constrained as they can only be pursued within a pending court procedure.

The EU Commission has recently launched a consultation concerning the Legal Framework for Payment in the Internal Market. Financial regulation was originally designed to deal with high-value payments, person-to-person transactions and higher risks for consumers. Current EU legislation already provides for regulation of e-money but has been interpreted in many different ways by national financial regulators. The purpose of the EU Commission's consultation is to harmonize the application of the existing framework. Harmonization could lead to an intensified application of financial regulation in countries in which we are active. As a result it, may become necessary for companies in our group to obtain banking or e-money licences. Increased regulation could have a detrimental effect on current business models, such as prepaid mobile services, premium rate services or micropayment systems, as well as potentially also on future business models.

### ***Infringement Proceedings Against Germany***

The EU Commission has launched infringement proceedings against Germany, which can also affect the regulatory situation of Deutsche Telekom.

On October 30, 2000, the EU Commission commenced proceedings against the Federal Republic alleging that the Federal Republic has failed to fully implement the European Union interconnection directive with regard to local carrier selection. The German government required us to offer carrier pre-selection and call-by-call selection for local calls from December 1, 2002. Following a suspension of this obligation for technical reasons by the German telecommunications regulator, Deutsche Telekom has offered call-by-call since April 2003 and local pre-selection since July 2003. The EU Commission has announced that it intends to close the proceedings relating to local carrier selection.

In December 2002, the EU Commission commenced a further proceeding against Germany, claiming that the partial revision of the German Telecommunications Act with regard to carrier selection unduly limits the obligation to offer carrier pre-selection and call-by-call selection for local calls because operators that want to offer local calls on the basis of carrier selection are obliged to connect with the local network operator on a local level. The EU Commission is of the view that a network operator connected at any level of the network should be able to offer carrier selection for local calls. In July 2003, the EU Commission extended its proceedings relating to the imposition of access deficit charges. These proceedings may have a negative impact on the regulatory environment with respect to local competition. Since the proposed amendments to the German Telecommunications Act do not provide for access deficit charges to be levied, we believe that this portion of the proceedings will be closed.



## ***Competition Law***

The European Union competition rules have the force of law in the member states and are therefore applicable to our operations. The main principles of the European Union competition rules are set forth in Articles 81 and 82 of the Treaty of Rome and in the European Merger Regulation.

Article 81(1) of the Treaty of Rome prohibits concerted practices or other agreements between competitors that may affect trade between member states and which restrict, or are intended to restrict, competition within the European Union. Article 82 prohibits any abuse of a market-dominant position within a substantial part of the European Union that may affect trade between member states. The EU Commission enforces these rules in cooperation with the national competition authorities (in Germany, the German Competition Authority). The German Competition Authority may also directly enforce the competition rules of the Treaty of Rome. In addition, the national courts have jurisdiction over alleged violations of European Union competition law.

We periodically receive requests for information from the EU Commission. Through inquiries of this kind, the EU Commission monitors the development of competition in the telecommunications markets in all member states of the European Union. Further investigations and other remedial measures of the EU Commission aimed at promoting competition in the European telecommunications sector may be expected. Other telecommunications providers and we are currently subject to sector-specific inquiries in the fields of local loop unbundling, leased lines and roaming.

The European Merger Regulation (amended effective May 1, 2004) requires that all mergers, acquisitions and joint ventures involving participants meeting certain turnover thresholds be submitted to the EU Commission for review, rather than to the national competition authorities. Under the amended Merger Regulation, concentrations will be prohibited if they significantly impede effective competition in the common market or a substantial part of it, in particular as a result of the creation or strengthening of a dominant position.

On July 11, 2001, the EU Commission issued a press release confirming that EU Commission inspectors and officials from national competition authorities had started carrying out simultaneous inspections at the premises of nine European mobile telephony operators located in the United Kingdom and Germany. Our subsidiaries T-Mobile Deutschland and T-Mobile UK were among the companies inspected. The EU Commission asserted that a European Union-wide sector inquiry had established serious competition concerns regarding pricing practices for mobile roaming services that warranted further investigations, particularly in the United Kingdom and Germany. The EU Commission statement indicated that the inspections in the United Kingdom and Germany were to ascertain whether there is consumer price fixing by mobile operators in both countries. The statement further indicated that the inspections intended to verify whether German operators have illegally fixed the wholesale prices they charge to other operators, and whether these prices are excessive or discriminatory. The EU Commission has been focusing its inquiry on the UK operators, resulting in a number of further requests for information. While the EU Commission has not yet opened formal proceedings against any of the operators, it has alluded that it may do so in the course of 2004. We are cooperating fully in the investigation. If the EU Commission were to establish that any anti-competitive activities have occurred, it could impose fines of up to 10% of prior year group global sales on each company participating in the violation, although we believe that the EU Commission has not as of yet imposed a fine to the maximum extent permissible. In addition, we could be obliged to lower the wholesale prices we charge to other operators. We do not believe that our subsidiaries T-Mobile Deutschland or T-Mobile UK have engaged in anti-competitive activities regarding mobile roaming services. This proceeding, however, if determined adversely, or if it results in other regulatory action relating to mobile roaming services, could have a negative impact on T-Mobile's and our results of operations. Lower wholesale prices to other operators may also result from a market analysis procedure regarding the market position of T-Mobile Deutschland and T-Mobile UK with respect to wholesale international roaming services. For more information, see "— The European Regulatory Framework."

T-Mobile and mmO2 have concluded an agreement concerning UMTS infrastructure sharing and roaming arrangements for their operations in Germany and the United Kingdom. The arrangements have been cleared by the EU Commission in April/July 2003, subject to time limits for roaming in the areas where UMTS licenses require licensees to build out their own network infrastructure. Similar arrangements have been put in place by T-Mobile's T-Mobile Austria and T-Mobile Netherlands

subsidiaries. The arrangement in Austria, which has a limited scope, is currently not subject to notification with the Austrian national competition authority. The arrangement in the Netherlands has been cleared by the Dutch Competition Authority.

In December 2003, T-Mobile formed an alliance of mobile phone operators with Telefonica Moviles, Telecom Italia Mobile and Orange (see “— Description of Business and Divisions — T-Mobile — Integration and Alliances”). The alliance has engaged in a number of cooperation projects between the parties which have been summarized in a notification to the EU Commission. The parties believe that the cooperation does not result in a significant restriction of competition. The EU Commission is currently reviewing the cooperation projects. Should the EU Commission identify significant restrictions of competition, the parties to the alliance may have to alter their cooperation arrangements.

On March 17, 1999, Mannesmann Arcor filed a complaint with the EU Commission against the Federal Republic and against us. The complaint is primarily related to our prices for unbundled access to the local loop, which were set by the German telecommunications regulator, and to our subscriber line prices which are subject to the German price-cap regime. Other competitors jointly filed two further complaints to the EU Commission containing similar allegations. On May 21, 2003, the EU Commission adopted a decision against us for allegedly abusing our dominant position by charging to our competitors and end-users unfair monthly and one-off charges for access to our local network. The EU Commission directed us to end the alleged unfair pricing practices immediately and to refrain from repeating the alleged abusive behavior. In addition, the EU Commission imposed a fine of EUR 12.6 million. To comply with the EU Commission’s decision, we requested that the German telecommunications regulator approve a modification of the price cap regime that would allow us to increase the monthly fee for basic charges for analog access, which request was granted. Additionally, in July 2003, we filed a lawsuit with the Court of First Instance of the European Communities to obtain reversal of the EU Commission’s decision and fine.

## **International Regulation**

### **Regulatory Regime**

We are subject to the regulatory regimes of those countries where we or our subsidiaries or affiliates are offering services and/or operating networks. Regulation in these countries includes, for instance, procedures for granting or renewing licenses to use scarce resources (mainly frequencies), coverage conditions and other conditions contained in licenses, universal service obligations, price approval and product launch procedures, regulation of the terms of interconnection and network access for other network operators, requirements to permit customers to select a different carrier for individual calls or to reselect a different carrier, number portability requirements, regulation relating to potential health effects of mobile communications devices and related regulatory cases. In some countries, the general legal framework and the regulatory framework relating to telecommunications are less well developed than in Germany. This leads to legal and regulatory uncertainty that could have an impact on our operations in those countries. Certain regulations may limit the flexibility of our subsidiaries to respond to market conditions. This is especially true for the mobile sector.

### **Licenses**

To provide services and to operate our network internationally, a network operator license or a service provider’s license, or both, is required from the regulatory authorities in the respective countries in which we are offering services and/or have network operations. The duration of any particular license depends, in part, on the requirements of the respective countries. In some countries, there are no time restrictions, and in others the duration of the license is between 3 and 25 years. Normally, the renewal of a license in Europe and in the United States and Canada will be granted at low cost upon application. We do not anticipate any significant difficulties in renewing our licenses.

In addition, T-Systems co-operates with duly licensed operators and service providers in those countries where T-Systems does not maintain its own operators licenses. In the event that T-Systems has not obtained a required license or otherwise entered into a cooperation arrangement with a licensed operator, T-Systems may be subject to penalties and sanctions, including criminal prosecution, in some countries.

The new regulatory framework of the European Union, which was required to be implemented by July 2003 by European Union member states, but which has not yet been implemented in Germany, is expected to have significant impact on our operations.

## **Eastern Europe**

Central and Eastern European states that are candidates for accession to the European Union by May 1, 2004, are required to implement the new European Union regulatory framework by this date. For further information regarding this new legal regime, see “— The European Union Regulatory Framework — New Regulatory Framework.” We are subject to the laws and regulations of other countries where we or our affiliates have operations. For fixed-line communications, these countries are Slovakia, Hungary, Croatia and Macedonia. Deutsche Telekom’s fixed-line subsidiaries in Central and Eastern Europe are facing strong competition from mobile phone operators and, to a lesser degree, from Voice-over-Internet Protocol operators.

The business impact of increased regulation on Deutsche Telekom’s subsidiaries in Central and Eastern Europe will depend on the way in which national regulatory authorities use their newly acquired powers and on whether competitors take advantage of regulatory decisions in their favor. However, increased pressure on prices and market shares is to be expected.

### ***Slovakia***

Slovakia, an EU accession country, is required to implement the EU’s New Regulatory Framework no later than the date of accession, which is scheduled for May 2004. On December 3, 2003, the Slovak Parliament adopted a new Slovak Telecommunications Act as part of the preparation for EU accession. This new Slovak Telecommunications Act became effective on January 1, 2004. Under the new legislation, the regulatory authority in Slovakia can now impose the full range of remedies provided by EU law, especially those contained in the Access Directive on telecommunications providers with significant market power. Among the remedies available are obligations to disclose information on the terms of interconnection and network access to competitors, to treat competitors in a non-discriminatory manner, to keep separate accounts for activities related to interconnection and network access, to grant competitors network access, and to comply with wholesale and — under certain additional conditions — retail price controls. Furthermore, operators with significant market power may be required to implement carrier selection and carrier pre-selection, which allow end users to choose a provider other than the incumbent to route and bill their calls. However, all of these remedies may only be applied after the national regulatory authority has conducted a market analysis showing that regulatory intervention is justified and proportionate. Given that competition within the fixed network is only beginning in Slovakia, it is likely that Slovak Telecom will be found to have significant market power on a large number of the markets subject to regulation. As a consequence, it is likely that certain obligations to grant network access at regulated terms and conditions will be imposed on the company. Network access obligations are likely to also include, for the first time, access to the unbundled local loop. For interconnection and access to the unbundled local loop, Slovak Telecom will have to submit reference offers, which are currently being prepared. In this manner, the new Slovak Telecommunications Act facilitates market entries of alternative carriers. In the event of increased competition, Slovak Telecom is likely to lose market shares in at least some segments of the markets in which the company is operating. That fixed line competition is about to start is underlined by the fact that several competitive carriers are currently negotiating interconnection agreements with Slovak Telecom.

### ***Hungary***

Hungary, also an EU accession country, is required to implement the EU’s new regulatory framework no later than the date of its accession, which is scheduled for May 1, 2004. On November 24, 2003 the Hungarian Parliament adopted a new Hungarian Telecommunications Act, most of which became effective on January 1, 2004. Under the new legislation, the Hungarian regulatory authority can impose the full range of remedies provided by EU law, especially those contained in the Access Directive on telecommunications providers with significant market power. Among the remedies available are obligations to disclose information on the terms of interconnection and network access to competitors, to treat competitors in a non-discriminatory manner, to keep separate accounts for activities related to interconnection and network access, to grant competitors network access, and to comply with wholesale and — under certain additional conditions — retail price controls. Furthermore, operators with significant market power may be required to implement carrier selection and carrier pre-selection, which allow end users to choose a provider other than the incumbent to route and bill their calls. However, all of these remedies may only be applied after the national regulatory authority has conducted a market analysis showing that regulatory intervention is justified

and proportionate. In addition to the aforementioned remedies, the Hungarian regulatory authority is empowered to check whether the relationship between Matáv's wholesale and retail prices constitutes a "price squeeze" for competitors. If a price squeeze were found to exist, the company would have to change its prices correspondingly, and could be fined for its past behavior.

Although some competition within the fixed network has existed in Hungary for several years now, Matáv still possesses substantial market shares in many telecommunications markets. Therefore, it is likely that Matáv will be found to have significant market power on a large number of the markets subject to regulation. As a consequence, it is likely that regulatory obligations, especially regarding network access at regulated terms and conditions, will be imposed on the company. In this manner, the new Hungarian Telecommunications Act facilitates market entries of alternative carriers. In the event of increased competition, Matáv is likely to lose market shares in at least some segments of the markets in which it is operating. However, many of the regulatory instruments provided by the new Act are not new. Already under the Hungarian Telecommunications Act of 2001, Matáv was required, for example, to grant access to the unbundled local loop and has concluded a number of interconnection agreements with competitors. To this end, the company was and is under an obligation to submit reference offers, which are subject to regulatory approval.

### ***Croatia***

Croatia has officially submitted an application to join the European Union, but is not yet scheduled for accession. A new Croatian Telecommunications Act was adopted on August 1, 2003. It confers new powers on the regulatory authority, bringing the country's legal framework roughly in line with the pre-2002 regulatory framework of the European Community.

The scope of these new powers is somewhat less far-reaching than in Hungary and Slovakia. The new Croatian Telecommunications Act does not allow the regulatory authority to impose unbundling of the local loop, carrier pre-selection, and number portability before January 1, 2005. However, the authority can, among other things, regulate access and connection charges as well as conditions for interconnection, which may have a detrimental impact on revenues especially as competition in the fixed network begins to unfold. Finally, Hrvatski Telecom is negatively affected by provisions of the new Croatian Telecommunications Act that exclude financial compensation for universal service if the obligated provider has a market share of more than 80%, and require telecommunications network operators to carry out wiretapping requests without getting their costs reimbursed.

### ***Macedonia***

Macedonia is not a candidate for EU accession at the present time. A new Macedonian Telecommunications Act is in preparation, but Makedonski Telekomunikacii still benefits from monopoly rights until January 1, 2005. However, interconnection agreements have already been concluded with mobile phone operators. Moreover, the need to prepare for a competitive environment could require some rebalancing of the company's retail prices.

## **International Mobile Regulation**

### **USA: T-Mobile USA**

Our telecommunications systems and operations in the United States are regulated by the FCC pursuant to the Communications Act of 1934 (the "U.S. Communications Act") and the Telecommunications Act of 1996 (the "U.S. Telecommunications Act") (collectively, the "Acts") and by various other federal, state and local government bodies. Various other federal, state and local governmental agencies may also exercise jurisdiction over Commercial Mobile Radio Service (CMRS) operators. Any of the aforementioned agencies could adopt regulations or take other actions that could adversely affect our business. If we fail to comply with applicable regulations, we may be subject to sanctions, which may have an adverse effect on our wireless business in the United States. FCC regulations applicable to CMRS operators include, among other things, required service features and capabilities, such as number pooling and portability and emergency 911 service. The FCC does not regulate the rates charged by CMRS operators.

The FCC allocates spectrum licenses for radio frequency spectrum through competitive bidding, or auctions. T-Mobile USA operates exclusively in the PCS frequency bands at 1900 MHz. The FCC



generally allows all qualified applicants to bid on spectrum licenses, with the exception of certain spectrum licenses that are reserved. The FCC divided the United States into 51 Major Trading Areas (MTAs) and 493 Basic Trading Areas (BTAs) for purposes of auctioning PCS spectrum, with the result that six or more CMRS licensees frequently compete against one another in a given market. Spectrum licensees are generally allowed to divide their licenses further, either spectrally (“disaggregation”), geographically (“partitioning”), or both, in private transactions after an auction, subject to certain restrictions.

T-Mobile USA’s ability to expand coverage and provide additional capacity to handle its growing customer base and new service offerings is limited to those markets where we have obtained or can obtain licenses with sufficient spectrum to provide voice, data and other services, or where we economically can become resellers of these services or enter into roaming arrangements with other GSM carriers. T-Mobile USA will continue to seek opportunities where appropriate to acquire additional spectrum licenses, systems and/or operators, or enter into joint ventures, which will add to our current footprint or increase our spectrum capacity. The FCC periodically makes additional spectrum available via competitive bidding, and has specifically identified 90 MHz of spectrum in the 1.7 GHz/2.1 GHz range for “advanced wireless services,” including third generation wireless services, that it intends to auction.

Spectrum licensees are also subject to other FCC and other regulatory rules and various recent industry developments that may affect U.S. operations as follows:

- *Renewal and construction requirements of spectrum licenses:* Spectrum licenses have a ten-year term, after which they must be renewed with the FCC. The renewal generally will be granted to a spectrum licensee that has: (1) provided substantial service during its past spectrum license term and (2) substantially complied with applicable FCC rules and policies and the Acts. The FCC also mandates that spectrum licensees construct facilities that provide adequate service to a certain percentage of the population of their spectrum licensed service areas within five, and in some cases, ten years of the initial spectrum license grant.
- *Compliance with antenna structure and other technical requirements:* PCS systems are subject to certain Federal Aviation Administration regulations with respect to location, lighting and construction of transmitter towers and antennas and are subject to regulation under the National Environmental Policy Act and environmental regulations of the FCC. The FCC also mandates various technical parameters, and state or local zoning and land use regulations also apply to wireless systems.
- *Transfers and assignments of spectrum licenses:* Subject to certain exceptions, the FCC’s approval must be obtained prior to assigning or transferring control of a spectrum license. Any acquisition or sale of spectrum licenses may also require prior review by the Federal Trade Commission and the Department of Justice if the transaction is over a certain size, as well as state or local regulatory authorities having jurisdiction.
- *FCC wireless spectrum cap:* Although the FCC eliminated effective January 1, 2003 the restrictions on holding spectrum licenses totaling more than 55 MHz in all markets where there was a significant overlap in a particular geographic area, the FCC indicated that it would engage in a case-by-case review of any anti-competitive effects of spectrum acquisitions to determine whether a particular transaction is in the public interest, balancing the benefits of the transaction against potential harms. It is not clear at this time what specific criteria the FCC will use in reviewing the competitive impacts of spectrum acquisitions.
- *Foreign ownership:* The U.S. Communications Act limits direct foreign ownership in a FCC spectrum license to 20%. The U.S. Communications Act also mandates that no more than 25% of a FCC spectrum licensee’s capital stock may be indirectly owned or voted on by non-United States citizens or their representatives, by a foreign government, or by a foreign corporation, absent an FCC finding that a higher level of foreign ownership is not inconsistent with the public interest. In connection with the VoiceStream and Powertel mergers, the FCC authorized indirect foreign ownership of T-Mobile USA’s licenses in excess of 25%.
- *Enhanced 911:* The FCC has established timetables for making emergency 911 services available by cellular, PCS, and other commercial mobile service providers, including enhanced 911 (“E911”) services that provide the caller’s telephone number, location and other useful information. Fundamentally, such carriers have an ongoing obligation to comply with various



implementation standards and deadlines imposed by the FCC relating to E911. In July 2003, T-Mobile USA entered into a consent decree with the FCC governing the deployment and provision of E-911 Phase II services, and the FCC required as part of the decree that T-Mobile USA make a voluntary contribution in the amount of USD 1.1 million to the U.S. Treasury. The consent decree contains a number of equipment deployment activation benchmarks commencing in 2004 and stretching into 2005. Failure to meet the benchmarks contained in the consent decree could result in initiation of additional enforcement actions against T-Mobile USA, including significant monetary fines.

- *Local Exchange Carrier (LEC)/CMRS interconnection:* FCC rules require LECs to provide CMRS carriers interconnection within a reasonable time after it is requested, unless such interconnection is not technically feasible or not economically reasonable. Interconnection allows the completion of calls between wireless and wireline phones. CMRS providers are entitled to reciprocal compensation arrangements with LECs, in which CMRS providers can collect the same charges for terminating wireline-to-wireless traffic on their systems that the LECs charge for terminating wireless-to-wireline calls, or are entitled to the Internet Service Provider (“ISP”) rate, whichever is lower, and prohibits LECs from charging CMRS providers for terminating LEC-originated traffic in its local area. The FCC is currently re-examining all of its currently regulated forms of intercarrier compensation, including the existing reciprocal compensation mechanism for LEC-CMRS interconnection, which may result in substantial modification of its interconnection rules, and may materially affect our U.S. operations. The impact of such modifications cannot be determined until the FCC issues its decision in this proceeding.
- *Universal service:* The goal of universal service is to ensure the provision of basic and enhanced telecommunications services to all areas in the United States, including high-cost and low-income areas. Wireless service providers are eligible to receive universal service subsidies, but are also required in a number of states to contribute to universal service funds. At this time, all 50 states have created universal service programs covering, at a minimum, services for deaf or disabled customers. Contributions are based on a percentage of interstate and international end-user revenues as determined on a quarterly basis by the FCC.
- *Wireless local number portability/Numbering resources:* CMRS carriers are required under FCC rules to provide wireless local number portability (“LNP”), which enables customers to migrate their landline telephone numbers to a CMRS carrier and vice versa, and to migrate their CMRS telephone numbers from one CMRS carrier to another CMRS carrier. CMRS carriers were required to implement LNP in the top 100 Metropolitan Service Areas (MSAs) by November 24, 2003. We have incurred substantial costs in complying with this requirement, and it is too early to ascertain what the long-term impact on our business will be of the increased ability of customers to change their wireless service providers. Regulators have closely monitored the initial deployment of wireless portability and operators’ compliance with the LNP rules, and such scrutiny will continue throughout 2004.
- *CALEA:* The Communications Assistance for Law Enforcement Act (“CALEA”) requires telecommunications carriers to ensure that their facilities are technically capable of assisting law enforcement officials’ use of wiretaps and like devices to intercept or isolate customer communications. All CMRS carriers must comply with CALEA. In addition, T-Mobile is subject to an agreement with the Federal Bureau of Investigation and Department of Justice, which imposes on us certain operational and other requirements designed to ensure that we can effectively respond to, and implement, such wiretap and other information requests by law enforcement agencies.
- *Regulation on the state and local level:* Some states, through their public service or utility commissions, or through other means, have taken, or are seeking to take actions to regulate various aspects of wireless operations, including customer billing, termination of service arrangements, advertising, the filing of “informational” tariffs and certification of operations. For example, the California Public Utilities Commission (“PUC”) has proposed extensive consumer protection and privacy regulations for all telecommunications carriers. If adopted, the rules will significantly alter T-Mobile USA’s business practices in California with respect to nearly every aspect of the carrier-customer relationship, including solicitations, marketing, activations, billing and customer care. The California PUC is also contemplating rules to address other service quality issues, including service repair, service outages and toll operator

answering time that could apply to CMRS providers. Such regulations, if approved, could expose carriers to increased risk of litigation and may materially impact operating costs. At the local level, wireless facilities typically are also subject to zoning and land use regulation, and may be subject to fees for use of public rights-of-way.

- *Mobile termination rates:* On March 11, 2004, the FCC announced that it would initiate a Notice of Inquiry (“NOI”) later this year to evaluate the effect of high foreign mobile termination rates on U.S. consumers and competition. Mobile termination rates are the charges a mobile operator charges for completing calls originating on another carrier’s network. It is still too early to determine whether this proceeding will ultimately result in any material change to termination rates outside the United States including those charged by Deutsche Telekom.

## **United Kingdom: T-Mobile UK**

### ***Legal Framework***

The principal legislation governing mobile telecommunications networks and services in the United Kingdom is the Communications Act 2003 (the “CA”) and the Wireless Telegraphy Acts 1949-1998, as amended by the Communications Act (“WTA”). Under these Acts, regulation of the telecommunications industry was, until December 29, 2003, conducted by the Secretary of State for Trade and Industry together with Oftel and the Radio Communications Agency, and since December 29, 2003, has been conducted by the Office of Communications (Ofcom), with a much reduced role for the U.K. Secretary of State.

Under the CA, implementing the new EU regulatory framework, Oftel undertook a market review of mobile access and call origination and has concluded in its submission to the EU Commission on August 4, 2003 that no supplier has significant market power, either individually or in combination with one or more other suppliers. The findings of the market review were provided to the EU Commission on August 4, 2003 and subsequently accepted by the EU Commission. The final results of the market review on call termination were provided to the EU Commission in December 2003. A further market review conducted by Oftel on wholesale termination is described below.

### ***Licensing and Frequency Allocation***

T-Mobile UK holds a WTA license to operate digital telecommunications systems for frequencies in the 1800 MHz band. Following an auction, T-Mobile UK was awarded a UMTS license allocating frequency packages of 2 x 10 MHz paired spectrum and 5MHz unpaired spectrum.

### ***WTA GSM License***

T-Mobile UK GSM license will remain in force until T-Mobile UK surrenders it, and is subject to variation or revocation on one year’s notice by the U.K. Secretary of State in the event of failure to pay license fees, in the interests of national security, to comply with EU obligations, for breach of the license terms or for reasons relating to the management of the radio spectrum. T-Mobile UK is also licensed under the WTA to run microwave links.

T-Mobile UK’s WTA licenses specify the performance and technical requirements with which it must comply. The Secretary of State may restrict the operations of mobile telegraphy stations or may close stations temporarily or permanently if T-Mobile UK breaches the WTA license conditions. T-Mobile UK may also be required to modify or restrict its use of, or permanently close down, radio equipment if a state of emergency is declared or in the interests of long-term spectrum planning.

WTA licences are not currently transferable although Ofcom is currently consulting on the introduction of spectrum trading. The current proposals are that spectrum trading would be introduced for GSM and UMTS licences in 2007.

T-Mobile UKs most recent annual license fee for GSM spectrum was GBP £16.6 million. T-Mobile UKs most recent annual license fee for microwave links was GBP £3.5 million. Ofcom is expected to consult on proposals to revise fees in 2004; this could result in increased fees.

### ***WTA UMTS License***

T-Mobile’s UMTS license was one of five licenses issued following the UMTS auction in the UK. T-Mobile’s license was issued on May 9, 2000 and will remain in force until December 31, 2021, unless

it is revoked by the Secretary of State or surrendered earlier. The UMTS license may be revoked in similar circumstances to the WTA GSM license but also due to material breach of the UK UMTS auction rules or if the UMTS network does not cover 80% of the UK population by the end of 2007. It cannot be revoked for reasons relating to the management of radio spectrum.

T-Mobile UK does not have any obligations to provide national roaming to third parties. However, Oftel in 2003 undertook a consultation on proposals to require T-Mobile and other operators to offer national roaming if requested by 3. All UK GSM licensees objected to this proposal and it is unclear if Ofcom will proceed with this consultation.

### ***Interconnection and Price Regulation***

Oftel published the results of its EU market review of call termination on December 19, 2003. The period for public comment expired on February 6, 2004. Ofcom is expected to publish its final proposals soon. Under the December 2003 proposals, T-Mobile UK would be required to reduce its termination rates as follows:

For the year April 1, 2004 to March 31, 2005, the average termination rates should be at or below 6.38 pence per minute; and

For the year April 1, 2005 to March 31, 2006, the average termination rates should be below 6.38 pence per minute less RPI (U.K. retail price index) minus 11 percentage points (around 5.8 pence per minute).

In addition, the Director General of Telecommunications proposed imposing conditions requiring the provision of network access for GSM call termination, no undue discrimination in the provision of such access, a requirement to provide Ofcom with copies of new or amended access agreements and prior notification of price changes.

### ***UK Competition Law***

The Competition Act 1998 became effective on March 1, 2000 and the Enterprise Act 2002 became effective on June 20, 2003. The U.K. Office of Fair Trading and other sector-specific regulators, including Ofcom, are responsible for applying and enforcing both Acts. The Competition Act prohibits agreements between undertakings or decisions by associations of undertakings or concerted practices that have the effect of preventing or distorting competition in the United Kingdom, and also prohibits conduct that amounts to abuse of a dominant position in a market in the United Kingdom. The Enterprise Act prohibits cartels and creates criminal offenses for breach of provisions of the Act, including for directors and other officers involved in prohibited conduct. T-Mobile UK has implemented a Competition Act Compliance, Program which includes procedures to review agreements and conduct to ensure that they are lawful.

Both the Enterprise Act and the Competition Act give Ofcom and the Office of Fair Trading concurrent jurisdiction to apply and enforce the Acts in the telecommunications sector. Ofcom is, among other things, empowered to carry out investigations into suspected breaches, including requiring the production of documents and information and searching premises. The Competition Act also enables affected third parties to bring enforcement actions directly against telecommunications operators who are in breach of the Act's prohibitions in the UK courts and seek damages.

### **The Netherlands: T-Mobile Netherlands**

#### ***Regulatory Framework***

Regulatory supervision of the Dutch Telecommunications Act (1998) is mainly carried out by the Independent Post and Telecommunications Authority ("OPTA"). The Dutch Telecommunications Act is based on the European Open Network Directives from the European Union. The Dutch Ministry of Economic Affairs is now in the process of implementing the new EU regulatory framework for electronic communications by amending the Dutch Telecommunications Act. The new framework is expected to become effective by the beginning of the second quarter of 2004.

Following the new regulatory framework, OPTA will have to analyze several markets within the mobile telecommunications market, which could have negative consequences for T-Mobile Netherlands' business. For example, the analysis of the market for wholesale voice call termination may lead to regulation of T-Mobile Netherlands' mobile termination tariffs by OPTA.

### ***Licensing and frequency allocation***

In 1998, national and regional licenses were awarded for the commercial use of frequencies on the basis of the GSM standard (DCS 1800 MHz). T-Mobile Netherlands has acquired six of these regional licences, which together allow for nationwide coverage. These licenses will expire in 2013. There are four additional national GSM licenses assigned to other mobile operators in the Netherlands.

In 2000, T-Mobile Netherlands was granted one of five national UMTS licenses, which license will expire in 2016. Coverage is required to reach all cities with more than 25,000 inhabitants as well as all major highways by January 1, 2007.

Since the granting of T-Mobile Netherlands' UMTS license, Versatel (a fixed-line operator that has entered the mobile market in March 2004 as a service provider on the Telfort network) has been trying to have the results of the auction annulled. In 2002, Versatel appealed a decision by the Rotterdam court upholding the grant of the license to T-Mobile Netherlands. The case is now pending before the Trade and Industry Appeals Board, where we have submitted our view as an interested third party. We expect a final decision in the second quarter of this year.

The Ministry of Economic Affairs has indicated that it is considering a change to the Dutch Telecommunications Act, in order to facilitate the desires of several parties regarding broader possibilities to trade, transfer and combine all or a portion of frequency lots. We expect the Ministry to present proposals during 2004.

### ***Interconnection***

Since December 2001, in response to complaints by fixed-line operators, both the Dutch telecommunications regulator OPTA as well as the Dutch competition authority have been investigating mobile call termination tariffs with respect to suspected excessive pricing. OPTA issued rules on March 28, 2002, indicating the levels at which OPTA was intending to regulate the mobile call termination tariffs. This led to a number of legal proceedings which, in April 2003, resulted in the suspension by the Court of Rotterdam of OPTA's intervention. The Court ruled that OPTA was not authorized to regulate indirect interconnection relationships. OPTA appealed this decision before the Trade and Industry Appeals Board, which appeal is still pending.

In August 2002, the Dutch competition authority determined that call termination on each mobile network is a separate market, leaving further regulatory interventions to the jurisdiction of OPTA. As of April 2003, after suspension of OPTA's intervention by the Court of Rotterdam, the Dutch competition authority reopened the investigation into call termination practices and required detailed information on costs from the mobile operators. Indications by the Dutch competition authority that it would issue a report on excessive pricing coming out against the mobile operators resulted in an agreement between the mobile operators in which they voluntarily agreed to regulate call termination tariffs from January 1, 2004 to December 1, 2006. Under this agreement the Dutch mobile operators may not exceed flat rate/minute tariffs in accordance with a specific schedule.

As a result of these voluntary decreases, the Dutch competition authority has formally ceased its investigation into suspected excessive pricing. OPTA has decided to adhere to the voluntarily set tariffs until December 1, 2005, and has adopted the voluntary tariffs in its own policy recommendations. After December 1, 2005, on the basis of the New Regulatory Framework, OPTA may impose further decreases based on market analysis. Other fixed operators may try to challenge this voluntary decrease and continue to request lower tariffs retroactively and in the future.

### ***Access***

On December 1, 2001 T-Mobile Netherlands was required by OPTA to negotiate an interconnection agreement with Yarosa (a SMS service provider), both for providing originating access and terminating access services. Measures against this decision (various legal proceedings against OPTA's decisions) are pending or currently being prepared. If Yarosa is ultimately successful, this would give SMS services providers a "carrier preselect" status on the T-Mobile Netherlands network and create a precedent for other services providers to demand origination or termination services thereby having a material adverse affect on the business of T-Mobile Netherlands due to increased competition and possibly lower wholesale tariffs.

### ***Competition Law***

The Dutch Competition Act became effective January 1, 1998 and simultaneously the Netherlands Competition Authority (NMa) was created. The Dutch Competition Act is based on and



closely linked to European competition law. The Act is based on a system very similar to that of Articles 81 and 82 of the EC Treaty. The Dutch Competition Act also includes a system of preventive concentration control, which is very similar to the EC Merger Regulation.

According to Article 6 of the Dutch Competition Act, agreements, decisions and concerted practices are prohibited if they have as their objective or effect the prevention, restriction or distortion of competition. According to Article 24 of the Dutch Competition Act undertakings are prohibited from abusing a dominant position. The criteria of Article 82 of the Treaty of Rome apply.

As part of the enforcement of the Dutch Competition Act, the Netherlands Competition Authority can impose fines which may not exceed the higher of Euro 450,000 or 10% of the undertaking's turnover, which makes Dutch competition law consistent with European competition law. In addition to the imposition of administrative fines, the Netherlands Competition Authority is authorized to impose interim measures and sanctions that are designed to ameliorate a violation.

According to a decision by the Netherlands Competition Authority on December 30, 2002, T-Mobile Netherlands will be fined EUR 15.2 million for alleged involvement in an anti-competitive scheme regarding dealer commissions carried out together with the four other Dutch mobile phone operators. T-Mobile Netherlands and other affected companies have filed an appeal relating to the decision of the Netherlands Competition Authority on a variety of grounds. T-Mobile Netherlands and other affected companies believe that, even if the findings of the Netherlands Competition Authority are upheld, the fines imposed with respect to the alleged violation are disproportionate.

### **Czech Republic: T-Mobile Czech Republic**

#### ***Legal Framework***

The legal framework for telecommunications is set by the Telecommunications Act No. 151/2000 which introduced full liberalization of the telecommunications sector in the Czech Republic on January 1, 2001. Regulatory supervision is carried out by the independent Czech Telecommunication Office ("CTO"). The Chairman of the CTO is appointed and dismissed by the Government at the recommendation of the Minister of Informatics. The CTO is a two-tier administrative body (first tier consisting of department Directors of the CTO, whose decisions can be reversed or amended by the Chairman as the second tier). The decisions of the CTO can be challenged in Court (with the exception of price regulation decisions, which are issued by the Chairman and are final).

The Czech Republic is obliged to implement the new EU regulatory framework for electronic communications by May 1, 2004 (day of accession to the European Union). The Ministry of Informatics has been preparing a draft bill but its implementation will most likely be delayed. Once the new framework is implemented, the CTO will start market analysis procedures on the three mobile markets included in the recommendation on relevant product and services markets. See "— The European Union Regulatory Framework."

#### ***Licensing and Frequency Allocation***

Frequencies and numbers are to be allocated upon request on a non-discriminatory basis. There is a one-off allocation fee and further usage fees paid to the CTO. The CTO can refuse frequency allocation if there are more requests than available number of frequencies. In that case, an auction or a beauty contest must be held. Frequency and number allocations are non-transferable and there is no secondary market for allocations. T-Mobile Czech Republic holds allocation of frequencies in the 900 and 1800 MHz band and based on an auction was awarded a UMTS license for 2x19.8 MHz FDD + 5 MHz TDD of spectrum and a part of the 28 GHz band. UMTS services must be launched by January 1, 2006, covering at least 90 % of the city of Prague.

T-Mobile Czech Republic is a holder of the following individual licenses:

- Establishment and operation of public GSM telecommunications network
- Establishment and operation of public UMTS telecommunications network
- Provision of public telephone service via a public fixed telecommunications network
- Provision of public telephone service via a public mobile telecommunications network

#### ***Significant Market Power Designations***

Operators designed as having a significant market power on a relevant market are subject to specific regulation:



- Provision of universal service (only fixed network SMP),
- Obligation to allow access to the network.

In the Czech Republic, T-Mobile Czech Republic is considered to have significant market power by the CTO relating to the market for the operation of a public mobile telephony network and the provision of public telephony service via public mobile telephony network. This designation obliges T-Mobile Czech Republic to agree on access to its network for all authorized service providers. There is no authorization/license for “non-infrastructure” mobile telephony providers. As a result, virtual mobile network operators cannot be introduced through this obligation.

### ***Interconnection***

All individually licensed network operators are obliged to interconnect upon request. If the requested operator refuses to interconnect (or to extend services included in interconnection agreement) or the negotiations take more than 90 days, the CTO will make a decision on interconnection which is binding for both interconnection parties. The majority of interconnection services are price regulated by the CTO (even when the interconnection was agreed to without any intervention of the CTO). Fixed-mobile interconnection is regulated in the same way as fixed-fixed interconnection. See below under “— Price Regulation.” T-Mobile Czech Republic has signed interconnection agreements and currently has interconnection in place with the other two mobile network operators and with all major fixed network operators.

### ***Price Regulation***

Price regulation can be imposed on interconnection prices, prices of the services within the universal service obligation and, in case of abuse of dominant position, on any price that is anticompetitive. There is no specific price regulation approach defined by the Act, but the CTO determined that interconnection prices must be based on cost — either long run incremental costing methodology or fully allocated historical cost approach.

Termination and origination charges for fixed networks are currently set upon long term incremental costs, whereas termination and origination charges for mobile networks are currently based upon fully allocated historical costs. In March 2004, CTO has lowered mobile termination charges by 13% as compared to the price level determined in November 2001 based upon fully allocated historical costs. Further price decreases could be the result of the implementation of the EU regulatory framework in the Czech Republic which is not expected until 2005.

### ***Competition Law***

The competition law framework in the Czech Republic is defined by the Act on Protection of Economic Competition No. 143/2001. This Act focuses on the protection of economic competition, restrictive or other practices endangering economic competition by: (1) agreements between competing companies, (2) abuse of a dominant position by competing undertakings, or (3) concentrations of competing companies. The Act prohibits the conclusion of agreements between competing undertakings leading to, or which may lead to, the distortion of economic competition. This Act also prohibits abuse of a dominant position by competing companies. The protection of economic competition falls within the competence of the Antimonopoly Office. The Antimonopoly Office is entitled, in particular, to impose sanctions for the breach of obligations under the Act. The penalty may amount to as much as 10% of the net turnover of the breaching entity.

The issue of the protection of economic competition is also included in the Act on Prices No. 526/1990 Coll. This Act stipulates that price regulation may be applied only in cases in which the market is threatened by the effects of restriction of economic competition or if an extraordinary market situation requires such regulation. If the defined conditions are met, prices are most often regulated in the form of an issued price decision which stipulates the maximum price. In the Czech Republic, the prices for interconnection are frequently regulated.

### ***Austria: T-Mobile Austria***

#### ***Legal Framework***

On August 20, 2003, the EU New Regulatory Framework was implemented in Austria through the new Austrian Telecommunications Act. Regulatory supervision is carried out by a regulatory authority that consists of the *Telekom-Control-Kommission* (TCK) and the *Rundfunk und Telekom Regulierungs-GmbH* (RTR).

On October 20, 2003, the regulatory authority commenced investigations into the following mobile markets:

- mobile access and call origination in public mobile networks (wholesale markets)
- call termination in individual public mobile networks (wholesale markets)

Depending on the outcome of these investigations, the regulatory authority may impose remedies against operators with significant market power. See “— The European Regulatory Framework — The New Regulatory Framework.”

#### ***Mobile Number Portability***

The new Austrian Telecommunications Act required implementation of mobile number portability in Austria. The experience in other European countries shows that number portability had no significant effect on churn.

#### ***Allocation of Frequencies***

Due to the new Austrian Telecommunications Act, frequency trading is permitted in Austria, including for GSM and UMTS frequencies. This may make it easier for T-Mobile Austria or its competitors to acquire additional frequencies.

#### ***Licensing and Frequency Allocation***

T-Mobile Austria holds GSM frequencies in the 900 and 1800 MHz bandwidth as well as UMTS frequencies. In accordance with the license conditions, T-Mobile Austria took up UMTS commercial service in December 2003. T-Mobile Austria's population coverage obligations under the license is 25% by December 31, 2003 (which has been achieved) and 50% by December 31, 2005.

#### ***Price Regulation and Interconnection***

Price regulation may be applied to wholesale and retail prices. Currently there is no price regulation for retail prices in the Austrian mobile market. In terms of wholesale prices, the regulatory authority regulated T-Mobile Austria's call termination prices until September 30, 2003. As of October 1, 2003, T-Mobile Austria signed bilateral agreements with the main mobile and fixed operators. Further regulatory measures relating to termination prices may be the result of either applications before the regulatory authority by other operators or the market analysis procedure.

#### **Other International Matters**

Over 70 member countries of the World Trade Organization, including European Union member states and the United States, have entered into the Basic Telecommunications Agreement (BTA), to provide market access to some or all of their basic telecommunications services. This agreement took effect on February 5, 1998. The BTA is part of the General Agreement on Trade in Services, which is administered by the World Trade Organization. Under the BTA, signatories have made commitments to provide market access. Under such commitments, they are to refrain from imposing certain quotas or other quantitative restrictions in specified telecommunications services sectors, and to treat foreign telecommunications service suppliers no differently than national service suppliers. In addition, a number of signatories have agreed to the pro-competitive principles set forth in a reference paper relating to anti-competitive behavior, interconnection, universal service, transparency of licensing criteria, independence of the regulator and scarce resources.

In complaints filed by U.S. associations in January 2004, the U.S. Trade Representative (USTR) has been asked to determine whether certain aspects of the telecommunications regulatory situation in Germany comply with Germany's obligations under the BTA. The criticism involved relates to, among other things, long provisioning times for leased lines, excessive and discriminatory fixed-to-mobile termination rates, and no regulated bitstream access offer. Concerning the proposed amendments to the German Telecommunications Act, the criticism is related, inter alia, to the “functional competition” and “double dominance” tests and the lack of an independent regulator. The USTR probably will publish its 2004 annual report in April 2004.

In April 2004, the OECD is expected to publish a report about regulatory reforms in Germany that investigates, among other sectors, the telecommunications sector. It can be expected that the

OECD will be influential as to the development of competition, the market behaviour of Deutsche Telekom and regulatory policy in Germany.

In October 2002, the U.S. Federal Communications Commission (FCC) commenced another review of termination rate policies for international calls. Such policies define how telephone companies offset tariffs charged for terminating calls within their network that originated in a competitor's network. On March 11, 2004, the FCC announced that it will issue a notice of inquiry to evaluate the effect of high foreign mobile termination rates on U.S. consumers and competition.

## **DESCRIPTION OF PROPERTY, PLANT AND EQUIPMENT**

### **Network Infrastructure**

We have made substantial investments in our telecommunications and cable networks since 1990, including the installation of a new network in the former East Germany. As a result, our fixed-line network in Germany is one of the most technologically advanced networks in the world, with full digital switching and nearly 100% digital transmission. We have introduced asynchronous transfer mode (ATM) technology and wavelength division multiplexing (WDM) technology on the basis of our advanced network. These advanced technologies provide much faster voice and data transmissions.

As of December 31, 2002, our domestic fixed-line telephone network and ISDN network in Germany consisted of approximately 5,200 local networks (including approximately 8,000 local exchange areas) connected by a long-distance transmission network. As of December 31, 2002, the transmission network linking our German local networks consisted of approximately 173,000 kilometers of fiber optic cable. The transport network is based on the WDM and SDH (Synchronous Digital Hierarchy) backbone. In the fall of 2002, the 10,000th network element for SDH was connected to the Deutsche Telekom network. SDH is the transport platform of our T-Com division upon which practically all digital communications (from leased lines through the Internet to traditional telephone traffic) are based. SDH provides nearly 100% availability to the network.

For more information about our network infrastructure, see “— Description of Business and Divisions — T-Com.”

In 1998, T-Systems' Global Network Factory commenced the development, building and operation of telecommunications networks outside Germany, including its own 2.5Gb SDH-network to major European cities. These international networks have partially migrated onto fiber optic and WDM systems. These newer networks include leased wavelengths up to multiples of 10GB leased capacity (e.g. leased lines from providers other than Deutsche Telekom), with state of the art SDH, Sonet, IP, MPLS and ATM Frame Relay, as well as digital Voice and VoIP, platforms.

### **Cable and Satellite Transmission Infrastructure**

T-Systems' international transmission infrastructure consists of both cable (underground and submarine cables) and satellite transmission systems, which, as of December 31, 2003, link its German national network directly to approximately 900 other telecommunications service providers worldwide. T-Systems owns substantially all of the technical equipment, such as switches and routers, for this transmission network.

As of December 31, 2003, T-Systems held interests in approximately 80 fiber-optic submarine and terrestrial cable networks worldwide. Restoration contracts with other cable operators and telecommunications carriers are entered into to prevent network failures from affecting the company's network availability. T-Systems' German domestic telecommunications network is connected to submarine cables via five cable landing points, the largest being in the city of Norden, Germany. T-Systems also operates and maintains for third parties the submarine cables in German landing stations.

T-Systems operates two large satellite earth stations in Usingen and Raisting (both situated in Germany), which are connected directly to the company's German telecommunications network. The station in Usingen is mainly used for media and broadcast services and the station in Raisting is mainly used as a gateway for international telecommunications services (voice, data and IP).

In 2002, T-Systems finalized the extension of our wholly-owned terrestrial network in major European countries as well as in the Americas and in Asia. This network is mainly a so-called

international backbone and has a ring structure that ensures high performance and connectivity throughout the network. It consists of both purchased and leased network capacities and of technical equipment that is installed at various points of presence locations (“PoP,” a space or room in a building where technical equipment is stored and maintained). T-Systems is the primary owner of the technical equipment (fixed assets). The worldwide total leased space housing the technical equipment within all of the PoPs amounts to approximately 3,630 square meters. As of December 31, 2003, T-Systems was a party to an aggregate of approximately 570 PoPs (owned or leased), including 149 PoPs of the Telekom Global Net. These PoPs are situated in 52 countries worldwide (including Germany), of which 33 countries are located in Europe, 12 countries in Asia, and 5 countries in the Americas, Australia and South Africa. Over this network, voice, data and IP services are provided for domestic customers, large national and international corporations, and other telecommunications carriers.

Currently, T-Systems does not have plans to extend its existing international transmission facilities or network to anticipate future growth that has not yet materialized. T-Systems expects that if the coverage of the network needs to be extended to accommodate new customers, this will be done either by partnering (network to network interface with other major carriers) or by actual customer demand-driven expansion of the network.

T-Systems leased some parts of our international network backbone from Global Crossing which had filed for Chapter 11 bankruptcy protection in the United States. Global Crossing has since emerged from bankruptcy protection. Due to the availability of sufficient cable capacity for the rerouting of network traffic, we do not anticipate that the loss of parts of our international network backbone as a result of prior or future bankruptcies of network operators would result in disruptions for our customers. However, securing such alternative capacity may result in increased costs for T-Systems.

**Internet Platforms**

The number of broadband users (cable and DSL) in Germany has increased from 638,000 in 2000 to 4,000,000 in 2003. To serve broadband users, T-Systems has employed extensive switching differentiated services in the global IP network that provide Internet solutions incorporating Internet platforms throughout Germany with high-capacity bandwidth connections into Western and Eastern Europe and North America, as well as certain high-capacity connections into Asia. T-Systems has a network presence in major North American cities such as New York, Washington, San Francisco, Los Angeles, Miami and Toronto. A further milestone has been reached for T-Systems’ business customers with the deployment of MPLS (multi-protocol label of service principles). MPLS allows different applications (e.g. e-mail, file transfer) to be assigned priorities to maximize performance over shared network resources. T-Systems MPLS backbone carries 32 petabytes of IP traffic per month. A petabyte is a unit of measurement for physical data storage (32 petabytes = 32 billion megabytes).

To allow the free exchange of Internet traffic with other IP networks, T-Systems negotiated interconnection agreements with other carriers operating IP networks of similar size, scope and reach. T-Systems has settlement free peering agreements with approximately 60 major IP carriers around the world and has established a total peering capacity of 100+ Gbps (gigabytes per second). A peering agreement is an agreement to directly interconnect to another carrier’s network and thus carry each others traffic. The following table sets forth our peering capacity in the regions and for the periods indicated:

<u>Year</u>	<u>Peering Capacity (Gbps) US/ Europe</u>
2001 (since 06/2001).....	2,488/14,768
2002.....	44,966/52,873
2003.....	45,213/64,746

T-Online does not own any network infrastructure assets. Instead, T-Online uses T-Com’s Internet platform to provide its customers with access to the Internet. T-Online International AG supports its portal and value added services as well as all customer care functions with its servers that are hosted in its own data processing centers operated by T-Systems. The servers are dual-connected to the Internet backbone load-balanced leased line connections, which enables several servers to support one service. T-Online employs high levels of security, including firewalls to protect against unauthorized access to its computer systems. The servers employ load-balancing systems to manage users’ requests, which enables T-Online’s systems to respond to user requests in an effective manner.

## **Global Computing Factory (GCF)**

GCF possesses the server equipment, software tools and expertise employed in the operation of the computer network infrastructure described above. As of December 31, 2003, the GCF's global mainframe systems performance had combined total computing power of 113,723 millions of instructions per second (MIPS).

The mainframe computing power in Germany, Austria and Switzerland (approximately 81% of T-Systems' total worldwide computing power) is based on a leasing contract with IBM. T-Systems only purchases the computing capacity actually required following a flexible demand-driven business agreement.

The mainframe systems are located in Germany, Italy, Switzerland, South Africa, Austria, France, Brazil, Spain and the United Kingdom.

As of December 31, 2003, a total of 28,399 servers (most of which are not leased) were operated worldwide in the following countries: Germany, Italy, Switzerland, Austria, Spain, Czech Republic, the United States, South Africa, France, Denmark, Brazil, Hungary, Turkey, Singapore, Benelux, Australia, the United Kingdom, Philippines, Russia and Poland.

## **Mobile Network Infrastructure**

At December 31, 2002, the mobile communications network of Deutsche Telekom's controlled mobile subsidiaries in Germany, the United States, the United Kingdom, Austria, the Czech Republic and the Netherlands consisted of approximately 50,000 base station cells.

## **Real Estate**

The German real estate portfolio of Deutsche Telekom is managed and serviced through Sireo, GMG, DeTe Immobilien and DFMG.

The real estate portfolio of our consolidated group had a book value of EUR 10.4 billion at December 31, 2003. Approximately 81% of the book value of the real estate portfolio (EUR 8.4 billion) of the Deutsche Telekom group relates to properties held directly by Deutsche Telekom AG (on an unconsolidated basis) and are allocated to the division "GHS." The majority of the remaining book value of real estate in the Deutsche Telekom group is related to the T-Mobile division and Eastern European subsidiaries of the T-Com division. For more information with respect to Deutsche Telekom AG's real estate portfolio, please refer to "Item 5. Operating and Financial Review and Prospects — Segment Analysis — Group Headquarters and Shared Services."

The real estate portfolio of Deutsche Telekom AG consists of approximately 11,000 properties. The total area of land on which these properties are situated amounts to approximately 48.0 million square meters. The total rentable area relating to these properties amounts to approximately 10.3 million square meters. Our rentable area in leased properties adds up to approximately 5.0 million square meters. These do not include the rentable area in technical buildings and facilities managed by DFMG. The majority of these properties are used for telecommunications installations, research centers, service outlets, computer centers and offices.

To improve operational efficiencies, achieve our goal of disposing of non-core assets to support investment in core growth areas, and increase our ability to reduce our debt, we continued our strategy to monetize certain of our real estate assets and to terminate some of our existing leases in 2003. Such monetization may be accomplished by direct sales, through the use of structured transactions, sale-and-lease-back transactions, or through the application of various other financing techniques. The pace and manner of this strategy depends on a number of factors, including, among other things, prevailing market conditions within Germany, and the demand for the types and locations of properties we have available.

In 2003, we entered into agreements for the sale of certain properties for an aggregate of about EUR 553 million. Of the EUR 779 million in proceeds received in 2003, EUR 507 million related to properties transferred in 2003, EUR 272 million related to transactions in 2002 and prior years. The sold properties are located on land with an area of approximately 1.6 million square meters and have 0.5 million square meters of rentable area. We leased back a part of these properties. Although we will incur rent expense related to the leased back properties, we will have a reduction in interest payments and other costs related to the properties sold. For more information with respect to these



transactions, please refer to “Item 5. Operating and Financial Review and Prospects — U.S. GAAP — Reconciling Differences between German GAAP and U.S. GAAP.”

The headquarters of Deutsche Telekom AG are located in a leased building in Bonn, Germany.

Our radio transmission sites in Germany, including towers, masts and rooftops, are owned or leased by our subsidiaries DFMG Deutsche Funkturm GmbH as well as Erste DFMG Deutsche Funkturm Vermoegens — GmbH & Co. KG and Zweite DFMG Deutsche Funkturm Vermoegens GmbH & Co. KG respectively. DFMG manages these radio transmission sites and the related technical infrastructure facilities to provide antenna space for T-Mobile Deutschland, T-Com and T-Systems in Germany. DFMG also offers these services to third party radio network operators. DFMG currently manages and owns approximately 22,000 radio transmission sites. Excluded are radio transmission sites for AM, short and long wave radio transmission owned by T-Systems.

## **ITEM 5. Operating and Financial Review and Prospects**

*You should read the following discussion in conjunction with our annual consolidated financial statements, including the notes to those financial statements, that appear elsewhere in this report. Our financial statements have been prepared in accordance with the requirements of the German Commercial Code (HGB-German GAAP), which differ in certain significant respects from U.S. generally accepted accounting principles (U.S. GAAP). For a discussion of the principal differences between German GAAP and U.S. GAAP as they relate to us and a reconciliation of net income (loss) and total shareholders' equity to U.S. GAAP, see "Reconciling Differences between German GAAP and U.S. GAAP" and notes (41) through (44) to the consolidated financial statements.*

*The strategies and expectations referred to in this discussion are considered forward-looking statements and may be strongly influenced or changed by shifts in market conditions, new initiatives we implement and other factors. We cannot provide assurance that the strategies and expectations referred to in this discussion will come to fruition. Forward-looking statements are based on current plans, estimates and projections, and therefore you should not place too much reliance on them. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement in light of new information or future events. Forward-looking statements involve inherent risks and uncertainties, most of which are difficult to predict and are generally beyond our control. We caution you that a number of important factors could cause actual results or outcomes to differ materially from those expressed in, or implied by, the forward-looking statements. Please refer to "Forward-Looking Statements," "Item 3. Key Information — Risk Factors" and "Item 5. Operating and Financial Review and Prospects — Factors Affecting Our Business" for descriptions of some of the factors relevant to this discussion and other forward-looking statements in this report.*

### **INTRODUCTION**

The 2003 financial year was very satisfactory overall for Deutsche Telekom. Our group achieved one of its most important goals for the year well before year's end. The objectives of the "6 plus 6" debt reduction program launched in the fourth quarter of 2002 was achieved in the third quarter of 2003. The success of our debt reduction efforts was mainly due to strong net cash provided by operating activities, reduced investments, cash inflows from the sale of non-core activities, and exchange rate effects. By the end of the year, we had reduced our debt by EUR 7.6 billion to EUR 55.4 billion.

Our net revenues increased by EUR 2.1 billion year-on-year in 2003 to EUR 55.8 billion. This increase is primarily a result of growth in the T-Mobile, T-Systems, and T-Online divisions. The Group's main growth and revenue driver was once more the T-Mobile division, which recorded a double-digit percentage increase in revenue despite unfavorable exchange rate trends. In addition to the effect of the first full-year consolidation of T-Mobile Netherlands, the considerable increase in the number of T-Mobile subscribers also a positive impact. Our T-Systems division succeeded in increasing its revenue year-on-year despite the unfavorable economic environment and the effects of the sale of shareholdings in 2003. The increase at T-Systems was mainly driven by the Telecommunication services unit, which offset the slight decline in information technology business. Revenue growth at T-Online was driven by continued growth of the customer base, especially for broadband services, coupled with stronger demand for content and services, and the resulting increase in time spent online. The development of T-Com's revenue was significantly affected by a weak economic environment and regulatory and competition-related influences. Lower call revenues in particular — partly as a result of the introduction of call-by-call and carrier preselection in the local network and the ensuing losses of market share — led to a decrease in revenues that even the dynamic trend towards more advanced lines such as T-DSL could not offset. The drop in net revenue was exacerbated by the deconsolidation of the cable companies.

Deutsche Telekom generated net income amounting to EUR 1.3 billion in the 2003 financial year. This represents a year-on-year improvement of EUR 25.9 billion from a net loss of EUR 24.6 billion in 2002. This development is mainly the result of the nonscheduled write-downs on goodwill and licenses at mobile communications companies in 2002, for which there were no comparable write-downs in 2003. Other factors contributing to this development were efficiency enhancements, increased levels of income from the disposal of noncurrent assets, and a considerable improvement in net financial expense.

Following on from our considerable progress in debt reduction during 2003, our focus for the 2004 financial year will be on profitable growth. For 2004, we intend to position our group as a growth leader in the IT/TC sector. But this growth is not to be at the expense of profitability. To achieve our goal, we have developed our “Agenda 2004.” This agenda defines six cross-divisional areas that will be our top priorities during 2004: broadband, human resources, innovation, quality, efficiency, and business customers. We expect that, as “Agenda 2004” is implemented, it will significantly enhance the business potential of our group’s divisions. We expect that it will also play an active role in strengthening coordination among our divisions. We intend to maintain the position of our T-Mobile and T-Online divisions as growth drivers in their respective markets. At the same time, we expect the T-Com division to benefit from the intensified broadband drive and once again to generate significant revenues for the Group. With an additional contribution from the T-Systems division, we currently expect net revenue to grow again this year. We also expect an increasing proportion of revenue growth to come from our international affiliates, especially T-Mobile USA.

## **OUTLOOK FOR 2004**

In 2004, we intend to focus on profitable growth. We expect to employ our cash flows flexibly to take advantage of possibilities that present themselves, including to further reduce debt and — if we perceive opportunities to further enhance the group’s value — to increase capital expenditures and also make selective acquisitions. We intend to accomplish our financial and operating objectives by, among other things, increasing consolidated net revenues and operating efficiencies. Accordingly, we intend to invest in areas of our business that we believe offer the best potential for sustainable and profitable growth. A central part of our strategy to accomplish these objectives consists of six cross-divisional initiatives: broadband, personnel, innovation, quality, efficiency and corporate customers. The following discussion provides a brief explanation of our outlook for 2004.

### **Net Revenues**

In keeping with our strategy of profitable growth, we expect a further increase in our consolidated net revenues for 2004, based on our current outlook and current market and regulatory conditions. However, since each division is affected by its individual business environment, and we are subject to circumstances and events as yet unforeseen or beyond our control. The following reflects our current expectations with respect to our divisional plans and initiatives for 2004.

- T-Com — continued growth in net revenues from ISDN and T-DSL access through increases in the number of access lines or charges relating to access lines or both, offset in part by expected price declines in calling charges in Germany due to the continued introduction of mandated carrier selection alternatives for local calls and the decrease of interconnection fees to be paid by competitors in 2004. Additionally, the regulatory decision concerning the resale of T-DSL access lines is expected to lower attainable revenues and margins. We hope to stabilize net revenues based on our broadband and innovation initiatives, which are to stimulate additional growth potential through higher demand for broadband access as well as to encourage the development of attractive and innovative new services. Additionally, we intend to improve the quality of our products and services to enhance customer retention. Our goal is to support the migration of customers to higher-priced access lines and tariff options and to achieve net revenues on approximately the same level as in 2003.
- T-Mobile — we expect continued growth in net revenues at T-Mobile, especially from T-Mobile USA. In the U.S. market, net revenue growth is primarily determined by subscriber growth. T-Mobile believes the mobile market in the United States has not yet reached saturation, and that it still holds ample opportunities for significant growth. In contrast, market penetration in Western Europe has reached or nears saturation levels and we expect weaker growth rates due to a limit on available subscribers. This trend may be partly offset by future growth potential of increased voice and data services usage and migration to higher-value services. Adverse actions by regulators may negatively affect our net revenues development. For further information, please refer to “Item 4. Information on the Company — Regulation.”
- T-Systems — we expect that the lackluster market will continue throughout 2004. However, in 2004, we currently target a moderate increase in net revenues. We intend to realize growth opportunities by focusing on corporate customers and further developing our sales and

distribution model. Growth is primarily driven by outsourcing projects and we expect to compete effectively and efficiently in our core areas of computing services and network services.

- T-Online — continued growth in net revenues is expected primarily through increase in the subscriber base and increased usage of our products and services. Additionally, our focus on the broadband business is expected to be a key driver of growth relating to our combined business model in 2004.

## **Costs**

In keeping with our strategy of profitable growth, through our efficiency and personnel initiatives, we expect to improve measures to control operating expenses in each of our divisions. One of our primary goals is to achieve high operating efficiencies. However, our management may determine that additional investment and increased operating expenses will have the potential to yield increased revenues in the future. For these and other reasons, an absolute reduction in costs may not be achieved and would not be an appropriate measure of the successful attainment of our objectives.

Although we currently expect net revenue growth in 2004, we anticipate that costs of goods sold will remain relatively constant. We believe that this will be supported through our coordinated purchasing system among our divisions, which is part of our efficiency initiative. We aim to further improve our buying position and realize savings on volume purchases of goods and services. Additional plans are being developed to optimize our working capital and to increase our productivity in all areas that will complement our efficiency initiative.

We expect that our personnel costs will rise slightly in 2004 because anticipated wage increases are only partially offset by the projected decrease in headcount. Within our personnel cost management initiative, we define five principal objectives: working time reduction with corresponding salary reduction as a result of decreased hours, a voluntary redundancy program offering layoffs with corresponding compensation, review of annual pay raises, natural attrition and continued development of Vivento (formerly the Personnel Service Agency). Employees transferred to Vivento will still remain on our group payroll. However, we will continue to seek ways to reduce headcount on a group level through external placements of our Vivento employees. Furthermore, we will bear retirement and severance costs for some of the employees who leave our active employee payrolls. For additional information relating to personnel matters, please refer to “Item 3. Key Information — Risk factors” and “Item 6. — Directors, Senior Management and Employees — Employees and Labor Relations.”

Depreciations and amortizations in 2004 are expected to be comparable to 2003. Based on our current outlook, we anticipate a stable level of scheduled write-downs and do not expect the very large unscheduled amortizations that were taken in the context of our strategic review in 2002.

We intend to continue the reduction of our debt obligations. Assuming no major changes in market conditions, we expect our interest costs to decrease moderately due to decreased levels of indebtedness.

## **Capital Expenditures**

Our 2004 capital expenditures are budgeted to be higher than in 2003. The increase is expected to be driven by T-Mobile's focus on the continued roll-out of our UMTS infrastructure in Europe as well as by the quality and capacity enhancement of our GSM network in North America. The total capital expenditures of T-Mobile are expected to amount to approximately EUR 3.5 billion. The majority of capital expenditures of the T-Com division are expected to relate to voice and data transmission capacity and the continued extension and improvement of our network infrastructure. T-Com's total capital expenditures are expected to reach approximately EUR 2.5 billion.

## **Other Factors**

We do not intend to duplicate the large sales of non-core assets in 2004 that were made in 2003. Nevertheless, we expect that the sale of certain real estate holdings may contribute positively to cash flows in 2004. However, no assurance can be given that such sales will actually occur in budgeted volumes in 2004 or that any such sales will yield anticipated proceeds. We are aiming for an increase in net income through improved operations notwithstanding the anticipated lower proceeds from the disposition of assets in 2004 compared to the significant earnings relating to sales of non-core assets in 2003.

## **FACTORS AFFECTING OUR BUSINESS**

Our business has been affected in recent years by a number of important factors. Investments in new markets and technologies, sales of non-core assets, declines in calling charges in the traditional fixed-line network voice telephony business, increased competition and regulatory constraints all have influenced and are expected to have significant continued influence on our business. In addition, the expanding market for mobile and Internet communications, growth in the volume of data transmissions and rapid technological change are continuously reshaping our business and our focus. In addition to the matters discussed under “Item 3. Key Information — Risk Factors,” we note the following items that have had and may continue to have an impact on our business.

### **Investment in UMTS Licenses and Infrastructure**

We have made substantial investments in UMTS licenses and are making significant investments in establishing UMTS networks. The economic success of these investments will depend upon the availability of handsets and services based on UMTS technology that will be attractive enough to customers to generate sufficient traffic volume at profitable levels. The demand for UMTS services, however, that will prevail in the future is unknown and may not justify the cost of developing and providing UMTS services. These costs include the costs of acquiring UMTS licenses and constructing, maintaining and upgrading UMTS networks. If we find that our current expectations concerning future cash flows from UMTS services are not likely to be met, the carrying value of our UMTS licenses and infrastructure will be adversely affected. For further information relating to our UMTS investments, please refer to “Item 3. Key Information — Risk Factors” and “Item 4. Information on the Company — Regulation.”

### **Deleveraging**

We have made substantial progress in reducing our indebtedness by increasing operating efficiencies, improving operating results and selling non-core assets. We intend to continue the reduction of our indebtedness. Although, in 2004, our strategy focuses on profitable growth, the management of our business will continue to be affected by our deleveraging objectives.

### **Effects of Acquisitions, Dispositions and Nonscheduled Depreciation and Amortization on Our Statements of Operations for the Three Years Ended December 31, 2003**

The comparison of our statements of operations for the years 2003, 2002 and 2001 is complicated by several acquisitions and dispositions that we made during those years and by nonscheduled depreciation and amortization of the carrying values of certain assets that affected items such as other operating income, depreciation and amortization and financial income (expense), net. These effects are often unpredictable and can significantly affect financial results, particularly net income, in any given period. The effects of acquisitions, dispositions and nonscheduled depreciation and amortization on our results of operations are discussed below and under the caption “— Consolidated Results of Operations.”

#### ***Other Operating Income***

Other operating income was influenced by the sale of non-core businesses in 2003. These mainly relate to the sale of the cable business, including the shares of the remaining regional cable business (EUR 0.4 billion), TeleCash (EUR 0.1 billion), Eutelsat (EUR 0.1 billion), Globe Telecom and Inmarsat (in total EUR 0.1 billion), UMC, T-Systems SIRIS and Celcom (in total EUR 0.1 billion), as well as shares in MTS (EUR 0.4 billion).

In 2002, other operating income was influenced by gains on the sale of a portion of our shares in T-Online International AG (EUR 0.3 billion) and gains on the sale of our interest in Satelindo (EUR 0.2 billion).

In 2001, other operating income included gains on the sale of our interest in Sprint (EUR 2.0 billion), gains on the sale of our interest in the regional cable television company for the German state of Baden-Wuerttemberg (EUR 0.9 billion), gains on the sale of other regional cable service companies (EUR 0.1 billion) and nonscheduled depreciation relating to buildings on owned real estate (EUR 0.3 billion) that was offset by gains in an equal amount (EUR 0.3 billion) on the reversal of provisions for general real estate risks.



### ***Depreciation and Amortization***

Depreciation and amortization in 2003 included nonscheduled amortization of EUR 0.3 billion, primarily relating to buildings.

Depreciation and amortization in 2002 were affected by the results of our impairment testing of certain of our assets that was conducted in the context of our strategic review. The testing resulted in nonscheduled amortization of goodwill and mobile communication licenses as follows: T-Mobile USA/Powertel (EUR 17.7 billion total nonscheduled amortization, of which EUR 8.3 billion related to goodwill and EUR 9.4 billion related to licenses), T-Mobile UK's nonscheduled amortization of UMTS licenses (EUR 2.2 billion), T-Mobile Netherlands' nonscheduled amortization of goodwill (EUR 1.0 billion), T-Systems (EUR 0.6 billion total nonscheduled amortization of which EUR 0.5 billion related to Siris goodwill and EUR 0.1 billion related to restructuring charges). In addition, we recorded nonscheduled depreciation of EUR 848 million relating to property plant and equipment consisting primarily of buildings (EUR 250 million), submarine cables (EUR 230 million) and property, plant and equipment at T-Systems (EUR 245 million).

Depreciation and amortization in 2001 included nonscheduled amortization of the book value of trade names relating to One 2 One and max.mobil (EUR 1.0 billion) in connection with a rebranding campaign conducted by T-Mobile, a nonscheduled depreciation of the book values of certain real property assets (EUR 0.5 billion) and nonscheduled depreciation of certain buildings (EUR 0.3 billion), which was offset by gains in an equal amount on the reversal of provisions relating to general real estate risks.

### ***Financial Income (Expense), Net***

Financial income (expense), net in 2003 was positively affected by the write-up of the net carrying amount of the stake in comdirect (EUR 0.1 billion).

Financial income (expense), net in 2002 was affected by nonscheduled writedowns of the book values of shares in France Telecom (EUR 0.6 billion) and the note receivable from Telewest (EUR 0.4 billion), deferred payments owed to us relating to the sale of regional cable companies (EUR 0.3 billion), interests in comdirect bank (EUR 0.1 billion) and the UMTS license of T-Mobile Netherlands (EUR 0.2 billion) relating to the period that T-Mobile Netherlands was not consolidated.

Financial income (expense), net in 2001 included writedowns in the book value of shares in France Telecom (EUR 0.3 billion) and in comdirect Bank (EUR 0.1 billion), debenture bonds we received in connection with the sale of regional cable companies (EUR 0.4 billion) and writedowns in the book value of shares we held in a regional cable company (EUR 0.1 billion).

### **Fixed-line Network Communications**

One of the most important trends in recent years has been the decline in the percentage of our revenues accounted for by the traditional fixed-line voice telephony business. That business accounted for 29.5% of our external revenues in 2003, as compared to 31.3% in 2002. This trend results from the increasing contribution of other activities to our group's revenues, as well as from the effects of strong competition in the local and long-distance voice telephony business and the continued substitution of mobile telephone calls for fixed-line calls.

Competition within the fixed-line voice telephony business in Germany is significantly influenced by decisions of the German telecommunications regulator. On the basis of interconnection rates fixed by the German telecommunications regulator, numerous competitors are able to compete against us with minimal or modest investments in network infrastructure and with prices that often undercut our pricing. Additionally, changes in our pricing policy for public fixed-line voice telephony services are subject to regulatory pre-approval. Beginning in 2003, we were required to offer our competitors unbundled access to our local loop (the wire that connects the premises of our customers to our network), which resulted in increasing pressure on tariffs for local calls and a loss of market share.

In 2003, the local call market was opened to competition relating to call-by-call and pre-selection of carriers. We expect a further loss of market share for calls based on minutes of traffic as a result of this regulatory action. In November 2003, the German telecommunications regulator ruled that interconnection tariffs were to be lowered by 9.5% as of December 2003. Although we plan the voluntary introduction of a resale offer for DSL in mid-2004 (bitstream access) as favored by the

German and European telecommunications regulators, these measures to strengthen market penetration concerning broadband will still be subject to regulatory scrutiny and review. It is expected that margins will be lower in this DSL resale business.

For more details concerning the effects of regulation on our fixed-line voice telephony business, see “Item 4. Information on the Company — Regulation — Regulation in Germany — Special Network Access and Interconnection” and “Item 3. Key Information — Risk Factors.”

Increasing competition has resulted in a decline in our market share. While our market share for access lines in Germany decreased to 94% in 2003 from 96% in 2002, our market share for voice minutes declined to 58% in 2003 from 61% in 2002. We expect a continuing decline in our market shares in Germany for access lines as well as for voice minutes.

In response to regulatory and competitive pressure on tariffs, we developed a variety of pricing plans. These plans offer customers lower traffic prices in return for an additional monthly fee. To compensate for the reduction of tariffs and the loss of market share, we have focused on migrating customers from analog to higher-priced T-ISDN access lines and the broadband T-DSL access lines. For 2004, we expect customers to continue to switch from analog to higher-priced T-ISDN and T-DSL access lines. We intend to emphasize our broadband initiative with attractive products like the combination with W-LAN (wireless local area network).

### **Regulation and Litigation**

Our business has been strongly influenced by the regulatory regime applicable to telecommunications operators and service providers in Germany. We are viewed by the German telecommunications regulator as dominant in markets that form a significant part of our business, particularly the market for fixed-line voice telephony services. Following the adoption of the new European Union telecommunications regulatory framework, amendments to the German Telecommunications Act are likely to be passed and become effective in mid-2004. These amendments could affect our business materially. Our international expansion has also made us subject to regulation in other jurisdictions, including in the mobile communications sectors in the United Kingdom and the United States. For further information on these topics, please see “Item 4. Information on the Company — Regulation.”

We are continuously involved in litigation and other forms of dispute resolution with regulators, competitors and other parties, the outcomes of which may have a material adverse effect on our results of operations or financial condition during the years in which such lawsuits and disputes are resolved. For further information concerning these disputes, see “Item 8. Financial Information — Litigation.”

### **Technology**

Our business is profoundly influenced by technological developments. The selection and commercialization of promising technologies is a significant challenge for us. We have to balance the opportunities of new technologies with the effectiveness and efficiency of the installed base in order to optimize the timing and intensity of investment activities.

The correctness of the timing of the introduction of new technologies will have an important impact on the competitiveness and cost structure of our company.

Investments in transmission technologies are mainly driven by the increasing IP-traffic. The economic success of investments in this area will largely depend on accurate estimates of the future traffic development. The growth will be strongly influenced by changes in the legal environment relating to peer-to-peer traffic (issue of copyrights) and developing expectations concerning the rate of increase of e-business and internet usage.

These future market development uncertainties may undermine the achievement of the balance mentioned above.

### **Real Estate**

We plan to continue the monetization of certain real estate holdings in 2004, though to a lesser extent compared to 2003. While making extensive use of real property in the operation of our business, we do not view the ownership and management of real estate as one of our core activities.

Our ability to dispose of the budgeted portion of these assets will be influenced by, among other things, the development of the German real estate market, economic growth expectations, the availability of financing and prevailing interest rate levels. For additional information concerning our real estate holdings, please refer to “Item 4. Information on the Company — Description of Property, Plant and Equipment.”

## **CRITICAL ACCOUNTING ESTIMATES**

Our consolidated financial statements prepared in accordance with accounting principles generally accepted in Germany (“German GAAP”) and the reconciliation of our consolidated financial statements from German GAAP to accounting principles generally accepted in the United States (“U.S. GAAP”) are dependent upon and sensitive to accounting methods, assumptions and estimates that we use as a basis for the preparation of the consolidated financial statements and reconciliation. We have identified the following critical accounting estimates and related assumptions and uncertainties inherent in our accounting policies which we believe are essential to an understanding of the underlying financial reporting risks and the impact that these accounting estimates, assumptions and uncertainties have on our consolidated financial statements under German GAAP and our reconciled U.S. GAAP financial statements information.

### **Accounting for and Recovery of Long-Lived Assets**

Our accounting for long-lived assets and intangible assets involves the use of estimates for determining the fair value at the acquisition date, especially in the case of such assets acquired in a business combination, and the useful lives of the assets over which the costs of acquiring these assets are reflected in the financial statements.

#### **Initial Valuation**

We record purchased property, plant and equipment and purchased intangible assets other than goodwill at acquisition or construction cost. When these assets are acquired in a business combination, the purchase price is allocated to the estimated fair value of the acquired property, plant and equipment and intangible assets. Property, plant and equipment and intangible assets, including mobile communication licenses, are depreciated or amortized on a straight-line basis over their estimated useful lives.

Property, plant and equipment are valued at acquisition or construction cost, less depreciation. Construction costs include directly allocable costs, an appropriate allocation of material and production overhead and interest accruing during the construction period. However, general administration expenses are not capitalized. As permitted by Postreform II, the legislation by which the former Deutsche Bundespost Telekom was legally transformed into a stock corporation, property, plant and equipment transferred to Deutsche Telekom AG on January 1, 1995, were 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 between the acquisition dates and January 1, 1995, property, plant and equipment acquired during 1993 and 1994 were valued at their remaining book value. The remaining useful lives and the depreciation methods applicable to these assets were not changed. Except as otherwise described in this Annual Report, the fair market values shown in the opening balance sheet have been carried forward as the acquisition costs.

We decided in late 2000 to introduce a real estate strategy oriented toward the monetization of our real estate portfolio. As a consequence, a new valuation approach based on the current replacement costs of individual plots of land owned by us was adopted for German GAAP, whereby the lower of the net book value or replacement cost was recorded. The comparison of the newly calculated replacement costs with the carrying amounts resulted in downward adjustments to book value totaling EUR 2.5 billion.

#### **Recoverability**

Under German GAAP, when an impairment in the value of assets occurs, nonscheduled depreciation and amortization charges are incurred. Further, nonscheduled charges may be reversed when the conditions giving rise to the impairment no longer exist. We assess the impairment of identifiable intangibles and long-lived assets whenever there is reason to believe that the carrying

value may exceed the fair value and where a permanent impairment in value is anticipated. The determination of impairments of long-lived and intangible assets involves the use of estimates that include but are not limited to the cause, the timing and the amount of the impairment. Impairment is based on a broad measure of factors. In evaluating assets for impairment, we apply the German commercial law principle of prudence (*Vorsichtsprinzip*) (Sec. 252(1)(4) of the German Commercial Code) in conjunction with the individual valuation principle (*Einzelbewertungsgrundsatz*). We typically consider, among other things, technological obsolescence, discontinuance of services, current replacement costs and other changes in circumstances that indicate an impairment.

In the strategic review undertaken in 2002, we used a discounted cash flow approach to estimate the fair value of our mobile communication licenses, including our FCC licenses in the United States. Assumptions regarding mid- 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. The use of this valuation method represents a change in valuation methodology, as previously we had used a market approach based primarily on the prices for mobile communication licenses established in relevant auctions for the initial recognition of these licenses in the acquisition of T-Mobile USA. Due to the length of time that had elapsed since these auctions took place, along with the general lack of an active marketplace for mobile communication licenses, we concluded that there was insufficient basis to use a market-based approach.

Under U.S. GAAP, 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 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.

#### **Accounting for Valuation and Recovery of Goodwill and Intangible Assets with Indefinite Lives**

Goodwill usually arises in business combinations. The amount of goodwill initially recognized is dependent on the allocation of the purchase price of an entity to all identifiable assets acquired and the liabilities assumed. Such allocations are based on the fair values of those assets. The determination of the fair values of assets and liabilities is based to a considerable extent on management's judgment. In addition, for German GAAP, the useful life assigned to goodwill is an estimate that is based on the judgment of management at the time of acquisition. Goodwill is then amortized on a straight-line basis over its useful life. For U.S. GAAP, goodwill is not amortized, but periodically tested for impairment.

We review, on a regular basis, the performance of our subsidiaries. Nonscheduled amortization charges are recorded under German GAAP when there is reason to believe that goodwill associated with a subsidiary is impaired and that the impairment is of a permanent nature. The amount of the nonscheduled amortization is determined by comparing the carrying amount of that subsidiary to its fair value. The determination of the fair value of a subsidiary involves extensive use of estimates by management. Methods commonly used to determine the fair value of a subsidiary include discounted cash flow based methods and methods that use quoted stock market prices as a basis. Factors affecting estimated fair values typically include discount rates, future cash flows, growth rates, industry developments, market prices and control premiums. These estimates, including the methodologies used, can have a material impact on the fair value and ultimately the amount of any goodwill amortization.

U.S. GAAP 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.

### **Recovery of Financial Assets**

We hold as financial assets minority interests in foreign telecommunications service providers that are principally engaged in the mobile, fixed line, Internet and data communications businesses, some of which are publicly traded and have highly volatile share prices. We record an investment impairment charge when we believe an investment has experienced a decline in value that is "permanent" under German GAAP or "other than temporary" under U.S. GAAP. Determining whether an impairment is permanent involves judgment and relies heavily on an assessment by management regarding the future development of the investee. In measuring impairments, we use quoted market prices, if available, or other valuation methods, based on information available from the investee.

Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future.

The most significant investments are PTC in which we own a 49% interest, MTS in which we own a 25.1% interest, and GSM Facilities in which we own a 29.2% interest.

For U.S. GAAP, our minority interest ownership in shares of publicly traded companies 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.

### **Allowance for Doubtful Accounts**

Management maintains an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Management bases its estimates on the aging of our accounts receivable balances and our historical write-off experience, customer credit-worthiness and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers were to deteriorate, actual write-offs might be higher than expected.

### **Deferred Taxes**

We are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves the jurisdiction-by-jurisdiction estimation of actual current tax exposure and the assessment of temporary differences resulting from differing treatment of items, such as accruals and



amortization, for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must assess in the course of our tax planning procedures the fiscal year of the reversal of our deferred tax assets and liabilities and if there will be future taxable profits in those periods. We reverse in the current year deferred tax assets and liabilities for timing differences that have been recorded if we anticipate that the future reversal will take place in a tax loss year. If we estimate that timing differences of a current year will be reversed in a later tax loss year, we do not record deferred tax assets and liabilities for those timing differences.

Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities. Under German GAAP, we do not record deferred tax assets consisting of net operating losses carried forward and foreign tax credits. The analysis is based on the estimates of taxable income in the jurisdictions in which the group operates and the period over which the deferred tax assets and liabilities will be recoverable. If actual results differ from these estimates, or we adjust these estimates in future periods, our financial position and results of operations may be affected materially.

Under U.S. GAAP, we record 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 is 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 an additional minimum liability is recorded in net income under German GAAP. During 2003, we recorded an increase to our additional minimum pension liability. This increase was mainly attributable to a 0.5 percent decrease of the discount rate used in the calculation of our pension liability to 5.25% in 2003. In addition, plan assets increased by EUR 77 million to approximately EUR 490 million at December 31, 2003. 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 (28) 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 our share of 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, 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. During 2003, we recorded an increase to our accrual to fund our portion of the expected shortfalls. This increase was mainly attributable to a 0.75% decrease of the discount rate used, in line with long-term interest rates. 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 changes used for the calculation.

### **Accrued Liabilities**

We exercise considerable judgment in recording our accrued liabilities and our exposure to contingent liabilities related to pending litigation or other outstanding claims subject to negotiated settlement, mediation, arbitration or government regulation as well as other contingent liabilities. Judgment is necessary in assessing the likelihood that a pending claim will succeed or a liability will arise and to quantify the possible range of the final settlement. Where we expect that the occurrence of a contingency is reasonably likely, we accrue an amount for the contingent liability under German GAAP that represents management's estimate at the balance sheet date considering all anticipated risks and losses up to that date, even if they became known after the balance sheet date but prior to the preparation of the financial statements. Under U.S. GAAP, 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. Because of the inherent uncertainties in this evaluation process, actual losses may be different from the originally estimated amount accrued.

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.

### **Revenue Recognition**

#### **Customer Activation Fees**

Our T-Com and T-Mobile divisions receive certain installation and activation revenues from new customers. For U.S. GAAP 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.

## **CONSOLIDATED RESULTS OF OPERATIONS**

Until the end of 2002, we classified our condensed consolidated statements of income using the total-cost method. Beginning with the first quarter of 2003, we published our condensed consolidated statements of income using the cost-of-sales method, which is more common for international financial

statements. Besides allocating operational expenses to functional areas, this also involves including other taxes in the operating results, or results from ordinary business activities. The prior-year comparative financial information has been revised to conform to the current year presentation.

The following table shows information concerning our consolidated statements of operations for the periods indicated.

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
Net revenue.....	55,838	53,689	48,309
Cost of sales .....	<u>(31,402)</u>	<u>(44,477)</u>	<u>(29,766)</u>
<b>Gross profit (loss)</b> .....	24,436	9,212	18,543
Selling costs.....	(13,505)	(13,264)	(11,675)
General and administrative costs.....	(4,976)	(6,062)	(5,622)
Other operating income .....	4,558	3,901	6,619
Other operating expenses.....	<u>(5,084)</u>	<u>(14,915)</u>	<u>(5,078)</u>
<b>Operating results</b> .....	5,429	(21,128)	2,787
Financial income (expense), net .....	<u>(4,031)</u>	<u>(6,022)</u>	<u>(5,348)</u>
<b>Results from ordinary business activities</b> .....	1,398	(27,150)	(2,561)
Income taxes.....	<u>225</u>	<u>2,847</u>	<u>(751)</u>
<b>Income (loss) after taxes</b> .....	1,623	(24,303)	(3,312)
(Income) losses applicable to minority shareholders.....	<u>(370)</u>	<u>(284)</u>	<u>(142)</u>
<b>Net income (loss)</b> .....	<u>1,253</u>	<u>(24,587)</u>	<u>(3,454)</u>

### Operating Results

In 2003, our operating results increased by approximately EUR 26.6 billion to operating results of EUR 5.4 billion. This improvement was largely attributable to EUR 21.4 billion in non-scheduled amortization of goodwill and mobile communications licenses recorded in 2002 that did not recur in 2003, as explained in greater detail below. Overall, operating costs (cost of sales, selling costs and general and administrative costs) as well as the other operating expenses declined in comparison with 2002 by a total of EUR 23.8 billion. Also influencing the improvement in our operating results was an increase in net revenues of EUR 2.1 billion. A decline in net revenues at our T-Com division was more than offset by increases at our other divisions, particularly T-Mobile.

In 2002, operating results decreased by approximately EUR 23.9 billion to operating results of EUR 21.1 billion as compared with 2001. This development was influenced by several factors. In 2002, net revenues increased by EUR 5.4 billion compared with the previous year, in particular in the T-Mobile and T-Online divisions. However, operating costs (cost of sales, selling costs and general and administrative costs) and other operating expenses increased by a total of EUR 26.6 billion. This increase was primarily attributable to the strategic review in the third quarter of 2002, which resulted in nonscheduled amortization of goodwill at T-Mobile USA (EUR 8.3 billion), T-Mobile Netherlands (EUR 1.0 billion) and T-Systems SIRIS (EUR 0.5 billion). Additionally, nonscheduled amortization was recorded with respect to the mobile communications licenses of T-Mobile USA (EUR 9.4 billion) and the UMTS license of T-Mobile UK (EUR 2.2 billion). The total nonscheduled amortization of goodwill and mobile communications licenses as a result of our strategic review amounted to EUR 21.4 billion. The inclusion of newly consolidated companies generated an increase in scheduled depreciation and amortization (EUR 1.7 billion), mainly attributable to the consolidation of T-Mobile USA for a full-year in 2002. Scheduled amortization of goodwill increased by EUR 0.7 billion, amortization of UMTS and U.S. mobile communications licenses increased by EUR 0.5 billion and depreciation of property plant and equipment increased by EUR 0.5 billion. The decrease in operating results relating to changes in the composition of our consolidated group amounted to EUR 2.1 billion, mainly attributable to the first-time full-year consolidation of T-Mobile USA and the first-time consolidation of T-Mobile Netherlands in 2002. In 2001, we recorded nonscheduled amortization of EUR 0.5 billion relating to the book values of real estate in 2001 and nonscheduled amortization of EUR 1.0 billion relating to goodwill associated with the trademarks of T-Mobile UK (formerly One 2 One) and T-Mobile Austria (formerly max.mobil) in connection with the T-Mobile rebranding campaign. In addition, in 2001 nonscheduled depreciation of EUR 0.4 billion was taken with respect

to buildings for which no further commercial use was expected. This nonscheduled depreciation was offset by a gain of the same amount on the reversal of provisions for general risks relating to such buildings. Further, nonscheduled depreciation on property, plant and equipment was taken in the amount of EUR 0.2 billion, relating principally to portions of the mobile communications network of T-Mobile UK (EUR 0.1 billion).

### **Net Revenues**

We generated consolidated net revenues of EUR 55.8 billion in 2003. This equates to a year-on-year increase of EUR 2.1 billion, or 4.0 %, despite negative exchange rate effects. A decline in net revenues at our T-Com division was more than offset by a rise in aggregate net revenues from our other operating divisions. T-Mobile was the main contributor to net revenue growth. The first-time full-year consolidation of T-Mobile Netherlands in 2003 accounted for EUR 0.6 billion increase in group net revenues. This positive influence was offset by a decrease in net revenues at T-Com of approximately EUR 0.5 billion as a result of the deconsolidation of the cable businesses and at T-System of approximately EUR 0.2 billion as a result of the deconsolidation of TeleCash and T-Systems SIRIS.

Our net revenues in 2002 amounted to EUR 53.7 billion, representing an increase of EUR 5.4 billion, or 11.1%, over 2001. Of this increase, changes in the composition of the Deutsche Telekom consolidated group in 2002 due to acquisitions accounted for EUR 3.3 billion of the increase, relating to the first-time full consolidations of T-Mobile USA starting from May 2001 (EUR 2.2 billion), T-Mobile Czech Republic starting from April 2001 (EUR 0.2 billion), Hrvatski Telecom starting from November 2001 (EUR 0.7 billion) and T-Mobile Netherlands starting from September 2002 (EUR 0.2 billion). Without regard to these changes in the composition of our consolidated group in 2002, net revenues increased by EUR 2.1 billion, or 4.3%, from 2001. This increase consisted of increased net revenues in the T-Mobile, T-Online and T-Com divisions (before acquisitions) that were partially offset by decreased net revenues in the T-Systems division.

For further information on our net revenue development and trends, see “— Segment Analysis.”

### **Cost of Sales**

Our cost of sales comprises the aggregate cost of products and services sold in the year under review. In addition to directly attributable costs, such as direct material and labor costs, it also includes indirect costs, such as depreciation and amortization (other than goodwill).

The cost of sales, which mainly relates to the T-Com and T-Mobile divisions, fell by EUR 13.1 billion to EUR 31.4 billion in 2003. This is primarily due to a decrease in the amortization of mobile communications licenses that is included in the cost of sales. As a result of the strategic review carried out in 2002, the cost of sales was affected nonscheduled write-downs of mobile communications licenses held by T-Mobile USA and T-Mobile UK totaling EUR 11.6 billion. Changes in the composition of the Deutsche Telekom Group in 2003 further reduced the cost of sales by EUR 0.1 billion.

In 2002, cost of sales increased compared with 2001, mainly attributable to the strategic review in 2002, which resulted in nonscheduled depreciation and amortization on mobile phone licenses of T-Mobile USA (EUR 9.4 billion) and the UMTS license of T-Mobile UK (EUR 2.2 billion). In 2001, no similar nonscheduled depreciation and amortization charges were recorded. Cost of sales relating to changes in the composition of our consolidated group amounted to EUR 2.3 billion, mainly attributable to the first-time full-year consolidation of T-Mobile USA and Hrvatski Telecom in 2002.

### **Selling Costs**

Our selling costs include all expenses for activities, that do not directly increase the value of the company's products or services, but help to secure sales. Selling costs generally include all expenses relating to the sales, advertising and marketing departments and other sales promotion activities.

In 2003, our selling costs were EUR 0.2 billion higher than in the previous year, mainly due to an increase at T-Mobile. This increase is attributable to the full-year consolidation of T-Mobile Netherlands for the first time and higher expenses for marketing and commissions. This increase was partially offset by lower losses on accounts receivable and provisions for doubtful accounts, in particular at T-Com.

In 2002, selling costs were EUR 1.6 billion higher than in 2001, mainly attributable to the first-time full-year consolidation of T-Mobile USA in 2002 (EUR 1.1 billion).

### **General and Administrative Costs**

Our general and administrative costs generally include all costs attributable to the core administrative functions that are not directly attributable to production or selling activities.

In 2003, general and administrative costs declined by EUR 1.1 billion. This development includes efficiency improvements and a decrease in other taxes. See note (12) to our consolidated financial statements.

General and administrative costs increased by EUR 0.4 billion in 2002 as compared to 2001. The increase in general and administrative costs was partially attributable to the first-time full-year consolidation of T-Mobile USA and Hrvatski Telecom in 2002 (EUR 0.2 billion).

### **Other Operating Expenses**

Other operating expenses consist of amortization of goodwill, foreign currency transactions, losses from disposals and miscellaneous items.

In 2003, the reduction in other operating expenses (EUR 9.8 billion) compared with 2002 was primarily attributable to the strategic review in the third quarter of 2002, which resulted in nonscheduled amortization of goodwill at T-Mobile and T-Systems (EUR 9.8 billion). In 2003, no similar nonscheduled amortization of goodwill was recorded. The increase of the miscellaneous items is mainly attributable to the personnel expenses resulting from the transfer of employees to Vivento. Other operating expenses relating to changes in the composition of our consolidated group amounted to EUR 0.2 billion, mainly attributable to T-Mobile Netherlands and the cable companies.

In 2002, the increase in other operating expenses (EUR 9.8 billion) compared to 2001 was primarily attributable to the strategic review in the third quarter of 2002, which resulted in nonscheduled amortization of goodwill at T-Mobile USA (EUR 8.3 billion), T-Mobile Netherlands (EUR 1.0 billion) and at T-Systems for T-Systems SIRIS (EUR 0.5 billion). In 2001, nonscheduled amortization of EUR 1.0 billion was recorded, relating to goodwill associated with the trademarks of T-Mobile UK (formerly One 2 One) and T-Mobile Austria (formerly max.mobil) in connection with the T-Mobile rebranding campaign. Of the increase in other operating expenses in 2002, EUR 1.6 billion were attributable to the first-time consolidation of T-Mobile Netherlands and the full-year consolidation of T-Mobile USA.

Of the operating expenses, EUR 395 million (2002: EUR 463 million, 2001: EUR 534 million) relates to transactions consummated in prior years.

### **Other Operating Income**

Other operating income consists of tax refunds, reversals of allowances and accruals, cost reimbursements, gains from sales of marketable securities and assets, foreign currency gains and other miscellaneous items.

In 2003 the increase in other operating income is due primarily to higher income from asset dispositions amounting to approximately EUR 1.5 billion, including the remaining shares of the regional cable companies (EUR 0.4 billion), TeleCash Kommunikations-Service GmbH (EUR 0.1 billion), Eutelsat S.A. (EUR 0.1 billion), Globe Telecom Inc. (0.1 billion), Joint Venture UMC (Ukrainian Mobile Communications), T-Systems SIRIS S.A.S. and Celcom, (Malaysia) Sdn. Bhd, (in total EUR 0.1 billion), as well as shares in MTS (EUR 0.4 billion).

Other operating income amounted to EUR 3.9 billion in 2002, representing a decrease of EUR 2.7 billion, or 41.1%, compared to 2001. Other operating income for 2002 was affected by gains from the sale of a portion of the shares of T-Online (EUR 0.3 billion) and Satelindo (EUR 0.2 billion). These gains were modest, however, compared to the 2001 gains from the sale of our shares held in Sprint Corporation (EUR 2.0 billion) and from the sale of the regional cable company in Baden-Wuerttemberg (EUR 0.9 billion). Leaving aside dispositions, the decline in other operating income from 2001 to 2002 was largely a result of lower realized foreign currency gains in 2002 (2002: EUR 0.2 billion; 2001: EUR 0.5 billion).

Of the total amount of other operating income, EUR 2,680 million (2002: EUR 1,342 million; 2001: EUR 1,897 million) relates to income recognized on transactions consummated in prior years.



## Financial Income (Expense), Net

The following table presents information concerning our financial income (expense), net.

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Results related to companies accounted for under the equity method . . . . .	(247)	(430)	(547)	42.6%	21.4 %
Other investments . . . . .	(8)	(1,544)	(663)	99.5%	(132.9)%
Loss from financial activities . . . . .	(255)	(1,974)	(1,210)	87.1%	(63.1)%
Net interest expense . . . . .	(3,776)	(4,048)	(4,138)	6.7%	2.2 %
<b>Financial income (expense), net .</b>	<b>(4,031)</b>	<b>(6,022)</b>	<b>(5,348)</b>	<b>33.1%</b>	<b>(12.6)%</b>

### *Net Interest Expense*

In 2003, our net interest expense decreased by EUR 272 million to EUR 3.8 billion at year-end 2003, largely attributable to a reduction in debt and the recognition of interest income from the reversal of interest rate derivatives which were no longer necessary.

Our net interest expense slightly decreased during 2002 by EUR 90 million to EUR 4.0 billion at year-end 2002, largely attributable to the reversal of interest rate derivatives that were no longer necessary.

The effective weighted average interest rate applicable to our outstanding indebtedness related to bonds and debentures was 6.8% in 2003, 6.7% in 2002 and 6.8% in 2001. The effective weighted average interest rate applicable to outstanding indebtedness related to bank liabilities was 6.1% in 2003, 5.7% in 2002 and 5.8% in 2001. A portion of our debt instruments have provisions that could cause the interest rate on such investments to increase upon the occurrence of certain downgrades in our long-term unsecured debt ratings. For more information, see “— Liquidity and Capital Resources — Capital Resources.”

### *Loss from Financial Activities*

Loss from financial activities includes our share of the income or losses on investments accounted for under the equity method and losses relating to write-downs of other investments. Results related to companies accounted for under the equity method includes the amount of annual amortization of goodwill relating to these investments, which is essentially the amortization of goodwill arising from the difference between the purchase price we paid and our share of the shareholders' equity for each of these investments. Income and loss from other investments consists primarily of dividends received from our investments as well as provisions for write-downs of the carrying amounts of other investments.

### *Other Investments*

In 2003, results from other investments improved, mainly due to a decline from the high level of write-downs on financial assets and marketable securities in 2002. The main factors with a negative impact on results from other investments in the previous year were the share price-related write-downs of the net carrying amount of the shareholding in France Telecom (EUR 0.6 billion), and valuation adjustments on investments in non-current securities (EUR 0.4 billion).

### *Results Related to Companies Accounted for Under the Equity Method*

Overall, results related to companies accounted for under the equity method developed positively in 2003. In particular, the non-recurrence, due to consolidation, of the expense relating to companies that were accounted for using the equity method in the previous year and the positive effect of the write-up of the net carrying amount of the stake in comdirect bank AG (EUR 0.1 billion) had a positive impact on loss relating to associated and related companies. Losses relating to Toll Collect (EUR 0.4 billion) had a negative effect.

In 2002, results related to companies accounted for under the equity method improved, mainly due to the reduction of the high level of expenses resulting from associated companies and the depreciation of goodwill of associated companies in 2001.

## Income Taxes

	For the year ended December 31,				
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	(millions of €)			(% change)	
Income taxes.....	(225)	(2,847)	751	92.1%	(479.1)%

Loss from ordinary business activities of EUR 27.2 billion in 2002 improved to positive earnings from ordinary business activities of EUR 1.4 billion in 2003. We had net operating loss carryforwards affecting corporate income tax and trade tax net operating loss carryforwards, with the result that we were able to utilize these tax loss carryforwards within our domestic tax consolidated group. The tax benefit reported relates to the 2002 corporate income tax benefit of EUR 0.4 billion at T-Mobile International AG & Co. KG as a result of the change of the legal form of T-Mobile from a stock corporation to a partnership. This tax benefit was partially offset by tax expense relating to domestic and foreign shareholdings not included in the domestic tax consolidation group.

In 2003, income taxes decreased by EUR 2.6 billion compared to the previous year. This was mainly attributable to the decrease in deferred tax benefits due to the reversal of deferred tax liabilities in 2002 as a result of the strategic review and the ensuing write-downs of U.S. mobile licenses. There were no comparable effects in 2003. Deferred taxes result primarily from temporary differences between income determined under German GAAP and under applicable tax law.

Effective January 1, 2004, the deductibility of tax loss carryforwards in Germany became limited to 60% of current taxable income. Due to this limitation, 40% of future taxable income of Deutsche Telekom AG's tax consolidation group in any year will be subject to corporate income tax.

Loss from ordinary business activities increased to EUR 27.2 billion in 2002. The resulting income tax benefit amounts to EUR 2.8 billion, compared with an expense of EUR 0.8 billion in 2001. 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, which generated income from deferred taxes of EUR 3.0 billion. In 2002, the Federal Finance Court confirmed our legal position concerning Deutsche Telekom AG's recognition of goodwill for tax reporting purposes. The retroactive amortization of goodwill to be carried for the years 1996-1999 resulted in an income tax reduction of approximately EUR 1.0 billion. In addition, amortization of goodwill increased net operating loss carry-forwards (corporate income tax and trade tax) for the years 2000-2002 by EUR 2.2 billion (EUR 741 million per year).

Our effective income tax rate (income taxes as a percentage of pre-tax income (loss)) was approximately (16)% in 2003, 11% in 2002 and (30)% in 2001. The German statutory income tax rate for us was approximately 40.4% in 2003, and 39% in 2002 as well as in 2001. It included corporate income tax of 25%, increased over one year by 1.5% to 26.5% to fund reparations resulting from the 2002 floods in Eastern Germany, a trade earnings tax (at a German national average rate) and a solidarity surcharge on corporate income tax (*Solidaritätszuschlag*) levied at 5.5% on corporate income tax.

## Net Income (Loss)

In 2003, we increased our net income to EUR 1.3 billion from a loss of EUR 24.6 billion in 2002. This was primarily a result of the factors set forth above.

## SEGMENT ANALYSIS

The following table presents total revenues (the sum of external (net) revenues and inter-segment revenues), net revenues and inter-segment revenues of our segments for the years indicated.

	For the year ended December 31,								
	2003			2002			2001		
	Net revenues	Inter- segment revenues	Total revenues	Net revenues	Inter- segment revenues	Total revenues	Net revenues	Inter- segment revenues	Total revenues
	(millions of €)								
T-Com .....	25,116	4,090	29,206	26,491	4,068	30,559	26,427	3,401	29,828
T-Mobile .....	21,572	1,206	22,778	18,339	1,396	19,735	13,101	1,536	14,637
T-Systems .....	7,184	3,430	10,614	6,895	3,594	10,489	7,121	3,700	10,821
T-Online .....	1,662	189	1,851	1,391	193	1,584	1,027	113	1,140
Group Headquarters and Shared Services .....	304	3,964	4,268	573	3,838	4,411	633	4,481	5,114
Reconciliation .....	—	(12,879)	(12,879)	—	(13,089)	(13,089)	—	(13,231)	(13,231)
Group .....	<u>55,838</u>	<u>—</u>	<u>55,838</u>	<u>53,689</u>	<u>—</u>	<u>53,689</u>	<u>48,309</u>	<u>—</u>	<u>48,309</u>

### Reclassifications

The segment information for 2002 and 2001 in the table above and throughout this Annual Report (including in note (36) to the consolidated financial statements included herein) has been reclassified to reflect the 2003 organizational changes among our segments. The structure of the segments was adapted to the new reporting structure for the T-Com and T-Online segments in the first quarter of 2003. Specifically, DeTeMedien is no longer included under T-Online, but has been reported under T-Com since January 1, 2003. Similarly, dilution gains resulting from the issuance of shares of T-Online, which affect income/loss related to associated and related companies, as well as depreciation and amortization, is no longer reported under the T-Online segment but in the reconciliation to consolidated amounts.

The internal accounting for and recording of transactions involving standard products that are sold and supported by T-Systems, but settled and billed by other divisions in the group (“agency business”), were simplified. This new arrangement has led to higher net revenues being reported at T-Com in particular, and to a lesser extent at T-Mobile, while the net revenues reported by T-Systems has decreased by a corresponding amount. T-Systems remains the primary contact to the customer, and continues to receive a selling or agency commission for acquisition and support services. These commissions increase the inter-segment revenues of T-Systems. These new structures do not affect consolidated results. The amounts reported for 2002 and 2001 were restated to aid comparability.

The following table presents 2002 and 2001 segment net revenues before and after these reclassifications.

	For the year ended December 31,					
	2002			2001		
	Previous	Change	Reclassified	Previous	Change	Reclassified
	(millions of €)					
T-Com .....	25,422	1,069	26,491	25,028	1,399	26,427
T-Mobile .....	18,229	110	18,339	12,994	107	13,101
T-Systems .....	7,793	(898)	6,895	8,316	(1,195)	7,121
T-Online .....	1,672	(281)	1,391	1,338	(311)	1,027
Group Headquarters and Shared Services .....	573	—	573	633	—	633
Group .....	<u>53,689</u>	<u>—</u>	<u>53,689</u>	<u>48,309</u>	<u>—</u>	<u>48,309</u>

The following table shows the components of net revenues affected by the reclassification.

	<u>For the year ended December 31,</u>	
	<u>2002</u>	<u>2001</u>
	(millions of €)	
<b>T-Com</b>		
Previous net revenues.....	25,422	25,028
Agency business.....	788	1,088
DeTeMedien.....	<u>281</u>	<u>311</u>
Reclassified net revenues.....	<u>26,491</u>	<u>26,427</u>
<b>T-Mobile</b>		
Previous net revenues.....	18,229	12,994
Agency business.....	<u>110</u>	<u>107</u>
Reclassified net revenues.....	<u>18,339</u>	<u>13,101</u>
<b>T-Systems</b>		
Previous net revenues.....	7,793	8,316
Agency business.....	<u>(898)</u>	<u>(1,195)</u>
Reclassified net revenues.....	<u>6,895</u>	<u>7,121</u>
<b>T-Online</b>		
Previous net revenues.....	1,672	1,338
DeTeMedien.....	<u>(281)</u>	<u>(311)</u>
Reclassified net revenues.....	<u>1,391</u>	<u>1,027</u>

## **T-Com**

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

	<u>For the years ending December 31,<sup>(1)</sup></u>				
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	(millions of €)			(% change)	
Net revenues.....	25,116	26,491	26,427	(5.2)%	0.2%
Inter-segment revenues.....	<u>4,090</u>	<u>4,068</u>	<u>3,401</u>	0.5 %	19.6%
Total revenues.....	<u>29,206</u>	<u>30,559</u>	<u>29,828</u>	(4.4)%	2.5%

(1) Information for 2002 and 2001 has been reclassified to conform to 2003 organizational changes, including adjustments to reflect the reorganization of the agency business as of January 1, 2003. For more information, please refer to “— Reclassifications.”

## **Net Revenues**

In 2003, T-Com was again the main contributor to revenues in the Deutsche Telekom group. Net revenues decreased by EUR 1,375 million, or 5.2%, to EUR 25,116 million in 2003 from EUR 26,491 million in 2002. The sale of the remaining cable companies in March 2003 had a negative affect on net revenues in 2003 since these companies are no longer included in the consolidated group. T-Com’s total cable operations (including the six cable company operations deconsolidated in 2003) contributed EUR 167 million to net revenues in 2003, EUR 897 million in 2002, and EUR 1,065 million in 2001. Net revenues in 2003 were also negatively affected by a decrease of 6.6% in the call traffic volume from end customers, which resulted in a reduction in average market share in T-Com’s domestic fixed-line network from 61.2% in 2002 to 57.6 % in 2003. We believe that the decline in our market share will continue throughout 2004.

Primarily as a result of the introduction of call-by-call in April 2003 and carrier pre-selection in July 2003, our local market share as at December 31, 2003 measured in call volume decreased from 99.3% 2002 to 81.3%. We believe that the decline in our market share will continue throughout 2004. Additionally, net revenues decreased in the data communications and the terminal equipment business.

In Eastern Europe, net revenues decreased by EUR 29 million in 2003. The decrease was primarily due to the effects of exchange rates in Hungary and Croatia as well as a decrease in revenues at Slovak Telecom.

Net revenues increased by EUR 64 million, or 0.2%, to EUR 26,491 million in 2002 from EUR 26,427 million in 2001. This increase was primarily a result of the full-year consolidation of Hrvatski Telecom in 2002 (EUR 981 million) and increased network communications revenues. Additionally, net revenues in 2002 were positively affected by increased data communications revenues due to increases in demand, as well as subscriber growth in Matáv's mobile communications business.

### Inter-Segment Revenues

In 2003, revenues from business with other Deutsche Telekom divisions and affiliates (inter-segment revenues) amounted to EUR 4,090 million, an increase of EUR 22 million, or 0.5%, compared to inter-segment revenues of EUR 4,068 million in 2002. The increase was partially due to higher revenues from T-Online and T-Systems. Revenues from T-Online increased largely due to the growth in ISP origination services due to a higher demand for bandwidth and a growing number of online subscribers. The increase in revenues from T-Systems is attributable to the increased services purchased by T-Systems as a result of the customer relocation from T-Com to T-Systems. In addition, T-Com's revenues from T-Mobile decreased due to the direct interconnection among the networks of mobile carriers. The migration to direct interconnection has decreased the amount of traffic among the mobile carriers that is routed by T-Com through its fixed-line network. We expect the trend to direct interconnection to continue throughout 2004.

In 2002, inter-segment revenues increased by EUR 667 million to EUR 4,068 million from EUR 3,401 million in 2001. Revenues from T-Online increased by approximately EUR 86 million and from T-Systems by approximately EUR 750 million. These increases were primarily due to increases in the demand for bandwidth by T-Online as well as the increase of domestic carrier services, network communications and data communications services provided to T-Systems.

### Total Revenues

The following table reflects total revenues by geographic area:

	For the years ending December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Domestic .....	25,351	26,682	27,079	(5.0)%	(1.5)%
Eastern Europe .....	3,855	3,877	2,749	(0.6)%	41.0 %
<b>Total revenues</b> .....	<u>29,206</u>	<u>30,559</u>	<u>29,828</u>	(4.4)%	2.5 %

In 2003, T-Com's total revenues decreased by EUR 1,353 million, or 4.4%, to EUR 29,206 million from EUR 30,559 million in 2002. Domestic revenues accounted for approximately 86.8% of total revenues in 2003. Matáv, Hrvatski Telecom and Slovak Telecom account for all Eastern European revenues and contributed EUR 3,855 million, or approximately 13.2%, of total revenues in 2003.

In 2002, total revenues increased by EUR 731 million, or 2.5%, to EUR 30,559 million from EUR 29,828 million in 2001. Domestic revenues accounted for approximately 87.3% of total revenues during 2002. Matáv, Hrvatski Telecom and Slovak Telecom contributed EUR 3,877 million, or approximately 12.7%, of total revenues in 2002.

### Components of Total Revenues

Total revenues are derived principally from domestic fixed-line network revenues (primarily revenues from network communications, data communications, value-added services and terminal equipment sales), domestic carrier services, systems integration and consulting services in Germany and results from T-Com's Eastern European subsidiaries, which include revenues from the fixed-line networks, mobile communications business and online services of these subsidiaries.



	For the years ending December 31,				
	2003	2002 (millions of €)	2001	2003/2002 (% change)	2002/2001 (% change)
<b>Domestic</b>					
Network communications . .	15,103	15,154	14,840	(0.3)%	2.1%
Data communications . . . . .	1,979	2,392	2,564	(17.3)%	(6.7)%
Value-added services . . . . .	1,380	1,426	1,451	(3.2)%	(1.7)%
Terminal equipment . . . . .	798	927	991	(13.9)%	(6.5)%
Other fixed line network revenue . . . . .	406	1,173	1,440	(65.4)%	(18.5)%
<b>Total fixed-line network revenues . . . . .</b>	<b>19,666</b>	<b>21,072</b>	<b>21,286</b>	<b>(6.7)%</b>	<b>(1.0)%</b>
Domestic carrier services . .	4,670	4,399	4,709	6.2%	(6.6)%
System integration and consulting . . . . .	175	261	260	(33.0)%	0.4%
Other domestic revenues . .	840	950	824	(11.6)%	15.3%
<b>Total domestic revenues . . .</b>	<b>25,351</b>	<b>26,682</b>	<b>27,079</b>	<b>(5.0)%</b>	<b>(1.5)%</b>
<b>Eastern Europe</b>					
Matáv . . . . .	2,392	2,429	2,136	(1.5)%	13.7%
Hrvatski Telecom <sup>(1)</sup> . . . . .	1,034	1,007	153	2.7%	558.2%
Slovak Telecom . . . . .	429	441	460	(2.7)%	(4.1)%
<b>Total Eastern Europe revenues . . . . .</b>	<b>3,855</b>	<b>3,877</b>	<b>2,749</b>	<b>(0.6)%</b>	<b>41.0%</b>
<b>Total revenues . . . . .</b>	<b>29,206</b>	<b>30,559</b>	<b>29,828</b>	<b>(4.4)%</b>	<b>2.5%</b>

(1) First consolidated in November 2001.

### ***Total Domestic Revenues***

In 2003, total domestic revenues (total revenues derived from within Germany) decreased by EUR 1,331 million, or 5.0%, to EUR 25,351 million, from EUR 26,682 million in 2002. The decrease in total domestic revenues was primarily attributable to the deconsolidation of the cable companies, the continued negative pressures on revenues as a result of price reductions imposed by the German telecommunications regulator and increased competition in most areas of the fixed-line business. All components of domestic revenues, with the exception of domestic carrier services, have been subject to a reduction in revenues, as discussed in more detail below.

Total domestic revenues decreased by EUR 397 million, or 1.5%, to EUR 26,682 million in 2002 from EUR 27,079 million in 2001. This decrease was largely due to weakness in the data communications business, terminal equipment sales and other fixed-line network revenues, as discussed in more detail below.

### ***Network Communications***

Revenues from network communications consist of revenues from telephone communications originated in Germany. These revenues include primarily initial installation fees, monthly access charges and call charges. Call charges originate from local, regional and domestic long-distance calls, international calls, calls to mobile networks and calls to Internet service providers and SMS services.

In 2003, network communications total revenues decreased by EUR 51 million, or 0.3%, to EUR 15,103 million, from EUR 15,154 million in 2002. The decrease in revenues was primarily the result of a reduction in revenues from call charges, which were also impacted by the introduction of call-by-call and carrier pre-selection, and the withdrawal of AktivMobil (a product offering that combined fixed-line and mobile network access) from the market in 2003. This decrease in revenues was partially offset by price increases in access lines, the migration of customers to more advanced lines with higher prices and the increase in sales of broadband lines.

Revenues from call charges decreased in 2003 compared to the previous year. T-Com recorded lower revenues from local call charges in 2003. The introduction of call-by-call in the local network in April 2003 resulted in a substantial reduction in T-Com's market share for extended local calls.

In 2003, T-Com's fixed-line network market share as measured by call time in minutes decreased from 61.2% to 57.6%. T-Com launched innovative rate plan options in an attempt to minimize this decrease. However, it is expected that T-Com's market share in this area will continue to decrease primarily as a result of the introduction of call-by-call and carrier pre-selection.

Price reductions for call minutes were introduced on February 1, 2003 as part of the price-cap regime mandated by the German telecommunications regulator. As a result of these price reductions and a decrease in the total volume of customer minutes billed (related to a lengthening of the time increment used to bill customers), local call revenues decreased.

In 2003, the growth in revenues from monthly access charges exceeded the decrease in revenues from call charges. On February 1, 2003 and September 1, 2003, the prices of analog telephone lines were increased as part of the price-cap adjustments. Prices for the installation of T-DSL lines were also increased on January 1, 2003, which resulted in an increase in installation fee revenues, which partially offset the decline in network communications revenues.

Although the total number of access lines decreased in 2003 by 2.1% compared to 2002, revenues from monthly access charges increased due to growth in the number of higher priced T-ISDN lines. In addition, the number of T-DSL lines in operation grew by approximately 42.9% in 2003, which had a positive affect on revenues.

The number of analog lines decreased by 4.8% in 2003, from 28.9 million at the end of 2002 to 27.5 million at the end of 2003. We expect that the number of analog lines will continue to decline because of the migration to more advanced lines, increased competition, and increased use of mobile phones.

The total number of T-ISDN lines increased by 6.1% in 2003, from 9.8 million at the end of 2002 to 10.4 million at the end of 2003. In 2004, the growth in T-ISDN lines is expected to slow as the market becomes saturated.

The number of T-DSL lines in operation increased by 42.9% in 2003, from 2.8 million at the end of 2002 to 4.0 million at the end of 2003. T-Com believes that growth will remain largely stable throughout 2004. The strategic goal for T-Com is to increase the penetration of broadband lines.

Network communications revenues increased by EUR 314 million, or 2.1%, to EUR 15,154 million in 2002, from EUR 14,840 million in 2001. The growth in revenues from monthly access charges exceeded the decrease in revenues from call charges. Price increases for access lines of between 2% and 5% approved by the German telecommunications regulator during 2002 contributed to the increase in revenues from monthly access charges as well as an increase in T-DSL and T-ISDN access lines.

The decrease in revenues from call charges was primarily attributable to decreases in tariffs, market share and volume, particularly local traffic volume. Increased competition was the main reason for the significant decline in tariffs and loss of market share. According to the German telecommunications regulator, our fixed-line network market share, based on call times in minutes, decreased from 67.2% in 2001 to 61.2% in 2002. The increased use of mobile telephones also led to lower levels of call minutes in the fixed-line network.

#### *Data Communications*

Revenues from data communications services decreased by EUR 413 million, or 17.3%, to EUR 1,979 million in 2003 from EUR 2,392 million in 2002. This decrease is primarily the result of customer transfer from T-Com to T-Systems and changes in the product offering of T-Com. The transfer of customers to T-Systems relates to our corporate business solutions, in which we are migrating certain customers to T-Systems' service platform where they can be serviced more effectively. In addition, revenues relating to Telekom Design Networks decreased primarily due to lower customer demand for Carrier Service Network products as well as lower revenues for separate customer network solutions for business clients. The decrease in revenues from Telekom Design Networks is a result of the substitution of Carrier Service Network products due to changes in customer preferences for standard products rather than standard solutions. In 2002, the decrease in revenues for data communications services resulted from the decrease in revenues for leased lines.

### *Value-Added Services*

Revenues from value-added services include revenues from public telephones, toll free lines, shared cost services, mass calling services, premium rate services, information services, the directory assistance service and other operator services, such as call center services.

Revenues from value-added services decreased by EUR 46 million, or 3.2%, to EUR 1,380 million in 2003, from EUR 1,426 million in 2002. The decrease is mainly attributable to lower revenues from public telephone booths and premium-rate services. The decrease in revenues contributed by public telephone booths is largely attributable to the substitution effect of increased use of mobile telephones instead of fixed-line telephones. T-Com had reduced the number of telephone booths in service from 2002 to 2003 in expectation of further reductions in the usage of public telephone booths and the resulting revenues. The reduction in revenues from premium-rate services was primarily due to a declining market demand and a shift in customer traffic from services provided by T-Com to services provided by third-party content providers. In the future, T-Com believes these trends will continue.

This decrease in revenues in 2003 was partially offset by an increase in the revenues from T-Vote Call. T-Vote Call is a value-added telephone service offered to customers slightly cheaper than premium rate-services to run telephone campaigns such as contests, or for voting on quiz shows, which was in greater demand from customers in 2003.

Revenues from value-added services remained relatively constant from 2001 to 2002. The continued decline in revenues from the traditional public telephone business was offset by increasing revenues from other value-added services, such as toll-free lines. The decrease in revenues contributed by public telephone booths was largely attributable to the substitution effect of mobile telephones. As a result, T-Com had reduced the number of telephone booths in service from 2001 to 2002.

### *Terminal Equipment*

Revenues from sales of terminal equipment consist of revenues from the sale and rental of analog telephones, ISDN telephones and private branch exchanges relating to the fixed-line network and personal computers.

Revenues from sales of terminal equipment decreased by EUR 129 million, or 13.9%, to EUR 798 million in 2003, from EUR 927 million in 2002, due primarily to a reduction in demand for terminal equipment as a result of stagnant market conditions and the accompanying deterioration in the investment climate, and intense competition for such products.

Revenues from sales of terminal equipment decreased from 2001 to 2002, primarily due to lower demand for terminal equipment and accessories as a result of the unfavorable economic environment, and declines in sales of new equipment due to lower growth rates for ISDN lines. As in 2001, prices for terminal equipment continued to decrease in 2002. These decreases were partially offset by increases in revenues related to data communications equipment, which were attributable primarily to initial sales of T-DSL modems. T-DSL modems were given to customers free of charge in 2001.

### *Other Fixed-Line Network Revenues*

Other fixed-line network revenues consist mainly of support services for the installation, maintenance and repair of telecommunications equipment and related service support.

Other fixed-line network revenues decreased by EUR 767 million, or 65.4%, to EUR 406 million in 2003, from EUR 1,173 million in 2002. This decrease is largely attributable to the sale of the cable companies in March 2003.

Other fixed-line network revenues decreased by EUR 267 million, or 18.5%, to EUR 1,173 million in 2002, from EUR 1,440 million in 2001. This decrease is largely attributable to the deconsolidation of the broadband cable business in Baden-Wuerttemberg.

### *Domestic Carrier Services*

The domestic carrier services business consists primarily of interconnection services for operators of fixed-line networks and mobile communications networks, carrier-specific transmission paths, access to the unbundled local loop and ISPs.

Revenues from the domestic carrier services business increased by EUR 271 million, or 6.2%, to EUR 4,670 million in 2003 from EUR 4,399 million in 2002. This was largely due to increases in revenues from ISP services, carrier leased lines and broadband cable services, which increase was offset in part as a result of a decrease in revenues from interconnection services for operators of fixed-line networks and mobile communications networks. The decrease in revenues from interconnection services for fixed-line and mobile communication networks was due primarily to direct interconnection between the networks of T-Mobile and other mobile carriers.

The increase in ISP services resulted from the growth in volume due to increased usage of online services, which resulted in an increase in demand for services provided by T-Com to online service providers. In addition, revenues relating to data communications services provided by T-Com to other telecommunications carriers was recorded under Domestic Carrier Services in 2003.

Revenues from access to T-Com's unbundled local loop, which allows competitors to have direct access to telecommunications customers, increased in 2003 due to a 43% increase in the number of customer connections requested by competing carriers.

Revenues from Domestic Carrier Services are expected to decline in the future as a result of a decrease in transit services (calls via the Deutsche Telekom network to other fixed-line and mobile networks) and a shift in call usage from long-distance to cheaper short-distance due to other carriers that may provide cheaper long distance and other services.

Driven by the creation and expansion of their own infrastructures by competitors in Germany, the decrease in revenues is partially offset by the increasing growth in carrier selection local call minutes, but not in sufficient volumes to reverse this trend.

Revenues from the domestic carrier business decreased by EUR 310 million, or 6.6%, to EUR 4,399 million in 2002, from EUR 4,709 million in 2001. This decrease was due primarily to a reduction in interconnection charges and lower sales volumes resulting from the direct interconnection between the networks of mobile communications operators. This direct interconnection caused a significant decrease in traffic routed through T-Com's network. Also, the demand for carrier services products decreased in 2002 due to market consolidation and the insolvency of a number of carriers. Further declines in revenues during 2002 from domestic carrier services resulted from reductions in the demand for shared space related to telecommunications equipment, lower volumes of call minutes generated through pre-selection and transfers of carriers from standard leased lines to lower priced carrier leased lines.

#### *Systems Integration and Consulting*

Systems integration and consulting consists of implementation, support and consulting in the area of telecommunications applications, and also include service solutions for T-LAN and communications networking, wiring and network expansion, as well as fault clearance and E-Business Solutions.

Revenues decreased by EUR 86 million, or 33.0%, to EUR 175 million in 2003, from EUR 261 million in 2002. The revenue trend from ongoing business was characterized by a difficult market environment and lack of investment activities due to the weak economy.

From 2001 to 2002, T-Com's total revenues from systems integration and consulting remained relatively stable.

#### *Other Domestic Revenues*

Other domestic revenues consist mainly of sales commissions from other segments for the sale of their products through our outlets, such as T-Punkt shops, and charges for support functions. They also include revenues from the publication and sale of subscriber data to telecommunications services (e.g. yellow pages), from the production and sale of prepaid cards for online-shopping and prepaid cards for mobile phones.

Other domestic revenues decreased by EUR 110 million, or 11.6%, to EUR 840 million in 2003 from EUR 950 million in 2002. This decrease was primarily the result of higher levels of non-product-specific rebates in the current year as well as lower revenues from the publishing and directory business. The decrease in revenues from the publishing and directory business was largely due to a consolidation of our portfolio of certain low-margin business customers, as well as a decline in advertising revenues due to the weakness in the German economy.

Other domestic revenues increased by EUR 126 million from 2001 to 2002. This increase is mainly attributable to higher sales from third-party products through our sales channels. Additionally, in 2002, for the first time, other Deutsche Telekom divisions were charged fees for administration and support functions provided through T-Com's sales channels.

### ***Total Eastern Europe Revenues***

Total revenues from Eastern European subsidiaries were EUR 3,855 million in 2003, slightly lower than the EUR 3,877 million in 2002. This decrease was largely due to the negative currency exchange rate effects in Hungary and Croatia. When measured in local currencies, revenues at Matáv and Hrvatski Telecom increased year-on-year. Revenues from the fixed-line networks have continued to decline in 2003, offset in part by the continuing trend towards strong growth in the mobile businesses. Demand for online services and fixed-network broadband applications has also grown in Eastern Europe in 2003, although from a lower initial base.

Total revenues increased by EUR 1,128 million, or 41.0%, to EUR 3,877 million in 2002, from EUR 2,749 million in 2001. Of this increase, Hrvatski Telecom contributed approximately EUR 854 million as a result of its full-year consolidation in 2002. The increase was also a result of the growth in the mobile communications and data communications businesses.

### ***Matáv***

Matáv generates its revenues from the fixed-line network, mobile communications business, carrier services business, online services, and from cable businesses. In 2003, total revenues decreased from EUR 2,429 million to EUR 2,392 million, or 1.5% primarily as a result of currency translation effects. In local currency, Matáv's total revenues increased from HUF 591 billion to HUF 607 billion, or 2.7%. The growth rate was slower than the previous year mainly due to the impact of stricter regulation affecting fixed-line network services.

Fixed-line network revenues fell by 6.7%, from EUR 1,297 million to EUR 1,210 million. Although more traffic was generated from the fixed-line network into the mobile network, this was not sufficient to offset the deterioration in international traffic — resulting from fewer minutes — and the less favorable currency exchange rate. In 2003, minutes in the fixed-line network fell appreciably and total number of access channels marginally declined.

Revenues from mobile communications increased by approximately 7%, due to an increase in call minutes and an increase in the number of subscribers. The number of subscribers increased from 3.4 million to 3.8 million. Prepaid customers represent 73.9% of the total Westel customers as of December 31, 2003.

Revenues from carrier services decreased by approximately 27%, primarily as a result of decreased termination and interconnection charges mandated by the regulatory authority.

Revenues from online services increased, primarily as a result of an increase in the number of subscribers, which grew by 14%, from 185,000 to 211,000, and an increase in the number of broadband customers.

Revenue from the fixed-line network and interconnection services is expected to continue to decrease in 2004. The mobile segment is still growing but at a slower pace, because of saturation of the market and competition.

Matáv's total revenues increased by EUR 293 million, or 13.7%, to EUR 2,429 million in 2002, from EUR 2,136 million in 2001, attributable primarily to higher growth in the mobile communications business (through Matáv's Westel and MakTel subsidiaries), online services and data communications business.

### ***Hrvatski Telecom***

Hrvatski Telecom generates its revenues from the fixed-line network, mobile communications business, carrier services business and online services. Total revenues increased by 2.7% to EUR 1,034 million in 2003, from EUR 1,007 million in 2002, despite a negative currency translation effect of 2.0%. In local currency, total revenues increased 4.8%. Although the fixed-line network revenues reflected a slight downward trend, mainly due to a decrease of analog access lines by 28,000 to 1.6 million and minutes of use from 5,166 billion to 5,120 billion, the mobile communications revenues



increased by approximately 14%, primarily as a result of an increase in subscribers from 1,242 million to 1,340 million. Revenues from carrier services increased by 10.7%, while online service revenues increased by nearly 100%, although from a lower initial base, due mainly to an increase in subscribers from approximately 370,000 to approximately 480,000.

In connection with the acquisition of the second tranche of 16% of the shares of Hrvatski Telecom, a commitment was signed to invest an amount of EUR 748 million in Hrvatski Telecom from 2002 to 2004. The goal of this investment program was primarily the expansion of the fixed-line and mobile network infrastructures.

Primarily as a result of its full-year consolidation, Hrvatski Telecom's total revenues increased by EUR 854 million to EUR 1,007 million in 2002, from EUR 153 million in 2001. Apart from this consolidation effect, Hrvatski Telecom's total revenues increased primarily due to increased subscriber growth in the mobile communications business, in particular with prepaid customers.

#### *Slovak Telecom*

Slovak Telecom generates its revenues from the fixed-line network, carrier services, online services and broadcasting services. Slovak Telecom's total revenues decreased by EUR 11 million, or 2.7%, to EUR 429 million in 2003 from EUR 441 million in 2002. The Slovak crown strengthened during 2003, so the decrease in euros was not as severe as in local currency, where the revenue decline amounted to 5.5%. The decrease in revenue is mainly attributable to the continuing decrease in analog access lines in the fixed-line network, which is primarily the result of competition from mobile operators, which decline could not be offset by the growth in ISDN and ADSL access lines and data communications. Furthermore, the decreasing prices for international traffic in combination with the increasing competition for termination of international calls led to a decrease of international carrier services revenues.

Slovak Telecom's total revenues decreased by EUR 19 million, or 4.1% to EUR 441 million in 2002 from EUR 460 million in 2001. The decrease is primarily attributable to the substitution of fixed-line business by increased usage of mobile communications.

### **Operating Expenses**

#### ***Cost of Sales***

Cost of sales decreased by EUR 1,381 million, or 7.5%, to EUR 16,958 million in 2003 when compared to EUR 18,339 million in 2002. This decrease is primarily attributable to lower depreciation and amortization as well as costs associated with the termination of customer traffic in the networks of other carriers. In addition, costs related to repair and network maintenance as well as rental costs related to housing for technical equipment decreased. A decrease in personnel costs due to a reduction in staff levels resulting from the transfer of T-Com employees to Vivento also contributed to the decrease in cost of sales. T-Com will not incur additional costs relating to employees transferred to Vivento. For more information see "—Group Headquarters and Shared Services." Furthermore, costs associated with purchases of terminal equipment decreased due to the decline in customer demand in this area. For more information see "—Terminal Equipment." In addition, costs decreased due to the sale of Kabel Deutschland GmbH in 2003, which had the effect of reducing costs in 2003, when compared to 2002.

Cost of sales increased from 2001 to 2002 primarily as a result of increases in personnel costs due to wage increases as well as the first full-year consolidation of Hrvatski Telecom. Cost of sales at Hrvatski Telecom was EUR 544 million in 2002 compared to EUR 82 million in 2001.

#### ***Selling Costs***

Selling costs decreased slightly in 2003 to EUR 6,115 million primarily as a result of the decrease in write-downs of receivables related to carrier services. In addition, advertising and marketing costs decreased compared to the previous year. Further, levels of personnel in our sales organization were reduced due to the transfer of these employees to Vivento. In addition, costs decreased due to the sale of Kabel Deutschland GmbH in 2003, which had the effect of reducing costs in 2003, when compared to 2002.

The increases in selling costs in 2002 and 2001 were the result of tariff increases in personnel costs and the first full-year consolidation of Hrvatski Telecom. The effect of the first full-year

consolidation of Hrvatski Telecom was in 2002. Selling costs at Hrvatski Telecom were EUR 106 million in 2002 compared to EUR 39 million in 2001.

### ***Administrative Costs***

In 2003, general administrative costs decreased slightly to EUR 1,707 million. The decrease was largely the result of reductions in travel and training costs. In addition, certain centralized personnel and organizational responsibilities were transferred into T-Com's operational areas. The costs associated with these activities have been shown under cost of sales and selling costs in the current year. This decrease was partially offset by increased costs from activities relating to press and communication, trademark protection, regulation, controlling and IT Services. T-Com assumed these additional responsibilities relating to T-Com businesses from Group Headquarters and Shared Services. In addition, costs decreased due to the sale of Kabel Deutschland GmbH in 2003, which had the effect of reducing costs in 2003, when compared to 2002.

The increase in administrative costs in 2002 from 2001 was primarily the result of additional personnel costs and the first full-year consolidation of Hrvatski Telecom. Administrative costs at Hrvatski Telecom were EUR 87 million in 2002 compared to EUR 29 million in 2001.

### **Financial Income (Expense) Net**

Net financial expense decreased in 2003 by EUR 140 million, or 16.1%, to EUR 727 million, from EUR 867 million in 2002. This decrease was primarily the result of reductions in net interest expense (EUR 247 million) reflecting the decline in T-Com's debt in 2003. This decrease was partially offset by increases in losses related to associated and related companies, which were largely due to the effects of write-downs, assumption of losses and loss accruals relating to our investment in the Toll Collect project company (EUR 442 million). These losses primarily related to delays in the scheduled completion of the toll collection system. Furthermore, non-recurring valuation adjustments for loans to associated companies of Kabel Deutschland GmbH (EUR 322 million) in 2002 had the effect of reducing net financial expenses in 2003, when compared to 2002. Net financial expense for 2002 remained relatively stable compared to 2001.

### **Income Before Taxes**

Income before taxes increased by EUR 643 million, or 17.8%, to EUR 4,247 million in 2003. The decrease in revenues was offset by decreases in maintenance and rental expenses for T-Com's fixed-line network, reductions of losses on accounts receivable and reductions in costs due to the transfer of T-Com employees to Vivento. In addition the gain on the sale of the six cable companies EUR 320 million also contributed to the increase in income before taxes. Increases in accruals for employee severance and pensions had a negative effect in 2003.

Income before taxes decreased by EUR 1,069 million, or 22.9%, to EUR 3,604 million in 2002 as compared to EUR 4,673 million in 2001. This decrease was primarily the result of lower gains from divestitures of approximately EUR 975 million and additional net interest expense of EUR 215 million. This was partially offset by a reduction in valuation adjustments for loans to associated companies as well as increases in the equity values in certain associated companies.

### **Depreciation and Amortization**

Depreciation and amortization decreased by EUR 370 million, or 6.7%, to EUR 5,169 million in 2003 from EUR 5,539 million in 2002. This decrease was primarily due to the reduced volume of depreciation following the disposal of the remaining cable companies in 2003. In addition reductions in capital expenditures led to lower depreciation and amortization costs in 2003.

The increase in depreciation and amortization in 2002 was largely due to the first full-year consolidation of Hrvatski Telecom. This was partly offset by reductions in capital expenditures for the fixed-line network in Germany, which led to lower depreciation and amortization costs in 2002.

### **Personnel Costs**

Personnel costs primarily consist of wages and salaries, but also include social security, pension costs and other employee benefits.

Personnel costs increased from 2002 to 2003 primarily as a result of increases in accruals for employee severance in Germany and Croatia, increases in pension accruals due to changes in interest rates as well as increases in wages and salaries as compared to the previous year. These increases were only partially offset by reductions in T-Com's headcount by approximately 19,500 employees of which approximately 12,500 were transferred to Vivento during 2003. T-Com will not incur further costs relating to employees transferred to Vivento. For more information, see "— Group Headquarters and Shared Services."

Personnel costs increased from 2001 to 2002 primarily as a result of increases in wages and salaries as well as the first full-year consolidation of Hrvatski Telecom. Personnel costs in 2002 were also affected by restructuring measures related to Matáv and Slovak Telecom and additions to pension accruals attributable to changes in the life expectancy tables underlying certain actuarial calculations.

### Capital Expenditures

Capital expenditures decreased by EUR 948 million (29.0%) in 2003 as compared to the previous year. This is mainly attributable to reduction in expenditures related to the extension of our SDH transmission platform in 2002. Other factors included a slow down in the expansion of the fixed-line network partially due to weak market conditions and a reduction in real estate construction in Germany. The increase in capacity utilization for ISDN access lines, declining growth rates and minimized capital expenditure in the PSTN network also led to a reduction in overall capital expenditures as well.

There was a decrease in capital expenditures in 2002 compared to 2001 primarily resulting from lower investments in core business areas.

### T-Systems

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

	For the year ended December 31, <sup>(1)</sup>				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Net revenues . . . . .	7,184	6,895	7,121	4.2%	(3.2)%
Inter-segment revenues . . . . .	3,430	3,594	3,700	(4.6)%	(2.9)%
Total revenues . . . . .	<u>10,614</u>	<u>10,489</u>	<u>10,821</u>	1.2%	(3.1)%
Loss before taxes . . . . .	<u>(138)</u>	<u>(1,990)</u>	<u>(389)</u>	93.1%	(411.6)%

(1) Information for 2002 and 2001 has been reclassified to conform to 2003 organizational changes, including adjustments to reflect the reorganization of the agency business as of January 1, 2003. For more information, please refer to "— Segment Analysis — Reclassifications."

### Net Revenues

Net revenues (total revenues excluding inter-segment revenues) amounted to EUR 7,184 million in 2003, representing an increase of EUR 289 million, or 4.2%, as compared with EUR 6,895 million in 2002 due to a large degree to a change in our business strategy in 2003. The increase of EUR 289 million was achieved despite the deconsolidation of companies, mainly T-Systems Siris SAS, T-Systems MultiLink SA and TeleCash GmbH. All deconsolidated companies contributed net revenues to T-Systems of approximately EUR 163 million in 2003, EUR 395 million in 2002 and EUR 376 million in 2001.

The 15.8% net revenue growth in 2003 in the Telecommunications services unit (TC) was partially offset by a 8.1% decline in net revenues of our Information Technology services unit (IT).

Net revenues decreased by EUR 226 million, or 3.1%, to EUR 6,895 million in 2002 as compared with EUR 7,121 million in 2001. This decrease in net revenues was primarily due to the impact of the difficult economic situation on T-Systems' various business activities and the corresponding decline in the market for telecommunications (TC) services and information technology (IT) services in all sectors. This decrease in net revenues was partially offset by the contribution to net revenues of EUR 86 million relating to the acquisition of DeTeCon International GmbH. Additionally, the sale of Groupe Spring and Marketech had a negative impact on net revenues.

## Total Revenues

In addition to providing data processing, other information technology and services such as provision of computer center services, desktop services and application services to third parties, T-Systems is the primary provider of such services, within Germany, to the Deutsche Telekom group.

Approximately 32.3% of T-Systems' total revenues in 2003 were attributable to inter-segment revenues, as compared to 34.3% in 2002 and 37.8% in 2001. For 2003, approximately 18.3% of T-Systems' TC services revenues and approximately 45.0% of T-Systems' IT services revenues were from other segments within the Deutsche Telekom group.

For the year ended December 31, 2003, total revenues of T-Systems increased by EUR 125 million, or 1.2%, to EUR 10,614 million, as compared to EUR 10,489 million in 2002. This increase was due to the increase of EUR 289 million in net revenues offset by a decrease in inter-segment revenues in the amount of EUR 164 million, or 4.6%. The increase in total revenues of EUR 125 million was achieved despite the deconsolidation of companies, mainly T-Systems Siris SAS, T-Systems MultiLink SA and TeleCash GmbH. All deconsolidated companies contributed to total revenues approximately EUR 165 million in 2003, EUR 418 million in 2002 and EUR 392 million in 2001. Inter-segment revenues amounted to EUR 3,430 million in 2003, as compared to EUR 3,594 million in 2002. In addition, the decrease in inter-segment revenues was affected by our ongoing group-wide cost efficiency program, which resulted in reduced budgets for IT services at other divisions and in reduced prices for IT services. The price reductions were partially offset by increasing volumes delivered by T-Systems.

Inter-segment revenues of the Deutsche Telekom group decreased by EUR 106 million, or 12.9%, to EUR 3,594 million in 2002 as compared to EUR 3,700 million in 2001, primarily as a result of reduced prices for IT services. For 2002, approximately 25.7% of T-Systems' TC services revenues and approximately 41.4% of T-Systems' IT services revenues were from other segments within the Deutsche Telekom group. Due to the high proportion of inter-segment revenues combined with its dependence on the purchase of services from other divisions, T-Systems' operating results before consolidation depend to a large degree on the conditions and prices employed in its dealings with our other divisions.

T-Systems expects a stabilization of inter-segment revenues in 2004. T-Systems also expects further growth in TC net revenues and a slight growth in IT net revenues in 2004.

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
<b>Total TC services revenues</b> .....	<b>5,033</b>	<b>4,779</b>	<b>4,911</b>	<b>5.3%</b>	<b>(2.7)%</b>
<b>Total IT services revenues</b>					
Systems Integration and Consulting. . .	1,833	1,918	2,023	(4.4)%	(5.2)%
Computing Services .....	2,427	2,366	2,444	2.6%	(3.2)%
Desktop Services.....	1,321	1,426	1,443	(7.4)%	(1.2)%
<b>Total IT services revenues</b> .....	<b>5,581</b>	<b>5,710</b>	<b>5,910</b>	<b>(2.3)%</b>	<b>(3.4)%</b>
<b>Total revenues</b> .....	<b>10,614</b>	<b>10,489</b>	<b>10,821</b>	<b>1.2%</b>	<b>(3.1)%</b>

## TC Services

For the year ended December 31, 2003, TC total revenues increased by EUR 254 million, or 5.3%, to EUR 5,033 million, as compared to EUR 4,779 million in 2002. The increase of EUR 254 million was achieved despite the deconsolidation of T-Systems Siris SAS, T-Systems MultiLink SA and TeleCash GmbH, which contributed to total TC revenues approximately EUR 128 million in 2003, EUR 371 million in 2002 and EUR 337 million in 2001. The increase in TC total revenues in 2003 was mainly due to higher revenues from external domestic and international network services accompanied by slight growth in International Carrier Sales and Solutions (ICSS) amounting to EUR 120 million and Media Broadcast amounting to EUR 27 million. These higher revenues resulted primarily from increased sales activities as well as international expansion to offer such services to globally active customers. Domestic TC revenues achieved an increase in total revenues of EUR 162 million, or 5.1%, in line with overall market growth.

As a result of previous investments in international backbone capacities, ICSS together with T-Systems' international affiliates was able to route approximately 8% more traffic over its own

network, compensating for decreasing prices in the world market (14.1 billion minutes of voice traffic in 2003 compared with 13.0 billion minutes in 2002). Decreasing prices mainly resulted from increasing wire capacity and increasing competitive pressure due to shorter price change intervals.

In 2003, inter-segment revenues accounted for 18.3% of TC total revenues and decreased by EUR 307 million as compared to 2002 primarily due to increased technical capacity resulting in price declines. In addition, other price reductions, especially with T-Com, resulted mainly from regulatory pricing decisions. Additionally, the sale of the cable companies led to a reduction of inter-segment revenues of approximately EUR 27 million.

For the year ended December 31, 2002, TC total revenues decreased by EUR 132 million, or 2.7%, to EUR 4,779 million, as compared to EUR 4,911 million in 2001. This decrease is primarily due to the decrease of EUR 99 million in the international activities of TC Services. The TC business was negatively affected by the general economic slowdown. Additionally, price decreases primarily caused by reduced call termination rates in the ICSS unit resulted in a decrease in revenues. Traffic volume remained nearly constant in 2002 (13.0 billion minutes of voice traffic versus 12.9 billion minutes in 2001).

## ***IT Services***

### *Systems Integration and Consulting*

Total revenues decreased by EUR 85 million, or 4.4%, to EUR 1,833 million as compared to EUR 1,918 million in 2002. This decrease resulted primarily from price pressure in contracting domestic and international markets. Despite reduced staff, invoiced hours remained nearly constant as compared to 2002. Inter-segment revenues accounted for approximately 46.5% of total system integration revenues in 2003 and remained nearly constant compared to the previous year.

For the year ended December 31, 2002, total revenues decreased by EUR 105 million, or 5.1%, to EUR 1,918 million, as compared to EUR 2,023 million in 2001. This decrease was primarily due to customers' discretionary spending reductions. In addition, the insolvency of other domestic customers added EUR 16 million to this decrease. The decrease was offset in part by the consolidation of Detecon International GmbH, which contributed revenues of EUR 86 million in 2002.

### *Computing Services*

For the year ended December 31, 2003, total revenues increased by EUR 61 million, or 2.5%, to EUR 2,427 million as compared to EUR 2,366 million in 2002. This increase is primarily a result of increasing inter-segment revenues. In 2003, approximately 44.6% of Computing Services' total revenues resulted from inter-segment revenues. Inter-segment revenues increased by EUR 137 million, or 14.5%, in 2003 as compared to a decline of EUR 183 million, or 16.2%, in 2002. Pricing pressure within the group was partially offset by increasing volumes in 2003. External revenues declined due to intense price pressure. The increase in inter-segment revenues was mainly due to outsourcing agreements with non-domestic companies within our T-Mobile division, which were entered into during the second half of 2002.

For the year ended December 31, 2002, total revenues decreased by EUR 78 million, or 3.2%, to EUR 2,366 million, as compared to EUR 2,444 million in 2001. This decrease is primarily attributable to a reduction in international activities, which was partially offset by an increase in national inter-segment activities. In addition, the insolvency of some domestic customers and the resulting termination of outsourcing agreements with them contributed to the decrease in net revenues (EUR 12 million).

### *Desktop Services*

Total revenues decreased by EUR 105 million, or 7.4%, to EUR 1,321 million as compared to EUR 1,426 million in 2002. A portion of this decrease related to revenues of Groupe Spring and Marketech, which were partially included in 2002 revenues and were no longer included in 2003 revenues. In 2003, total international revenues, including this deconsolidation effect, decreased by EUR 71 million, or 17.7%, to EUR 330 million as compared to EUR 401 million in 2002. Domestic revenues decreased by EUR 34 million from 2002 to 2003 mainly as a result of lower revenues from major customers due to the difficult general economic situation. Revenues in the reselling business decreased due to continuing low demand in the market while revenues from services such as user help desk and support activities increased to 61% of the total domestic revenues in 2003 from 58% in 2002.



Inter-segment revenues account for approximately 43.5% of Desktop Services' total revenues in 2003. From 2002 to 2003, inter-segment revenues remained at the previous year's level due to the effects of reduced prices (approximately EUR 37 million) and reduced number of desktops managed and amounted to EUR 574 million.

For the year ended December 31, 2002, total revenues decreased by EUR 17 million, or 1.2%, to EUR 1,426 million, as compared to EUR 1,443 million in 2001. The decrease was primarily due to the divestiture of the subsidiaries T-Systems Marketech and Groupe Spring. This decrease was partially offset by an increase in total revenues (EUR 26 million) from the reselling of workstations and desktops.

### **International Revenues**

	<b>For the year ended December 31,</b>				
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	(millions of €)			(% change)	
Total Revenues .....	10,614	10,489	10,821	1.2%	(3.1)%
Domestic .....	7,762	7,584	7,783	2.3%	(2.6)%
International .....	2,852	2,905	3,038	(1.8)%	(4.4)%

Total revenues from international operations declined over the period 2001 to 2003. International revenues decreased by EUR 53 million, or 1.8%, to EUR 2,852 million in 2003 as compared to EUR 2,905 million in 2002. The disposal of the non-core subsidiaries Siris and MultiLink led to a decline in international revenues in the amount of EUR 176 million, which was partly offset by increased revenues in the TC unit.

As a percentage of T-System's total revenues, international revenues declined from 28.1% in 2001, to 27.7% in 2002 and 26.9% in 2003.

### **Operating Expenses**

The following table provides information regarding components of operating expenses of T-Systems.

	<u>2003</u>		<u>2002</u>		<u>2001</u>		<u>2003/2002</u>	<u>2002/2001</u>
	(in millions of €, except percentages)							
Cost of sales .....	9,183	79.0%	9,529	73.0%	9,315	79.2%	(3.6)%	2.3%
Selling costs .....	671	5.8%	876	6.7%	1,018	8.7%	(23.4)%	(13.9)%
Administrative costs .....	751	6.5%	909	7.0%	767	6.5%	(17.4)%	18.5%
Other operating expenses .....	1,011	8.7%	1,741	13.3%	662	5.6%	(41.9)%	163.0%
<b>Total</b> .....	<u>11,616</u>	<u>100.0%</u>	<u>13,055</u>	<u>100.0%</u>	<u>11,762</u>	<u>100.0%</u>	(11.0)%	11.0%

### **Cost of Sales**

Cost of sales decreased in 2003 by EUR 346 million, or 3.6%, to EUR 9,183 million as compared to 2002. The cost of sales of the deconsolidated companies recorded by T-Systems were EUR 151 million in 2003 and EUR 481 million in 2002. In addition, the decrease in cost of sales was primarily a result of lower depreciation costs in 2003 as compared to 2002 resulting from the strategic review in 2002, which led to non-scheduled asset write-downs in 2002 and of the group-wide efficiency efforts such as reduced investments and related depreciation. In addition, the reduction of average staffing levels for the year led to a further decrease in costs of sales. The decrease in cost of sales was partially offset by increased expenses for goods and services purchased due to increased revenues.

Cost of sales increased in 2002 by EUR 214 million, or 2.3%, to EUR 9,529 million as compared to 2001. This increase resulted mainly from non-scheduled asset depreciation relating to telecommunications equipment at SIRIS and Multilink. In addition, T-Systems recorded non-scheduled write-downs relating to mainframe and storage equipment, servers and other assets in computer center operations. Further, EUR 33 million of the increase in depreciation was due to accelerated depreciation charges for storage equipment based on a reassessment of the useful life of the relevant equipment. Due to an oversupply of capacity in the telecommunications market, T-Systems recorded non-scheduled depreciation of submarine cable assets amounting to EUR 228 million, partly offset by a reduction in depreciation expense resulting from a decrease in capital expenditures, primarily in network services and computing services.

### ***Selling Costs***

Selling costs amounted to EUR 671 million in 2003, representing a decrease of EUR 205 million, or 23.4%, compared to 2002. This was mainly a result of staff reductions within T-Systems. The deconsolidation of companies contributed to the decrease in selling costs. The selling costs of deconsolidated companies recorded by T-Systems were EUR 18 million in 2003 and EUR 117 million in 2002. In addition, this decrease was partially attributable to an increase in allowances for accounts receivable recorded in 2002 with respect to the insolvency of some domestic customers amounting to EUR 21 million. The decrease in selling costs was partially offset by increased selling costs attributable to the establishment of international network sales organizations.

Selling costs amounted to EUR 876 million in 2002, representing a decrease of EUR 142 million, or 13.9%, compared to 2001. This decrease in selling costs was mainly a result of the cost efficiency program implemented during 2002.

### ***Administrative Costs***

Administrative costs amounted to EUR 751 million in 2003, representing a decrease of EUR 158 million, or 17.4%, compared to 2002. The decrease was mainly a result of our cost efficiency program covering all functional areas. In addition, the reduction of average staffing levels for the year led to a further decrease in costs of sales. The deconsolidation of companies contributed to the decrease in administrative costs. The administrative costs of the deconsolidated companies recorded by T-Systems were EUR 14 million in 2003 and EUR 33 million in 2002.

Administrative costs amounted to EUR 909 million in 2002, representing an increase of EUR 142 million, or 18.5%, compared to 2001. This was mainly a result of increased staff.

### ***Other Operating Expenses***

Other operating expenses amounted to EUR 1,011 million in 2003, representing a decrease of EUR 730 million, or 41.9%, as compared to 2002. This is mainly a result of lower amortization expenses amounting to EUR 640 million relating to the deconsolidated companies SIRIS, MultiLink and Telecash. This was partially offset by higher amortization expenses in the amount of EUR 44 million due to the full year amortization with respect to the acquisition the remaining stake of debis Systemhaus GmbH, which was merged into T-Systems International GmbH at the end of 2002. In addition, no further significant restructuring charges were recorded in 2003, as compared to 2002 leading to a decrease in other operating expenses.

Other operating expenses amounted to EUR 1,741 million in 2002, representing an increase of EUR 1,079 million, or 162.9%, as compared to 2001. This was mainly a result of amortization expenses affected by non-scheduled amortization (EUR 597 million) in conjunction with our 2002 strategic review and restructuring initiatives, primarily related to business activities in France and Switzerland, including nonscheduled amortization of the entire amount of goodwill (EUR 564 million) related to the SIRIS domestic carrier service business in France and EUR 32 million related to MultiLink SA, as a result of management's decision to refocus its strategy, to downsize and to exit specific business activities.

### **Financial Income (Expense), Net**

Net financial expense in 2003 decreased by EUR 76 million to EUR 42 million as compared to EUR 118 million in 2002. This decrease is in part due to a positive cash flow in 2003 resulting in improved interest income amounting to EUR 58 million.

Net financial expense increased by EUR 233 million to EUR 118 million in 2002 when compared to net financial income of EUR 115 million in 2001, primarily as a result of the acquisition of the remaining 49.9% of the shares of debis Systemhaus in the first quarter of 2002. T-Systems used its inter-segment financial receivables (approximately EUR 2,165 million) and also a loan from Deutsche Telekom AG in the amount of EUR 2,538 million to finance this transaction.

### **Income (Loss) Before Taxes**

T-Systems recorded a loss before taxes of approximately EUR 138 million in 2003 compared to a loss of EUR 1,990 million in 2002, which reflects a substantial year-on-year improvement. This is primarily the result of a decline in operating expenses across all cost areas. In addition, other

operating income increased by EUR 214 million, or 31.0%, from 2002 to 2003 mainly due to the sale of non-core businesses and assets and, to a lesser extent, gains from foreign currency translations.

T-Systems recorded a loss before taxes of approximately EUR 1,990 million in 2002 compared to a loss before taxes of EUR 389 million in 2001. This increase was primarily attributable to non-scheduled amortization of goodwill and depreciation of property, plant and equipment along with restructuring charges as described above. Additionally, 2002 was marked by fierce price competition due to overcapacities in the market. Due to the economic slowdown, many customers decreased their information technology budgets.

## T-Mobile

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

	For the year ended December 31,				
	2003	2002 <sup>(1)</sup>	2001 <sup>(1)</sup>	2003/2002	2002/2001
	(millions of €)			(% change)	
Net revenues . . . . .	21,572	18,339	13,101	17.6%	40.0%
Inter-segment revenues . . . . .	1,206	1,396	1,536	(13.6)%	(9.1)%
Total revenues . . . . .	22,778	19,735	14,637	15.4%	34.8%
Income (loss) before taxes . . . . .	831	(23,754)	(6,441)	n.m.	n.m.

(1) Information for 2002 and 2001 has been reclassified to conform to 2003 organizational changes, including adjustments to reflect the reorganization of the agency business as of January 1, 2003. For more information, please refer to “— Reclassifications.”

### Net Revenues

The net revenues from our T-Mobile division, which reflects revenues from customers outside of the Deutsche Telekom group, increased by EUR 3,233 million or 17.6% to EUR 21,572 million in 2003 from EUR 18,339 million in 2002. Continued growth in the number of subscribers was the dominant factor in the revenue development of the T-Mobile group in 2003, especially for the revenue growth at T-Mobile USA. Additionally, net revenues were affected by the full year consolidation in 2003 of T-Mobile Netherlands, which contributed to net revenues for only three months in 2002.

The aggregate number of subscribers increased from 53.9 million in 2002 to 61.1 million in 2003 (including Virgin Mobile subscribers of 2.4 million in 2002 and 3.6 million in 2003) or 13.2%. This increase was mainly a result of strong subscriber growth in the United States, and to a lesser extent, subscriber growth in Europe.

Net revenues increased by EUR 5,238 million, or 40.0%, to EUR 18,339 million in 2002 from EUR 13,101 million in 2001. The increase in T-Mobile’s net revenues in 2002 was partly due to the effect of the full-year consolidation in 2002 of our U.S. subsidiary, T-Mobile USA, as compared to the seven-months consolidation in 2001. Additionally, net revenues were affected by the consolidation for a full year in 2002 of T-Mobile Czech Republic as compared to the nine-months consolidation in 2001 and the full consolidation of T-Mobile Netherlands since September 30, 2002.

### Total Revenues

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

Inter-segment revenues decreased by EUR 190 million, or 13.6%, to EUR 1,206 million in 2003 from EUR 1,396 million in 2002. This decrease was primarily due to a decline in the volume of calls through our fixed-line network in Germany. Inter-segment revenues decreased by EUR 140 million, or 9.1% to EUR 1,396 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.

Revenues from mobile termination fees are primarily generated in our European operations. Revenues from European mobile termination fees were approximately 12.0% of total revenues in 2003 (14.0% of total revenues in 2002). In 2003, in the UK and the Netherlands, the regulatory bodies and

mobile operators agreed to decrease mobile termination fees. In other European countries, T-Mobile expects that termination fees will decrease in the future. T-Mobile further expects that the negative impacts on revenues will be somewhat mitigated by volume increases and revenues generated by other mobile services.

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

<b>Subsidiary</b>	<b>As of December 31,</b>				
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003/2002</b>	<b>2002/2001</b>
	<b>(Subscribers in millions)</b>			<b>(% change)</b>	
T-Mobile Deutschland . . . . .	26.3	24.6	23.1	6.9%	6.5%
T-Mobile UK <sup>(1)</sup> . . . . .	13.6	12.4	10.4	9.7%	19.2%
T-Mobile USA <sup>(2)</sup> . . . . .	13.1	9.9	7.0	32.3%	41.4%
T-Mobile Austria . . . . .	2.0	2.0	2.1	—	(4.8)%
T-Mobile Czech Republic (RadioMobil) <sup>(3)</sup> . . . . .	4.0	3.5	2.9	14.3%	20.7%
T-Mobile Netherlands (Ben) <sup>(4)</sup> . . . . .	<u>2.0</u>	<u>1.4</u>	<u>—</u>	42.9%	n.m.
Total <sup>(5)</sup> . . . . .	<u>61.1</u>	<u>53.9</u>	<u>45.5</u>	13.2%	18.2%

(1) Includes Virgin Mobile subscribers of 3.6 million for 2003, 2.4 million for 2002 and 1.4 million for 2001.

(2) First consolidated May 31, 2001.

(3) First consolidated March 31, 2001.

(4) First consolidated September 30, 2002.

(5) Percentage and total number of subscribers calculation based on actual figures.

The figures above represent the total number of contract and prepaid subscribers at year-end for the periods presented. The subscriber counting methodologies employed differ in some respects between national markets, so that the figures in the table above may not be directly comparable with one another. For further information relating to how we calculate our subscriber data, see “Item 4. Information on the Company — Description of Business and 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.

	<b>For the year ended December 31,</b>				
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003/2002</b>	<b>2002/2001</b>
	<b>(millions of €)</b>			<b>(% change)</b>	
Germany <sup>(1)</sup> . . . . .	8,479	7,801	7,075	8.7%	10.3%
North America <sup>(1)(2)</sup> . . . . .	7,416	6,138	2,798	20.8%	119.4%
United Kingdom <sup>(1)</sup> . . . . .	4,303	3,997	3,279	7.7%	21.9%
Austria <sup>(1)</sup> . . . . .	1,098	1,034	1,052	6.2%	(1.7)%
Czech Republic <sup>(1)(3)</sup> . . . . .	768	705	487	8.9%	44.8%
Netherlands <sup>(1)(4)</sup> . . . . .	861	162	—	n.m.	n.m.
Other <sup>(1)</sup> . . . . .	95	6	6	n.m.	n.m.
Intra-segment revenues . . . . .	<u>(242)</u>	<u>(108)</u>	<u>(60)</u>	n.m.	80.0%
Total revenues . . . . .	<u>22,778</u>	<u>19,735</u>	<u>14,637</u>	15.4%	34.8%

(1) These amounts relate to each mobile subsidiary’s respective separate financial statements (single-entity financial statements adjusted for uniform group accounting policies and reporting currency) without taking into consideration consolidation effects at the division level or the group level, which consolidation effects are included under “Intra-segment revenues ” in the table.

(2) First consolidated May 31, 2001.

(3) First consolidated March 31, 2001.

(4) First consolidated September 30, 2002.

Germany

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Total revenues .....	8,479	7,801	7,075	8.7%	10.3%
less Terminal equipment .....	809	692	579	16.9%	19.5%
less Other .....	325	227	241	43.2%	(5.8)%
Service revenues.....	<u>7,345</u>	<u>6,882</u>	<u>6,255</u>	6.7%	10.0%

Through T-Mobile Deutschland, we offer mobile communication services to individual and business subscribers in Germany. In 2003, the total revenues of T-Mobile Deutschland increased by EUR 678 million, or 8.7%, as compared to 2002. This increase was primarily attributable to an increase in service revenues and terminal equipment sales. In 2002, the total revenues of T-Mobile Deutschland increased by EUR 726 million, or 10.3%, as compared to 2001. This increase was attributable primarily to an increase in service revenues and terminal equipment sales.

Service revenues increased by EUR 463 million, or 6.7%, to EUR 7,345 million in 2003 as compared to EUR 6,882 million in 2002. This increase was primarily attributable to an increase in non-voice revenues and subscription fee revenues due to a higher subscriber base. Non-voice and subscription fee revenues increased by EUR 258 million to EUR 2,735 million in 2003 from EUR 2,477 million in 2002. Also, as a result of the growth in the subscriber base, the voice revenues increased in 2003 by EUR 205 million to EUR 4,610 million as compared to EUR 4,405 million in 2002. The increase in voice revenues induced by the number of subscribers was partly offset by a lower usage per subscriber. The increase in service revenues was also partly offset by reduced inter-segment revenues primarily resulting from a decrease in termination of calls from T-Com's fixed-line network customers in Germany.

In 2002, service revenues increased by EUR 627 million, or 10.0%, as compared to 2001. This was due primarily to an increase in the number of subscribers. The increase in service revenues was partly offset by reduced inter-segment revenues primarily resulting from the termination of calls from T-Com's fixed-line network customers in Germany. Mobile termination revenues decreased by EUR 157 million, or 10.2%, to EUR 1,379 million in 2002 from EUR 1,536 million in 2001, primarily due to a decline in the rates charged for terminating calls from the fixed-line network.

Revenues from terminal equipment sales increased by EUR 117 million to EUR 809 million in 2003 compared to 2002 due to an increase in handsets sold to dealers and higher priced terminal equipment with functionalities such as multimedia messaging services ("MMS"). Revenues from terminal equipment sales increased by EUR 113 million to EUR 692 million in 2002 compared to EUR 579 million in 2001, primarily as a result of an increase in handsets sold to dealers and a reduction of handset subsidies.

Other revenues mainly comprise visitor revenues, virtual network operator (VNO) revenues and activation revenues and disconnection fees. VNO revenues are generated by O2 traffic being routed through the T-Mobile Deutschland network. VNO revenues account for approximately 25% of the total other revenues in 2003.

Other revenues increased by EUR 98 million to EUR 325 million in 2003 compared to 2002 primarily as a result of higher visitor revenues and higher VNO revenues caused by an increase in the subscriber base of O2. The reduction of EUR 14 million to EUR 227 million in 2002 compared to 2001 was influenced by the reduction of visitor revenues.

North America

	For the year ended December 31,				
	2003	2002	2001 <sup>(1)</sup>	2003/2002	2002/2001
	(millions of €)			(% change)	
Total revenues .....	7,416	6,138	2,798	20.8%	119.4%
less Terminal equipment .....	958	819	297	17.0%	175.8%
less Other .....	480	468	196	2.6%	138.8%
Service revenues.....	<u>5,978</u>	<u>4,851</u>	<u>2,305</u>	23.2%	110.5%

(1) First consolidated May 31, 2001.



Total revenues increased by EUR 1,278 million, or 20.8%, to EUR 7,416 million in 2003 compared to EUR 6,138 million in 2002. The increase in revenues resulted primarily from an increase in service revenues due to an increase in the subscriber base and, to a lesser extent, from an increase in terminal equipment sales. Total revenues increased by EUR 3,340 million, or 119.4%, to EUR 6,138 million in 2002 compared to EUR 2,798 million in 2001, primarily due to the full-year consolidation in 2002 of T-Mobile USA (seven months consolidation in 2001), and an increase in the overall subscriber base in 2002. Expressed in local currency, the total revenue increase was higher on a percentage basis before currency translation effects as described in “Notes to the Consolidated Financial Statements – Summary of Accounting Policies.”

Service revenues increased by EUR 1,127 million, or 23.2%, to EUR 5,978 million in 2003 compared to EUR 4,851 million in 2002, due primarily to an increase in subscribers. Service revenues increased EUR 2,546 million, or 110.5%, to EUR 4,851 million in 2002 compared to EUR 2,305 million in 2001, as a result of the full-year consolidation in 2002 of T-Mobile USA (seven months consolidation in 2001) and an increase in subscribers.

Revenues from terminal equipment sales increased by EUR 139 million to EUR 958 million in 2003 compared to EUR 819 million in 2002, due mainly to an increase in gross subscriber additions of 10.5%. Revenues from terminal equipment sales 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 of T-Mobile USA in 2002.

Other revenues include mainly visitor revenues and activation revenues. Other revenues increased to EUR 480 million in 2003 from EUR 468 million in 2002 mainly as a result of increased subscriber activation revenues and to a lesser extent an increase in visitor revenues. Other revenues increased to EUR 468 million in 2002 compared to EUR 196 million in 2001 primarily due to the full-year consolidation of T-Mobile USA in 2002 and an increase in subscriber activation revenues.

#### *United Kingdom*

	<b>For the year ended December 31,</b>				
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003/2002</b>	<b>2002/2001</b>
	(millions of €)			(% change)	
Total revenues .....	4,303	3,997	3,279	7.7%	21.9%
less Terminal equipment .....	422	429	393	(1.6)%	9.2%
less Other .....	<u>430</u>	<u>332</u>	<u>204</u>	29.5%	62.7%
Service revenues .....	<u>3,451</u>	<u>3,236</u>	<u>2,682</u>	6.6%	20.7%

Total revenues increased by EUR 306 million, or 7.7%, to EUR 4,303 million in 2003 compared to EUR 3,997 million in 2002, due primarily to an increase in subscribers. Expressed in local currency, the total revenue increase was higher on a percentage basis before currency translation effects as described in “Notes to the Consolidated Financial Statements — Summary of Accounting Policies.” Total revenues in 2002 increased by EUR 718 million, or 21.9%, to EUR 3,997 million as compared to EUR 3,279 million in 2001, due primarily to an increase in subscribers.

Service revenues increased by EUR 215 million, or 6.6%, to EUR 3,451 million in 2003 as compared to EUR 3,236 million in 2002. Service revenues increased due to higher usage by subscribers. This income was offset, in part, by a decrease in termination fee rates mandated by the UK telecommunications regulator. Service revenues increased by EUR 554 million, or 20.7%, to EUR 3,236 million in 2002 as compared to EUR 2,682 million in 2001, due primarily to an increase in subscribers.

Revenues from terminal equipment sales decreased slightly in 2003 compared to 2002 mainly due to lower gross adds of subscribers. Revenues from terminal equipment sales increased in 2002 compared to 2001, mainly due to higher average revenue per terminal equipment sale.

Other revenues increased from 2001 through 2003 due primarily to the subscriber growth of the joint venture with Virgin Mobile. However, revenues will not continue to grow as T-Mobile UK has sold its stake in Virgin Mobile at the end of January 2004 and T-Mobile UK and Virgin have renegotiated both the shareholder and service agreement in 2004. It is expected that the new service agreement will impact revenue significantly as inbound revenues will decrease at T-Mobile UK and

will be passed directly to Virgin. The marketing contribution payment of T-Mobile UK to Virgin will vanish, which will have a positive effect on overall results of T-Mobile UK.

#### *Austria*

	<b>For the year ended December 31,</b>				
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	(millions of €)			(% change)	
Total revenues .....	1,098	1,034	1,052	6.2%	(1.7)%
less Terminal equipment.....	70	70	57	—	22.8%
less Other .....	<u>275</u>	<u>238</u>	<u>302</u>	15.5%	(21.2)%
Service revenues.....	<u>753</u>	<u>726</u>	<u>693</u>	3.7%	4.8%

Total revenues increased by EUR 64 million, or 6.2%, to EUR 1,098 million in 2003 from EUR 1,034 million in 2002. This increase was due to increases in service revenues and other revenues.

Service revenues increased by EUR 27 million to EUR 753 million in 2003. This increase was mainly due to higher usage.

Service revenues increased by EUR 33 million, or 4.8%, to EUR 726 million in 2002 from EUR 693 million in 2001. This increase was due primarily to increased usage.

Terminal equipment revenues remained stable at EUR 70 million in 2003 as compared to 2002. Terminal equipment revenues increased by EUR 13 million in 2002 compared to EUR 57 million in 2001.

Other revenues were derived substantially from revenues received from the sale of non-telecommunications products and services sold through Niedermeyer, an Austrian electronics retail chain owned by T-Mobile Austria. Revenues from Niedermeyer were EUR 153 million and revenues from visitors were EUR 85 million of other revenues in 2003. In January 2004, T-Mobile sold Niedermeyer to a third party. Accordingly, this disposal will have a negative effect on other revenues in the future.

#### *Czech Republic*

	<b>For the year ended December 31,</b>				
	<u>2003</u>	<u>2002</u>	<u>2001<sup>(1)</sup></u>	<u>2003/2002</u>	<u>2002/2001</u>
	(millions of €)			(% change)	
Total revenues .....	768	705	487	8.9%	44.8%
less Terminal equipment.....	29	30	21	(3.3)%	42.9%
less Others.....	<u>65</u>	<u>74</u>	<u>73</u>	(12.2)%	1.4%
Service revenues.....	<u>674</u>	<u>601</u>	<u>393</u>	12.1%	52.9%

(1) First consolidated March 31, 2001.

Total revenues increased by EUR 63 million, or 8.9%, to EUR 768 million in 2003 as compared to EUR 705 million in 2002. In local currency total revenues have increased. However, the strong value of the euro had a negative currency translation effect. The increase in total revenues is related mainly to an increase in service revenues due to a higher subscriber base, which increased by 14.3% from 3.5 million to 4.0 million subscribers. Total revenues increased by EUR 218 million, or 44.8%, to EUR 705 million in 2002 as compared to EUR 487 million in 2001, due primarily to the first-time consolidation of T-Mobile Czech Republic at the end of March 2001. Further, the number of subscribers increased significantly from 2.9 million at the end of 2001 to 3.5 million, or 20.7%, at the end of 2002.

Service revenues increased by EUR 73 million to EUR 674 million in 2003. This increase was mainly due to a higher subscriber base. Service revenues increased by EUR 208 million to EUR 601 million in 2002 from EUR 393 million in 2001. This increase was due primarily to the full-year consolidation of T-Mobile Czech Republic in 2002 (nine months in 2001), and a higher subscriber base.

Other revenues mainly include visitor and activation revenues. Variances between the years are influenced by variances in activation revenues being dependent on the number of new subscribers gained.

*The Netherlands*

	<b>For the year ended December 31,</b>				
	<b>2003</b>	<b>2002<sup>(1)</sup></b>	<b>2001</b>	<b>2003/2002</b>	<b>2002/2001</b>
	(millions of €)			(% change)	
Total revenues .....	861	162	—	n.m.	n.m.
less Terminal equipment.....	42	7	—	n.m.	n.m.
less Other .....	<u>60</u>	<u>13</u>	—	n.m.	n.m.
Service revenues.....	<u>759</u>	<u>142</u>	—	n.m.	n.m.

(1) First consolidated September 30, 2002.

Total revenues, service revenues, terminal equipment revenues and other revenues, increased from 2002 to 2003 primarily as a result of twelve months of consolidated results in 2003 as compared to three months in 2002, and an increase in the number of subscribers to 2.0 million subscribers at the end of 2003 from 1.4 million subscribers at the end of 2002. Other revenues include mainly visitor revenues and subscriber activation revenues.

**Average Revenue Per User by Geographic Area**

The following discussion provides additional revenue information by geographic area with respect to Average Revenue per User (ARPU). We use ARPU to measure the average monthly service revenues on a per subscriber basis. We believe that ARPU provides management with useful information concerning usage and acceptance of our product and service offerings and an indicator of our ability to attract and retain high-value customers. We calculate ARPU as services revenues generated by subscribers (revenues for originating and terminating voice calls and data revenues), including our subscribers' roaming revenues and monthly subscription fees, divided by our average subscribers for the period. The revenues we use in the calculation of ARPU exclude revenues from equipment sales and customer activation revenues because they do not represent ongoing subscriber revenue streams and revenues from visitor roaming, virtual network operators (VNO) and other revenues because they are not generated directly by our subscribers. Non-GAAP financial measures, such as the ARPU discussions below, are not prepared in accordance with German GAAP or U.S. GAAP and are not uniformly defined and utilized by all companies in our industry group. Accordingly, such measures may not be comparable with similarly titled measures disclosed by other companies. Non-GAAP financial measures should not be viewed in isolation or as an alternative to other figures reported under German GAAP or U.S. GAAP. For a more detailed breakdown of subscribers by geographic area see "Item 4 — Description of Business and Divisions — T-Mobile." The calculation of the ARPU figures below is based on actual figures. Differences in calculating ARPU using the service revenues and average subscriber numbers below may be a result of rounding.

*Germany*

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2003/2002</b>
	(millions of €, except where indicated)		(% change)
Total revenues .....	8,479	7,801	8.7%
thereof Service revenues .....	7,345	6,882	6.7%
Average subscribers (in millions).....	25.3	23.5	7.6%
ARPU/month (in euro) <sup>(1)</sup> .....	24	24	—

(1) For comparative purposes, monthly ARPU using total revenues for the twelve months period ended December 31, 2003 and 2002 was EUR 28 for both periods.

The ARPU per month decreased by EUR 0.20 in 2003 as compared to 2002 calculated based on actual figures. This decrease was due to a lower usage per subscriber in both the prepaid subscriber base and the contract subscriber base. In 2003, the share of contract subscribers grew in the total subscriber base which partly offset the decline in the average usage per subscriber.

## North America

	For the year ended December 31,		
	2003	2002	2003/2002
	(millions of €, except where indicated)		(% change)
Total revenues . . . . .	7,416	6,138	20.8%
thereof Service revenues . . . . .	5,978	4,851	23.2%
Average subscribers (in millions) . . . . .	11.5	8.2	40.2%
ARPU/month (in euro) <sup>(1)</sup> . . . . .	44	49	(10.2)%

(1) For comparative purposes, monthly ARPU using total revenues for the twelve months ended December 31, 2003 and 2002 were EUR 54 and EUR 62 respectively.

ARPU per month decreased to EUR 44 in 2003 as compared to EUR 49 in 2002, due to changes in local currency exchange rates. In local currency ARPU per month increased primarily as a result of an increase in the proportion of contract subscribers in the overall subscriber base. Additionally, the increase in ARPU per month in local currency also reflects contract subscriber migration to higher-priced rate plans and increased usage of data and short message service by contract customers, and higher usage by prepaid subscribers.

## United Kingdom

	For the year ended December 31,		
	2003	2002	2003/2002
	(millions of €, except where indicated)		(% change)
Total revenues . . . . .	4,303	3,997	7.7%
thereof Service revenues <sup>(1)</sup> . . . . .	3,451	3,236	6.6%
Average subscribers (in millions) <sup>(2)</sup> . . . . .	9.6	9.4	2.1%
ARPU/month (in euro) <sup>(3)</sup> . . . . .	30	29	3.4%

(1) Does not include revenues earned from Virgin Mobile subscribers, which revenues are not included in ARPU calculation.

(2) Does not include Virgin Mobile subscribers for purposes of ARPU calculation.

(3) For comparative purposes, monthly ARPU using total revenues for the twelve month period ended December 31, 2003 and 2002 were EUR 37 and EUR 35, respectively.

ARPU per month increased to EUR 30 in 2003 compared to EUR 29 in 2002 due to a higher share of contract subscribers in the total subscriber base and an increase in the usage per subscriber. Compared to ARPU measured in euro, ARPU per month in local currency increased at a higher rate in 2003 as compared to 2002 due to changes in local currency exchange rates. The increase in service revenues was offset, in part, by a decrease in termination fee rates mandated by the UK telecommunications regulator.

## Austria

	For the year ended December 31,		
	2003	2002	2003/2002
	(millions of €, except where indicated)		(% change)
Total revenues . . . . .	1,098	1,034	6.2%
thereof Service revenues . . . . .	753	726	3.7%
Average subscribers (in millions) . . . . .	2.0	2.0	—
ARPU/month (in euro) <sup>(1)</sup> . . . . .	31	30	3.3%

(1) For comparative purposes, monthly ARPU using total revenues for the twelve month period ended December 31, 2003 and 2002 were EUR 46 and EUR 43, respectively.

ARPU per month increased to EUR 31 in 2003 from EUR 30 in 2002. This increase is mainly due to increasing usage and a relatively higher proportion of contract subscribers in 2003.

## Czech Republic

	For the year ended December 31,		
	2003	2002	2003/2002
	(millions of €, except where indicated)		(% change)
Total revenues . . . . .	768	705	8.9%
thereof Service revenues . . . . .	674	601	12.1%
Average subscribers (in millions) . . . . .	3.6	3.2	12.5%
ARPU/month (in euro) <sup>(1)</sup> . . . . .	15	16	(6.3)%

(1) For comparative purposes, monthly ARPU using total revenues for the twelve month period ended December 31, 2003 and 2002 was EUR 18 for both periods.

ARPU per month decreased to EUR 15 in 2003, from EUR 16 in 2002 as a result of local currency exchange rates. In local currency the ARPU in 2003 was virtually the same as in 2002. The ARPU was negatively impacted in 2003 due to decreases in both the tariffs for and volume of terminating calls received from other operators. These decreases were offset by an increase in data usage, excluding SMS, and by an increase in the average monthly subscription fee per subscriber due to the higher share of contract subscribers.

## The Netherlands

	For the year ended December 31,		
	2003	2002 <sup>(1)</sup>	2003/2002
	(millions of €, except where indicated)		(% change)
Total revenues . . . . .	861	162	n.m.
thereof Service revenues . . . . .	759	142	n.m.
Average subscribers (in millions) . . . . .	1.7	1.4	n.m.
ARPU/month (in euro) <sup>(2)</sup> . . . . .	37	33	n.m.

n.m. — not meaningful

(1) First consolidated September 30, 2002.

(2) For comparative purposes, monthly ARPU using total revenues for the twelve month period ended December 31, 2003 and the three month period ended December 31, 2002 were EUR 42 and EUR 39, respectively.

ARPU per month increased to EUR 37 in 2003 from EUR 33 in 2002. This increase was primarily the result of an increase in the proportion of contract subscribers within the customer base, and an increase in usage per subscriber.

## Operating Expenses

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

	For the year ended December 31,							
	2003		2002		2001		2003/2002	2002/2001
	(millions of €, except percentages)						(% change)	
Cost of sales . . . . .	12,893	57.9%	24,009	56.0%	9,956	54.1%	(46.3)%	141.2%
Selling costs . . . . .	6,689	30.0%	6,243	14.6%	4,816	26.2%	7.1%	29.6%
General and administrative costs . . . . .	1,004	4.5%	1,018	2.4%	653	3.5%	(1.4)%	55.9%
Other operating expenses . . . . .	1,684	7.6%	11,586	27.0%	2,991	16.2%	(85.5)%	287.4%
Total . . . . .	<u>22,270</u>	<u>100.0%</u>	<u>42,856</u>	<u>100.0%</u>	<u>18,416</u>	<u>100.0%</u>	<u>(48.0)%</u>	<u>132.7%</u>

## Cost of Sales

Cost of sales includes the purchase 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. Main components include goods and services purchased, personnel costs as well as depreciation and amortization of mobile telecommunication licenses and other tangible and intangible assets related to the network.

In 2003, cost of sales decreased by EUR 11,116 million, or 46.3%, compared to 2002. This is a direct result of the 2002 strategic review and the resulting nonscheduled amortization of FCC licenses at T-Mobile USA and the UMTS license at T-Mobile UK in the year 2002. Amortization of mobile telecommunication licenses decreased by EUR 12,121 million, mainly because nonscheduled amortization of licenses in 2002 (EUR 11,549 million) was not repeated in 2003. As a result of the lower amortization basis and the weaker U.S. Dollar, scheduled amortization of mobile telecommunication licenses decreased by EUR 572 million from EUR 1,733 million to EUR 1,161 million. In contrast, goods and services purchased increased by EUR 1,001 million, partially as a result of the first full year consolidation of T-Mobile Netherlands which accounted for EUR 321 million of the increase in 2003. In addition goods and services purchased at T-Mobile USA increased by EUR 366 million in 2003 mainly due to an increase in the quantity of terminal equipment sold, and to a lesser degree, the procurement of higher priced terminal equipment. T-Mobile Deutschland contributed EUR 197 million to the increase in goods and services purchased in 2003 mainly due to a higher volume of terminal equipment purchases.

In 2002 cost of sales increased by EUR 14,053 million compared to 2001 mainly as a result of nonscheduled amortization of mobile telecommunication licenses. Additionally, the increase in cost of sales reflected the full year consolidation of T-Mobile USA and T-Mobile Czech Republic, and the partial-year consolidation of T-Mobile Netherlands (three months). 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 mobile telecommunication licenses was performed. The assumptions regarding middle and long-term business development prospects were reassessed in light of the 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. As a result, EUR 9,384 million relating to licenses at T-Mobile USA and EUR 2,165 million relating to the UMTS license at T-Mobile UK were recognized as nonscheduled amortization. Excluding nonscheduled amortization of the licenses, cost of sales increased by EUR 2,504 million or 25.2% mainly the result of the expanded scope of consolidated entities. At T-Mobile USA cost of sales increased by EUR 1,928 million (excluding EUR 9,384 million of nonscheduled amortization of the FCC licenses) primarily as a result of the full-year consolidation in 2002 (7 months in 2001). In addition cost of sales increased by EUR 107 million at T-Mobile Czech Republic primarily as a result of the full-year consolidation in 2002 (9 months in 2001) and T-Mobile Netherlands contributed EUR 139 million to the increase for three months of consolidation in 2002. Subscriber growth and the related increase in traffic also contributed to the increase in cost of sales.

### ***Selling Costs***

Selling costs are the second most important cost component after cost of sales, and accounted for 30% of the T-Mobile division's total operating expenses in 2003. Selling costs include all expenses relating to sales, including, among other things, commissions paid to resellers and third-party distributors, call center and customer care expenses, marketing costs and billing services.

The EUR 446 million increase from 2002 to 2003 was mainly attributable to a EUR 254 million increase in selling costs associated with the first full-year consolidation of T-Mobile Netherlands, as compared to only three months of full consolidation in 2002. Additionally, EUR 207 million of the increase resulted from T-Mobile Deutschland mainly driven by an increase in commissions. The increase in selling costs was offset in part by the currency translation effects relating to T-Mobile USA.

The increase in selling costs between 2002 and 2001 in the amount of EUR 1,427 million was mainly attributable to the consolidation of T-Mobile USA for a full twelve months in 2002 compared to seven months in 2001, the consolidation of T-Mobile Czech Republic for a full twelve months in 2002 compared to nine months in 2001 and the consolidation of T-Mobile Netherlands for a three-month period in 2002.

### **General and Administrative Costs**

General and administrative costs include all costs allocated to core administrative functions which are not directly attributable to the cost of sales or selling activities, including, among other items, costs relating to accounting, finance, human resources, general management, communications, strategy and legal services.

General and administrative costs decreased by EUR 14 million in 2003 mainly as a result of the weaker U.S. Dollar, offset in part by the full-year consolidation of T-Mobile Netherlands, which increased general administrative costs by EUR 29 million.

The increase in general and administrative costs between 2002 and 2001 in the amount of EUR 365 million was mainly attributable to the consolidation of T-Mobile USA for a full twelve months in 2002 compared to seven months in 2001, the consolidation of T-Mobile Czech Republic for a full twelve months in 2002 compared to nine months in 2001 and the consolidation of T-Mobile Netherlands for a three-month period in 2002.

### **Other Operating Expenses**

The following table provides information regarding other operating expenses.

	<b>For the year ended December 31,</b>				
	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2003/2002</b>	<b>2002/2001</b>
		(millions of €)		(% change)	
Losses on disposition of non-current assets.....	26	34	36	(23.5)%	(5.6)%
Transfers to accruals.....	—	6	2	n.m.	200.0%
Foreign currency transaction losses.....	18	20	35	(10.0)%	(42.9)%
Amortization of goodwill.....	1,435	11,447	2,843	(87.5)%	302.6%
Other operating expenses.....	205	79	75	159.5%	5.3%
Total.....	<u>1,684</u>	<u>11,586</u>	<u>2,991</u>	(85.5)%	287.4%

Other operating expenses decreased to EUR 1,684 million in 2003 from EUR 11,586 million in 2002, primarily as a result of the non-recurrence of nonscheduled goodwill amortization in 2003. In addition, the lower basis for goodwill at T-Mobile USA after the 2002 nonscheduled amortization and the weaker U.S. Dollar contributed to the decrease in 2003. T-Mobile UK contributed EUR 638 million, or 44.5%, of the total goodwill amortization in 2003, while T-Mobile USA contributed EUR 542 million, or 37.8%, of total goodwill amortization in 2003. At T-Mobile USA, goodwill amortization decreased by EUR 8,971 million, or 94.3%, mainly as the result of the non-recurrence of nonscheduled amortization that amounted to EUR 8,288 million in 2002. The remaining goodwill amortization in 2003 is attributable to T-Mobile Netherlands (EUR 113 million), T-Mobile Austria (EUR 90 million), T-Mobile Czech Republic (EUR 40 million) and others (EUR 12 million).

The increase of EUR 8,604 million between 2001 and 2002 in goodwill amortization was directly attributable to the nonscheduled goodwill amortization at T-Mobile USA as discussed above, and nonscheduled goodwill amortization at T-Mobile Netherlands in the amount of EUR 958 million. These nonscheduled goodwill amortizations were a result of the group-wide strategic review in 2002. In this strategic review, a cash flow-based analysis of mobile communication licenses and goodwill was performed. The assumptions regarding middle and long term business development prospects were reassessed in light of the 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. Scheduled amortization of goodwill totalled EUR 2,186 million in 2002, with T-Mobile USA contributing EUR 1,225 million and T-Mobile UK contributing EUR 788 million of this amount.

Total goodwill amortization amounted to EUR 2,843 million in 2001, of which EUR 1,040 million related to nonscheduled amortization associated with the brand names acquired with T-Mobile UK and T-Mobile Austria. We recognized scheduled goodwill amortization of EUR 1,803 million in 2001, primarily relating to T-Mobile USA (EUR 882 million) and T-Mobile UK (EUR 797 million).

## Other Operating Income

The following table provides information regarding other operating income.

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Reversal of accruals . . . . .	141	59	50	139.0%	18.0%
Income from reversal of valuation adjustments (including asset-backed securities). . . . .	61	54	7	13.0%	n.m.
Cost reimbursements. . . . .	371	381	137	(2.6)%	178.1%
Income from the disposals of noncurrent assets (including sales of investments). . . . .	359	8	3	n.m.	166.7%
Insurance compensation. . . . .	17	8	4	112.5%	100.0%
Foreign currency transaction gains. . . . .	35	30	22	16.7%	36.4%
Other income . . . . .	234	259	326	(9.7)%	(20.6)%
Total. . . . .	<u>1,218</u>	<u>799</u>	<u>549</u>	52.4%	45.5%

Other operating income consists of a number of items such as income from the disposal of non-current assets, cost reimbursements from Deutsche Telekom, reversal of accruals and foreign currency transaction gains.

The significant increase in income from the disposal of non-current assets in 2003 relates to the sale of part of T-Mobile's stake in the Russian mobile operator MTS, which amounted to EUR 352 million. Other significant components are subsidies received from handset suppliers and income from the reversal of accruals (especially the reversal of the accrual for service providers, for property rationalization accruals and "Universal Services").

The increase in other operating income for 2002 when compared to 2001 is mainly the result of the expanded scope of consolidated entities. Of the total increase of EUR 250 million, T-Mobile USA contributed EUR 170 million as a result of its first full year consolidation (7 months in 2001) and EUR 25 million related to T-Mobile Czech Republic's first full year consolidation (9 months in 2001). Other income in 2002 includes income relating to a purchase price adjustment (EUR 47 million) from the sale of Westel in 2001 and income from the sale of the Salzburg-Vienna data line (EUR 29 million).

For 2001, the main components of other operating income were income from the reversal of accruals and foreign currency transaction gains and a gain of EUR 25 million received from the sale of Westel to Matáv.

## Financial Income (Expense), Net

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

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Other income from investments . . . . .	4	—	—	n.m.	—
Income (loss) from companies accounted for under the equity method . . . . .	93	(355)	(204)	n.m.	74.0%
Write-downs on financial assets and marketable securities. . . . .	—	(72)	—	n.m.	n.m.
Income (loss) from financial activities. . . . .	97	(427)	(204)	n.m.	109.3%
Net interest expense . . . . .	(992)	(1,005)	(3,008)	(1.3)%	(66.6)%
Total. . . . .	<u>(895)</u>	<u>(1,432)</u>	<u>(3,212)</u>	(37.5)%	(55.4)%

Net financial expense in 2003 decreased to EUR 895 million from EUR 1,432 million in 2002. This decrease was primarily attributable to income from financial activities of EUR 97 million in 2003 compared to a loss of EUR 427 million in 2002, especially because income from companies accounted for under the equity method amounted to EUR 93 million in 2003 as compared to a loss of EUR 355 million in 2002. This positive increase of EUR 448 million was primarily the result of the full consolidation of T-Mobile Netherlands since September 30, 2002. Additionally, income from companies accounted for under the equity method in 2003 was primarily derived from T-Mobile's equity stake in MTS (EUR 121 million) and PTC (EUR 84 million), offset in part by losses mainly related to T-Mobile USA's equity investment in GSM Facilities (EUR 84 million) and scheduled goodwill amortization at PTC (EUR 76 million). Net interest expense in the amount of EUR 992 million decreased by 1.3% in 2003 compared to 2002.

Net financial expense in 2002 decreased to EUR 1,432 million from EUR 3,212 million in 2001. This decrease is primarily attributable to a decrease in net interest expense and an increase in loss from companies accounted for under the equity method. 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. Additionally, 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 (including write-downs on financial assets) amounted to EUR 173 million during 2002. These losses were partially offset by income related to MTS in the amount of EUR 99 million.

### **Income (Loss) Before Taxes**

Income before taxes improved from a loss of EUR 23,754 million in 2002 to a profit of EUR 831 million in 2003. This improvement is mainly due to the nonrecurrence of nonscheduled amortization of licenses and goodwill that effected 2002 in the amount of EUR 20,810 million. Additionally, total revenues increased from EUR 19,735 million to EUR 22,778 million, or 15.4%, while cost of sales (excluding nonscheduled amortization in 2002) only increased by 3.5% between 2002 and 2003. Other contributing factors to the 2003 income before taxes were an improvement in net financial expense in the amount of EUR 537 million, due to improved results from affiliates accounted for under the equity method, the improvement in other operating expenses in the amount of EUR 9,902 million, mainly as a result of lower goodwill amortization and an increase in other operating income mainly as a result of the EUR 352 million gain from the sale of part of the stake in the Russian mobile operator MTS.

In 2002 the loss before taxes amounted to EUR 23,754 million, representing a EUR 17,313 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 and T-Mobile UK and the increase in cost of sales, excluding the effects of the nonscheduled amortization on licenses (EUR 2,504 million) offset in part by the increase in total revenues (EUR 5,098 million) and the decrease in financial expense (EUR 1,780 million), primarily due to the decline in net interest expense (EUR 2,003 million).

Loss before taxes amounted to EUR 6,441 million in 2001, especially as a result of the first-time consolidation of T-Mobile USA since June 2001, which accounted for EUR 2,765 million of the loss. Depreciation and amortization increased mainly due to scheduled goodwill amortization relating to T-Mobile USA (EUR 882 million); nonscheduled amortization of tradenames relating to T-Mobile UK and T-Mobile Austria in connection with 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).

## T-Online

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

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Net Revenues.....	1,662	1,391	1,027	19.5%	35.4%
Inter-segment revenues .....	189	193	113	(2.1)%	70.8%
Total revenues .....	<u>1,851</u>	<u>1,584</u>	<u>1,140</u>	16.9%	38.9%
Income (loss) before taxes.....	<u>104</u>	<u>(471)</u>	<u>(820)</u>	n.m.	42.6%

n.m.—not meaningful.

### Revenues

As a result of its combined business model, which focuses on access, content, services, and e-commerce, the T-Online division generated consolidated total revenues of approximately EUR 1,851 million in fiscal 2003. This represents a year-on-year increase of 16.9%, or EUR 267 million. T-Online's revenues are generated primarily by Internet access fees, such as monthly charges and time-based usage charges, and, to a lesser extent, by services and fees in connection with content and e-commerce. Also during 2003, paid content offerings increased primarily as a result of the increased usage of broadband access.

T-Online's expanding subscriber base is the primary reason for the increase in net and total revenues. Total subscribers increased to 13.1 million as of December 31, 2003, an increase of 0.9 million, or 7.3%, as compared to 12.2 million subscribers as of December 31, 2002. Our subscriber base increased by 1.6 million subscribers from December 31, 2001 to December 31, 2002.

Of the total number of subscribers as of December 31, 2003, 3.6 million subscribers accessed the Internet via broadband (T-Online defines broadband as ADSL technology with a data rate greater than 128kb/s), an increase of 0.8 million subscribers, or 27.7%, since December 31, 2002. The broadband subscriber base increased by 1.4 million from December 31, 2001 to December 31, 2002. These customers generally use the Internet more frequently and for longer periods of time than narrowband users. They are also heavier users of e-commerce. T-Online considers broadband customers as one of the key growth drivers in the Internet industry.

The numbers of subscribers in Germany using the T-DSL flat rate increased by 0.3 million to 2.0 million subscribers at the end of 2003. The number of subscribers in Germany using the T-DSL volume tariff also increased by 0.2 million to 0.3 million registered subscribers as of December 31, 2003. In Rest of Europe there was also a significant increase in the level of broadband subscribers by approximately 69.2% to 0.3 million customers.

In addition, we believe that well-presented content and services, such as news, e-mail and online chats, were instrumental in boosting the time spent online and intensity of use, which contributed to the improved results. The average volume of minutes per month spent on the Internet per subscriber increased from 2,523 minutes in 2002 to 3,052 minutes in 2003. The average volume of minutes per month spent on the Internet for the T-Online division increased by 1,248 minutes per subscriber from December 31, 2001 to December 31, 2002.



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

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Germany . . . . .	1,682	1,445	1,044	16.4%	38.4%
Rest of Europe . . . . .	169	139	96	21.6%	44.8%
Total revenues . . . . .	1,851	1,584	1,140	16.9%	38.9%
Inter-segment revenues . . . . .	(189)	(193)	(113)	(2.1)%	70.8%
Net revenues . . . . .	1,662	1,391	1,027	19.5%	35.4%

The increase in revenues in Germany of 16.4% and Rest of Europe of 21.6% was a result of further subscriber growth as well as an increase in the average revenue per subscriber. Revenues did not increase at the same rate in comparison to the prior year due to T-Online focusing more on effective revenues (revenues that result in a higher profit margin) and developing new products and designs intended to secure growth in the future, but which only had an impact on a portion of the current year.

A substantial portion of inter-segment revenues 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 website.

### Gross Margin

Gross margin (total revenues less cost of goods and services divided by total revenues) has improved during 2003 to 59.2%, as compared to 48.8% for fiscal 2002 and 39.8% for fiscal 2001. This increase in the gross margin was a result of the decrease in goods and services purchased.

### Operating Expenses

	For the year ended December 31,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Cost of sales . . . . .	1,053	1,068	917	(1.4%)	16.5%
thereof goods and services					
purchased . . . . .	755	811	686	(6.9%)	18.2%
Selling costs . . . . .	527	477	378	10.5%	26.2%
Administrative costs . . . . .	89	90	85	(1.1%)	5.9%
Other operating income . . . . .	77	75	21	2.7%	n.m.
Other operating expenses . . . . .	355	358	384	(0.8%)	(6.8%)
Financial income (expense), net . . . . .	200	(137)	(217)	n.m.	36.9%
Income (loss) before taxes . . . . .	104	(471)	(820)	n.m.	42.6%

n.m.—not meaningful.

### Cost of Sales

Cost of sales mainly include goods and services purchased, which decreased from EUR 811 million in 2002 to EUR 755 million in 2003. The decrease was due to better utilization of capacity purchased from Deutsche Telekom through its T-Com division and the increasing prevalence of fixed basic rates, for example the T-DSL flat rate. Moreover, attractive content and service offerings ensured higher capacity utilization of traffic. Goods and services purchased increased from EUR 686 million in 2001 to EUR 811 million in 2002, due primarily to the growth in the use of access services by T-Online's customers.

### Selling Costs

Selling costs increased from EUR 378 million in 2001 to EUR 477 million in 2002 and to EUR 527 million in 2003 due to direct-marketing and marketing campaigns, as well as increased availability in T-Online's call centers resulting in increased costs relating to customer care services.

### **Other Operating Income**

The increase in other operating income in 2003 and 2002 has been influenced by the gain of EUR 26 million in 2003 resulting from the transfer of T-Online's 100% stake in t-info to DeTeMedien (included in the T-Com division). In 2002, T-Online recorded a gain of EUR 27 million from the transfer of its 40% stake in T-Motion plc. to T-Mobile International AG.

### **Other Operating Expenses**

Other operating expenses mainly include the amortization of goodwill which amounted to EUR 348 million in 2003, EUR 349 million in 2002 and EUR 364 million in 2001.

### **Financial Income (Expense) Net**

In 2003, T-Online recorded net financial income of approximately EUR 200 million which was mainly attributable to the partial reversal of prior write-downs of the net carrying value of T-Online's investment in comdirect bank AG in the amount of EUR 96 million. In the same year T-Online recorded interest income of EUR 111 million.

In 2002, T-Online recorded net financial expense of approximately EUR 137 million including a write-down of EUR 224 million against the carrying value of its investment in comdirect bank, offset in part by net interest income of EUR 128 million.

In 2001, T-Online recorded net financial expense of approximately EUR 217 million, reflecting losses relating to companies accounted for under the equity method in the amount of EUR 381 million, including a write-down of EUR 281 million against the carrying value of T-Online's investment in comdirect bank. These losses were offset in part by net interest income of EUR 163 million.

### **Group Headquarters and Shared Services**

The following table presents selected financial information concerning our segment "Group Headquarters and Shared Services."

	For the year ended December 31,				
	2003	2002 <sup>(1)</sup>	2001 <sup>(1)</sup>	2003/2002	2002/2001
	(millions of €)			(% change)	
Net revenues .....	304	573	633	(46.9)%	(9.5)%
Inter-segment revenues .....	3,964	3,838	4,481	3.3%	(14.3)%
Total revenues .....	<u>4,268</u>	<u>4,411</u>	<u>5,114</u>	(3.2)%	(13.7)%
Income (loss) before taxes.....	<u>(4,071)</u>	<u>(4,690)</u>	<u>402</u>	13.2%	n.m.

n.m.—not meaningful

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

### **Net Revenues**

Net revenues from Group Headquarters and Shared Services were EUR 304 million in 2003, a decrease of approximately EUR 269 million, as compared to 2002. The decrease is primarily attributable to lower real estate related revenues, in part due to the completion of a specific real estate development project and lower net revenues in Billing Services. Since January 1, 2003, net revenues generated with third party carriers formerly recorded in Billing Services were recorded at T-Com. This led to a corresponding increase of inter-segment revenues for Billing Services compared to 2002. Substantially all net revenues in 2003 were derived from real estate related services and debt collection services.

Net revenues from Group Headquarters and Shared Services amounted to EUR 573 million in 2002, representing a decrease of approximately EUR 60 million as compared to 2001. This decrease is primarily attributable to the deconsolidation of Deutsche Telekom Gesellschaft fuer Satellitenkommunikation GmbH (DeTeSat). Accordingly, DeTeSat contributed net revenues of approximately EUR 100 million in 2001 with no corresponding net revenues in 2002. Net revenues in 2002 were derived primarily from real estate services, Billing Services and a specific real estate development project.

## **Total Revenues**

Total revenues in 2003 amounted to EUR 4,268 million and were derived principally from real estate services (EUR 3.2 billion), billing services (EUR 0.9 billion), fleet management services (EUR 0.2 billion) and debt collection service (EUR 0.1 billion). Total revenues for 2003 decreased by EUR 143 million compared to 2002. The decrease is primarily attributable to the lower real estate related revenues and lower revenues of Billing Services. The Billing Services and real estate related services provided by Group Headquarters and Shares Services continued to pass on its cost savings to the divisions as in the previous year. This led to a revenue decline of approximately EUR 200 million in 2003 as compared to 2002. Another factor contributing to the lower revenues relates to a specific real estate development project which generated most of its revenues last year.

The decrease in total revenues in 2003 was offset, in part, by the increased revenues from fleet services and debt collection services. The increased revenues from fleet services were the result of organizational changes in 2002. DeTeFleetServices GmbH was formed on July 1, 2002 to provide cross-divisional vehicle fleet management services. Accordingly, no comparative data exists for this service prior to that date.

Total revenues in 2002 amounted to EUR 4,411 million and were derived principally from real estate services (EUR 3.4 billion), Billing Services (EUR 1.0 billion), fleet management services (EUR 0.1 billion) and debt collection services (EUR 40 million). Total revenues in 2002 declined by EUR 703 million compared to 2001. This decrease is, in part, attributable to the deconsolidation of DeTeSat which accounted for approximately EUR 100 million in 2001 with no corresponding revenues in 2002. 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 in 2002. The remaining decrease in revenues relates to a decrease in demand for real estate services among the divisions. In addition, the real estate segment handled fewer projects in 2002 than in 2001.

## **Income (Loss) Before Taxes**

Loss before taxes amounted to a loss of EUR 4,071 million in 2003. This marks a significant improvement over the loss before taxes of EUR 4,690 million in 2002.

Real estate, Billing Services and fleet management services generated profits before taxes of EUR 787 million, an increase of EUR 546 million as compared to EUR 241 million in 2002. The increase is attributable to higher net gains in connection with sale of real estate. Furthermore, the results for 2002 were negatively affected by one-time write-downs for real estate. In addition, fleet management services contributed profits for the full year in 2003 and only six months in 2002.

Costs relating to Deutsche Telekom's obligation for certain civil servants benefits amounted to approximately EUR 150 million in 2003, an amount unchanged from 2002. In addition, personnel costs for the group's apprentices were approximately EUR 229 million in 2003, which were only slightly increased from the previous year.

The results before taxes was negatively impacted in 2003 by higher interest costs of EUR 261 million for pensions and civil servants health insurance.

The costs for headquarter functions, supporting services and obligations, including communication and marketing activities, accounting and controlling and human resource management, amounted to approximately EUR 1,150 million in 2003, a decrease of around EUR 250 million as compared to 2002. The results of 2002 were negatively impacted by rebranding costs and costs that mainly related to credit risk discounts from the sale of receivables through the asset-backed securitization program in 2002.

With the treasury and financing function becoming part of headquarters, loss before taxes was also influenced in 2003 by net financial expense of EUR 2,877 million, which improved significantly as compared with net financial expense of EUR 3,603 million in 2002. The main reason for this improvement is that the results for 2002 were negatively impacted by write-downs on investment in France Telecom as well as other marketable securities. These write-downs were not repeated in 2003.

Gains in connection with sale of investments amounted to EUR 245 million in 2003, a decrease of EUR 215 million compared to 2002.

Loss before taxes in 2003 was also impacted by the considerable increase in personnel transferred to Vivento. Personnel and operating costs of EUR 544 million and a provision for a one-time

severance package program for 2003 were only partially offset by one-time transfer payments of EUR 131 million from T-Com in 2003 for employees who were transferred to Vivento.

For 2004, no further transfer payments from T-Com will be made, thereby resulting in a decrease in T-Com's personnel costs. We believe that the success of Vivento in placing surplus personnel will have a considerable effect on the results of Group Headquarters and Shared Services.

In 2002, loss before taxes amounted to EUR 4,690 million, as compared with income before taxes of 402 million in 2001. 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). Furthermore, in 2002 the net financial income deteriorated by EUR 2,126 million due to write-downs on investment in France Telecom as well as other marketable securities and higher interest expenses in 2002. The interest expenses compared to 2001 increased by EUR 1,408 million, largely attributable to loans to T-Mobile International AG (EUR 38 billion) that were converted from inter-group loans to equity.

In 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. Loss before taxes in 2002 was negatively impacted by provisions of approximately EUR 200 million 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. The loss before taxes in 2002 was offset in part by gains from the sale of Satelindo and a portion of the shares in T-Online.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

Generally, we centrally manage the liquidity and capital resources for each segment within our consolidated group. 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 2003 amounted to EUR 14.3 billion. This represented an increase of EUR 1.8 billion, or 14.4%, as compared with 2002. The increase was attributable to an increase in cash generated from operations of EUR 1.5 billion and a reduction in net interest payments of EUR 0.4 billion.

Our net income in 2003 was EUR 1.3 billion, an increase of EUR 25.8 billion from 2002. Our 2003 operating results included non-cash depreciation and amortization charges of EUR 12.9 billion, a EUR 24.0 billion decrease from that recorded in 2002. In addition, net results for 2003 included gains of EUR 0.8 billion from the sale of the remaining investments in our cable businesses and other financial investments, as compared with 2002 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.

Net cash provided by operating activities in 2002 amounted to EUR 12.5 billion. This represents an increase of EUR 0.5 billion, or 4.2%, as compared with 2001. This increase was 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.

In 2002, 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. Our 2002 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 included 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. Our operating results in 2001 included non-cash depreciation and amortization charges of EUR 15.2 billion.

#### Net Cash Used for Investing Activities

Net cash used for investing activities in 2003 amounted to EUR 2.1 billion, representing a decrease of EUR 8.0 billion, or 79.4%, when compared with 2002. The decrease primarily resulted from a EUR 6.3 billion reduction in acquisitions of consolidated companies, a EUR 1.6 billion reduction in cash outflows for investments in property, plant and equipment and from a EUR 1.0 billion increase in cash inflows from disposals of non current assets (primarily relating to the sale of our remaining cable businesses, financial assets and real estate). In addition, there was a reduction in cash outflows due to the reduction of our acquisition activity in 2003 from that in 2002.

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 T-Mobile Netherlands (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. In 2001, we made cash payments to acquire T-Mobile USA and to invest in property, plant and equipment, reduced by cash proceeds received from the disposals of Sprint, FON and PCS, WIND, and the proceeds received from the sales of T-Com trade receivables in connection with its securitization program.



### Significant Investing Events

<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2003	GHS	Sale of real estate . . . . .	0.8
2003	T-Com	Sale of cable businesses . . . . .	1.7
2003	GHS	Sale of interest in Eutelsat . . . . .	0.1
2003	GHS	Sale of interest in TeleCash. . . . .	0.1
2003	T-Mobile	Sale of interest in MTS . . . . .	0.5
2003	GHS	Sale of interest in Celcom . . . . .	0.1
2003	GHS	Sale of interest in Globe Telecom . . . . .	0.4
2003	GHS	Sale of interest in Inmarsat. . . . .	0.1
2003	T-Mobile	Asset-backed securities transaction . . . . .	0.5
2003	GHS	Buyback of T-Online shares . . . . .	(0.2)

<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2002	GHS	Sales of real estate. . . . .	1.3
2002	GHS	Sale of shares in T-Online International AG . . . . .	0.7
2002	T-Systems	Asset-backed securitization transaction. . . . .	0.3
2002	GHS	Sale of interest in Satelindo. . . . .	0.3
2002	GHS	Sale of interest in France Telecom. . . . .	0.3
2002	T-Mobile	Exercise of call option to acquire 51% of T-Mobile Netherlands (Ben) . . . . .	(1.7)
2002	T-Systems	Acquisition of remaining 49.9% of T-Systems ITS GmbH (formerly debis Systemhaus) . . . . .	(4.7)

<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2001	GHS	Sale of interests in Sprint, FON and PCS. . . . .	3.4
2001	GHS	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	GHS	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 T-Mobile Czech Republic (RadioMobil) . . . . .	(0.6)
2001	T-Mobile	Acquisition of T-Mobile USA <sup>(1)</sup> . . . . .	(5.1)

(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 5.2 billion in 2003, representing an increase of EUR 1.8 billion, or 52.9%, when compared with 2002. Net additions to our medium-term and long-term borrowings decreased by EUR 4.1 billion to EUR 4.1 billion in 2003, primarily due to the issuance of U.S. dollar and mandatorily convertible bonds in the aggregate amounts of USD 2.0 billion (EUR 1.6 billion) and EUR 2.3 billion, respectively, offset in part by the repurchase of bonds previously issued by T-Mobile USA with a principal amount of USD 1.1 billion and the repayment of debt that was approaching maturity. The 2003 net decrease in short-term debt of EUR 9.2 billion represents a EUR 0.8 billion decrease, as compared with 2002. Net cash used for financial activities in 2003 and 2002 included the dividend payments of EUR 0.1 billion and 1.6 billion for 2002 and 2001, respectively. The dividend payments in 2003 represented payments distributed to minority interest holders in our consolidated subsidiaries.

Net cash used for financing activities amounted to EUR 3.4 billion in 2002, as compared with net cash used for financing activities of EUR 4.8 billion in 2001. 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 in principal amount of 5-year bonds, EUR 2.0 billion in principal amount of 10-year bonds, and USD 0.5 billion (EUR 476 million) in principal amount of 30-year bonds. The issuances of this medium and long-term debt were used to refinance bank debt.

Net cash used for financing activities in 2001 amounted to EUR 4.8 billion. In 2001, we issued EUR 4.5 billion in principal amount of 5-year bonds, EUR 3.5 billion in principal amount of 10-year bonds, and JPY 160 billion (EUR 1.4 billion) in principal amount of 3 to 7-year bonds. New indebtedness incurred during 2001 was used primarily to refinance maturing bonds. The payment of dividends in respect of 2001 resulted in an outflow of cash and cash equivalents of EUR 1.6 billion.

### ***Significant Financing Events***

<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2003	GHS	Net repayments of short-term debt . . . . .	(9.2)
2003	GHS	Issuance of medium and long-term debt . . . . .	7.0
2003	GHS	Repayments of medium and long-term debt . . . . .	(2.9)
2003	GHS	Payment of dividends to minority interest shareholders. . . . .	(0.1)
<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2002	GHS	Net repayments of short-term debt . . . . .	(10.0)
2002	GHS	Issuances of medium and long-term debt . . . . .	11.7
2002	GHS	Repayments of medium and long-term debt . . . . .	(3.5)
2002	GHS	Payment of dividends to Deutsche Telekom AG shareholders. . . . .	(1.6)
<u>Year Ended</u>	<u>Segment</u>	<u>Event</u>	<u>Amount</u> (billions of €)
2001	GHS	Net repayments of short-term debt . . . . .	(10.3)
2001	GHS	Issuances of medium and long-term debt . . . . .	13.9
2001	GHS	Repayments of medium and long-term debt . . . . .	(6.6)
2001	GHS	Payment of dividends to Deutsche Telekom AG shareholders. . . . .	(1.9)

### **Capital Resources**

Our debt position on December 31, 2003, decreased from the 2002 year-end level of EUR 63.0 billion to EUR 55.4 billion due to the repurchase of T-Mobile USA bonds of EUR 1.0 billion and to redemptions of a EUR 2.6 billion fixed-rate bond of medium-term notes and borrower's note loans at maturity. Our debt position was also positively affected (EUR 2.5 billion) by changes in foreign currency exchange rates principally related to the ongoing weakening of the U.S. dollar against the euro. For further information concerning the development of our debt and liquid assets, see notes (20) and (30) to our consolidated financial statements. At December 31, 2003, the Federal Republic was the guarantor of EUR 11.6 billion of these liabilities. For further details, see "Item 7. Major Shareholders and Related Party Transactions." For a discussion of funding and treasury policies, see note (30) to our consolidated financial statements and "Item 11. Quantitative and Qualitative Disclosures About Market Risk."

In 2003, we increased our liquid assets from the 2002 year-end level of EUR 1.9 billion to EUR 9.1 billion through a combination of factors. Among the major contributors were cash generated from operations (EUR 14.3 billion), the cash inflow from the sale of the remaining regional cable companies and other consolidated companies (EUR 1.8 billion) and several minority interests (EUR 1.4 billion), real estate disposals (EUR 0.8 billion) and the sale of receivables under the T-Mobile International asset-backed securitization program (EUR 0.5 billion). These cashflows were partially offset by cash used for a buy-back in T-Online shares (EUR 0.2 billion), net decrease in short-, medium- and long-term debt (EUR 5.2 billion) and investments in fixed assets (EUR 6.4 billion). Additionally, our liquid assets were further reduced as a result of the deconsolidation of certain companies (EUR 0.3 billion). Our liquid assets are expected to be reduced within the first half of 2004 as a result of the redemption of bonds and medium-term notes amounting to EUR 5.3 billion.

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 of bilateral credit agreements and syndicated loans.

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

In March 2002, Moody's Investors Service lowered its rating of our long term 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 long term senior unsecured debt from A- to BBB+. The changes in credit rating in 2002 triggered a step-up of 50 basis points with effect from the next interest payment dates after April 2002 for future interest payments on Deutsche Telekom bonds of approximately EUR 21.8 billion at December 31, 2003, denominated in various currencies. This step-up will result in an increase in our interest expense on these bonds of approximately EUR 0.1 billion in 2004. In case of an upgrade to at least A- by Standard & Poor's and A3 by Moody's our interest expense on the respective outstanding bonds and loans would decrease accordingly.

From May 2002 to April 2003, we issued bonds and medium-term notes with step-up provision that would result in a 50 basis point increase in interest rates in the event of a lowering of our long-term senior unsecured debt ratings below Baa1 by Moody's and BBB+ by Standard & Poor's. The aggregate principal amounts were EUR 4.5 billion and USD 0.5 billion for the bonds and EUR 3.0 billion and GBP 1.0 billion for the medium-term notes. We estimate that such a step-up would result in an increase in our interest expense of approximately EUR 46.6 million per annum.

On June 24, 2003, Moody's changed its outlook from stable to positive for our Baa3 long-term senior unsecured debt rating. On March 3, 2004, Moody's raised the rating to Baa2 with a positive outlook. Standard and Poor's placed the BBB+ long-term senior unsecured debt rating on CreditWatch with positive implications on March 10, 2004. Definitions of the rating agencies are as follows:

#### **Moody's: Baa**

Moody's has nine generic long-term debt ratings, ranging from Aaa to C. The Baa rating is the fourth highest of the generic ratings. According to Moody's Global Rating Guide, obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics. Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

#### **Standard & Poor's: BBB**

Standard & Poor's has eleven generic long-term issuer credit ratings, ranging from AAA to SD or D. The BBB issuer rating is the fourth highest of the generic ratings. According to Standard & Poor's Ratings Handbook, an obligor rated 'BBB' has ADEQUATE capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments. Plus (+) or minus (-) the ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

A securities rating is not a recommendation to buy, sell or hold securities and is subject to revision or withdrawal at any time by the assigning rating organization. Each rating should be evaluated independently of any other rating.

### **Lines of Credit**

On December 31, 2003, we had committed credit facilities with banks totaling EUR 17.6 billion, as well as uncommitted credit facilities of EUR 0.5 billion. The credit facilities include two syndicated loan facilities: one having T-Mobile UK as borrower (the "T-Mobile UK loan facility") in the aggregate committed amount of GBP 2.8 billion (EUR 3.9 billion) and one having Deutsche Telekom AG and its Dutch finance subsidiary, Deutsche Telekom International Finance B.V. as borrowers (the "DT loan facility"). The aggregate committed amount of the DT loan facility is EUR 9.0 billion on December 31, 2003, compared to EUR 12.0 billion on December 31, 2002. Tranche B (EUR 3.0

billion) was cancelled by the company on August 11, 2003 and Tranche A (EUR 5.0 billion) was extended for one year to September 28, 2004. Under the T-Mobile UK loan facility, GBP 0.7 billion (EUR 1.0 billion) in borrowings were outstanding on December 31, 2003. There were no borrowings outstanding under the DT loan facility.

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

<u>Tranche name</u>	<u>Maximum amount</u>	<u>Maturity date</u>
Tranche A.....	EUR 5.0 billion	September 28, 2004
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:

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

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. On December 31, 2003, we had committed lines of credit through these agreements totaling EUR 4.7 billion. The interest and commitment fees payable on these facilities are based upon the terms of each specific contract. Approximately EUR 0.2 billion in aggregate principal amount was outstanding under these agreements at December 31, 2003.

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, 2003, EUR 0.9 billion of our bilateral credit agreements, 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, 2003, 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.

### 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.

	<u>For the year ended December 31,</u>				
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2003/2002</u>	<u>2002/2001</u>
	<u>(millions of €)</u>			<u>(% change)</u>	
Capital expenditures.....	6,031	7,625	10,868	(20.9)%	(29.8)%
Investments.....	648	6,973	6,193	(90.7)%	12.6%
Proceeds from sales of non-current assets and investments.....	(4,158)	(3,145)	(5,872)	(32.2)%	46.4%
Other.....	(448)	(1,413)	(5,824)	68.3%	75.7%
<b>Net cash used for investing activities.....</b>	<u>2,073</u>	<u>10,040</u>	<u>5,365</u>	(79.4)%	87.1%

## 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,				
	2003	2002	2001	2003/2002	2002/2001
	(millions of €)			(% change)	
Intangible assets (excluding goodwill) . . . . .	683	873	1,376	(21.8)%	(36.6)%
Fixed networks . . . . .	1,604	2,609	3,831	(38.5)%	(31.9)%
Mobile networks . . . . .	663	826	1,692	(19.7)%	(51.2)%
Buildings . . . . .	199	177	159	12.4%	11.3%
Other capital expenditures . . . . .	2,882	3,140	3,810	(8.2)%	(17.6)%
<b>Total capital expenditures . . . . .</b>	<u>6,031</u>	<u>7,625</u>	<u>10,868</u>	(20.9)%	(29.8)%

Capital expenditures for fixed networks relating to transmission and radio equipment (EUR 0.9 billion) and telecommunications networks (EUR 0.3 billion) decreased in 2003. In particular, the conversion to the SDH and WDM transmission technology from 2001 to 2002 meant that, in 2003, little investment had to be made in the fixed-line network backbone and that capital expenditures were needed primarily for the expansion of new technologies. Other capital expenditures decreased slightly, primarily as a result of the reduction in expenditures for plant and office equipment (EUR 0.4 billion). The reduction in capital expenditure in 2003 compared with 2002 is also attributable to the realization of purchasing advantages through reduced prices and the use of technological advances.

In 2002 capital expenditures decreased compared to 2001, mainly for switching and radio equipment (EUR 2.1 billion). In particular, T-Com in Germany recorded a capital expenditure decrease. The regional roll-out of T-DSL was to a large extent complete in 2002 and subscriber growth slowed after the initial boom. At T-Systems, the roll-out of the international network (TGS) was completed, and at T-Mobile network roll-out for GSM technology was also largely completed (with the exception of the United States). By comparison, the new UMTS technology required little pre-production capital expenditures.

For 2004, we expect to invest up to EUR 1.5 billion more than we invested in intangible assets (excluding goodwill) and property, plant and equipment in 2003. The precise amount for our capital expenditures will depend in part on the development of our cash flows in 2004. 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 these capital expenditures 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.

Our 2004 capital expenditures are budgeted to be higher than in 2003. The increase is expected to be driven by T-Mobile's focus on the continued roll-out of our UMTS infrastructure in Europe as well as by the quality and capacity enhancement of our GSM network in North America. The total capital expenditures of T-Mobile are expected to amount to approximately EUR 3.5 billion. The majority of capital expenditures of the T-Com division is expected to relate to voice and data transmission capacity and the continued extension and improvement of our network infrastructure. T-Com's total capital expenditures are expected to reach approximately EUR 2.5 billion.

## Investments

Investments in subsidiaries, associated companies and other financial assets amounted to EUR 0.6 billion in 2003. In particular, we invested in the associated companies GSM Facilities and MTS. The significant decrease is primarily attributable to high level of cash outflows for the full acquisition of T-System ITS GmbH (EUR 4.7 billion) and T-Mobile Netherlands (EUR 1.7 billion) in 2002. In



addition, in 2002 our 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, T-Mobile Czech Republic, Hrvatski Telecom and Matáv. Investments in associated and related companies and other financial assets, amounted to EUR 0.5 billion.

### Contractual Obligations and Other Commitments

At December 31, 2003, we had accrued contractual cash obligations totaling EUR 15.7 billion and liabilities totaling EUR 65.9 billion. In addition, we have other contractual obligations for payments to special pension funds, capital lease obligations, operating leases and purchase commitments.

### Contractual Cash Obligations

The following table summarizes our long-term debt as well as our obligations and commitments to make future payments under contracts as of December 31, 2003:

	Payments Due by Period				
	<u>Total</u>	<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>More than 5 Years</u>
	(millions of €)				
Long-term debt					
Bonds and debentures . . . . .	51,613	12,295	15,015	7,321	16,982
Liabilities to banks . . . . .	<u>3,798</u>	<u>806</u>	<u>1,567</u>	<u>361</u>	<u>1,064</u>
	55,411	13,101	16,582	7,682	18,046
Capital lease obligations . . . . .	423	33	60	58	272
Other long-term debt . . . . .	<u>10,028</u>	<u>9,191</u>	<u>198</u>	<u>13</u>	<u>626</u>
<b>Total long-term Debt</b> . . . . .	<u><u>65,862</u></u>	<u><u>22,325</u></u>	<u><u>16,840</u></u>	<u><u>7,753</u></u>	<u><u>18,944</u></u>
Present value of payments to special pension fund . . . . .	9,000	950	1,618	1,393	5,039
Operating leases . . . . .	11,737	1,703	2,862	2,120	5,052
Purchase commitments for capital projects in progress, including obligations arising from future expenditures . . . . .	1,924	1,634	285	5	0
Commitments arising from transactions not yet settled . . . . .	869	783	9	5	72
Purchase commitments for interest in other companies . . . . .	763	254	0	0	509
Other financial obligations . . . . .	<u>12</u>	<u>3</u>	<u>6</u>	<u>0</u>	<u>3</u>
<b>Total other contractual obligations</b> . . . . .	<u><u>24,305</u></u>	<u><u>5,327</u></u>	<u><u>4,780</u></u>	<u><u>3,523</u></u>	<u><u>10,675</u></u>
<b>Total contractual obligations</b> . . . . .	<u><u>90,167</u></u>	<u><u>27,652</u></u>	<u><u>21,620</u></u>	<u><u>11,276</u></u>	<u><u>29,619</u></u>

For more information regarding our long-term debt, refer to “— Capital Resources” and note (30) to the consolidated financial statements.

Other long-term debt consists of liabilities arising from advances to consolidated and affiliated companies, bills, trading and other liabilities.

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, 2003.

The total future payment obligations under non-cancelable operating leases amounted to EUR 11.7 billion over varying terms of up to 25 years. In 2003, new lease agreements have been consummated and old lease agreements have been renewed, primarily for real estate and radio towers. The majority of the lease obligations are attributable to Group Headquarters and Shared Services and to T-Mobile.

The purchase commitments for capital projects in progress are primarily attributable to Deutsche Telekom AG (EUR 1.0 billion), T-Systems (EUR 0.4 billion), and T-Mobile (EUR 0.3 billion). A large number of different purchase commitments, most of which are short-term in nature, have been entered into by Deutsche Telekom AG. T-Systems has entered into commitments relating in particular to license agreements and software projects. T-Mobile's commitments include commitments to purchase network and UMTS equipment. There are agreements covering the purchase quantities and periods.

The commitments arising from transactions not yet settled relate primarily to short-term purchase commitments at T-Mobile (EUR 0.8 billion). The increase in commitments is due in particular to new contracts for mobile terminals at T-Mobile Deutschland and T-Mobile UK. There are detailed agreements covering the purchase quantities and periods.

The purchase commitments for interests in other companies relate mainly to Deutsche Telekom AG (EUR 510 million). 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 15 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 394 million, net of mortgage loans assumed of approximately EUR 203 million. The slight decrease in the commitments is marked by offsetting effects. An arbitration panel decided that T-Mobile's obligation to purchase additional shares of PTC no longer applies (2002: EUR 128 million). In addition, T-Online no longer has an obligation to contribute to a venture fund due to the inclusion of the company in the group. New obligations result from the announcement by T-Online that it will acquire Scout24 AG (EUR 180 million).

Other financial obligations primarily concern contingent contractual obligations.

### ***Guarantees and Commitments***

The following table summarizes liabilities arising from warranty agreements and guarantees as of December 31, 2003:

	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 Years</b>
	(millions of €)				
Liabilities arising from warranty agreements . . . . .	2,199	1,486	47	56	610
Guarantees . . . . .	<u>28</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>16</u>
Total . . . . .	<u><u>2,227</u></u>	<u><u>1,490</u></u>	<u><u>51</u></u>	<u><u>60</u></u>	<u><u>626</u></u>

The increase in liabilities arising from warranty agreements is due primarily to loan collateral guarantees by Deutsche Telekom AG for T-Mobile. This increase was partially offset by a decline in T-Mobile International AG's obligation under a QTE (Qualified Technology Equipment) lease, which decreased by EUR 140 million year-on-year to EUR 768 million due to exchange rate effects.

### ***Toll collection system***

As previously reported, in September 2002, Deutsche Telekom AG, DaimlerChrysler Services AG, and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) (individually, the "partners" and collectively, the "consortium") entered into an agreement dated September 2002 and last amended in November 2002 (the "operating agreement") with the Federal Republic of Germany (represented by the German Federal Ministry of Transport, Building and Housing) relating to a

project to create and operate an innovative system for the collection of toll charges for the use by heavy vehicles of the German high-speed highway system. We refer to this project as the “Toll Collect project.” The toll collection system is to be created and operated by the joint venture Toll Collect GmbH (“Toll Collect”). DaimlerChrysler Services and we each hold a 45% stake in Toll Collect, with the remaining 10% being held by Cofiroute. Our involvement with Toll Collect includes our equity interest in Toll Collect that is recognized in our consolidated financial statements using the equity method of accounting, and certain financial guarantees. Additionally, certain of our divisions may act as sub-contractors of services to Toll Collect. We believe our maximum exposure to loss as a result of our interest in Toll Collect could extend beyond the amounts we have invested because of other risks associated with the financial guarantees issued for Toll Collect.

Pursuant to the provisions of the operating agreement, we, together with our partners, have, on a joint and several basis, guaranteed that Toll Collect will duly perform its duties in line with the operating agreement for the period of one year after the agreed start of operations.

In addition, the partners of Toll Collect, on a joint and several basis, undertook to fund Toll Collect in order to maintain a minimum equity ratio for Toll Collect of 20% (based on German GAAP) until August 31, 2004, and 15% thereafter (“Equity Maintenance Undertaking”) until the operating agreement expires. Toll Collect’s total assets, financial liabilities and total liabilities at December 31, 2003, calculated on the basis of U.S. GAAP, were EUR 0.8 billion (EUR 1.3 billion under German GAAP), EUR 0.5 billion (EUR 0.5 billion under German GAAP) and EUR 1.1 billion (EUR 1.1 billion under German GAAP), respectively. Our involvement with Toll Collect includes our equity interest in Toll Collect that is recognized in the consolidated financial statements using the equity method of accounting. Under German GAAP, the share of the Toll Collect equity losses to be recorded under the equity method is limited to the value of the investment. Therefore, we recorded approximately EUR 108 million as our share of the equity in net losses. Due to the risks associated with the financial guarantees issued for Toll Collect, we recorded a provision of approximately EUR 334 million under German GAAP. In addition, we have provided a guarantee for bank loans to Toll Collect amounting to EUR 312 million as of December 31, 2003.

The start of operations initially was scheduled for August 31, 2003, but has been delayed. Commencing on December 2, 2003, the consortium, or Toll Collect (provided it joins as a party to the operating agreement) has become liable for contractual penalties of EUR 250,000 per day until the end of February 2004 and EUR 500,000 per day thereafter until the toll collection system is operational. Beside these penalties, we believe that further penalties or liability for fault are excluded in the operating agreement.

In case of a culpable violation of contractual duties during the operational phase, the Federal Republic of Germany would not be prevented from claiming damages from Toll Collect. If such penalties, revenue reductions, and other events eventually result in an equity ratio of Toll Collect below the ratio agreed upon in the Equity Maintenance Undertaking, the partners are obligated to fund operations to the extent needed to reach these equity levels.

Specific circumstances may entitle the parties to terminate the operating agreement. For termination to be effective, notice of termination must generally be given at least two months before the termination takes effect. This period may be used to rectify the reasons for termination. Termination of the operating agreement may have significant consequences for us as financial guarantor of certain obligations of Toll Collect. On February 17, 2004, the Federal Ministry of Transport sent us a letter advising that a notice of termination of the operating agreement was imminent. On February 25, 2004, we received such notice of termination of the operating agreement, dated February 19, 2004. While the notice of termination has not been formally retracted, on February 29, 2004, the consortium members reached an agreement with the Federal Republic to continue the Toll Collection project on the following basic terms:

- Toll collection will be introduced in two phases — the first to commence no later than January 1, 2005 (phase 1), and the second to commence no later than January 1, 2006 (phase 2). Phase 2 operation of the toll collection system will be as specified in the operating agreement. Phase 1 operation of the toll collection system will employ certain modified components, which allow for slightly less than full technical performance in accordance with original specifications. Due to this slight deficiency, the remuneration owed by the Federal Republic to Toll Collect in phase 1 will be 95% of the remuneration which will be payable in phase 2. The agreement provides that if the toll collection system is in stable operation, the one-year term of phase 1 may be extended by mutual agreement up to two years.

- During phase 1, the consortium is required to make available a sufficient number of on-board units (OBUs) to meet demand, with no fewer than 500,000 OBUs available at the commencement of phase 1. OBUs are devices installed in vehicles in order to allow for the collection by satellite of highway travel data. The consortium is also required to ensure the availability of necessary OBU installation facilities in Germany and abroad.
- During phase 1, the Federal Republic is guaranteed to receive net toll revenues (revenues less Toll Collect remuneration) in an amount equal to at least EUR 83.4 million per month, whether from toll revenues or from the agreed contractual liability for shortfall payments. The Federal Republic is to pay during phase 1 the full 95% of the remuneration provided for in the original operating agreement for what is now phase 2 if the net toll revenues received by the Federal Republic from the toll collection system in a given month do not fall short of the gross revenues by more than 20%. No remuneration will, however, become payable when and if any given month total revenues exceed the guaranteed EUR 83.4 million by no more than 20% of the toll collection system gross revenues.
- Delays in the commencement of phase 1 operation of the toll collection system will result in monthly penalties of EUR 40 million increasing by EUR 5 million each month up to a maximum of EUR 80 million per month through the initial agreed phase 1 period of one year.
- During phase 1, the project company or the consortium will be liable in case of a toll shortfall to guarantee net toll revenues in an amount up to EUR 1 billion per year, but no more than EUR 83.4 million per month. Contractual penalties due to reduced performance of certain minimum parameters set out for the toll collection system in the operating agreement, certain maluses relating to less than full performance of the toll collection system or recourse claims against the consortium or the project company in the case of third party liability of the Federal Republic will not be counted against the liability cap.
- In the event of major deviations from the project plan that endanger the realization of the project, the consortium and the Federal Republic are obligated to reach a good faith agreement on mutually beneficial, appropriate and reasonable measures to minimize the disadvantages for either party. In the event that neither phase 1 testing operation nor the development of phase 2 technology has been successfully completed by June 1, 2005, the Federal Republic may take measures to initiate procurement of an alternative toll collection system without prior termination of the agreement, which action would then, however, not suspend Toll Collect's obligations to continue development of the phase 2 system, nor the Federal Republic's obligation to use the system after successful completion.
- Following the end of the agreed phase 1 operational period, the provisions governing penalties for delay of operation and liabilities contained in the original agreement shall continue to apply (i.e., a maximum of EUR 500,000 per day for delay, and potential unlimited liability under general principles of German law in the operating stage of phase 2).
- Phase 2, thus, contemplates full operation of the Toll Collect project in accordance with the specifications set forth in the original agreement, provided, however, that certain dates and deadlines, including with respect to grounds for termination, are to be modified to conform to the amended arrangement.

Toll Collect and the consortium are currently in discussions with the Federal Ministry of Transport to implement the agreement reached on February 29, 2004.

Additionally, the consortium and the Federal Republic have agreed to waive rights to mediation proceedings before arbitration with respect to any claims of the Federal Republic for damages and penalties. The Federal Republic is expected to assert claims for damages from the consortium of EUR 156 million per month for the period September 1, 2003 to December 31, 2003 and EUR 180 million per month from January 1, 2004 for lost toll revenues. In addition, the Federal Republic is expected to allege contractual penalties of EUR 680 million because the members of the consortium did not seek the necessary agreement of the Federal Ministry of Transport before concluding certain subcontractor agreements. Deutsche Telekom AG believes the claims of the Federal Republic are unfounded. Under the terms of the agreement, the Federal Republic may resort to arbitral proceedings for clarification of its legal position. The maximum future obligations arising from the Toll Collect project cannot be quantified with adequate certainty.

## **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, Euro Tel Bratislava a.s. (Euro Tel). Pursuant to a Shareholders' Agreement dated July 2000 and an amendment in April 2003 with the Slovak Republic, we are obligated to make additional investments in the development of the core business activities of Slovak Telecom (currently at least EUR 1 billion by December 31, 2005). These additional investments include 51% of the capital expenditure of Euro Tel.

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 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.

## **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 (41) through (44) 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.

## **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, except for licenses deemed to have indefinite lives. 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 assets. Once the networks are in use, capitalization of these costs will cease and related costs capitalized will be amortized into earnings over the remaining expected period of use.

## **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.

## **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 valuation at residual interests in, asset-backed securitizations, hedge accounting from derivatives, additions to pension liabilities and investments in equity investees, which historically are recurring differences. In 2003, other differences also differences resulting from the adoption of a new U.S. GAAP accounting standard for asset retirement obligations.

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

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, for revenue arrangements entered into on or after January 1, 2004. 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. On December 24, 2003, the FASB issued a revised interpretation to FIN 46 (“FIN 46 R”) to modify some of the provisions of FIN 46 and to exempt certain entities from its requirement. We plan to adopt the provisions of FIN 46 R as of March 31, 2004, to all entities that existed prior to February 1, 2003. We have identified Toll Collect as a VIE, and are assessing whether we are the primary beneficiaries. To accomplish this, we must 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. Other than our variable interest in Toll Collect, we hold variable interests in other VIE’s which are not significant either individually or in the aggregate.

On May 28, 2003, The Financial Accounting Standards Board ratified the consensus reached in the Emerging Issues Task Force Issue No. 01-8, “Determining Whether an Arrangement Contains a Lease” (“EITF 01-8”). EITF 01-8 addresses the issue of how to determine whether an arrangement contains a lease that is within the scope of SFAS 13, “Accounting for Leases.” EITF 01-8 requires lease accounting for contractual arrangements that explicitly or implicitly convey the right to use (or control the use of) specific property, plant or equipment. These “embedded lease” attributes exist in certain data processing outsourcing arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer, or where providers of network capacity grant rights to capacity on the basis of an indefeasible right of use. The adoption of EITF 01-8 will result in the applicability of lease accounting to agreements previously recorded as service revenues. We plan to adopt the provisions of EITF 01-8 for all agreements entered into after December 31, 2003, which is not expected to have a material impact on our results of operations, financial position and cash flows.

## NEW GERMAN ACCOUNTING REGULATION

No new German accounting standards (GAS) or accounting legislation became effective in 2003.

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

#### GENERAL

In accordance with the German Stock Corporation Act, we have a Supervisory Board and a Management Board. 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. 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 Audit Committee of the Supervisory Board will make recommendations to the Supervisory Board regarding the engagement of our auditors, however, our independent auditors are appointed by our shareholders (usually upon recommendation by the Supervisory Board) and are engaged by the Audit Committee subsequent to shareholder approval.

Both the members of the Management Board and the members of the Supervisory Board owe a duty of loyalty and a duty of care to our company and its constituents. 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. The company's constituent interests are deemed to include the interests of our shareholders, the interests of our employees and, to some extent, the interests of the community. Both the Management Board and the Supervisory Board must take all these interests into account when taking actions or making decisions. Although there is no explicit obligation to act solely in the interests of shareholders, the Management Board is required to respect the shareholders' rights to receive 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 developments 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 contains a provision that the Management Board must obtain the consent of the Supervisory Board for certain actions, including decisions or measures that fundamentally change the assets, financial, earnings or risk situation of the company and measures concerning the corporate structure and 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 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 such 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 Deutsche Telekom. As a general rule, under German law, only the company has the right to claim damages from the members of the two boards. The company 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.

## SUPERVISORY BOARD

In accordance with the German Stock Corporation Act and the Co-Determination Act of 1976, 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.

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.

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 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 makes 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 Supervisory Board met eleven times in 2003. No member attended less than 50% of the meetings of the Supervisory Board. The members of our Supervisory Board during 2003, the years in which they were appointed, the months in which their current terms expire and their principle occupations were as follows:

Dr. Klaus Zumwinkel Chairman (since March 2003)	Member since: Expiration of Current Term: Principal Occupation:  Supervisory Board Memberships/Directorships:	March 2003 Annual Meeting 2008 Chairman of the Board of Management of Deutsche Post AG, Bonn  Allianz Versicherungs-AG, Munich Deutsche Lufthansa AG, Cologne Karstadt Quelle AG, Essen Tchibo Holding AG, Hamburg Morgan Stanley, BoD, New York, USA Deutsche Postbank AG, Bonn, Chairman of the Supervisory Board* C.V. International Post Corp. U.A., Amsterdam, Netherlands; Deputy Chairman Board of IPC * Danzas Holding AG, City, Switherland,
--	--	--

Franz Tremel Vice Chairman (since August 2003)	Member since: Expiration of Current Term: Principal Occupation: Supervisory Board Memberships/Directorships:	Chairman of the Administrative Board* Deutsche Post Ventures GmbH, Bonn, Investment Committee* DHL Worldwide Express B.V., BoD, City, Netherlands* (*mandates (companies) within Deutsche Post group) July 2003 2007 Deputy Chairman of the union ver.di, Berlin  DeTeImmobilien Deutsche Telekom Immobilien und Service GmbH, Münster, Deputy Chairman DBV-Winterhur – Leben, Wiesbaden
Monika Brandl	Member since: Expiration of Current Term: Principal Occupation:  Supervisory Board Memberships/Directorships:	2002 Annual Meeting 2007 Member of the Central Works Council at Deutsche Telekom AG, Bonn  None
Josef Falbisoner	Member since: Expiration of Current Term: Principal Occupation:  Supervisory Board Memberships/Directorships:	1997 Annual Meeting 2007 Chairman of the Bavarian District of the Union ver.di  PSD-Bank, Munich, Augsburg office
Dr. Hubertus von Gruenberg	Member since: Expiration of Current Term: Principal Occupation:  Supervisory Board Memberships/Directorships:	2000 Annual Meeting 2006 Serves as member on several Supervisory Boards  Allianz-Versicherungs AG, Munich Continental AG, Hannover, Chairman of the Supervisory Board MAN AG, Munich SAI Automotive, Frankfurt/Main until 6/2003 Schindler Holding AG, Hergiswil/Switzerland, Administrative Board
Lothar Holzwarth	Member since: Expiration of Current Term: Principal Occupation:  Supervisory Board Memberships/Directorships:	2002 Annual Meeting 2007 Chairman of the Works Council of Deutsche Telekom AG, branch office South-Western, Stuttgart  PSD Bank RheinNeckarSaar e.G., Chairman of the Supervisory Board



Dr. sc. techn. Dieter Hundt	Member since: Expiration of Current Term: Principal Occupation:	1995 Annual Meeting 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 Verwaltungs-AG, Stuttgart, Vice Chairman of the Supervisory Board Landesbank Baden-Wuerttemberg, Stuttgart, Administrative Board
Waltraud Litzenberger	Member since: Expiration of Current Term: Principal Occupation:	1999 Annual Meeting 2007 Member of the Works Council of Deutsche Telekom AG, technical branch office Mitte, Mainz
	Supervisory Board Memberships/Directorships:	PSD-Bank e.G., Koblenz
Michael Loeffler	Member since: Expiration of Current Term: Principal Occupation:	1995 Annual Meeting 2007 Member of the Works Council of Deutsche Telekom AG, technical branch office Dresden
	Supervisory Board Memberships/Directorships:	None
Dr. Manfred Overhaus	Member since: Expiration of Current Term: Principal Occupation:	2002 Annual Meeting 2008 State Secretary in the Federal Ministry of Finance (Bundesministerium der Finanzen), Berlin
	Supervisory Board Memberships/Directorships:	Deutsche Post AG, Bonn GEBB mbH, Cologne
Hans W. Reich	Member since: Expiration of Current Term: Principal Occupation:	1999 Annual Meeting 2006 Speaker of the Management Board KfW Bankengruppe, Frankfurt/Main
	Supervisory Board Memberships/Directorships:	Aareal Bank AG, Wiesbaden ALSTOM GmbH, Frankfurt/Main until 11/2003 DePfa Bank plc., Dublin, Ireland, BoD HUK-COBURG Haftpflicht-Unterstuetzungs-Kasse kraftfahrender Beamter Deutschlands a.G., Coburg HUK-COBURG Holding AG, Coburg IKB Deutsche Industriebank AG, Duesseldorf RAG AG, Essen Thyssen Krupp Steel AG, Duisburg

Dr. Hans-Jürgen Schinzler	Member since: Expiration of Current Term: Principal Occupation:	Annual Meeting 2003 Annual Meeting 2008 Member of the Supervisory Board of Münchener Rückversicherungs AG, Munich
	Supervisory Board Memberships/Directorships:	Bayerische Hypo- und VereinsbankAG, Munich, Deputy Chairman of the Supervisory Board ERGO Versicherungsgruppe AG, Düsseldorf, Chairman of the Supervisory Board MAN AG, Munich, Deputy Chairman of the Supervisory Board Metro AG, Düsseldorf Aventis S.A., Schiltigheim, France
Dr. Klaus G. Schlede	Member since: Expiration of Current Term: Principal Occupation:	Annual Meeting 2003 Annual Meeting 2008 Member of the Supervisory Board of Deutsche Lufthansa AG, Düsseldorf
	Supervisory Board Memberships/Directorships:	Deutsche Postbank AG, Bonn Deutsche Lufthansa AG, Köln Gerling-Konzern Globale Rückversicherungs- AG, Cologne until 12/2003 Thomas Cook AG, Oberursel until 11/2003
Wolfgang Schmitt	Member since: Expiration of Current Term: Principal Occupation:	1997 Annual Meeting 2007 Executive Vice President Deutsche Telekom AG Business Customer Branch Office South West, Stuttgart
	Supervisory Board Memberships/Directorships:	PSD-Bank, RheinNeckarSaar e.G.
Michael Sommer	Member since Expiration of Current Term: Principal Occupation:	2000 Annual Meeting 2007 President of the Trade Union Council, Berlin
	Supervisory Board Memberships/Directorships:	BHW Bausparkasse, Hameln Postbank, Bonn, Vice Chairman of the Supervisory Board T-Systems International GmbH, Bonn, Vice Chairman of the Supervisory Board
Ursula Steinke	Member since: Expiration of Current Term: Principal Occupation:	1995 Annual Meeting 2007 Chairwoman of the Works Council at T-Systems CDS GmbH, Kiel
	Supervisory Board Memberships/Directorships:	None

Prof. Dr. h.c. Dieter Stolte	<p>Member since: 1995</p> <p>Expiration of Current Term: Annual Meeting 2006</p> <p>Principal Occupation: Editor in Chief of "WELT" and "Berliner Morgenpost," Berlin</p> <p>Supervisory Board</p> <p>Memberships/Directorships: Out of home Media AG, Cologne ZDF Enterprises GmbH, Mainz</p>
Bernhard Walter	<p>Member since: 1999</p> <p>Expiration of Current Term: Annual Meeting 2006</p> <p>Principal Occupation: Dresdner Bank AG</p> <p>Supervisory Board</p> <p>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, Deputy Chairman of the Supervisory Board Joint Stock Company "Sibirsko-Uralskaya Neftegazohimicheskaya Companiya" (AK "Sibur"), Moscow, until March 2003</p>
Wilhelm Wegner	<p>Member since: 1996</p> <p>Expiration of Current Term: Annual Meeting 2007</p> <p>Principal Occupation: Chairman of the Central Works Council at Deutsche Telekom AG, Bonn</p> <p>Supervisory Board</p> <p>Memberships/Directorships: VPV Allgemeine Versicherungs-AG, Cologne VPV Holding AG, Stuttgart Vereinigte Postversicherung VVaG, Stuttgart PSD Bank Duesseldorf e.G.</p>
Dr. Wendelin Wiedeking	<p>Member since: Annual Meeting 2003</p> <p>Expiration of Current Term: Annual Meeting 2008</p> <p>Principal Occupation: Chairman of the Management Board of Dr. Ing. h.c. F. Porsche AG, Stuttgart</p> <p>Supervisory Board</p> <p>Memberships/Directorships: Novartis AG, Basel, Schweiz  Eagle-Picher Industries Inc., Phoenix, Arizona, USA* Porsche Business Services Inc., Wilmington/Delaware, USA* Porsche Cars Great Britain Ltd., Reading, England* Porsche Cars North America Inc., Wilmington/Delaware, USA* Porsche Deutschland GmbH, Bietigheim-Bissingen* Porsche Engineering Group GmbH, Weissach* Porsche Enterprises Inc., Wilmington/Delaware, USA*</p>

Porsche Financial Services GmbH,  
 Bietigheim-  
 Bissingen\*  
 Porsche Financial Services Inc., Wilmington/  
 Delaware, USA\*  
 Porsche Iberica S.A., Madrid, Spain\*  
 Porsche Italia S.p.A., Padua, Italy\*  
 Porsche Japan K.K., Tokyo, Japan\*  
 Porsche Lizenz- und Handelsgesellschaft  
 mbH,  
 Bietigheim-Bissingen\*  
 (\*mandates (companies) within Dr. Ing. h.c.  
 F. Porsche group)

The following individuals resigned from the Supervisory Board in 2003:

Gert Becker	Member since: Resigned: Principal Occupation:	1995 Annual Meeting 2003 Former Chairman of the Management Board of Degussa AG, Duesseldorf
	Supervisory Board Memberships/ Directorships:	Bankhaus Metzler KGaA,  Frankfurt/Main, Chairman of the Supervisory Board Bilfinger + Berger Bau AG, Mannheim, Chairman of the Supervisory Board
Dr. h.c. Andre Leysen	Member since: Resigned: Principal Occupation:	1995 February 2003 Honorary Chairman of the Administrative Board of GEVAERT N.V., Antwerp, Belgium
	Supervisory Board Memberships/ Directorships:	E.ON AG, Duesseldorf until 4/2003  Schenker AG, Essen until 5/2003
Ruediger Schulze Vice Chairman (until July 2003)	Member since: Resigned: Principal Occupation:	1999 July 2003 Former Chairman of Division 9 “Telecommunication, Information Technology and Data Processing” of the Union ver.di, Berlin
	Supervisory Board Memberships/ Directorships:	T-Mobile Deutschland GmbH, Bonn  Vice Chairman of the Supervisory Board, until 7/2003
Prof. Dr. Helmut Sihler	Member since: Resigned: Principal Occupation:	1996 Annual Meeting 2003 Vice Chairman of the Administrative Board, Novartis AG, Basel
	Supervisory Board Memberships/ Directorships:	Dr. Ing. h.c. F. Porsche AG,  Stuttgart, Chairman of the Supervisory Board Novartis AG, Basel, Vice Chairman of the Administrative Board

Dr. Hans-Dietrich Winkhaus Chairman (until March 2003)	Member since	1999
	Resigned:	Annual Meeting 2003
	Principal Occupation:	Member of the Shareholders' Committee of Henkel KGaA, Duesseldorf
	Supervisory Board Memberships/ Directorships	BMW AG, Munich
		Degussa AG, Duesseldorf
		Deutsche Lufthansa AG, Cologne
		ERGO Versicherungsgruppe AG, Duesseldorf
		Schwarz Pharma AG, Monheim, Chairman of the Supervisory Board

Deutsche Post AG and Kreditanstalt fuer Wiederaufbau (KfW) are both majority-owned by our largest shareholder, the Federal Republic. The Federal Ministry of Finance is a ministry of the Federal Republic. Among our current Supervisory Board members, Ms. Brandl, Mr. Holzwarth, Ms. Litzenberger, 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 Dr. Zumwinkel, Dr. von Gruenberg, Dr. Hundt, Dr. Overhaus, Mr. Reich, Dr. Schinzler, Dr. Schlede, Prof. Dr. Stolte, Mr. Walter and Dr. Wiedeking.

The Supervisory Board maintains the following committees:

- The General Committee 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. Klaus Zumwinkel (Chairman, since March 14, 2003, replaced former Chairman Dr. Hans-Dietrich Winkhaus), Dr. Manfred Overhaus (since February 21, 2003, replaced Dr. Andre Leysen), Franz Treml (since August 21, 2003, replaced Ruediger Schulze), and Wilhelm Wegner. The Executive Committee met nine times in 2003.
- The Audit Committee is responsible for oversight of accounting and risk management, auditor independence, questions regarding the issuing of the audit mandate to the auditors, the determination of auditing focal points and the fee agreement with the auditors following approval of the auditors by the shareholders, and, as of November 2002, matters that the audit committee of a New York Stock Exchange-listed foreign private issuer is required to be responsible for pursuant to SEC and NYSE regulations and under U.S. law, including the Sarbanes-Oxley Act of 2002. The current members of the Audit Committee are Dr. Klaus G. Schlede (Chairman), Wolfgang Schmitt, Franz Treml, Bernhard Walter, Wilhelm Wegner and Dr. Manfred Overhaus. The Audit Committee met two times in 2003.
- The Finance Committee is responsible for reviewing and consulting on complex finance and business matters concerning Deutsche Telekom. Those matters are delegated by the Chairman of the Supervisory Board or the Supervisory Board itself to the Finance Committee. In addition, the Finance Committee also reviews our annual reports during a meeting with our auditors in preparation for the Supervisory Board's annual meeting relating to the approval of the our financial statements in accordance with the German Stock Corporation Act. The members of the Finance Committee are the same as the Audit Committee. The Finance Committee met once in 2003.

Prior to October 2003, the tasks of the Finance Committee and the Audit Committee were combined. These committees were separated in response to new U.S. law requirements applying to foreign private issuers. The combined Finance and Audit Committee met four times prior to October 2003, and its members were the same as listed for the Audit Committee above.

- The Personnel Committee is responsible personnel matters of Deutsche Telekom AG, in particular with staff structure and human resources development and planning. The members of this committee are Franz Treml (Chairman), Dr. Dieter Hundt, Wilhelm Wegner and Dr. Klaus Zumwinkel. The Personnel Committee met twice in 2003.



In addition to the committees mentioned above, the Supervisory Board has a Mediation Committee. This committee's function is to assist the Supervisory Board by making proposals for Management Board member nominees in the event that the two-thirds majority of employee votes needed to appoint a Management Board member is not met. Current members are Dr. Klaus Zumwinkel (Chairman), Dr. Dieter Hundt, Franz Treml and Wilhelm Wegner. The Mediation Committee did not have to meet in 2003.

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 a deadlock on matters voted on in the Executive Committee. The chairman of the Audit Committee and the Finance 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 20, 2003, our Management Board has had 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 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. The Management Board generally meets on a weekly basis.

### **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 2003 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 Management Board 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 Malmö, 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 and CEO 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 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. He left Sony Deutschland in 1997 to join Deutsche Telekom.

Expiration of current term: Mr. Brauner has submitted notice of resignation effective April 30, 2004.

Other board memberships outside Deutsche Telekom:  
FC Bayern München AG, Supervisory Board, Munich  
Karstadt Warenhaus AG, Supervisory Board, Essen

**Dr. Karl-Gerhard Eick**, born in 1954, has been head of the Finance and Controlling Division and a member of the Management Board of Deutsche Telekom AG 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., Administrative 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

**René Obermann** was born in 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 that 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

**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 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 Managing Partner until the end of 2002.

Expiration of current term: January 19, 2008

Other board memberships outside Deutsche Telekom: none

## 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 have been in effect since 1999. For Supervisory Board members who served on the Supervisory Board for only part of the year, we paid a proportionate share 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 2003 amounted to an aggregate of EUR 656,573 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 2003 has been paid out in two tranches: the first half in July 2003 and the second half in December 2003.

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.

For more detailed information concerning compensation to Supervisory Board members in 2003, see note (38) to the consolidated financial statements.

### Management Board Compensation

The aggregate remuneration of our Management Board for 2003 amounted to EUR 12,996,216. This amount includes fringe benefits and imputed income valued at EUR 928,387. The aggregate remuneration amount for 2003 reflects the reversal of a set-aside recorded in 2002 for estimated variable compensation in the amount of EUR 82,053.

The variable 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 two performance targets, each of which is weighted equally in determining the total bonus payment. These performance targets include:

- 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).

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

The members of the Management Board received or will receive the following total compensation (base salary, variable pay and long term incentive components) in respect of 2003:

Name	Base Salary in 2003 (amounts in €)	Variable pay for 2003 (amounts in €)	Long Term Incentive: Stock Options Grants for 2003
Kai-Uwe Ricke.....	1,250,000	1,375,000	0
Dr. Karl-Gerhard Eick.....	937,500	1,031,250	0
Dr. Heinz Klinkhammer.....	900,000	660,000	0
Josef Brauner.....	900,000	546,000	0
René Obermann.....	700,000	770,000	0
Konrad F. Reiss.....	711,694	898,438	0
Thomas Holtrop.....	700,000	770,000	0
Total.....	6,099,194	6,050,688	0

The variable pay for 2003 is contingent on the approval of our 2003 financial statements at our annual shareholders' meeting in May 2004.

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. As shown above, no stock options were granted to members of our Management Board in 2003. For further information on this program, see “— Share Ownership” below and notes (27) and (44) to the consolidated financial statements.

Payments to 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 1,106,105 in 2003.

Accrued pension benefit obligations (ABO) for both active and former members of the Management Board amounted to EUR 56,629,974 as of December 31, 2003.

Obligations for pensions for former Management Board members for which no reserve is required to be established under the Post Labor Law Act (*Postpersonalrechtsgesetz*) amounted to EUR 3,393,899 as of December 31, 2003.

None of the members of the Management Board has a service contract with the company or any of its 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 his or her term, then 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 (27) and (44) 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 (27) and (44) to the consolidated financial statements. See "Item 8. Financial Information — Litigation" for a description of litigation with respect to the Stock Option Plan 2000.

### **Loans 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. As a reporting issuer in the United States, we are subject to certain prohibitions on loans to officers and directors. At present there are no loans to our Supervisory Board or Management Board members.

### **SHARE OWNERSHIP**

The members of our Management Board owned a total of 5,800 Deutsche Telekom shares and options in respect of a total of approximately 824,600. Deutsche Telekom shares as of January 30, 2004. No individual member of the Management Board beneficially owned 1% or more of our outstanding shares as of January 30, 2004.

On an individual basis, the members of our Management Board beneficially owned the following number of Deutsche Telekom shares as of January 30, 2004:

<u>Name</u>	<u>No. of Shares Beneficially Owned</u>
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
Total .....	5,800

The members of the Supervisory Board owned a total of 13,392 Deutsche Telekom shares as of January 30, 2004. No individual member of the Supervisory Board beneficially owned 1% or more of our outstanding shares at January 30, 2004.



On an individual basis the members of our Supervisory Board beneficially owned the following number of Deutsche Telekom shares as of January 30, 2004:

<u>Name</u>	<u>No. of Shares Beneficially Owned</u>
Current members	
Dr. Klaus Zumwinkel.....	none
Franz Treml.....	none
Monika Brandl.....	704
Josef Falbisoner.....	256
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
Dr. Hans-Jürgen Schinzler.....	2,200
Dr. Klaus G. Schlede.....	none
Wolfgang Schmitt.....	2,510
Michael Sommer.....	none
Ursula Steinke.....	360
Prof. Dr. h.c. Dieter Stolte.....	none
Bernhard Walter.....	none
Wilhelm Wegner.....	335
Dr. Wendelin Wiedeking.....	3,000
Total.....	10,212
Former members who served on our Supervisory Board during 2003:	
Gert Becker.....	none
Dr. h.c. Andre Leysen.....	none
Rüdiger Schulze.....	none
Prof. Dr. Helmut Sihler.....	none
Dr. Hans-Dietrich Winkhaus.....	3,180
Total.....	3,180

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

## EMPLOYEES AND LABOR RELATIONS

### Employees

As of December 31, 2003, the companies within the Deutsche Telekom consolidated group employed a workforce of 248,519 people worldwide, excluding interns and apprentices. This represents a decrease of 2.9 % from year-end 2002.

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

	For the year ended December 31,		
	2003	2002	2001
Deutsche Telekom group employees <sup>(1)</sup> .....	248,519	255,969	257,058
Thereof:			
Germany .....	173,278	177,823	178,336
European Union outside of Germany .....	16,698	17,647	16,538
Other European countries .....	35,336	39,601	43,343
North America .....	21,525	19,144	16,909
Rest of the world .....	1,682	1,754	1,932

(1) Employees excluding interns and apprentices.

The following table shows (i) the number of civil and non-civil servant employees within the Deutsche Telekom consolidated group as well as within Deutsche Telekom AG, and (ii) the total number of employees by division, at the dates indicated.

### Deutsche Telekom Group Employees<sup>(1)</sup>

	As of December 31,		
	2003	2002	2001
Deutsche Telekom AG .....	118,669	120,009	124,328
Thereof:			
Civil servants .....	49,793	50,776	54,615
Salaried employees and wage earners <sup>(2)</sup> .....	68,876	69,233	69,713
Deutsche Telekom group <sup>(3)</sup> .....	248,519	255,969	257,058
Thereof:			
Civil servants .....	49,793	50,776	54,615
Salaried employees and wage earners .....	198,726	205,193	202,443
Thereof: <sup>(4)</sup>			
T-Com .....	129,644	149,106	155,583
T-Systems .....	40,833	43,292	43,449
T-Mobile .....	43,427	41,597	38,025
T-Online .....	2,615	2,608	2,719
Other activities .....	32,000	19,366	17,282

During fiscal year 2003, we did not employ a significant number of temporary employees.

(1) Employees excluding interns and apprentices.

(2) Thereof 8,256 "civil servants temporarily without civil servant status" at December 31, 2003. 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) Thereof 29,658 employees and civil servants that have been transferred from Deutsche Telekom AG to subsidiaries with the right to return to Deutsche Telekom AG.

(4) The figures for 2001 and 2002 have been restated to correspond with the organizational structure of the Deutsche Telekom consolidated group for the year 2003.

### 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, 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 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, as required by the EU Act on European Works Councils, we will establish in 2004 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 important to us, including with regard to our work force reduction plans. Constructive relations with our employees and their representatives are of importance to us.

### **Civil Servants**

As of December 31, 2003, approximately 20.0% of our consolidated 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*) 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. 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 financial administration for the Federal Republic on a trust basis. All transactions for pension and allowance payments to employees are made by BPS-PT 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, the special 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 of Deutsche Telekom AG and the imputed gross remuneration of civil servants temporarily without civil servant status of Deutsche Telekom AG entitled to pension payments. These contributions amounted to approximately EUR 809 million in 2003, EUR 838 million in 2002 and EUR 845 million in 2001. 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, 2003, approximately 80.0% 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, 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*). We also have labor contracts negotiated with smaller unions. Due to our acquisition of debis Systemhaus GmbH in 2002, 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 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%.

On March 23, 2004, we reached a new collective bargaining agreement with ver.di. This agreement includes among other things, a reduction in the weekly working time for the employees of Deutsche Telekom AG in the divisions T-Com and Group Headquarters & Shared Services from 38 hours to 34 hours, with a partial reduction in wages beginning in March 2004. As of January 1, 2005, a 2.7% increase in compensation will take effect. Further, we committed to avoid layoffs until the end of 2008. The new compensation agreement will be effective until March 31, 2006.

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, Vivento (formerly the Personnel Services 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. 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 Vivento for a limited period of a maximum of one year immediately after the completion of their training. In this case, too, the task and objective of Vivento is to find long-term positions for the apprentices in or outside the Deutsche Telekom group.

In addition to the above mentioned commitments contained in the new collective bargaining agreement signed on March 23, 2004, we also agreed to reduce the compensation level for inactive employees within Vivento from 100% to 85% starting July 1, 2004. There will be no layoffs for employees within Vivento until 2008.

Our intention in establishing Vivento was 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 Vivento commenced in the fourth quarter of 2002. Until June 30, 2003, the divisions transferring employees to Vivento were obligated to make a one-time contribution to Vivento. Commencing in 2004, divisions transferring employees to Vivento, except T-Com, will be required to make certain one-time payments to Vivento relating to such transferred employees. The costs associated with future salaries of employees transferred to Vivento will be reflected in the results of our “Group Headquarters and Shared Services” segment.

For information concerning our pension plan arrangements for non-civil servant employees, refer to note (28) to our consolidated financial statements and to “Item 5. Operating and Financial Review and Prospects — Critical Accounting Estimates.

## ITEM 7. Major Shareholders and Related Party Transactions

### MAJOR SHAREHOLDERS

Historically, we were part of Deutsche Bundespost, a state-owned special asset (*Sondervermogen 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, effective January 1, 1995, into Deutsche Telekom AG, a private law stock corporation, which initially remained wholly-owned by the Federal Republic. Our first public offering was in November 1996, followed by a second public offering in June 1999.

According to information supplied to us by the Federal Republic, at December 31, 2003, the Federal Republic's direct ownership interest in our company was approximately 26.03%. Kreditanstalt fuer Wiederaufbau (KfW), a development bank that is 80% owned by the Federal Republic and 20% owned by the German federal states, owned 16.74% of our shares at December 31, 2003.

The Federal Republic administers its shareholdings and exercises its rights as a shareholder of Deutsche Telekom through the Federal Post and Telecommunications Agency, which is subject to the supervision of the Finance Ministry. In their capacities as shareholders, the Federal Republic and KfW may exercise only those rights that they have under the German Stock Corporation Act and our Articles of Association. 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 supplied to us by the Federal Republic and KfW as of the dates indicated.

Identity of Person or Group	For the year ended December 31,					
	2003 <sup>(1)</sup>		2002		2001	
	Shares owned	%	Shares owned	%	Shares owned	%
Federal Republic of Germany . . .	1,092,721,315	26.03%	1,290,835,401	30.75%	1,297,986,644	30.92%
Kreditanstalt fuer Wiederaufbau .	702,704,750	16.74%	504,590,664	12.02%	509,164,599	12.13%
		<u>42.77%</u>		<u>42.77%</u>		<u>43.05%</u>

(1) Reflects the most recent acquisition that took place in November 2003, when KfW received approximately 199 million shares formerly held directly by the Federal Republic.

As noted above, KfW is 80% owned by the Federal Republic. The Federal Republic has publicly stated its intention to reduce its holdings of Deutsche Telekom shares. A reduction in the holdings of our shares by the Federal Republic or KfW will not have a material negative effect on our governance or business.



## RELATED PARTY TRANSACTIONS

### Relationship with the Federal Republic

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 agencies and 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 inform the shareholders as to the conclusion of both. In the 2003 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 Postal and Telecommunications 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 2003 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 (*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 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 made a payment on account of EUR 62.9 million for these services in 2003 (as compared to EUR 64.5 million in 2002 and 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 German telecommunications regulator. Our telecommunications licenses held in Germany were acquired from the Federal Republic or its agencies. See "Item 4. Information on the Company — Regulation."

### Federal Republic and Affiliated Entities as Customers

Collectively, the Federal Republic is one of 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.

In 2003, Deutsche Telekom purchased goods and services amounting to EUR 0.7 billion from Deutsche Post World Net group. These mainly relate to postage charges for letters and packages. In the same period, Deutsche Post purchased goods and services totaling EUR 0.5 billion from Deutsche Telekom. This amount primarily consists of IT products and services.

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, undertaken certain obligations, including relating to certain financial and performance obligations. For more information, see "Item 5. Operating and Financial Review and Prospects — Liquidity and Capital Resources — Guarantees and Commitments" and "Item 8. Financial Information — Litigation."

#### **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 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. In 2003, that credit facility had been drawn upon in maximum in the amount of EUR 104 million with an interest rate of the average monthly Euro Overnight Index Average (EONIA) rate + 45 basis points 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 9 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 London InterBank Offered Rate (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 2003. See "Item 5. Operating and Financial Review and Prospects — Liquidity and Capital Resources — Capital Resources."

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.

#### **Federal Republic Guarantees**

Under German law, all of our liabilities outstanding as of January 1, 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 1, 1995. These guarantees amount to an aggregate of EUR 11.6 billion as of December 31, 2003.

#### **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 prosecutor’s investigations of certain real estate valuation-related questions and other matters. See “Item 8. Litigation — Investigations” for a description of these investigations. 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 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.

## **ITEM 8. Financial Information**

### **CONSOLIDATED FINANCIAL STATEMENTS**

See “Item 18. Financial Statements.”

#### **EXPORT SALES**

See note (1) to our consolidated financial statements for a discussion of our revenues by geographic area.

#### **LITIGATION**

The companies in our group 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 regulatory and competition law authorities. For additional information concerning pending proceedings before competition and regulatory 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 selling shareholder in the offering, *KfW*, has been dismissed from the action. Fact discovery in the U.S. class action suits is largely complete, and we expect any remaining fact discovery to be completed during 2004. Deutsche Telekom and the former Chairman of its Management Board have filed motions for summary judgment seeking dismissal of all plaintiffs’ claims with respect to nondisclosure of negotiations with VoiceStream and all plaintiffs’ claims with respect to alleged overstatement of real estate values. Those motions have not yet been fully briefed or argued.

Purported purchasers of our shares sold pursuant to prospectuses dated May 28, 1999, and May 26, 2000, have filed approximately 1,920 lawsuits (with approximately 11,358 plaintiffs) in Germany. The plaintiffs predominantly 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. In the most recent series of lawsuits, which were mostly filed in May 2003, plaintiffs assert additional allegations. They allege, among other things, that the purchase price for the U.K. cellular phone carrier One2One was unreasonably high and the prospectus did not inform investors about necessary write-offs to goodwill, that our internal mid-term financial plan for 2000-2004 was inaccurate, that the prospectus did not properly inform investors about the general risks of international expansion, relations with our major shareholder, the Federal Republic of Germany, and the risks of the liberalization of the German telecommunication market. Further, they allege that our business prospects were described too positively and that the prospectus did not properly inform investors about the price to be paid for a UMTS license to be bought in an auction in August 2000.

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 former presiding judge had issued a statement describing his preliminary view that it will be necessary to take evidence by obtaining an expert opinion. The former presiding judge also stated that he was inclined to order a stay of the civil

litigation until the prosecutorial investigation into the real estate matter has been resolved. However, the presiding judge changed in October 2003, and so far we have no indication how the new presiding judge intends to proceed. The aggregate euro amount of all shareholders' claims filed in Germany in these lawsuits is approximately EUR 73 million.

Many shareholders have also initiated conciliation proceedings with a state institution in Hamburg ("*Oeffentliche Rechtsauskunfts- und Antragsstelle der Freien und Hansestadt Hamburg*" or "OeRA"). According to information we have received orally from the OeRA, approximately 12,000 to 15,000 shareholders have instituted conciliation proceedings. Participation in these conciliation proceedings is voluntary, and we have declined to participate. We expect the claims made in these conciliation proceedings to be analogous to those made in the purported prospectus liability lawsuits described above.

We are contesting each of the aforementioned lawsuits vigorously. Because the lawsuits and the conciliation proceedings, which in the aggregate involve substantial damage claims, are in their preliminary stages, the plaintiffs in the U.S. class action suits have not yet responded to the motions for summary judgment and those motions have not been argued or decided, 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 the outcome or impact of the lawsuits or conciliation proceedings. However, we believe that the allegations in the lawsuits and the conciliation proceedings 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 one of our stock option plans 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*). The Federal Court of Justice dismissed the appeal on February 16, 2004, ending the proceedings.

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 breach of the PTC shareholders' 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. On April 9, 2003, the arbitration panel rejected all claims and counterclaims brought before the court by T-Mobile and the defendants.

In December 2000, T-Mobile filed a second set of arbitration proceedings against Elektrim and Elektrim Telekomunikacja (Telco) claiming that Elektrim and Telco 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 each of Elektrim and Vivendi S.A. has a shareholding of 49% (with Ymer holding another 2%). In particular, T-Mobile claims that (i) the transfer of shares required approval by the Supervisory Board of PTC, (ii) the shareholders' 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. The witness and evidence hearings were completed in the autumn of 2003. The parties are awaiting the decision by the tribunal, which should be handed down in 2004.

The previously reported proceedings arising from T-Mobile's joint venture agreement with Virgin group companies and Virgin Mobile were settled on January 29, 2004. The Court of Appeal was requested not to deliver its judgment in the appeals heard in November 2003 and all parties were released from all accrued liabilities. As part of the settlement, the Shareholders' Agreement was terminated and the T-Mobile-appointed directors on the board of Virgin Mobile Telecoms Limited resigned. A new Telecommunications Supply Agreement was entered into, which became effective immediately. As part of the settlement accord, there was agreement that in the event of a sale or listing of Virgin Mobile within 30 months of the date of settlement, T-Mobile may receive a share of the proceeds of the sale up to a maximum of GBP 100 million.

### **Investigations**

As previously disclosed, the Bonn public prosecutor is conducting an investigation into allegations in the press and elsewhere asserting that the book values we recorded for our real property portfolio



were 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 and whether we wrongfully paid dividends to our shareholders in 1998 in reliance on the overstatement. We believe that the book values of our fixed assets with respect to the real property portfolio have been correctly presented in 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. We cannot offer assurances as to the timing or outcome of the prosecutor's investigation. The investigations are being conducted with regard to certain individuals and are not directed against us as a corporate entity. Adverse consequences for our company could follow if any of the individuals who are or who become the subject of the investigation are found to have violated the law. We have been informed that the Bonn public prosecutor's investigation into allegations that the book values recorded for our fixed assets in general, including technical equipment and machinery, were improperly established and maintained under applicable accounting principles and so were substantially overvalued in our 1995 opening balance sheet and in later balance sheets, has been concluded without action.

The Bonn public prosecutor is also conducting other investigations. One 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. Another investigation concerns allegations, that we wrongfully bore liability risks in connection with the June 2000 global offering by KfW of our shares. A third investigation concerns allegations of prohibited insider transactions with respect to amendments in lock-up agreements with Sonera, allowing Sonera to sell a number of our shares before the expiration of the relevant lock-up period. We understand that 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.

As previously disclosed, purported purchasers of Deutsche Telekom shares sold pursuant to prospectuses dated May 28, 1999, and May 26, 2000, have filed a number of lawsuits in Germany that among other allegations allege, that Deutsche Telekom failed to disclose certain risks as well as ongoing discussions in the Management Board in anticipation of the One2One transaction (now T-Mobile UK). We understand, that the Bonn public prosecutor has declined to open criminal investigations with respect to these allegations.

We understand that the Bonn public prosecutor office has concluded without action its investigation into alleged breaches of duty by past and present 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.

## **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 (*Verwaltungsgericht*

*Köln*) claiming higher rates. As regards the rates for services provided in 1998 and 1999, the Appellate Administrative Court in Muenster (*Oberverwaltungsgericht Münster*) dismissed the case. We did not appeal the decision. Proceedings are still pending with respect to the rates for services provided in 2000 and January 2001.

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 services in the period from December 1, 2001, through November 2003, 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 November 2003, the German telecommunications regulator issued a decision adjusting the rates applicable to interconnection services from December 1, 2003, through May 2006. We filed a complaint against this decision with the Cologne Administrative Court claiming higher rates. The proceedings are still pending. Also, a competitor filed a complaint avoiding the charges for certain interconnection services. The proceedings are still pending.

In December 2003, the German telecommunications regulator partly approved an application from 15 local carriers for higher call termination charges. We pay these charges for calls that are terminated in the networks of other carriers. Before this decision, these charges were always billed on a reciprocal basis, which is to say at the rate approved for Deutsche Telekom. Under the new decision, with effect from December 15, 2003, through October 31, 2004, local carriers would be allowed to charge 0.5 cent per minute more for the termination of calls in their networks than Deutsche Telekom can charge for the termination of calls in its network. A competitor and we filed a complaint against this decision and asked the court for an injunction. The competitors' request for an injunction was rejected. However, the Cologne Administrative Court granted our request for an injunction in February 2004. The German telecommunications regulator appealed this decision. The proceedings are still pending. Apart from that, 7 of the 15 local carriers have filed a complaint against the aforementioned regulator's decision claiming that the call termination charges they are allowed to charge should be higher. The proceedings are still pending.

In 2000, the German telecommunications regulator imposed upon us the obligation to offer Internet service providers and other enterprises Internet access to our fixed-line network at a flat rate by February 1, 2001. Additionally, the German telecommunications regulator barred us from charging different rates for peak and 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.

In 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.

In June 2003, the German telecommunications regulator issued a decision approving a surcharge of EUR 0.04 on our basic interconnection tariffs (access cost contribution). We filed a complaint against this decision with the Cologne Administrative Court claiming higher rates. The proceedings are still pending. Certain of our competitors filed complaints claiming the annulment of the decision and asked the courts for an injunction. The Appellate Administrative Court in Muenster rejected the competitors' request for an injunction. The proceedings in the main action are still pending.

In September 2003, the German telecommunications regulator revoked the aforementioned access cost contribution insofar as it applies to the future. We filed a complaint against this decision with the

Cologne Administrative Court. The proceedings are still pending. Two of our competitors also filed complaints against the revocation, claiming an extensive effect even for the past. The proceedings are still pending.

### ***Local Loop***

In 1998, the German telecommunications regulator issued a decision establishing rates for access to the local loop (the monthly rate for the main option was DM 20.65 (EUR 10.56) plus VAT), thereby rejecting our application and cost calculations. We filed a complaint against this order with the Cologne Administrative Court claiming higher rates. In 2003, we withdrew our complaint.

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 (EUR 12.99) 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 competitors taking part in the proceedings. In August 2003, the Federal Administrative Court ordered the German telecommunications regulator to disclose all of its files in connection with this decision, including the disclosure of our business secrets. In October 2003, we filed a complaint with the Federal Constitutional Court (*Bundesverfassungsgericht*) and applied for a preliminary injunction. In February 2004, the Federal Constitutional Court granted the preliminary injunction in essence. The court decided that the German telecommunications regulator cannot disclose the files containing business secrets except for the regulators' decision. The proceedings in the main action are still pending. Although the outcome of these proceedings cannot be determined at this time, an adverse decision in the main action could subject our business secrets submitted to the German telecommunications regulator to public disclosure, which may have a material adverse effect on our competitive position or results of operations.

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 EUR 12.48 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 Appellate Administrative Court in Muenster granted an injunction. The proceedings in the main action are still pending.

In 2003, the German telecommunications regulator issued a decision adjusting the rates for access to the local loop from May 1, 2003, through March 31, 2005 (the monthly rate for the main option is now EUR 11.80 plus VAT). Certain of our competitors and we filed complaints against this decision with the Cologne Administrative Court. The proceedings are still pending.

### ***Leased Lines***

In 2002, the German telecommunications regulator imposed upon us the obligation to modify our 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 the 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. However, in the main action the Appellate Administrative Court in Muenster rejected our complaint. We did not appeal this decision.

In March 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, but the Appellate Administrative Court in Muenster specified some important limitations on the imposed obligation. In the main action, the Federal Administrative Court decided that we are obliged to offer these resale services. The decision is final.

In 2003, the German telecommunications regulator imposed upon us the obligation to offer unbundled resale services that would permit telecommunications services resellers to acquire line access services (including DSL) unbundled from voice telephony calls. We asked the courts for an injunction and filed a complaint. The Appellate Administrative Court in Muenster rejected our request for an injunction. The proceedings in the main action are still pending.

### ***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, pre-selection services, certain value-added services, Internet-by-call services and directory assistance services. We asked the courts for an injunction and filed a complaint. In July 2002, the request for an injunction was rejected. In November 2002, the Cologne Administrative Court decided in the main action partly in our favor by excluding value-added services, Internet-by-call services and directory services from the obligation. In December 2002, the German telecommunications regulator and Deutsche Telekom appealed the decision before the Appellate Administrative Court in Muenster. The proceedings in the main action are still pending.

In 2000, one of our competitors filed a complaint against the aforementioned obligation, claiming that we were also obliged to manage customer complaints, to send late payment warnings and to enforce late payments. In November 2002, the Cologne Administrative Court rejected this complaint. The competitor has appealed the decision. The proceedings are still pending.

### ***Obligation to Provide Service 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. In the main action, the Federal Administrative Court confirmed the aforementioned obligation. However, the court decided that we are allowed to bill retroactively the rates that ultimately receive regulatory approval. The decision is final.

### ***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 2002, the German telecommunications regulator imposed upon us the obligation to raise the rates we had contractually agreed upon with two closed user groups. We asked the courts for an injunction and filed a complaint in the main action. The Appellate Administrative Court in Muenster granted the requested injunction. The proceedings in the main action are still pending.

In 2003, the German telecommunications regulator approved our new “AktivPlus” tariffs, which offer our customers reduced price telephone services for an additional monthly fee. Certain of our competitors filed complaints against the approval of these tariffs and asked the courts for an injunction. The Cologne Administrative Court granted the requested injunction. We appealed this decision. The Appellate Administrative Court in Muenster granted our request. 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*). In March 2004, the German Federal Court of Justice has remanded the case to the Hamburg Court of Appeals for further proceedings in connection with certain factual determinations that may have a significant influence on the outcome of the appellate proceeding. We believe that these additional proceedings will not be concluded in the near term and that a determination with respect to a likely outcome cannot be made at this time.

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 by our employees. Deutsche Post AG currently is seeking payment in the amount of EUR 131 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 previously reported 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 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.

In connection with the current delay in the introduction of a toll collection system, the Federal Republic of Germany has indicated that it will initiate arbitration proceedings against us, DaimlerChrysler Services and Cofiroute for damages and penalties. The Federal Republic is expected to assert claims for damages from the consortium of EUR 156 million per month for the period September 1, 2003 to December 31, 2003 and EUR 180 million per month from January 1, 2004 for lost toll revenues. In addition, the Federal Republic is expected to allege contractual penalties of EUR 680 million because the members of the consortium did not seek the necessary agreement of the Federal Ministry of Transport before concluding certain subcontractor agreements. Deutsche Telekom AG believes the claims of the Federal Republic are unfounded. Under the terms of the agreement, the Federal Republic may resort to arbitral proceedings for clarification of its legal position. The



maximum future obligations arising from the Toll Collect project cannot be quantified with adequate certainty. For more information, see “Item 5. Operating and Financial Review and Prospects — Liquidity and Capital Resources—Guarantees and Commitments.”

In 2000, we acquired UMTS licenses in auctions in Germany, the United Kingdom, the Netherlands and Austria for an aggregate amount of approximately EUR 15.8 billion. These purchases were invoiced by the respective countries without identifying whether a portion of the purchase price included the collection of value-added tax (VAT) from the purchaser. Subsequent to the acquisition of these licenses, we and other licensees initiated proceedings under the provisions of the EU Directives relating to the recovery of VAT in certain circumstances. We do not expect a decision regarding these claims for repayment of VAT in the near future. However, should we prevail in these proceedings, we may receive a significant tax refund.

## 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.

<b>For the year ended December 31,</b>	<b>Dividend Paid per Ordinary Share</b>	
	<b>EUR</b>	<b>USD<sup>(1)</sup></b>
2000 .....	0.62	0.53
2001 .....	0.37	0.34
2002 .....	0	0

(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 2003 fiscal year be omitted. Our shareholders will make a final decision on this recommendation at the annual general shareholders’ meeting scheduled for May 2004.

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 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, 2003 were EUR 9.1 billion, as compared to EUR 7.0 billion at the end of 2002. 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. However, the Board of Management intends to recommend reinstatement of the dividend for the 2004 financial year, payable in 2005.

## 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.

## 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.

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, 2003, the shares of 5,730 companies traded on the official, regulated and unregulated markets. Of these, 829 were German companies and 4,901 were non-German companies.

Our shares are listed in the Prime Standard segment of the Frankfurt Stock Exchange. The Prime Standard imposes internationally accepted transparency and disclosure requirements, such as filing of quarterly reports, application of internationally accepted accounting standards (either IAS or US-GAAP), publication of a corporate calendar, covering key events of interest to investors, convening at least one analyst conference per year, period disclosure and ongoing financial communications in English.

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 also traded on Xetra (Exchange Electronic Trading). Xetra is an electronic exchange trading platform. Xetra is available daily between 9:00 a.m. and 5:30 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.

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 (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.

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
Yearly highs and lows				
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
2003 .....	14.51	9.13	3,965.16	2,202.96
Quarterly highs and lows				
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
2003 .....				
First Quarter .....	14.26	9.13	3,157.25	2,202.96
Second Quarter .....	13.50	10.33	3,304.15	2,450.19
Third Quarter .....	13.92	12.44	3,668.67	3,146.55
Fourth Quarter .....	14.51	12.36	3,965.16	3,276.64
Monthly highs and lows				
2003 .....				
September .....	13.29	12.44	3,668.67	3,256.78
October .....	13.55	12.36	3,655.99	3,276.64
November .....	13.85	13.34	3,797.40	3,638.04
December .....	14.51	13.79	3,965.16	3,806.54
2004 .....				
January .....	16.55	14.96	4,151.83	3,995.91
February .....	16.78	15.63	4,141.53	3,991.47
March (through March 26, 2004) .....	16.08	14.40	4,145.99	3,726.07

- (1) The DAX is a weighted performance index of the shares of thirty large German corporations. 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 our shares in these indices have led to fluctuations in our share price in the past and could cause similar fluctuations in the future.

On March 26, 2004, the closing sales price per ordinary share on the Frankfurt Stock Exchange was EUR 14.70, which was equivalent to USD 17.78 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 26, 2004. On March 26, 2004, the noon buying rate was 1.2092 U.S. dollar per Euro.

#### 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 depositary 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
Yearly highs and lows		
1999.....	71	36 <sup>1</sup> / <sub>16</sub>
2000.....	98 <sup>5</sup> / <sub>8</sub>	29 <sup>1</sup> / <sub>4</sub>
2001.....	36.56	13.39
2002.....	18.01	8.27
2003.....	18.13	10.11
Quarterly highs and lows		
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
2003		
First Quarter.....	15.09	10.11
Second Quarter.....	15.38	11.30
Third Quarter.....	15.70	13.96
Fourth Quarter.....	18.13	14.48
Monthly highs and lows		
2003		
September.....	14.98	14.17
October.....	15.90	14.48
November.....	16.48	15.31
December.....	18.13	16.73
2004		
January.....	20.78	18.87
February.....	21.17	19.63
March (through March 26, 2004).....	20.06	17.50

On March 26, 2004, the closing sales price per ADS on the NYSE was US\$17.76.

Based on the share register, as of March 26, 2004, we had approximately 2,655,134 registered holders of our ordinary shares, including holders of record of our shares with addresses in the U.S.

As of March 26, 2004, there were 156,930,461 of our ADSs outstanding, with 1,468 holders of record of our ADSs with addresses in the United States and 39 holders of record of ADSs with addresses outside the United States.

## ITEM 10. Additional Information

### ARTICLES OF ASSOCIATION

This Item provides a summary of certain information relating to our share capital and 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 our Annual Report on Form 20-F/A filed with the U.S. Securities and Exchange Commission on June 27, 2003.

#### 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 “HR 6794.”

#### 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 ourselves to the administration of our 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.

### **Class of Stock**

Our capital stock consists of 4,197,752,425 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.

### **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 2001 resolved upon conditional capital authorizing our Management Board to increase the capital stock by up to EUR 500,000,000, divided into up to 195,312,500 shares (Conditional 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 prior to 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
- holders or creditors obligated to convert the convertible bonds issued prior to 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.

In February 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 by 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 for each EUR 50,000 nominal amount of bonds. The bonds that remain outstanding on June 1, 2006, are then subject to mandatory conversion.

The share capital also may be increased by up to EUR 307,200,000, divided into up to 120,000,000 shares (Contingent Capital II), for the purpose of granting subscription rights to members of our Management Board, executives at levels below our Management Board and other executives,



managers and specialists of Deutsche Telekom AG and to management board members, and other executives of second- and lower-tier affiliates on the basis of the 2001 Stock Option Plan as provided for in the resolution of the shareholders' meeting of May 29, 2001. The capital increase will only be effected to the extent such options are exercised. Any new shares issued 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 shareholders' meeting that adopts a resolution appropriating net income for the financial year ended, the new shares participate in the profits starting at the beginning of the financial year ended.

In addition, the share capital may be increased by up to EUR 2,621,237.76, divided into up to 1,023,921 shares (Conditional Capital III) exclusively to grant subscription rights to members of our Management Board and other executives of Deutsche Telekom AG, as well as management board members and other executives of second- and lower-tier affiliates on the basis of a Stock Option Plan as provided for in the resolution of the Shareholders' Meeting of May 25, 2000. The capital increase will only be effected to the extent such options are exercised. 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 shareholders' meeting that adopts a resolution appropriating 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 our stock-based compensation plans, including the numbers of options granted and exercised, exercise prices and expiration dates, please refer to notes (27) and (44) to the consolidated financial statements.

### **Voting Rights and Shareholders' Meetings**

Each share entitles its holder to one vote at our general shareholders' meetings. 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 passing resolutions at 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;
- 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 our 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. Shareholders holding in the aggregate at least EUR 500,000 or at least 5% of our issued share capital may require that particular items be placed on the agenda. 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 our 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 with the company to participate at the shareholders' meeting (either in person

or represented by an agent) and who are included in the share register (*Aktienbuch*) 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 our Management Board shortens the time period. 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) need 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 our share register. ADEUS Aktienregister-Service-GmbH (a company not related to us) is the transfer agent and registrar for our 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.

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 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, 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 on the date of the meeting will be entitled to attend and vote at the meeting only if we have received from such holders notice of their desire to attend early enough so that there are at least six days between the day the notice is received 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 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. We are 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 Federal Agency for Financial Services Supervisory.

### **Repurchase of Shares**

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

On May 20, 2003, our shareholders approved a resolution that authorizes Deutsche Telekom AG to purchase up to 419,775,242 of its own shares, which is slightly less than 10% of our registered share capital. 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 made to all shareholders.

Pursuant to the resolution, our Management Board is authorized to:

- (1) resell the acquired shares through a stock exchange;
- (2) with the consent of the Supervisory Board, to use the acquired shares for the purpose of listing our shares on a foreign stock exchange where they are not listed;
- (3) with the consent of the Supervisory Board, offer the acquired shares to third parties in the context of mergers or acquisitions of other companies, business units or interests in other companies;
- (4) with the consent of the Supervisory Board, redeem the acquired shares. With the consent of the Supervisory Board, the Management Board may determine, i.e., that the capital stock remains unchanged upon redemption and instead that the proportion of the remaining shares in the capital stock is increased through redemption pursuant to §8(3) of the German Stock Corporation Act;
- (5) to offer the acquired shares to shareholders for subscription on the basis of an offer sent to all the shareholders without prejudice to their subscription right and without prejudice to the principle of equal treatment of the shareholders (according to §53a of the German Stock Corporation Act);
- (6) with the consent of the Supervisory Board, sell the acquired shares other than through the stock exchange or by offering them to all shareholders, if the shares are sold against cash settlement at a price which is not significantly lower than the market price of the shares on the date of sale.

Shareholders' preemptive rights are excluded for the purposes listed in clauses (2), (3) and (5) above. Furthermore, the Management Board may, with the consent of the Supervisory Board, exclude the preemptive rights of shareholders for fractional amounts if shares are sold to our shareholders by offering them for sale as described in clause (6) above.

### **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 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.

### **Significant Differences in Corporate Governance Practices**

German corporate governance practices generally derive from the provisions of the German Stock Corporation Act, the German Codetermination Act and the German Corporate Governance Code, which was most recently revised by a German government-appointed commission in May 2003. German corporate governance standards differ from the corporate governance listing standards applicable to U.S. domestic companies that have been adopted by the New York Stock Exchange (NYSE). The following is a brief, general summary of the significant differences between German corporate governance standards and the NYSE listing standards relating to corporate governance practices.

A German stock corporation (an *Aktiengesellschaft* or *AG*) has three basic governance groups — a management board (*Vorstand*), a supervisory board (*Aufsichtsrat*) and its shareholders. The German Stock Corporation Act requires a clear separation of management and oversight functions and therefore prohibits simultaneous membership on both boards. Members of the management board and the supervisory board must exercise the standard of care of a prudent and diligent business person when carrying out their duties. In complying with this standard of care, members must not only take into account the interests of shareholders, as would typically be the case with a U.S. board of directors, but also the interests of other constituents, such as the company's employees, and, to some extent, the public interest.

The management board is responsible for managing the company and representing it in its dealings with third parties. The members of the management board of a German stock corporation, including its chairman or speaker, are regarded as peers and share a collective responsibility for all management decisions.

The supervisory board oversees the company's management board and appoints and removes its members. Members of the supervisory board cannot be involved in the day-to-day management of the company. However, the company's articles of association or its supervisory board must specify matters of fundamental importance which will require the approval of the supervisory board. Matters requiring such approval include decisions or actions which would fundamentally change the company's assets, financial position or results of operations.

Supervisory boards of large German stock corporations consist of shareholder representatives and a certain percentage of employee representatives. Traditionally, the shareholder representatives on the supervisory board are knowledgeable about the operations of the company. One rationale was that these individuals would have knowledge of the company's internal affairs and as such would be better suited to oversee the company's management. Depending on the company's total number of employees, up to one half of the supervisory board members may be elected by the company's employees. Traditionally, the chairman is a representative of the shareholders. In case of a tie vote, the supervisory board chairman may cast the tie-breaking vote.

German law also has several rules applicable to supervisory board members which are designed to ensure a certain degree of independence of the board's members. German law also requires members of the supervisory board to act in the best interest of the company. They do not have to

follow direction or instruction from third parties. Any service, consulting or similar agreements between the company and any of its supervisory board members must be approved by the supervisory board.

The German Corporate Governance Code contains additional corporate governance rules applicable to German corporations. While these rules are not legally binding, companies failing to comply with the Corporate Governance Code's recommendations must disclose publicly how their practices differ from those recommended by the Corporate Governance Code. Some of the Corporate Governance Code's recommendations are also directed at ensuring the independence of supervisory board members. Specifically, the Corporate Governance Code recommends that the supervisory board should take into account potential conflicts of interest when nominating candidates for election to the supervisory board. Similarly, if a material conflict of interest arises during the term of a member of the supervisory board, the Corporate Governance Code recommends that the term of that member be terminated. The Corporate Governance Code further recommends that at any given time not more than two former members of the management board should serve on the supervisory board. For nominations for the election of members of the Supervisory Board, care must be taken that the Supervisory Board, at all times, is composed of members who have the required knowledge, abilities and expert experience to complete their tasks properly. The Corporate Governance Code furthermore includes the suggestion that the supervisory board members meet without any representatives of the management board attending, whenever necessary. Deviations from suggested practices are, however, not required to be disclosed publicly.

With one exception, German corporate law does not mandate the creation of specific supervisory board committees. German corporations with more than 2,000 employees are only required to establish a mediation committee to assist the Supervisory in connection with disputes among the members of the supervisory board that may arise in connection with the appointment or dismissal of members of the management board. The Corporate Governance Code recommends, however, that the supervisory board establish an audit committee which would handle the formal engagement of the company's independent auditors once they have been approved by the general meeting of shareholders. The audit committee would also address issues of accounting, risk management and auditor independence. In practice, many supervisory boards constitute committees to facilitate the work of the supervisory board. Under German law, members of the supervisory board elected by the employees may serve on any committee established by the supervisory board.

The NYSE Listing Manual only requires U.S. companies to seek shareholder approval for certain equity compensation plans and issuances of common stock. Under the Stock Corporation Act and other applicable German laws, shareholder approval is required for amendments to the articles of association, certain corporate measures (including inter-company agreements and material restructurings), the issuance of new shares and of convertible bonds or bonds with warrants attached, the authorization to purchase the corporation's own shares and other essential issues, such as transfers of important assets by the stock corporation, including shareholdings in subsidiaries. However, we might not be required to seek shareholder approval for issuances of shares in some circumstances in which a U.S. company would be required to do so under the NYSE rules applicable to domestic companies (e.g., an acquisition of another company for shares representing more than 20% of our shareholders' voting power using previously authorized capital available for the acquisition).

## **EXCHANGE CONTROLS**

There are currently no legal restrictions in Germany on international capital movements and foreign exchange transactions, except in limited embargo circumstances relating to certain areas, entities or persons as a result of applicable resolutions adopted by the United Nations and the European Union. Restrictions currently exist with respect to, among others, Iraq, the Taliban and Osama bin Laden. The Deutsche Bundesbank publishes information concerning financial sanctions programs at [www.bundesbank.de/finanz/index.en.php](http://www.bundesbank.de/finanz/index.en.php).

For statistical purposes, there are, however, limited reporting requirements regarding transactions involving cross-border monetary transfers. With some exceptions, every corporation or individual residing in Germany must report to the German Central Bank (i) any payment received from or made to a non-resident corporation or individual that exceeds EUR 12,500 (or the equivalent in a foreign currency) and (ii) any claim against or liability payable to, a non-resident or corporation in excess of EUR 5 million at the end of any calendar month (or the equivalent in a foreign currency).



Residents are also required to report annually to the German Central Bank any shares or voting rights of 10% or more they hold in non-resident 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 shares or voting rights of 10% held by a non-resident.

## TAXATION

The following is a summary of the material German tax and U.S. federal income 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 in, 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 in 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.

**The following is not a comprehensive discussion of all German and U.S. tax consequences that may be relevant for U.S. Holders. Therefore, each U.S. Holder 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's or shares in light of his or her particular circumstances, including the effect of any state, local, or other foreign or domestic 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, and the Tax Incentive Reduction Act (*Steuervergünstigungsabbaugesetz*), which was enacted in May 2003, are applicable to us for the fiscal year beginning January 1, 2003.

Additionally, on December 19, 2003, the Federal Council of Germany (*Bundesrat*) adopted the Act concerning the Implementation of the Protocol Notice of the Federal Government referring to the Recommendation for Mediation regarding the Tax Incentive Reduction Act (*Gesetz zur Umsetzung der Protokollerklärung der Bundesregierung zur Vermittlungsempfehlung zum Steuervergünstigungsabbaugesetz*) and the Trade Tax Reform Act (*Gesetze zur Aenderung des Gewerbesteuergesetzes*). These laws are applicable to us for the fiscal year beginning January 1, 2004.

### 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 was increased from 25% to 26.5% for fiscal year 2003 only. As of 2004, the tax rate regarding German corporate income tax will again amount to 25%.

For the fiscal year 2003, 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 only there is an optional carryback to the previous year of up to EUR 511,500.

According to the Act concerning the Implementation of the Protocol Notice of the Federal Government referring to the Recommendation for Mediation regarding the Tax Incentive Reduction Act, the offset of 100% of profits for a particular year against tax loss carryforwards will only be possible up to an amount of EUR 1,000,000. Further, profits exceeding the EUR 1,000,000 threshold can only be offset up to 60% against the loss carryforwards so that the remaining 40% will remain taxable income (so-called minimum taxation) for corporate income and trade tax purposes.

In addition, a German resident company is subject to profit-related trade tax, which is levied on taxable income for trade tax purposes. The effective rate of the trade tax depends on the rate set by each municipality where the company maintains its business establishment(s). It generally ranges from 15 to 21%. In computing the taxable income of a corporation for corporate income as well as trade tax purposes, the trade tax on income is deductible as a business expense.

The Trade Tax Reform Act introduced a minimum taxation regime also for trade tax purposes so that the utilization of loss carryforwards is limited in the same way as for German corporate income tax purposes.

### **German Withholding Tax on Dividends**

The full amount of a dividend distributed by a 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.

### **Taxation of Capital Gains**

Under German domestic law as currently in effect, capital gains derived by a U.S. Holder from the sale or other disposition of shares or ADSs are subject to tax in Germany if such U.S. Holder has held, directly or indirectly, shares or ADSs representing 1% or more of the registered share capital of a company at any time during the five-year period immediately preceding the disposition. In computing the relevant size of a U.S. Holder's shareholding, shareholdings existing prior to the effective date of the German Tax Reduction Act are also taken into account.

In general, pursuant to the German Tax Reduction Act, corporate U.S. Holders will be fully exempt from German tax on capital gains derived on or after January 1, 2002 from the sale or other disposition of shares or ADSs. Please note that, according to the Act concerning the Implementation of the Protocol Notice of the Federal Government referring to the Recommendation for Mediation regarding the Tax Incentive Reduction Act, as of January 1, 2004, corporate U.S. Holders will not be fully exempt from German tax on capital gains since 5% of the capital gains will be treated as non-deductible business expenses and will be subject to German corporate income tax and solidarity surcharge so that 95% of capital gains will be tax exempt. However, please refer to "— U.S. Taxation and U.S.-German Double Tax Agreement of August 29, 1989" explaining that under a tax treaty a U.S. Holder will not be liable for German tax on capital gains.

### **Inheritance and Gift Tax**

Under German law, German gift or inheritance tax will be imposed only on transfers of shares or ADSs by a U.S. Holder at death or by way of gift, if:

- (i) the decedent or donor, or the heir, donee or other transferee, has his residence in Germany at the time of the transfer;
- (ii) the decedent or donor, or the heir, donee or other transferee, is a citizen of Germany, is not resident in Germany, but has not been continuously outside of Germany for a period of more than five years; or
- (iii) the shares or ADSs subject to such transfer form part of a portfolio that represents 10% or more of the registered share capital of a company and has been held, directly or indirectly, by the decedent or donor, respectively, actually or constructively together with related parties.

The right of the German government to impose inheritance or gift tax on a U.S. Holder may be further limited by the U.S.-German Inheritance and Gifts Tax Treaty of December 21, 2000.

### **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 issued a release dated December 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 (*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 circular of the Federal Ministry of Finance (*Bundesministerium der Finanzen*) 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 ruling dated July 17, 2002, 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 Finance Court (*Bundesfinanzhof*). Shareholders may consider appealing any German income tax assessment that treats the receipt of bonus shares as a taxable dividend.

## **U.S. TAXATION AND U.S.—GERMAN DOUBLE TAXATION AGREEMENT OF AUGUST 29, 1989**

### **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 and Taxation of Dividends in the U.S.**

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. Subject to certain exceptions for positions that are hedged or held for less than 61 days, an individual U.S. holder generally will be subject to U.S. taxation at a maximum rate of 15% in respect of dividends received after 2002 and before 2009. German withholding tax at the 15% rate provided under the Treaty will be treated as a foreign income tax that, subject to 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. tax authorities have indicated an intention to use existing law and to issue new regulations to limit the creditability of foreign withholding taxes in certain situations, including where the burden of foreign taxes is separated inappropriately from the related foreign income. You should consult your own tax advisor if you have questions about whether such rules may affect your ability to utilize foreign tax credits.

Dividends will be paid in euros 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 case of ADSs, by the depository, 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 U.S. Holder generally is subject to taxation at a maximum rate of 20%; however, net long-term capital gain recognized by an individual U.S. Holder after May 5, 2003 and before January 1, 2009 generally is subject to taxation at a maximum rate of 15%. 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 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 depository 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 depository 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 depository.

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 for certification (generally on IRS Form 8802) 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 and Form 8802, 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 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.

### **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.

### **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 (35) to the consolidated financial statements which provides a summary of the nominal amounts of and terms for derivative financial instruments, 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 conditions. 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 BBB+ credit rating or equivalent, 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 the 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 corresponding to their requirements and local circumstances. Central Treasury management activities can be complex, and sometimes involve assumptions about the future or assessments of products, strategies or counterparty creditworthiness that may prove to be inaccurate. In such circumstances, unexpected losses or missed opportunities may result.

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 investment, financing and operating activities. Since our corporate objectives are pursued through our commercial operations — meaning the sale of telecommunications and IT services — 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 the assets and liabilities of our consolidated group members outside the euro-zone 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.

Foreign currency transaction risks in the investment area arise, for example, from the acquisition and sale of investments in foreign entities. The Central Treasury hedges these exposures. If the exposure exceeds EUR 100 million the Management Board decides about the hedging based on a proposal by Central Treasury. We were not subject to material foreign currency transaction risk in the investment area at December 31, 2003. In July 2003, 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, five-year cross-currency interest rate swaps (we pay U.S. dollars at fixed rates and receive euros at fixed rates) and U.S. dollar-denominated long-term debt. Since the change, we have hedged our U.S. dollar investment in T-Mobile preferred stock almost entirely with U.S. dollar-denominated long-term debt. The hedging instruments are:

<u>Hedging Instrument</u>	<u>Nominal USD in millions</u>	<u>Maturity</u>
Sell USD/Buy EUR.....	30	August 4, 2004
Fixed-rate bond .....	785	June 15, 2005
Fixed-rate bond .....	1,685	June 15, 2030
Fixed-rate bond .....	500	June 1, 2032
Fixed-rate bond .....	750	July 22, 2008
Fixed-rate bond .....	1,250	July 22, 2013
Total .....	5,000	

At the end of December 2003, there were not additional investment-related hedges in place.

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 euros, U.S. dollars and British pounds). At December 31, 2003, 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. A variety of short-term foreign currency inter-company loans are typically hedged with forward contracts by Central Treasury. 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, 2003.

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, 2003.

The table below provides information about foreign currency derivative instruments as of December 31, 2003. The non-derivative foreign currency denominated assets and liabilities are indicated in the interest rate tables below.

## Derivative instruments subject to foreign exchange risk

	Maturities <sup>(3)</sup>					Thereafter	Total <sup>(4)</sup>	Fair Value
	2004	2005	2006	2007	2008			
	(millions of €)							
<b>Foreign currency forward contracts</b>								
<b>Buy USD/sell EUR<sup>(2)</sup></b> .....	358	231	172	386	11	—	1,157	(110)
Average contractual exchange rate (EUR/USD) .....	1.12	1.11	1.11	1.14	0.94	—	1.12	
<b>Sell USD/buy EUR<sup>(2)</sup></b> .....	776	1	1	—	—	—	778	28
Average contractual exchange rate (EUR/USD) .....	1.21	0.89	0.90	—	—	—	1.21	
<b>Sell GBP/buy EUR<sup>(2)</sup></b> .....	150	—	—	—	—	—	150	2
Average contractual exchange rate (EUR/GBP) .....	0.70	—	—	—	—	—	0.70	
<b>Sell JPY/buy EUR<sup>(2)</sup></b> .....	6	0	—	—	—	—	6	0
Average contractual exchange rate (EUR/JPY) .....	129.23	117.13	—	—	—	—	128.51	
<b>Buy CHF/sell EUR<sup>(2)</sup></b> .....	—	4	—	—	—	—	4	0
Average contractual exchange rate (EUR/CHF) .....	—	1.40	—	—	—	—	1.40	
<b>Sell CHF/buy EUR<sup>(2)</sup></b> .....	—	7	—	—	—	—	7	0
Average contractual exchange rate (EUR/CHF) .....	—	1.44	—	—	—	—	1.44	
<b>Buy HUF/sell EUR<sup>(2)</sup></b> .....	24	—	—	—	—	—	24	1
Average contractual exchange rate (EUR/HUF) .....	276.43	—	—	—	—	—	276.43	
<b>Sell HUF/buy EUR<sup>(2)</sup></b> .....	5	—	—	—	—	—	5	0
Average contractual exchange rate (EUR/HUF) .....	269.15	—	—	—	—	—	269.15	
<b>Sell CZK/buy EUR<sup>(2)</sup></b> .....	9	—	—	—	—	—	9	0
Average contractual exchange rate (EUR/CZK) .....	32.30	—	—	—	—	—	32.30	
<b>Sell SKK/buy EUR<sup>(2)</sup></b> .....	25	—	—	—	—	—	25	0
Average contractual exchange rate (EUR/SKK) .....	41.76	—	—	—	—	—	41.76	
<b>Buy ZAR/sell EUR<sup>(2)</sup></b> .....	6	—	—	—	—	—	6	0
Average contractual exchange rate (EUR/ZAR) .....	8.27	—	—	—	—	—	8.27	
<b>Sell ZAR/buy EUR<sup>(2)</sup></b> .....	2	—	—	—	—	—	2	0
Average contractual exchange rate (EUR/ZAR) .....	8.84	—	—	—	—	—	8.84	
<b>Foreign Currency Options</b>								
<b>Buy USD-Put/EUR-Call<sup>(2)</sup></b> .....	5	—	—	—	—	—	5	1
Average strike rate (EUR/USD) .....	0.88	—	—	—	—	—	0.88	
<b>Cross-Currency interest rate swaps</b>								
<b>Receive variable USD, pay variable EUR<sup>(2)</sup></b> .....								
Average contractual exchange rate ...	—	—	—	—	—	38	38	(13)
Average receive rate (%) <sup>(1)</sup> .....	—	—	—	—	—	0.85	0.85	
Average pay rate (%) <sup>(1)</sup> .....	—	—	—	—	—	1.19	1.19	
Average pay rate (%) <sup>(1)</sup> .....	—	—	—	—	—	2.37	2.37	

	Maturities <sup>(3)</sup>					Total <sup>(4)</sup>	Fair Value
	2004	2005	2006	2007	2008		
	(millions of €)						
<b>Receive fixed GBP, pay variable</b>							
<b>EUR<sup>(2)</sup></b> .....	—	—	—	—	—	761	761 (81)
Average contractual exchange rate ...	—	—	—	—	—	0.66	0.66
Average receive rate (%) <sup>(1)</sup> .....	—	—	—	—	—	6.71	6.71
Average pay rate (%) <sup>(1)</sup> .....	—	—	—	—	—	4.23	4.23
<b>Receive variable EUR, pay variable</b>							
<b>GBP<sup>(2)</sup></b> .....	393	—	—	—	—	—	393 3
Average contractual exchange rate ...	0.70	—	—	—	—	—	0.70
Average receive rate (%) <sup>(1)</sup> .....	2.35	—	—	—	—	—	2.35
Average pay rate (%) <sup>(1)</sup> .....	4.20	—	—	—	—	—	4.20
<b>Receive fixed EUR, pay variable</b>							
<b>CHF<sup>(2)</sup></b> .....	—	19	—	—	—	—	19 2
Average contractual exchange rate ...	—	1.48	—	—	—	—	1.48
Average receive rate (%) <sup>(1)</sup> .....	—	4.31	—	—	—	—	4.31
Average pay rate (%) <sup>(1)</sup> .....	—	1.45	—	—	—	—	1.45
<b>Receive variable CHF, pay variable</b>							
<b>EUR<sup>(2)</sup></b> .....	35	—	—	—	—	—	35 0
Average contractual exchange rate ...	1.55	—	—	—	—	—	1.55
Average receive rate (%) <sup>(1)</sup> .....	2.61	—	—	—	—	—	2.61
Average pay rate (%) <sup>(1)</sup> .....	0.75	—	—	—	—	—	0.75
<b>Receive fixed JPY, pay fixed EUR<sup>(2)</sup></b> ..	326	—	233	—	93	—	652 (161)
Average contractual exchange rate ...	107.30	—	107.30	—	107.30	—	107.30
Average receive rate (%) <sup>(1)</sup> .....	1.50	—	1.95	—	2.40	—	1.79
Average pay rate (%) <sup>(1)</sup> .....	5.92	—	6.36	—	6.81	—	6.20
<b>Receive fixed JPY, pay variable</b>							
<b>EUR<sup>(2)</sup></b> .....	—	—	38	—	—	246	285 (61)
Average contractual exchange rate ...	—	—	130.50	—	—	121.75	122.93
Average receive rate (%) <sup>(1)</sup> .....	—	—	1.80	—	—	3.65	3.40
Average pay rate (%) <sup>(1)</sup> .....	—	—	4.25	—	—	5.01	4.91
<b>Receive variable JPY, pay variable</b>							
<b>EUR<sup>(2)</sup></b> .....	—	892	—	—	—	—	892 (227)
Average contractual exchange rate ...	—	100.85	—	—	—	—	100.85
Average receive rate (%) <sup>(1)</sup> .....	—	(0.07)	—	—	—	—	(0.07)
Average pay rate (%) <sup>(1)</sup> .....	—	2.21	—	—	—	—	2.21
<b>Receive variable JPY, pay fixed</b>							
<b>EUR<sup>(2)</sup></b> .....	831	—	—	—	—	—	831 (180)
Average contractual exchange rate ...	108.35	—	—	—	—	—	108.35
Average receive rate (%) <sup>(1)</sup> .....	1.17	—	—	—	—	—	1.17
Average pay rate (%) <sup>(1)</sup> .....	5.88	—	—	—	—	—	5.88
<b>Receive fixed PLN, pay variable</b>							
<b>EUR<sup>(2)</sup></b> .....	—	—	—	72	—	—	72 (3)
Average contractual exchange rate ...	—	—	—	3.87	—	—	3.87
Average receive rate (%) <sup>(1)</sup> .....	—	—	—	11.57	—	—	11.57
Average pay rate (%) <sup>(1)</sup> .....	—	—	—	4.26	—	—	4.26
<b>Receive variable EUR, pay fixed</b>							
<b>HUF<sup>(2)</sup></b> .....	295	—	50	—	—	—	345 7
Average contractual exchange rate ...	259.86	—	253.00	—	—	—	258.86
Average receive rate (%) <sup>(1)</sup> .....	2.65	—	2.38	—	—	—	2.61
Average pay rate (%) <sup>(1)</sup> .....	9.17	—	9.92	—	—	—	9.28

	Maturities <sup>(3)</sup>					Total <sup>(4)</sup>	Fair Value	
	2004	2005	2006	2007	2008			Thereafter
	(millions of €)							
<b>Receive variable EUR, pay variable</b>								
<b>HUF<sup>(2)</sup></b> .....	195	—	252	—	—	—	446	6
Average contractual exchange rate ...	257.00	—	252.50	—	—	—	254.46	
Average receive rate (%) <sup>(1)</sup> .....	2.65	—	2.38	—	—	—	2.50	
Average pay rate (%) <sup>(1)</sup> .....	10.25	—	9.61	—	—	—	9.89	
<b>Receive fixed EUR, pay fixed</b>								
<b>CZK<sup>(2)</sup></b> .....	—	—	10	—	—	—	10	0
Average contractual exchange rate ...	—	—	31.55	—	—	—	31.55	
Average receive rate (%) <sup>(1)</sup> .....	—	—	5.44	—	—	—	5.44	
Average pay rate (%) <sup>(1)</sup> .....	—	—	5.43	—	—	—	5.43	
<b>Receive variable EUR, pay variable</b>								
<b>CZK<sup>(2)</sup></b> .....	—	—	—	—	55	—	55	(1)
Average contractual exchange rate ...	—	—	—	—	32.95	—	32.95	
Average receive rate (%) <sup>(1)</sup> .....	—	—	—	—	3.08	—	3.08	
Average pay rate (%) <sup>(1)</sup> .....	—	—	—	—	3.07	—	3.07	
<b>Receive variable CZK, pay variable</b>								
<b>EUR<sup>(2)</sup></b> .....	—	50	—	—	—	—	50	(3)
Average contractual exchange rate ...	—	30.30	—	—	—	—	30.30	
Average receive rate (%) <sup>(1)</sup> .....	—	3.89	—	—	—	—	3.89	
Average pay rate (%) <sup>(1)</sup> .....	—	4.12	—	—	—	—	4.12	

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

(2) Represents notional amounts.

(3) Contractual maturities

(4) Differences in the figures may be a result of rounding.

The fair value of cross-currency interest rate swaps is affected by changes in foreign exchange rates and also by changes in interest rates as described under “Item 3. Key Information — Risk Factors — 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 on our cash-flow 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 these derivative hedging activities, 85% of our euro-denominated liquid financial assets and liabilities, 79% of the British pound-denominated liquid financial assets and liabilities, and 77% of the U.S. dollar-denominated liquid financial assets and liabilities, had interest rates that were effectively fixed at December 31, 2003.



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, 2003.

**Assets and related derivative instruments subject to interest rate risk**

	Maturities <sup>(4)</sup>						Total <sup>(5)</sup>	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
	(millions of €)							
<b>Assets</b>								
<b>Long-term loans</b>								
Fixed Rate, EUR <sup>(3)</sup> .....	3	23	3	2	3	13	47	46
Average interest rate (%) <sup>(1)</sup> .....	0.34	1.77	0.32	0.49	0.28	0.15	0.98	
Variable Rate, EUR <sup>(3)</sup> .....	0	—	—	—	—	—	0	0
Average interest rate (%) <sup>(1)</sup> .....	0.00						0.00	
Fixed Rate, USD <sup>(3)</sup> .....	—	—	10	—	—	—	10	10
Average interest rate (%) <sup>(1)</sup> .....			7.31				7.31	
Variable Rate, USD <sup>(3)</sup> .....	7	—	—	—	—	—	7	7
Average interest rate (%) <sup>(1)</sup> .....	7.49						7.49	
Fixed Rate, HUF <sup>(3)</sup> .....	10	—	—	—	—	—	10	10
Average interest rate (%) <sup>(1)</sup> .....	0.00						0.00	
Fixed Rate, HRK <sup>(3)</sup> .....	1	0	0	0	0	3	5	5
Average interest rate (%) <sup>(1)</sup> .....	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
<b>Investment in non-current securities</b>								
Fixed Rate, EUR <sup>(3)</sup> .....	59	14	—	—	7	1	80	74
Average interest rate (%) <sup>(1)</sup> .....	3.20	8.38			6.88	4.99	4.41	
Variable Rate, EUR <sup>(3)</sup> .....	—	—	—	—	—	2	2	2
Average interest rate (%) <sup>(1)</sup> .....						0.00	0.00	
Fixed Rate, USD <sup>(3)</sup> .....	0	—	—	—	—	—	0	0
Average interest rate (%) <sup>(1)</sup> .....	0.00						0.00	
Fixed Rate, HUF <sup>(3)</sup> .....	3	—	—	—	—	—	3	3
Average interest rate (%) <sup>(1)</sup> .....	0.00						0.00	
<b>Investment in marketable securities</b>								
Fixed Rate, EUR <sup>(3)</sup> .....	65	—	—	—	—	0	65	65
Average interest rate (%) <sup>(1)</sup> .....	7.13					0.00	7.08	
Fixed Rate, HUF <sup>(3)</sup> .....	1	—	—	—	—	—	1	1
Average interest rate (%) <sup>(1)</sup> .....	5.00						5.00	
Fixed Rate, HRK <sup>(3)</sup> .....	83	—	—	—	—	—	83	83
Average interest rate (%) <sup>(1)</sup> .....	6.00						6.00	
Variable Rate, HRK <sup>(3)</sup> .....	17	—	—	—	—	—	17	18
Average interest rate (%) <sup>(1)</sup> .....	5.00						5.00	
Fixed Rate, SKK <sup>(3)</sup> .....	0	—	—	—	—	—	0	0
Average interest rate (%) <sup>(1)</sup> .....	0.00						0.00	
<b>Liquid Assets</b>								
Fixed Rate, EUR <sup>(3)</sup> .....	7,684	—	—	—	—	—	7,684	7,684
Average interest rate (%) <sup>(1)</sup> .....	2.12						2.12	
Fixed Rate, USD <sup>(3)</sup> .....	148	—	—	—	—	—	148	148
Average interest rate (%) <sup>(1)</sup> .....	1.15						1.15	
Fixed Rate, GBP <sup>(3)</sup> .....	126	—	—	—	—	—	126	126
Average interest rate (%) <sup>(1)</sup> .....	4.04						4.04	
Fixed Rate, CHF <sup>(3)</sup> .....	18	—	—	—	—	—	18	18
Average interest rate (%) <sup>(1)</sup> .....	0.24						0.24	
Fixed Rate, CZK <sup>(3)</sup> .....	107	—	—	—	—	—	107	107
Average interest rate (%) <sup>(1)</sup> .....	2.09						2.09	
Fixed Rate, HUF <sup>(3)</sup> .....	33	—	—	—	—	—	33	33

	<b>Maturities<sup>(4)</sup></b>						<b>Total<sup>(5)</sup></b>	<b>Fair Value</b>
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>Thereafter</b>		
	<b>(millions of €)</b>							
Average interest rate (%) <sup>(1)</sup> .....	12.26						12.26	
Fixed Rate, HRK <sup>(3)</sup> .....	543	—	—	—	—	—	543	543
Average interest rate (%) <sup>(1)</sup> .....	6.00						6.00	
Fixed Rate, JPY <sup>(3)</sup> .....	4	—	—	—	—	—	4	4
Average interest rate (%) <sup>(1)</sup> .....	0.06						0.06	
Fixed Rate, PLN <sup>(3)</sup> .....	3	—	—	—	—	—	3	3
Average interest rate (%) <sup>(1)</sup> .....	5.45						5.45	
Fixed Rate, DKK <sup>(3)</sup> .....	1	—	—	—	—	—	1	1
Average interest rate (%) <sup>(1)</sup> .....	2.20						2.20	
Fixed Rate, HKD <sup>(3)</sup> .....	1	—	—	—	—	—	1	1
Average interest rate (%) <sup>(1)</sup> .....	6.00						6.00	
Fixed Rate, MKD <sup>(3)</sup> .....	52	—	—	—	—	—	52	52
Average interest rate (%) <sup>(1)</sup> .....	3.00						3.00	
Fixed Rate, SGD <sup>(3)</sup> .....	3	—	—	—	—	—	3	3
Average interest rate (%) <sup>(1)</sup> .....	0.69						0.69	
Fixed Rate, SKK <sup>(3)</sup> .....	381	—	—	—	—	—	381	381
Average interest rate (%) <sup>(1)</sup> .....	5.70						5.70	
Fixed Rate, BRL <sup>(3)</sup> .....	7	—	—	—	—	—	7	7
Average interest rate (%) <sup>(1)</sup> .....	15.54						15.54	
Fixed Rate, ZAR <sup>(3)</sup> .....	15	—	—	—	—	—	15	15
Average interest rate (%) <sup>(1)</sup> .....	8.50						8.50	

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

(2) Represents notional amounts.

(3) Maturity amounts presented in book value, in most cases equal or close to the nominal value.

(4) Contractual maturities

(5) Differences in the figures may be a result of rounding.

## Liabilities and related derivative instruments subject to interest rate risk

	Maturities <sup>(5)</sup>						Total <sup>(6)</sup>	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
	(millions of €)							
<b>Liabilities</b>								
<b>Bonds and debentures</b>								
Fixed Rate, EUR <sup>(4)</sup> . . . . .	9,827	3,250	6,842	3,500	3,052	8,574	35,046	38,269
Average interest rate (%) <sup>(1)</sup> . . . . .	7.23	6.09	6.41	6.98	5.41	7.30	6.80	
Variable Rate, EUR <sup>(4)</sup> . . . . .	1,050	350	128	—	—	—	1,528	1,189
Average interest rate (%) <sup>(1)</sup> . . . . .	2.75	3.91	3.77				3.10	
Fixed Rate, USD <sup>(4)</sup> . . . . .	105	2,571	—	—	595	6,556	9,826	11,458
Average interest rate (%) <sup>(1)</sup> . . . . .	6.29	8.08			3.87	8.16	7.86	
Fixed Rate, GBP <sup>(4)</sup> . . . . .	—	885	—	—	—	1,852	2,738	3,009
Average interest rate (%) <sup>(1)</sup> . . . . .		7.63				7.12	7.28	
Fixed Rate, CZK <sup>(4)</sup> . . . . .	154	—	—	—	—	—	154	162
Average interest rate (%) <sup>(1)</sup> . . . . .	8.20						8.20	
Variable Rate, CZK <sup>(4)</sup> . . . . .	—	50	—	—	—	—	50	51
Average interest rate (%) <sup>(1)</sup> . . . . .		3.89					3.89	
Fixed Rate, HUF <sup>(4)</sup> . . . . .	0	—	—	—	—	0	1	0
Average interest rate (%) <sup>(1)</sup> . . . . .	0.00					0.00	0.00	
Fixed Rate, JPY <sup>(4)</sup> . . . . .	327	668	271	—	93	—	1,359	1,255
Average interest rate (%) <sup>(1)</sup> . . . . .	2.00	2.00	2.36		2.90		2.13	
Variable Rate, JPY <sup>(4)</sup> . . . . .	832	—	—	—	—	—	832	670
Average interest rate (%) <sup>(1)</sup> . . . . .	1.66						1.66	
Fixed Rate, PLN <sup>(4)</sup> . . . . .	—	—	—	80	—	—	80	87
Average interest rate (%) <sup>(1)</sup> . . . . .				9.69			9.69	
<b>Liabilities to banks</b>								
Fixed Rate, EUR <sup>(4)</sup> . . . . .	451	139	12	94	12	837	1,546	1,437
Average interest rate (%) <sup>(1)</sup> . . . . .	4.90	6.52	5.42	6.86	5.35	5.45	5.47	
Variable Rate, EUR <sup>(4)</sup> . . . . .	31	—	—	—	—	—	31	31
Average interest rate (%) <sup>(1)</sup> . . . . .	2.12						2.12	
Fixed Rate, USD <sup>(4)</sup> . . . . .	3	3	3	4	4	9	26	26
Average interest rate (%) <sup>(1)</sup> . . . . .	1.28	1.28	1.28	1.28	1.28	1.28	1.28	
Fixed Rate, GBP <sup>(4)</sup> . . . . .	59	1,240	18	—	212	212	1,741	1,782
Average interest rate (%) <sup>(1)</sup> . . . . .	4.38	4.66	4.17		6.77	6.78	5.16	
Fixed Rate, HUF <sup>(4)</sup> . . . . .	253	61	91	22	14	6	446	446
Average interest rate (%) <sup>(1)</sup> . . . . .	11.75	11.06	10.83	11.44	10.25	13.16	11.43	
Fixed Rate, ZAR <sup>(4)</sup> . . . . .	8	—	—	—	—	—	8	8
Average interest rate (%) <sup>(1)</sup> . . . . .	13.70						13.70	
<b>Interest rate swaps</b>								
<b>EUR interest rate swap</b>								
Receive variable, pay fixed <sup>(2)</sup> . . . . .	—	892	—	307	256	1,100	2,555	(281)
Average receive rate (%) <sup>(1)</sup> . . . . .	—	2.21	—	2.21	2.16	2.21	2.20	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	5.65	—	5.82	5.84	5.91	5.80	
<b>EUR interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	7,156	820	4,000	332	256	1,100	13,664	369
Average receive rate (%) <sup>(1)</sup> . . . . .	4.08	4.21	2.94	5.12	5.03	5.26	3.89	
Average pay rate (%) <sup>(1)</sup> . . . . .	2.12	2.08	2.08	2.39	2.16	2.21	2.12	

	Maturities <sup>(5)</sup>						Total <sup>(6)</sup>	Fair Value
	2004	2005	2006	2007	2008	Thereafter		
	(millions of €)							
<b>Forward EUR interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	—	—	—	1,000	1,000	—	2,000	15
Average receive rate (%) <sup>(3)</sup> . . . . .	—	—	—	3.80	3.92	—	3.86	
Average pay rate (%) <sup>(3)</sup> . . . . .	—	—	—	EURIBOR6M	EURIBOR6M	—	EURIBOR6M	
<b>GBP interest rate swap</b>								
Receive variable, pay fixed <sup>(2)</sup> . . . . .	—	425	354	—	—	—	779	(21)
Average receive rate (%) <sup>(1)</sup> . . . . .	—	3.83	3.83	—	—	—	3.83	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	6.03	5.53	—	—	—	5.80	
<b>GBP interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	—	283	—	—	—	—	283	(3)
Average receive rate (%) <sup>(1)</sup> . . . . .	—	3.84	—	—	—	—	3.84	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	4.18	—	—	—	—	4.18	
<b>USD interest rate swap</b>								
Receive variable, pay fixed <sup>(2)</sup> . . . . .	—	—	—	793	—	—	793	(42)
Average receive rate (%) <sup>(1)</sup> . . . . .	—	—	—	1.22	—	—	1.22	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	—	—	4.65	—	—	4.65	
<b>USD interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	—	1,745	—	793	—	—	2,539	(3)
Average receive rate (%) <sup>(1)</sup> . . . . .	—	2.03	—	2.92	—	—	2.31	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	1.23	—	1.22	—	—	1.23	
<b>Forward USD interest rate swap</b>								
Receive variable, pay fixed <sup>(2)</sup> . . . . .	—	—	—	1,587	1,428	—	3,015	(126)
Average receive rate (%) <sup>(3)</sup> . . . . .	—	—	—	USDL6M	USDL6M	—	USDL6M	
Average pay rate (%) <sup>(3)</sup> . . . . .	—	—	—	5.28	4.05	—	4.70	
<b>Forward USD interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	—	—	—	793	—	—	793	(1)
Average receive rate (%) <sup>(3)</sup> . . . . .	—	—	—	3.22	—	—	3.22	
Average pay rate (%) <sup>(3)</sup> . . . . .	—	—	—	USDL6M	—	—	USDL6M	
<b>JPY interest rate swap</b>								
Receive fixed, pay variable <sup>(2)</sup> . . . . .	—	668	—	—	—	—	668	11
Average receive rate (%) <sup>(1)</sup> . . . . .	—	1.50	—	—	—	—	1.50	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	0.31	—	—	—	—	0.31	
<b>HUF interest rate swap</b>								
Receive variable, pay fixed <sup>(2)</sup> . . . . .	—	—	241	—	—	—	241	6
Average receive rate (%) <sup>(1)</sup> . . . . .	—	—	9.61	—	—	—	9.61	
Average pay rate (%) <sup>(1)</sup> . . . . .	—	—	9.25	—	—	—	9.25	

(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, in most cases equal or close to the nominal value.

(5) Contractual maturities.

(6) Differences in the figures may be a result of rounding.

## EQUITY PRICE RISK

We continuously evaluate investment opportunities to help us meet our business and strategic goals. With limited exceptions, we intend 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, 2003 which are sensitive to changes in share prices.

	<b>December 31, 2003</b>	
	<b>Assets subject to equity price risk</b>	
	<u>Carrying value</u>	<u>Fair Value</u>
	(millions of €)	
Investments in marketable equity securities. . . . .	380	635

### CHANGES IN MARKET RISK EXPOSURE IN 2003 COMPARED TO 2002

The issuance of medium-term notes denominated in British pounds and Japanese yen in 2003 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 conversion of an intercompany U.S. dollar-denominated loan receivable from Deutsche Telekom AG to T-Mobile US of USD 3 billion into an equity interest in July 2003, cross-currency swaps (Deutsche Telekom AG paid U.S. dollars at fixed rates and received euros at fixed rates) and short-term U.S. dollar currency forward contracts used to hedge the foreign currency risk inherent in the intercompany loan asset were terminated.

To achieve the defined target mixture of fixed and floating rate debt in our functional currencies, Central Treasury terminated and entered into various interest rate swap transactions. The result of these adjustments is that the level of our euro liquid financial assets and liabilities at fixed rates increased whereas the level of our British Pound liquid financial assets and liabilities at fixed rates declined. The level of U.S. dollar liquid financial assets and liabilities remained stable.

The following table summarizes the level of liquid financial assets and liabilities at fixed rates after derivative adjustment at December 31, 2003 and 2002 for our main functional currencies as compared to overall liquid financial assets and liabilities:

<u>Currency</u>	<u>December 31, 2003</u>	<u>December 31, 2002</u>
Euro . . . . .	85%	70%
U.S. Dollar . . . . .	77%	83%
British Pound . . . . .	79%	99%

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

Not applicable.



## PART II

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

None.

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

1. Resolution renewing the authorization of Deutsche Telekom to purchase its own shares.

The resolution adopted by the Shareholders on May 28, 2002, authorizing Deutsche Telekom to purchase its own shares was rescinded effective on May 20, 2003, and has been replaced by the authorization of the Shareholders on May 20, 2003 as set forth below:

- The Board of Management is authorized to purchase a total of 419,775,242 shares of Deutsche Telekom by November 19, 2004, which is slightly less than 10% of the capital stock, subject to the proviso that the shares to be purchased on the basis of this authorization do not account for more than 10% of the capital stock of Deutsche Telekom in conjunction with the other shares of Deutsche Telekom which Deutsche Telekom has already purchased and still possesses. This authorization may be exercised in whole or in portions. The purchase can be carried out in partial tranches spread over various purchase dates within the authorization period until the maximum purchase volume is reached. The shares may also be purchased by dependent group companies of Deutsche Telekom within the meaning of §17 of the German Stock Corporation Act or third parties for the account of Deutsche Telekom or for the account of the dependent group companies of Deutsche Telekom pursuant to §17 of the German Stock Corporation Act.
- The shares are purchased in compliance with the principle of equal treatment (§53 a of the German Stock Corporation Act) through the stock exchange or by means of a public purchase offer sent to all shareholders.
- The Board of Management is authorized to sell shares of Deutsche Telekom which are purchased on the basis of the above authorization without prejudice to the principle of equal treatment (§53 a of the German Stock Corporation Act) again through the stock exchange.
- The Board of Management is authorized, with the consent of the Supervisory Board, to use shares of Deutsche Telekom acquired on the basis of the above authorization for the purpose of listing Deutsche Telekom shares on foreign stock exchanges where they are not quoted.
- The Board of Management is authorized, with the consent of the Supervisory Board, to offer shares of Deutsche Telekom acquired on the basis of the above authorization to third parties in the context of mergers or acquisitions of other companies, business units or interests in other companies.
- The Board of Management is authorized, with the consent of the Supervisory Board, to redeem Deutsche Telekom's own shares purchased on the basis of the above authorization, without such redemption or its implementation requiring a further resolution of the Shareholders. The redemption shall lead to a capital reduction. With the consent of the Supervisory Board, the Board of Management may determine otherwise, i.e., that the capital stock remains unchanged upon redemption and instead that the proportion of the remaining shares in the capital stock is increased through redemption pursuant to §8(3) of the German Stock Corporation Act. In such case, the Board of Management is authorized to amend the number of shares stated in the Articles of Incorporation.
- The Board of Management is authorized to offer the shares of Deutsche Telekom, which are purchased pursuant to the authorization above, to shareholders for subscription on the basis of an offer sent to all the shareholders without prejudice to their subscription right and without prejudice to the principle of equal treatment of shareholders (§53 a of the German Stock Corporation Act)
- The Board of Management is authorized, with the consent of the Supervisory Board, to sell the purchased shares other than through the stock exchange or by offering them to all shareholders, if the shares purchased are sold against cash settlement at a price which is not significantly lower than the market price of Deutsche Telekom shares of equal type and class

on the date of sale. This authorization is limited to a maximum of 10% of Deutsche Telekom's capital stock on the date of the resolution adopted by the Shareholders (i.e., to a maximum of EUR 1,074,624,619.52 in total or — if this value is lower — 10% of the capital stock on the date of sale of the shares); it shall be reduced insofar as new shares have been issued with subscription rights being excluded pursuant to §186(3) sentence 4 of the German Stock Corporation Act since this authorization was granted.

## 2. Amendments to the Articles of Association

The Articles of Association of Deutsche Telekom AG have been amended in line with the Transparency and Disclosure Act with effect to all shareholders as follows:

- §4 of the Articles of Association has been amended as follows:  
“Announcements of the Corporation shall be published in the electronic Federal Gazette.”
- §14(2) of the Articles of Association has been amended as follows:  
“(2) Convocation shall be published in the electronic Federal Gazette at least one month prior to the date by which shareholders have to register for the shareholders' meeting (§16(1)); the date of publication and the last date by which shareholders have to register for the shareholders' meeting shall not be counted.”
- §19(1) of the Articles of Incorporation has been amended as follows:  
“(1) The Board of Management shall submit to the Supervisory Board the annual financial statements and the management report as well as the consolidated financial statements and the Group management report for the previous year within the first three months of the financial year without delay after the preparation thereof. The Board of Management must submit the proposal for the appropriation of net income to the Supervisory Board at the same time. §298(3) and §315(3) German Commercial Code (HGB) remain unaffected.”

### **ITEM 15. Controls and Procedures**

As of December 31, 2003 (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)-15(e) and 15(d)-15(e) 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 and that our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in this Annual Report is recorded, processed, summarized and reported on a timely basis. 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 16A. Audit committee financial expert**

The Supervisory Board has determined that Dr. Klaus G. Schlede is an “audit committee financial expert” as defined by Item 401(h) of Regulation S-K of the Securities Exchange Act of 1934, as amended. Dr. Klaus G. Schlede has a Business Management Degree and received a Doctorate in 1969. From 1965 to 1980, he held various positions within the financial departments at Bayer Group in Bombay, Lima and Sao Paulo. From 1980 to 1987, Dr. Schlede was Director of Finance and, from 1984, Chief Financial Officer at Bayer AG. In 1987, he was appointed to Lufthansa AG's Executive Board as Chief Financial Officer. From 1991 to 1998, Dr. Schlede was Deputy Chairman of the Executive Board, and from 1998 to 2003, he was Chairman of the Supervisory Board at Deutsche Lufthansa AG. For more information, see “Item 6. Directors, Senior Management and Employees — Members of the Supervisory Board of Deutsche Telekom.”

### **ITEM 16B. Code of Ethics**

In addition to business conduct and fiduciary duties applicable by law to our directors, officers and employees, we have adopted a code of ethics specifically applicable to our chief executive officer, chief financial officer and chief accounting officer in order to promote honesty, integrity, transparency

and ethical conduct in such persons' performance of their management responsibilities. Our code of ethics is available through our investor relations page on our website at <http://www.telekom.de>.

### Other Corporate Governance Practices required by the Sarbanes-Oxley Act

Although not required by the Sarbanes-Oxley Act until 2005, we have early adopted procedures for the treatment of complaints relating to auditing and accounting matters. More information is available through our investor relations page of our website at <http://www.telekom.de>.

### ITEM 16C. Principal Accountant Fees and Services

The "Audit and Non-Audit Services Pre-Approval Policy" was approved by the Audit Committee of the Deutsche Telekom AG Supervisory Board on April 9, 2003. This requires all services which are to be performed by our external auditors to be pre-approved. This may be in the form of a general pre-approval or as pre-approval on a case-by-case basis. All services to be performed by the external auditors were subjected to the above policy and approved in advance. The Audit Committee has been regularly informed of the services and the fees to be paid.

No services which are classified as prohibited services by the U.S. Securities and Exchange Commission were commissioned after May 6, 2003.

Our external auditors PwC Deutsche Revision AG ("PwC") and Ernst & Young AG ("E&Y") billed the following services related to our 2003 and 2002 financial years:

#### *PwC*

<u>Nature of the service</u>	<u>2003</u>	<u>2002</u>
	(millions of €)	(millions of €)
Audit services .....	16.2	21.0
Audit-related services.....	8.2	10.0
Tax services .....	3.4	2.7
All other services .....	4.2	35.2*
Total .....	32.0	68.9

\* Includes aggregate fees billed of EUR 30.0 million related to PwC's consulting services unit for the period from January 1, 2002 to October 1, 2002. This consulting services unit of the firm was sold on October 1, 2002.

#### *E&Y*

<u>Nature of the service</u>	<u>2003</u>	<u>2002</u>
	(millions of €)	(millions of €)
Audit services .....	13.7	11.2
Audit-related services.....	2.7	0.8
Tax services .....	0.3	0.1
All other services .....	1.3	0.1
Total .....	18.0	12.2

#### **Audit services**

The following services were billed under the category "audit services": audit of financial statements, reviews of quarterly reports and services performed in relation to legal obligations and submissions required by regulatory provisions, including the formulation of audit opinions and reports, domestic and international legal audits, tax services, provided they are necessary for compliance with generally accepted auditing principles, and support in the preparation and auditing of the documents to be filed. Audit services also included the auditing of information systems and processes and tests which serve to promote understanding and reliability of the systems and internal corporate controls, as well as advice on issues of billing, accounting and reporting.

#### **Audit-related services**

Audit-related services mainly consisted of services which are normally performed by the external auditor in connection with the auditing of the annual financial statements. Audit-related services also included due diligence tests relating to possible acquisitions and sales of companies, advice on issues

of billing, accounting and reporting which were not classified as audit services, support with the interpretation and implementation of new accounting and reporting standards, auditing of employee benefit plans and support with the implementation of corporate control requirements for reporting.

**Tax services**

Tax services consist of services relating to issues of domestic and international taxation (adherence to tax law, tax planning and tax consulting). Furthermore, services were commissioned for the review of tax returns, assistance with tax audits and appeals, evaluations for taxation purposes, as well as assistance relating to tax law and the review of compliance with tax law for international employees.

**Other services**

Other services mainly consist of risk management advisory services, treasury advisory services, valuation services (the results of these services were not subject to audit procedures), review of valuation work performed by us or an independent third-party specialist employed by us, assistance related to procedures required by the German telecommunications regulator and other regulatory bodies, as well as management consulting services from PwC's consulting services unit from January 1, 2002 to October 1, 2002. All these services were unrelated to the audits of our financial statements.

**ITEM 16D. Exemptions from the Listing Standards for Audit Committees**

Not applicable.

**ITEM 16E. Purchases of Equity Security by the Issuer and Affiliated Purchasers**

Not applicable.

## PART III

### ITEM 17. Financial Statements

Not applicable.

### ITEM 18. Financial Statements

See pages F-1 through F-104.

Separate financial statements required by Rule 3-09 of Regulation S-X are included on pages A-1 through A-270 in this Annual Report.

### ITEM 19. Exhibits

Documents filed as exhibits to this Annual Report.

- 1.1 Articles of Incorporation (*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.
- 8.1 Significant subsidiaries as of the end of the year covered by this Annual Report.\*
- 11.1 Deutsche Telekom AG's Code of Ethics.\*
- 12.1 Certification of the Principal Executive Officer pursuant to Section 302 of of the Sarbanes-Oxley Act of 2002.
- 12.2 Certification of the Principal Financial Officer pursuant to Section 302 of of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 14.1 Combined consent of Ernst & Young Deutsche Allgemeine Treuhand AG Wirtschaftspruefungsgesellschaft AG and PwC Deutsche Revision Aktiengesellschaft Wirtschaftspruefungsgesellschaft.\*
- 14.2 Consent of PricewaterhouseCoopers Accountants N.V.
- 14.3 Consent of ZAO Deloitte & Touche CIS.
- 14.4 Statement Regarding Consent of Arthur Andersen and Arthur Andersen Sp. z o.o.

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\* Previously filed.



## SIGNATURES

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

Date: June 25, 2004

DEUTSCHE TELEKOM AG

By: /s/ Kai-Uwe Ricke

Name: Kai-Uwe Ricke

Title: Chairman of the Management Board

By: /s/ Dr. Karl-Gerhard Eick

Name: Dr. Karl-Gerhard Eick

Title: Deputy Chairman of the Management Board  
Finance and Controlling

# DEUTSCHE TELEKOM AG

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## REPORT OF INDEPENDENT AUDITORS

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, 2003 and 2002, and the related consolidated statements of operations, shareholders' equity, cash flows, and segment reporting for each of the three years in the period ended December 31, 2003. 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, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in Germany.

As discussed in the Summary of Accounting Policies note to the financial statements, the Company changed its basis of presentation of the statement of operations in 2003.

Accounting principles generally accepted in Germany vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature of such differences is presented in Notes 41 through 44 to the consolidated financial statements.

March 11, 2004

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

## CONSOLIDATED STATEMENTS OF OPERATIONS

	Notes	For the year ended December 31,		
		2003	2002	2001
		(millions of €)		
Net revenue.....	(1)	55,838	53,689	48,309
Cost of sales.....	(2)	<u>(31,402)</u>	<u>(44,477)</u>	<u>(29,766)</u>
<b>Gross profit</b> .....		<b>24,436</b>	<b>9,212</b>	<b>18,543</b>
Selling costs.....	(3)	(13,505)	(13,264)	(11,675)
General and administrative costs.....	(4)	(4,976)	(6,062)	(5,622)
Other operating income.....	(5)	4,558	3,901	6,619
Other operating expenses.....	(6)	<u>(5,084)</u>	<u>(14,915)</u>	<u>(5,078)</u>
<b>Operating results</b> .....		<b>5,429</b>	<b>(21,128)</b>	<b>2,787</b>
Financial income (expense), net.....	(7)	<u>(4,031)</u>	<u>(6,022)</u>	<u>(5,348)</u>
<b>Results from ordinary business activities<sup>(1)</sup></b> .....		<b>1,398</b>	<b>(27,150)</b>	<b>(2,561)</b>
Income tax benefit (expense).....	(8)	<u>225</u>	<u>2,847</u>	<u>(751)</u>
<b>Income (loss) after tax benefit (expense)</b> .....		<b>1,623</b>	<b>(24,303)</b>	<b>(3,312)</b>
(Income) loss applicable to minority shareholders.....	(9)	<u>(370)</u>	<u>(284)</u>	<u>(142)</u>
<b>Net income (loss)</b> .....		<u><u>1,253</u></u>	<u><u>(24,587)</u></u>	<u><u>(3,454)</u></u>
<b>Earnings (loss) per share in €</b> .....		<u>0.30</u>	<u>(5.86)</u>	<u>(0.93)</u>

(1) Including other taxes in accordance with the classification of the statement of operations by the cost-of-sales method.

The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED BALANCE SHEETS

	<u>Notes</u>	<u>As of December 31,</u>	
		<u>2003</u>	<u>2002</u>
(millions of €)			
<b>Assets</b>			
<b>Noncurrent assets</b>			
Intangible assets .....	(13)	45,193	53,402
Property, plant and equipment.....	(14)	47,268	53,955
Financial assets .....	(15)	3,190	4,169
		<b>95,651</b>	<b>111,526</b>
<b>Current assets</b>			
Inventories, materials and supplies .....	(16)	1,432	1,556
Receivables .....	(17)	5,762	6,258
Other assets.....	(18)	3,162	3,392
Marketable securities.....	(19)	173	413
Liquid assets .....	(20)	9,127	1,905
		<b>19,656</b>	<b>13,524</b>
<b>Prepaid expenses and deferred charges .....</b>	(21)	<b>772</b>	<b>771</b>
		<b>116,079</b>	<b>125,821</b>
<b>Shareholders' equity and liabilities</b>			
<b>Shareholders' equity</b>			
Capital stock .....	(22)		
Capital stock .....	(23)	10,746	10,746
Additional paid-in capital.....	(24)	50,092	50,077
Retained earnings.....	(25)	248	248
Unappropriated net income (loss) carried forward from previous year.....		(24,564)	23
Net income (loss).....		1,253	(24,587)
Cumulative translation adjustment account.....		(8,017)	(5,079)
Minority interest.....	(26)	4,053	3,988
		<b>33,811</b>	<b>35,416</b>
<b>Accruals</b>			
Pensions and similar obligations .....	(28)	4,456	3,942
Other accruals.....	(29)	11,247	12,155
		<b>15,703</b>	<b>16,097</b>
<b>Liabilities</b>			
Debt .....	(30)	55,411	63,044
Other .....		10,451	10,541
		<b>65,862</b>	<b>73,585</b>
<b>Deferred income.....</b>		<b>703</b>	<b>723</b>
		<b>116,079</b>	<b>125,821</b>

The accompanying notes are an integral part of the consolidated financial statements.



## CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the year ended December 31,		
	2003	2002	2001
	(millions of €)		
Net income (loss) . . . . .	1,253	(24,587)	(3,454)
Income applicable to minority shareholders . . . . .	370	284	142
<b>Income (loss) after taxes . . . . .</b>	<b>1,623</b>	<b>(24,303)</b>	<b>(3,312)</b>
Depreciation and amortization . . . . .	12,884	36,880	15,221
Income tax (benefit) expense . . . . .	(225)	(2,847)	751
Net interest expense . . . . .	3,776	4,048	4,138
Net gains from the disposition of noncurrent assets . . . . .	(792)	(428)	(1,106)
Results from associated companies . . . . .	247	430	547
Other noncash transactions . . . . .	(699)	1,144	(1,146)
(Increase) decrease in capitalized working capital <sup>(1)</sup> . . . . .	(542)	184	428
(Increase) decrease in accruals . . . . .	1,584	1,410	(136)
Decrease in other working capital carried as a liability <sup>(2)</sup> . . . . .	149	101	761
Income taxes (paid) received . . . . .	88	(15)	10
Dividends received . . . . .	39	63	115
<b>Cash generated from operations . . . . .</b>	<b>18,132</b>	<b>16,667</b>	<b>16,271</b>
Interest paid . . . . .	(4,481)	(6,112)	(4,779)
Interest received . . . . .	665	1,908	442
<b>Net cash provided by operating activities . . . . .</b>	<b>14,316</b>	<b>12,463</b>	<b>11,934</b>
Cash outflows for investments in			
— intangible assets . . . . .	(844)	(841)	(1,021)
— property, plant and equipment . . . . .	(5,187)	(6,784)	(9,847)
— financial assets . . . . .	(373)	(568)	(498)
— consolidated companies . . . . .	(275)	(6,405)	(5,695)
Cash inflows from disposition of			
— intangible assets . . . . .	24	14	208
— property, plant and equipment . . . . .	1,055	1,304	1,146
— financial assets . . . . .	1,569	1,130	3,514
— shareholdings in consolidated companies and business units . . . . .	1,510	697	1,004
Net change in short-term investments and marketable securities . . . . .	(18)	226	4,440
Other . . . . .	466	1,187	1,384
<b>Net cash used for investing activities . . . . .</b>	<b>(2,073)</b>	<b>(10,040)</b>	<b>(5,365)</b>
Changes in short-term debt . . . . .	(9,214)	(10,012)	(10,266)
Issuance of medium and long-term debt . . . . .	6,951	11,677	13,949
Repayments of medium and long-term debt . . . . .	(2,879)	(3,472)	(6,589)
Dividends paid . . . . .	(92)	(1,582)	(1,905)
Proceeds from exercise of stock options and warrants . . . . .	15	1	—
Change in minority interests . . . . .	(7)	(47)	—
<b>Net cash used for financing activities . . . . .</b>	<b>(5,226)</b>	<b>(3,435)</b>	<b>(4,811)</b>
Effect of foreign currency exchange rate changes on cash and cash equivalents . . . . .	(43)	(14)	(26)
<b>Net increase (decrease) in cash and cash equivalents . . . . .</b>	<b>6,974</b>	<b>(1,026)</b>	<b>1,732</b>
<b>Cash and cash equivalents, at beginning of year . . . . .</b>	<b>1,712</b>	<b>2,738</b>	<b>1,006</b>
<b>Cash and cash equivalents, at end of year . . . . .</b>	<b>8,686</b>	<b>1,712</b>	<b>2,738</b>

(1) Change in receivables, liabilities, other assets, inventories, materials and supplies and prepaid expenses and deferred charges.

(2) 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.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

millions of €	Consolidated shareholders' equity generated						Minority interest			Consol. shareholders' equity <sup>(1)</sup>			
	Capital stock nominal value	Additional paid-in capital	Retained earnings	Unappr. net income (loss) carried forward	Net income (loss)	Cumulative translation adjustment account	Shareholders' equity in. acc. with consol. bal. sheet	Treasury shares <sup>(1)</sup>	Total		Minority interest capital	Cumulative Translation adjustment account	Total in acc. with cons. bal. sheet
<b>Balance at Jan. 1, 2001.</b>	<u>7,756</u>	<u>24,290</u>	<u>1,159</u>	<u>44</u>	<u>5,926</u>	<u>(761)</u>	<u>38,414</u>	<u>(7)</u>	<u>38,407</u>	<u>4,667</u>	<u>(365)</u>	<u>4,302</u>	<u>42,709</u>
Changes in the composition of the Group										808		808	808
Dividends for 2000				(1,877)			(1,877)		(1,877)	(33)		(33)	(1,910)
Unappropriated net income carried forward			3,992	1,934	(5,926)		—		—				—
Increase in nominal value of capital stock	2,990	25,704					28,694		28,694				28,694
Loss after taxes					(3,454)		(3,454)		(3,454)	142		142	(3,312)
Difference from currency translation			28			(811)	(783)		(783)		88	88	(695)
<b>Balance at Dec. 31, 2001.</b>	<u>10,746</u>	<u>49,994</u>	<u>5,179</u>	<u>101</u>	<u>(3,454)</u>	<u>(1,572)</u>	<u>60,994</u>	<u>(7)</u>	<u>60,987</u>	<u>5,584</u>	<u>(277)</u>	<u>5,307</u>	<u>66,294</u>
Changes in the composition of the Group										(1,586)		(1,586)	(1,586)
Dividends for 2001				(1,539)			(1,539)		(1,539)	(43)		(43)	(1,582)
Unappropriated net income (loss) carried forward			(4,915)	1,461	3,454		—		—				—
Stock issued for the acquisition of VoiceStream/Powertel		83					83		83				83
Loss after taxes					(24,587)		(24,587)		(24,587)	284		284	(24,303)
Difference from currency translation			(16)			(3,507)	(3,523)		(3,523)		26	26	(3,497)
<b>Balance at Dec. 31, 2002.</b>	<u>10,746</u>	<u>50,077</u>	<u>248</u>	<u>23</u>	<u>(24,587)</u>	<u>(5,079)</u>	<u>31,428</u>	<u>(7)</u>	<u>31,421</u>	<u>4,239</u>	<u>(251)</u>	<u>3,988</u>	<u>35,409</u>
Changes in the composition of the Group										(123)		(123)	(123)
Dividends for 2002										(102)		(102)	(102)
Unappropriated net income (loss) carried forward				(24,587)	24,587		—		—				—
Stock issued on exercise of stock options, warrants and exchange rights		15					15		15	370		370	15
Income after taxes					1,253		1,253		1,253			370	1,623
Difference from currency translation						(2,938)	(2,938)		(2,938)		(80)	(80)	(3,018)
<b>Balance at Dec. 31, 2003.</b>	<u>10,746</u>	<u>50,092</u>	<u>248</u>	<u>(24,564)</u>	<u>1,253</u>	<u>(8,017)</u>	<u>29,758</u>	<u>(7)</u>	<u>29,751</u>	<u>4,384</u>	<u>(331)</u>	<u>4,053</u>	<u>33,804</u>

(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.

## STATEMENT OF SEGMENT REPORTING

		<u>Net revenue</u>	<u>Revenue between segments</u>	<u>Depreciation and amortization</u>	<u>Net interest income/ (expense)</u>	<u>Income/ (loss) related to associated and related companies</u>	<u>Income/ (loss) before income taxes</u>	<u>Segment assets</u>	<u>Segment investments</u>	<u>Segment liabilities</u>	<u>Employees<sup>(2)</sup></u>
T-Com <sup>(1)</sup> . . . . .	2003	25,116	4,090	(5,169)	(315)	(412)	4,247	29,030	2,324	4,549	139,548
	2002	26,491	4,068	(5,539)	(562)	(304)	3,604	33,782	3,273	13,120	153,065
	2001	26,427	3,401	(5,444)	(346)	(509)	4,673				
T-Mobile <sup>(1)</sup> . . . . .	2003	21,572	1,206	(5,196)	(992)	97	831	50,025	3,813	17,617	41,767
	2002	18,339	1,396	(27,285)	(1,005)	(427)	(23,754)	57,655	5,766	20,224	38,943
	2001	13,101	1,536	(6,324)	(3,008)	(204)	(6,441)				
T-Systems <sup>(1)</sup> . . . . .	2003	7,184	3,430	(1,499)	(39)	(4)	(138)	5,665	708	4,314	42,108
	2002	6,895	3,594	(2,616)	(98)	(20)	(1,990)	6,646	3,551	5,268	43,482
	2001	7,121	3,700	(1,372)	102	13	(389)				
T-Online <sup>(1)(3)</sup> . . . . .	2003	1,662	189	(430)	110	90	104	1,532	116	212	2,637
	2002	1,391	193	(435)	128	(265)	(471)	1,797	170	119	2,536
	2001	1,027	113	(416)	164	(381)	(820)				
<b>Group</b>											
<b>Headquarters &amp; Shared Services . . . . .</b>											
	2003	304	3,964	(881)	(2,874)	(3)	(4,071)	10,631	455	41,334	25,203
	2002	573	3,838	(1,298)	(2,510)	(1,093)	(4,690)	12,978	551	34,539	17,870
	2001	633	4,481	(1,447)	(1,102)	(375)	402				
Reconciliation <sup>(1)</sup> . . . . .	2003	0	(12,879)	291	334	(23)	425	(1,232)	(349)	(3,255)	—
	2002	0	(13,089)	293	(1)	135	151	(1,332)	(149)	(844)	—
	2001	0	(13,231)	(218)	52	246	14				
Group . . . . .	2003	55,838	0	(12,884)	(3,776)	(255)	1,398	95,651	7,067	64,771	251,263
	2002	53,689	0	(36,880)	(4,048)	(1,974)	(27,150)	111,526	13,162	72,426	255,896
	2001	48,309	0	(15,221)	(4,138)	(1,210)	(2,561)				

(1) According to new structure (see note (36) Segment reporting).

(2) Average number of employees for the year

(3) Figures are calculated in accordance with German GAAP, as applied throughout the Deutsche Telekom Group, and differ from those published in the reports of T-Online International AG under International Financial Reporting Standards (“IFRS”)

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

SCHEDULE OF CONSOLIDATED NONCURRENT ASSETS

millions of €	Acquisition or production costs							Depreciation, amortization, and write-downs							Net carrying amount		
	Jan. 1, 2003	Translation adjustment	Changes in the composition of the Telekom Group	Additions	Disposals	Reclassifications	Dec. 31, 2003	Jan. 1, 2003	Translation adjustment	Changes in the composition of the Telekom Group	Additions	Disposals	Reclassifications	Write-ups	Dec. 31, 2003	Dec. 31, 2003	Dec. 31, 2002
<b>Intangible assets</b>																	
Concessions, industrial and similar rights and assets, and licenses in such rights and assets . . . . .	40,774	(4,055)	(79)	681	752	297	36,866	16,937	(2,022)	(62)	2,157	728	(22)	0	16,260	20,606	23,837
of which: UMTS licenses . . . . .	15,371	(483)	0	0	0	0	14,888	4,254	(223)	0	597	0	0	0	4,628	10,260	11,117
of which: FCC licenses . . . . .	20,273	(3,398)	14	20	17	(16)	16,876	9,909	(1,712)	0	516	16	0	0	8,697	8,179	10,364
of which: GSM licenses . . . . .	741	(4)	0	0	0	0	737	206	(1)	0	48	0	0	0	253	484	535
of which: other assets . . . . .	4,389	(170)	(93)	661	735	313	4,365	2,568	(86)	(62)	996	712	(22)	0	2,682	1,683	1,821
Goodwill . . . . .	46,875	(4,331)	(41)	150	969	0	41,684	17,439	(1,934)	(41)	2,521	814	0	0	17,171	24,513	29,436
Advance payments . . . . .	134	1	0	2	14	(48)	75	5	0	0	0	4	0	0	1	74	129
	<u>87,783</u>	<u>(8,385)</u>	<u>(120)</u>	<u>833</u>	<u>1,735</u>	<u>249</u>	<u>78,625</u>	<u>34,381</u>	<u>(3,956)</u>	<u>(103)</u>	<u>4,678</u>	<u>1,546</u>	<u>(22)</u>	<u>0</u>	<u>33,432</u>	<u>45,193</u>	<u>53,402</u>
<b>Property, plant, and equipment</b>																	
Land and equivalent rights, and buildings including buildings on land owned by third parties . . . . .	18,779	(99)	(2)	199	1,288	423	18,012	7,417	(25)	(1)	743	600	87	8	7,613	10,399	11,362
Technical equipment and machinery . . . . .	86,460	(1,490)	(3,954)	2,267	1,786	1,658	83,155	48,426	(506)	(2,588)	6,700	1,630	(38)	1	50,363	32,792	38,034
Other equipment, plant, and office equipment . . . . .	6,573	(189)	(256)	456	466	253	6,371	4,287	(100)	(226)	763	365	(26)	0	4,333	2,038	2,286
Advance payments and construction in progress . . . . .	2,274	(184)	(19)	2,629	78	(2,583)	2,039	1	0	0	0	0	(1)	0	0	2,039	2,273
	<u>114,086</u>	<u>(1,962)</u>	<u>(4,231)</u>	<u>5,551</u>	<u>3,618</u>	<u>(249)</u>	<u>109,577</u>	<u>60,131</u>	<u>(631)</u>	<u>(2,815)</u>	<u>8,206</u>	<u>2,595</u>	<u>22</u>	<u>9</u>	<u>62,309</u>	<u>47,268</u>	<u>53,955</u>
<b>Financial assets</b>																	
Investments in unconsolidated subsidiaries . . . . .	310	(2)	39	9	33	(1)	322	161	0	32	22	11	0	0	204	118	149
Loans to unconsolidated subsidiaries . . . . .	58	0	(57)	0	0	0	1	0	0	0	0	0	0	0	1	58	
Investments in associated companies . . . . .	3,151	(409)	(28)	607	503	(44)	2,774	558	(41)	(8)	94	88	(43)	84	388	2,386	2,593
Other investments in related companies . . . . .	1,488	(14)	0	4	852	45	671	467	(5)	1	3	327	43	7	175	496	1,021
Long-term loans to associated and related companies . . . . .	800	(1)	0	24	490	0	333	797	0	0	0	489	0	0	308	25	3
Other investments in noncurrent securities . . . . .	622	(1)	46	3	584	0	86	384	0	0	9	393	0	0	0	86	238
Other long-term loans . . . . .	121	(4)	(42)	36	19	0	92	14	0	0	0	0	0	0	14	78	107
	<u>6,550</u>	<u>(431)</u>	<u>(42)</u>	<u>683</u>	<u>2,481</u>	<u>0</u>	<u>4,279</u>	<u>2,381</u>	<u>(46)</u>	<u>25</u>	<u>128</u>	<u>1,308</u>	<u>0</u>	<u>91</u>	<u>1,089</u>	<u>3,190</u>	<u>4,169</u>
	<u>208,419</u>	<u>(10,778)</u>	<u>(4,393)</u>	<u>7,067</u>	<u>7,834</u>	<u>0</u>	<u>192,481</u>	<u>96,893</u>	<u>(4,633)</u>	<u>(2,893)</u>	<u>13,012</u>	<u>5,449</u>	<u>0</u>	<u>100</u>	<u>96,830</u>	<u>95,651</u>	<u>111,526</u>

The consolidated noncurrent assets schedule is part of the notes to the consolidated financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Summary of Accounting Policies

#### Description of Business and Relationship with the Federal Republic of Germany

The Deutsche Telekom Group (hereafter referred to as Deutsche Telekom, the Group or the Company) is one of the world's leading companies in the telecommunications industry. With its four divisions T-Com, T-Mobile, T-Systems, and T-Online, Deutsche Telekom offers a full range of state-of-the-art telecommunications services.

**T-Com** is responsible for Deutsche Telekom's fixed-network business, where it is one of Europe's largest operators. T-Com provides network-related services to all of Deutsche Telekom's divisions, as well as approximately 200 telecommunications companies. In Germany, T-Com serves residential and business customers with a broad range of products and services. Small and medium-sized enterprises (SMEs) benefit from T-Com's end-to-end, integrated IT and telecom solutions.

T-Com is present within Central and Eastern Europe through its shareholdings in Magyar Távközlési (Matáv) (Hungary), HT-Hrvatske telekommunikacije (Croatia), and Slovak Telecom (Slovakia) (formerly Slovenské Telekomunikácie).

The DeTeMedien business previously reported within the T-Online division has been reported within the T-Com division since January 1, 2003. T-Com has operated as an independent brand under the umbrella of the Deutsche Telekom Group since August 1, 2003.

**T-Mobile's** business combines all the activities of the T-Mobile International group. Through its operating subsidiaries, T-Mobile operates a transatlantic GSM mobile communications network and thus offers the advantages of a standardized technical platform for a broad range of customers mainly in Germany, the United Kingdom, the United States, Austria, the Czech Republic, and the Netherlands. T-Mobile is also represented in the Polish and Russian markets through its equity investments in the mobile communications companies Polska Telefonia Cyfrowa (PTC) and OJCS Mobile TeleSystems (MTS).

**T-Systems** provides Deutsche Telekom's national and international key accounts with customized information and communication technology (ICT) solutions. T-Systems provides the infrastructure needed to do this, implements customer solutions, and operates end-to-end business processes based on these solutions if required. T-Systems is represented in over 20 countries around the world by branch offices and its own national companies.

**T-Online** is one of the leading Internet service providers in Germany. T-Online operates a combined business model within Deutsche Telekom, that consists of the access business as well as content, services, e-commerce, and advertising. T-Online is represented through its operating subsidiaries in France and Spain and certain other European countries.

The DeTeMedien business previously included in the T-Online division has been reported in the T-Com division since January 1, 2003.

**Group Headquarters and Shared Services** includes all other group units which are not directly allocable to the divisions. During 2003, Deutsche Telekom completed its reorganization to create a virtual Strategic Management Holding. As part of this reorganization, the unit previously reported as "Other" has been renamed "Group Headquarters and Shared Services." Group Headquarters now focuses on strategic and cross-divisional management functions. All other operating functions not directly related to the divisions' core businesses are now performed by Shared Services. In particular, these include subsidiaries and shared services, such as real estate, billing services, fleet management, and Vivento (formerly PSA).

The Company was registered as Deutsche Telekom AG 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, 2003 amounted to 42.77 percent. In accordance with the letter dated January 12, 2004, the direct shareholding amounted to 26.03 percent (1,092,721,315 shares); an additional 16.74 percent (702,704,750 shares) are held by a federal corporation, Kreditanstalt für Wiederaufbau, Frankfurt/Main, (KfW), in accordance with the letter dated January 20, 2004. The Federal Republic



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

administers its shareholding and exercises its rights as a shareholder through a public law entity, the Bundesanstalt für 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 (BMWA), supervises the telecommunications sector in Germany and in this capacity regulates the business activities of Deutsche Telekom.

The Federal Republic of Germany is a customer of Deutsche Telekom; it sources services from the Company on an arm's length basis. 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. Revenues from services provided to individual departments or agencies do not represent a significant component of Deutsche Telekom's net revenues.

### Summary of Significant Accounting Principles

The consolidated financial statements and the group 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”, and the German Stock Corporation Act (Aktiengesetz — AktG). In general, Deutsche Telekom applies the relevant German Accounting Standards (GASs), but reserves the right to diverge from these standards where it believes that non-application is justified. At present, the Company has not adopted the revaluation method for capital consolidation (required by GAS 4) and changes in accounting for “Deferred taxes in consolidated financial statements” (GAS 10).

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 Depository 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 accompanying consolidated financial statements also differ from consolidated financial statements prepared in accordance with U.S. GAAP where the classification and presentation requirements of German GAAP (§§ 298 in conjunction with 266 and 275 HGB) are binding. Differences between accounting and measurement principles applied in Deutsche Telekom's consolidated financial statements and those of U.S. GAAP are presented as a separate reconciliation to supplement the consolidated financial statements, and explained in detail in the notes 41 through 44.

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.

In 2003 the statement of operations format has been changed to reflect the cost-of-sales method (in accordance with § 275 (3) HGB). This format compares net revenue with the expenses incurred to generate those revenues, classified into cost of sales, selling, and general and administrative functions. The classification of the consolidated statement of operations using the cost-of-sales method is designed to enhance the international comparability of financial reporting.

Unless otherwise noted all amounts shown are in millions of euro. Certain items have been combined for presentation purposes in the statement of operations and the consolidated balance sheets in order to make the financial statements more informative and understandable. These items are disclosed separately in the notes. In the case of changes in presentation, prior-year amounts have been reclassified to conform with the current-year presentation. In accordance with § 297 (1) sentence 2 HGB, the consolidated financial statements also include consolidated statements of cash flows, consolidated statements of shareholders' equity, and segment reports.

The single-entity financial statements included in the consolidated financial statements were prepared in accordance with uniform Group accounting policies. The accounting policies used in the consolidated financial statements differ from those used in the single-entity financial statements of Deutsche Telekom AG. Such differences, mostly applied to conform with U.S. GAAP, include the following:

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

- 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 (primarily excluding sale and lease back transactions) are recognized at cost. Scheduled depreciation is recorded over the 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 expense incurred during the construction of items of property, plant and equipment has been capitalized as part of these assets' costs.
- No accruals are recorded for internal year-end closing expenses to be incurred after year-end.
- Investment grants received are recorded as reductions of the acquisition costs of invested assets.

The single-entity financial statements of Deutsche Telekom AG as well as the consolidated financial statements of the Deutsche Telekom Group are published in the Federal Gazette (*Bundesanzeiger*) and filed under HRB 6794 with the Commercial Registry of the Bonn District Court.

### Consolidated Group

The consolidated financial statements are comprised of the accounts of Deutsche Telekom AG and its subsidiaries.

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 holds majority voting rights or management control.
- Associated companies are companies in which Deutsche Telekom directly or indirectly holds between 20 and 50 percent 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 percent of the voting rights are carried in the consolidated financial statements at the lower of cost or market value and classified as "Other investments in related companies."

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The changes in the composition of the Deutsche Telekom Group in 2003 are presented in the following table:

	<u>Domestic</u>	<u>International</u>	<u>Total</u>
<b>Consolidated subsidiaries</b>			
January 1, 2003 .....	101	260	361
Additions .....	4	11	15
Disposals .....	(42)	(22)	(64)
Reclassifications .....	<u>1</u>	<u>(3)</u>	<u>(2)</u>
December 31, 2003.....	<u>64</u>	<u>246</u>	<u>310</u>
<b>Associated companies included at equity</b>			
January 1, 2003 .....	22	27	49
Additions .....	3	3	6
Disposals .....	(7)	(6)	(13)
Reclassifications .....	<u>1</u>	<u>(2)</u>	<u>(1)</u>
December 31, 2003.....	<u>19</u>	<u>22</u>	<u>41</u>
<b>Other unconsolidated subsidiaries and other investments in related companies (greater than 5 %)</b>			
January 1, 2003 .....	89	48	137
Additions .....	25	4	29
Disposals .....	(25)	(16)	(41)
Reclassifications .....	<u>(2)</u>	<u>5</u>	<u>3</u>
December 31, 2003.....	<u>87</u>	<u>41</u>	<u>128</u>
<b>Total .....</b>			
January 1, 2003 .....	212	335	547
Additions .....	32	18	50
Disposals .....	(74)	(44)	(118)
Reclassifications .....	<u>0</u>	<u>0</u>	<u>0</u>
December 31, 2003.....	<u>170</u>	<u>309</u>	<u>479</u>

The consolidated financial statements include the financial statements of the parent company, Deutsche Telekom AG, as well as 64 (December 31, 2002: 101) domestic and 246 (December 31, 2002: 260) foreign subsidiaries in which Deutsche Telekom AG has a direct or indirect controlling interest.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The changes in the composition of the Deutsche Telekom Group have had the following effects on the consolidated financial statements:

Effects on the 2003 consolidated statement of operations:

	<b>For the year ended December 31, 2003</b> (millions of €)
Net revenue.....	(86)
Cost of sales.....	<u>144</u>
<b>Gross profit</b> .....	58
Selling costs.....	(129)
General and administrative costs.....	(21)
Other operating income.....	551
Other operating expenses.....	<u>(205)</u>
<b>Operating results</b> .....	254
Financial income (expense), net.....	<u>(54)</u>
<b>Results from ordinary business activities<sup>(1)</sup></b> .....	200
Income taxes.....	<u>(180)</u>
<b>Income after taxes</b> .....	<u>20</u>
(Income) loss applicable to minority shareholders.....	<u>0</u>
<b>Net income (loss)</b> .....	<u><u>20</u></u>

(1) Including other taxes in accordance with the classification of the statement of operations under the cost-of-sales method.

Effects on the 2003 consolidated balance sheet:

	<b>As of December 31, 2003</b> (millions of €)
<b>Assets</b>	
Noncurrent assets.....	(1,615)
Current assets, prepaid expenses and deferred charges.....	<u>1,425</u>
	<u>(190)</u>
<b>Shareholders' equity and liabilities</b>	
Shareholders' equity.....	248
Accruals.....	(49)
Liabilities and deferred income.....	<u>(389)</u>
	<u>(190)</u>

### Significant Changes in the Composition of the Deutsche Telekom Group

#### 2003:

Deutsche Telekom AG completed the sale of its cable activities in the six regions of Rhineland Palatinate/Saarland, Lower Saxony/Bremen, Berlin/Brandenburg, Bavaria, Hamburg/Schleswig-Holstein/Mecklenburg-Western Pomerania, and Saxony-Anhalt on March 13, 2003. These companies were sold for a total of EUR 1.7 billion to a consortium consisting of APEX, Goldman-Sachs Capital Partners, and Providence Equity. The companies were deconsolidated in the first quarter of 2003. The sale of the companies generated a gain of approximately EUR 0.4 billion.

T-Systems International GmbH sold TeleCash Kommunikations-Service GmbH for EUR 0.1 billion effective March 24, 2003 and deconsolidated the company in the first quarter of 2003. The disposition of this company generated a book gain of EUR 0.1 billion.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In early May 2003, T-Systems International GmbH disposed of its interest in T-Systems SIRIS S.A.S. for a price of EUR 30 million. This company was deconsolidated in the second quarter of 2003, and the transaction generated a gain of EUR 32 million.

### 2002:

Deutsche Telekom AG acquired the remaining shares of T-Systems ITS GmbH from DaimlerChrysler Services AG on March 4, 2002 via its T-Systems International GmbH subsidiary. The purchase price was EUR 4.7 billion. The goodwill of EUR 2.7 billion generated by this acquisition is being amortized on a straight-line basis over a period of up to ten years, corresponding to 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 percent. In November 2002, T-Systems International GmbH was combined with T-Systems ITS GmbH in a downstream merger. At the same time, T-Systems ITS GmbH was renamed T-Systems International GmbH.

On September 25, 2002, T-Mobile International AG, Bonn (herein referred to as T-Mobile International) acquired the remaining 50.0001 percent of the shares of the mobile communications company Ben Nederland Holding B.V. (renamed T-Mobile Netherlands Holding B.V. on February 25, 2003) from the company's other shareholders Belgacom, TDC, and Gringots (Crédit Suisse First Boston) for a purchase price of EUR 1.7 billion. In addition, T-Mobile International took over outstanding shareholder loans amounting to approximately EUR 0.3 billion. The goodwill of EUR 1.7 billion generated by this transaction was written down by EUR 1.0 billion as a result of the strategic review of net carrying amounts; the remaining amount is being amortized over a period of 12 years. T-Mobile Netherlands provides mobile communications services in the Netherlands. The company was included in the consolidated financial statements as a fully consolidated subsidiary for the first time as of September 30, 2002.

### 2001:

On January 15, 2001 Deutsche Telekom acquired 51 percent of the shares of the Macedonian telecommunications company Makedonski Telekomunikacii A.D., Skopje (referred to as Maktel below) via a subsidiary of Matáv. The acquisition costs amounted to EUR 302 million. Maktel was included in the subgroup financial statements of Matáv for the first time in the first quarter of 2001. The resulting goodwill of EUR 180 million is being amortized over a period of 20 years.

In April 2001, Deutsche Telekom increased its shareholding in the Czech mobile communications company T-Mobile Czech Republic, Prague (formerly RadioMobil) via CMobil B.V., Amsterdam, a subsidiary of T-Mobile International. The acquisition costs for this additional 11.77 percent stake amounted to EUR 598 million. CMobil's shareholding thus increased to 60.77 percent. The additional goodwill generated amounting to EUR 444 million is being amortized over a period of 12 years. T-Mobile Czech Republic was fully consolidated for the first time on April 1, 2001.

On May 31, 2001 Deutsche Telekom acquired 100 percent of the shares in Voicestream Wireless Corporation (T-Mobile USA) and Powertel, Inc. (Powertel) for a total purchase price of EUR 39.4 billion, including a cash component of EUR 4.9 billion and the initial investment in T-Mobile USA preferred stock amounting to EUR 5.6 billion that Deutsche Telekom had made in September 2000. T-Mobile USA provides communications services for private households 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 USD 15.7262 in cash, 3.6683 Deutsche Telekom shares and USD 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 fully consolidated for the first time on May 31, 2001. The consolidation of T-Mobile USA and Powertel generated goodwill totaling EUR 23.6 billion. This goodwill 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 conjunction with the acquisition of T-Mobile USA and Powertel, Deutsche Telekom granted rights to acquire a total of 43,619,261 no par value Deutsche Telekom shares in exchange for outstanding options, warrants and exchange rights for shares in T-Mobile USA and Powertel.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

On October 25, 2001, Deutsche Telekom AG acquired an additional 16 percent equity interest in 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 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 income (loss) under German GAAP (billions of €)</b>		
Reported .....	(24.6)	(3.5)
Pro forma.....	(24.9)	(6.9)
<b>Earnings (loss) per share under German GAAP (€)</b>		
Reported .....	(5.86)	(0.93)
Pro forma.....	(5.93)	(1.85)

At December 31, 2003 and 2002, 88 and 77 subsidiaries, respectively, were not consolidated because they were not material to the net worth, financial position, and results of the Deutsche Telekom Group.

At December 31, 2003, in accordance with § 311 (1) HGB, 41 (December 31, 2002: 49) companies over which Deutsche Telekom exercises significant influence have been classified as associated companies and are accounted for using the equity method. The remaining 30 (December 31, 2002: 35) 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, and are carried at acquisition cost adjusted for applicable write-downs and reversals to the extent of previously recognized write-downs.

The full list of investment holdings is filed with the Commercial Registry of the Bonn District Court (HRB 6794). Furthermore, the list of investment holdings includes a full list of all subsidiaries that exercise disclosure simplification options in accordance with § 264 (3) HGB.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Principal Subsidiaries and Associated Companies**

The principal subsidiaries and associated companies whose revenues and results, together with Deutsche Telekom AG, account for more than 90 percent of the results of operations and financial position of the Group are shown in the table below:

<u>Name and registered office</u>	<u>Deutsche Telekom share December 31, 2003</u> (%)	<u>Shareholders' equity December 31, 2003</u> (millions of €)	<u>Revenue 2003</u> (millions of €)	<u>Income/loss after taxes 2003</u>	<u>Employees 2003</u> (annual average)
<b>Fully consolidated subsidiaries</b>					
<b>T-Mobile Deutschland</b> GmbH, Bonn <sup>(2)</sup> . . .	100.00	1,456	8,479	2,273	8,812
<b>T-Mobile Holdings</b> Ltd., Hatfield, United Kingdom <sup>(1)(3)</sup> . . . . .	100.00	7,523	4,303	(613)	6,201
<b>T-Mobile Austria</b> GmbH, Vienna, Austria <sup>(1)(4)</sup> . . . . .	100.00	462	1,098	73	2,540
<b>T-Mobile USA, Inc.</b> , Bellevue, Washington, United States <sup>(1)(2)</sup> . . . . .	100.00	13,351	7,416	(1,298)	19,372
<b>T-Mobile Czech Republic</b> a.s., Prague, Czech Republic <sup>(5)</sup> . . . . .	60.77	515	768	139	2,532
<b>T-Mobile Netherlands Holding</b> B.V., The Hague, Netherlands <sup>(1)(3)</sup> . . . . .	100.00	326	861	(76)	1,418
<b>T-Online International</b> AG, Darmstadt <sup>(1)</sup> .	73.94	5,367	1,851	0	2,638
<b>T-Systems International</b> GmbH, Frankfurt/Main . . . . .	100.00	1,179	6,325	531	12,351
<b>T-Systems CDS</b> GmbH, Darmstadt <sup>(6)</sup> . . . . .	100.00	260	1,981	323	6,697
<b>T-Systems GEI</b> GmbH, Aachen <sup>(6)</sup> . . . . .	100.00	80	546	58	4,085
<b>T-Systems PCM</b> GmbH, Feldkirchen <sup>(6)</sup> . . .	100.00	30	491	22	1,582
<b>GMG Generalmietgesellschaft</b> mbH, Münster . . . . .	100.00	264	2,340	(290)	0
<b>DeTeImmobilien</b> , Deutsche Telekom Immobilien und Service GmbH, Münster . . . . .	100.00	11	941	(12)	6,647
<b>Deutsche Telekom Network Projects &amp; Services</b> GmbH, Bonn <sup>(1)</sup> . . . . .	100.00	533	1,066	56	2,710
<b>Matáv Magyar Távközlési Rt.</b> , Budapest, Hungary <sup>(1)(7)</sup> . . . . .	59.49	2,362	2,396	319	15,178
<b>Slovak Telecom a.s.</b> (formerly: Slovenské Telekomunikácie, a.s.), Bratislava, Slovakia <sup>(1)</sup> . . . . .	51.00	1,175	431	89	8,091
<b>HT-Hrvatske telekomunikacije</b> d.d., Zagreb, Croatia <sup>(1)</sup> . . . . .	51.00	1,895	1,036	193	9,708
<b>Associated companies</b>					
<b>MTS, OJSC Mobile TeleSystems</b> , Moscow, Russia <sup>(1)(8)(10)(11)</sup> . . . . .	25.15	1,152	1,205	245	11,042
<b>PTC, Polska Telefonia Cyfrowa</b> Sp.z o.o., Warsaw, Poland <sup>(1)(9)(10)(11)</sup> . . . . .	49.00	308	1,121	79	3,643

- (1) Consolidated subgroup financial statements
- (2) Indirect shareholding via T-Mobile International AG & Co. KG, Bonn (Deutsche Telekom AG's indirect share: 100%)
- (3) Indirect shareholding via T-Mobile Global Holding GmbH, Bonn (Deutsche Telekom AG's indirect share: 100%)
- (4) Indirect shareholding via T-Mobile Global Holding Nr. 2 GmbH, Bonn (Deutsche Telekom AG's indirect share: 100%)
- (5) Indirect shareholding via CMobil B.V., Amsterdam (Deutsche Telekom AG's indirect share: 92.14%)
- (6) Indirect shareholding via T-Systems International GmbH, Frankfurt/Main (Deutsche Telekom AG's share: 100%)
- (7) Indirect shareholding via MagyarCom Holding GmbH, Bonn (Deutsche Telekom AG's share: 100%)
- (8) Indirect shareholding via T-Mobile Worldwide Holding GmbH, Bonn (Deutsche Telekom AG's share: 100%)
- (9) Indirect shareholding via T-Mobile Deutschland GmbH, Bonn; Mediaone International B.V., Eindhoven; and Polpajer Sp.z o.o., Warsaw (Deutsche Telekom AG's indirect share: 100% each)
- (10) 2002 financial year. The amounts included in the consolidated financial statements are based on the 2003 financial year results.
- (11) Employees at balance sheet date at end of 2002

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### 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 value of net assets acquired is capitalized as goodwill and amortized over its 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 (deficit). They also include the consolidation adjustments recognized in the statement of operations 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 statement of operations; 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 of the companies included in the consolidated 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 measured at the corresponding hedge rate.

The financial statements of foreign subsidiaries are translated using the functional currency method. 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 exchange rates for the respective period.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The exchange rates of certain significant currencies changed as follows:

	Average Rate			Spot Rate	
	2003	2002	2001	Dec. 31, 2003	Dec. 31, 2002
		(€)			(€)
100 Swiss Francs (CHF) . . . . .	65.76650	68.15990	66.20630	64.15200	68.73340
100 Czech Koruna (CZK) . . . . .	3.14101	3.24851	2.90920	3.08873	3.18167
1 Pound Sterling (GBP) . . . . .	1.44585	1.59101	1.60761	1.41663	1.53635
100 Croatian Kuna (HRK) . . . . .	13.21220	13.49190	13.36850	13.11000	13.37340
1000 Hungarian Forints (HUF) . . . . .	3.94347	4.11657	3.90371	3.79407	4.23909
1000 Japanese Yen (JPY) . . . . .	7.64138	8.47821	9.16991	7.42171	8.03280
100 Malaysian Ringgit (MYR) . . . . .	23.28190	27.93620	29.39340	20.89500	25.07720
100 Philippine Pesos (PHP) . . . . .	1.63218	2.08452	2.19127	1.44055	1.79995
100 Polish Zloty (PLN) . . . . .	22.73590	25.99300	27.22010	21.27500	24.99940
100 Russian Ruble (RUB) . . . . .	2.88655	3.38456	3.82700	2.71500	2.98257
100 Singapore Dollars (SGD) . . . . .	50.70260	59.22700	62.55940	46.72500	55.34030
100 Slovak Koruna (SKK) . . . . .	2.41004	2.34284	2.30987	2.43000	2.41429
1 U.S. Dollar (USD) . . . . .	0.88492	1.06158	1.11683	0.79340	0.95293

### Accounting Policies

**Net revenues** consist of goods and services sold in connection with the ordinary business activities of Deutsche Telekom. Net revenues are recorded net of value-added tax (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 for 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 are recognized when the products are delivered, 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-Mobile

Mobile revenues include revenues from the rendering 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-Systems

##### Telecommunication Services

Telecommunication Services include "Network Services" which consists of "Hosting and ASP Services", "Global Synergy, Strategy, and Solution" and "Media and Broadcast." Telecommunications services also include "International Carrier Sales and Solutions" and "Global Network Factory." 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,

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

billed on a per-minute basis, and data services, billed on a bandwidth basis, are recognized under such contracts when used by the customer. Revenues from Carrier Services and Hosting and ASP Services 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 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 on a similar basis to time and material service contracts. Revenue from maintenance services is recognized over the contractual period or as the services are performed.

In some of the Company's services 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 statement of operations.

Revenue from hardware sales or sales-type leases is recognized when the product is shipped to the customer, 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 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-Online

T-Online revenues consist primarily of revenues from subscriber fees, and charges for advertising and e-commerce. 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. Transaction revenues are recognized upon notification from the customer that qualifying transactions have occurred and collection of the resulting receivable is reasonably assured.

**Cost of sales** comprises the aggregate cost relating to the revenues recognized from products and services sold in the relevant year. In addition to directly attributable costs, such as direct material and labor costs, cost of sales also includes indirect costs, including depreciation and amortization.

**Selling costs** comprise all costs of activities that do not directly increase the value of the Company's products and services, but serve to secure sales. Selling costs include the costs of all sales, advertising, and marketing departments.

**General and administrative costs** generally include all expenses attributable to the core administrative functions that cannot be allocated directly to the production or selling process.

**Research and development costs** are expensed in full as incurred and amounted to approximately EUR 0.9 billion, EUR 0.9 billion and EUR 0.9 billion for the years ended December 31, 2003, 2002 and 2001, respectively.

**Pension costs** for defined benefit plans are actuarially computed using the projected unit credit method in accordance with SFAS No. 87, and are presented in accordance with SFAS No. 132 (as revised in 2003). This method is based on the total present value of the benefit obligations



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 (see note (28) 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 plan 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 record an additional minimum liability (AML), 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 component; therefore, changes in the additional minimum liability are expensed in the period of change.

**Marketing expenses** are expensed as incurred and amounted to approximately EUR 1.5 billion, EUR 2.2 billion and EUR 1.9 billion for the years ended December 31, 2003, 2002 and 2001, respectively.

**Income tax benefit (expenses)** includes current income taxes payable as well as deferred taxes. Deferred income taxes are recognized for the expected future tax effects attributable to temporary differences between the carrying amounts in the tax accounts and in the financial statements, except for the effects of those differences that are not expected to reverse in the foreseeable future. Due to the minimum taxation provision (i.e. companies are required to pay income tax on at least 40 percent of their taxable income regardless of net operating loss carry forwards that are available) in effect from the 2004 financial year, deferred taxes are recognized for only 40 percent of the differences in Deutsche Telekom AG's income tax consolidation group that are offset within the expected net operating loss carryforward periods. Such differences may arise at the individual taxable entity level as well as in the consolidated financial statements as a result of measurement and consolidation adjustments. 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 a taxable entity prior to its privatization on January 1, 1995, and benefited from an essentially complete exemption from tax in 1995.

**Earnings (loss) per share** for each period are calculated by dividing net income (loss) by the weighted average number of ordinary registered shares outstanding during that period. The weighted average number of ordinary registered shares in 2001 was calculated after recognizing the effect of the issuance of shares as part of the acquisition of T-Mobile USA and Powertel and the start of trading in these shares on June 4, 2001 in Frankfurt/Main, including those shares that are held on a trust basis for later issue and later trading as registered ordinary shares or ADRs.

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 useful life.

Deutsche Telekom tests for possible impairment on the goodwill of subsidiaries for which a considerable level of goodwill is recorded. These tests are based on the calculation of the enterprise value of 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 were recorded in the opening balance sheet of Deutsche Telekom AG at their fair market values at that date. However, due to the short period of time that had elapsed since the measurement date for the items of property, plant, and equipment acquired since January 1, 1993, their carrying amount as of 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 cost.

Other property, plant, and equipment is carried at acquisition or construction cost, less depreciation. Construction cost includes directly attributable costs, an appropriate allocation of

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

material and production overhead, and interest accruing during construction. General and administrative 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.

Noncurrent assets are depreciated or amortized using the straight-line method over the following estimated useful lives:

	<u>Years</u>
Mobile communications licenses	
UMTS licenses .....	20 to 22
FCC licenses .....	20
GSM licenses .....	10 to 20
Goodwill .....	3 to 20
Other intangible assets .....	2 to 7
Buildings .....	25 to 50
Shop improvements .....	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
Broadband distribution networks, outside plant networks and cable conduit lines ...	15 to 35
Telecommunications power facilities and other .....	3 to 10
Other equipment, plant, and office equipment .....	3 to 23

Additions to real estate are depreciated ratably in the year of acquisition. For assets other than buildings acquired in the first half of a year, the full-year rate of depreciation is charged in the year of acquisition and, for those assets acquired in the second half of the year, half the full-year rate of depreciation is charged. This methodology does not result in a significant difference to depreciation amounts calculated had depreciation commenced when the asset was placed in service.

Items with low acquisition cost are expensed in the year acquired.

Maintenance and repair costs are expensed as incurred.

Noncurrent assets are sold or otherwise disposed of at their relevant carrying amount (cost less accumulated depreciation). A gain or loss is recognized in results from operations for the difference between the sale consideration and the carrying amount of the disposed asset.

**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. 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 measured at acquisition cost, while **work in process and finished goods** are carried at production cost. Based on normal capacity utilization, production cost includes directly attributable costs, such as direct material and labor costs, as well as special production costs, plus an appropriate pro rata allocation of indirect material and labor costs and straight-line depreciation. General and administrative, and selling costs, social amenities expenses, as well as voluntary benefits to personnel, including pensions, are not generally included in production costs. 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. See Note (16) Inventories, Materials and Supplies.

**Receivables and other assets** are carried at their nominal value. Identifiable 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 to maturity are discounted.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Marketable securities** are carried 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 recognized at the date the options are exercised, and not at the grant date. At the time the options are exercised, the amount received by the Company is transferred to capital stock in the amount of the corresponding nominal capital increase and a value of an additional amount to 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 presented in accordance with SFAS No. 132 (as revised in 2003).

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 tax and other accruals**, including those for contingent losses and environmental liabilities, are computed in line with prudent commercial practice. Sufficient allowance was made for all identifiable risks when assessing these provisions and accruals.

**Deferred taxes** are calculated for the expected tax effects of temporary differences between balance sheet amounts in the financial statements and the amounts used for tax reporting purposes, as well as for the temporary differences arising from consolidation adjustments. Deferred taxes are offset and the balance is reported separately either as a deferred tax asset, or as a deferred tax liability reported 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 assessment national rate), and the solidarity surcharge (Solidaritätszuschlag); the respective local tax rate is used for foreign companies. Deferred taxes are not recognized if the temporary difference will reverse during a period covered by a net operating loss carryforward.

**Cost accruals** are only recognized by Deutsche Telekom when there is an obligation to carry such liabilities in the balance sheet pursuant to § 249 (1) HGB. These relate mainly to accruals for costs of maintenance work deferred in the financial year but carried out within the first three months of the following year.

No accruals are discounted, with the exception of pensions and similar obligations, accruals for future funding obligations for shortfalls in the Civil Service Health Insurance Fund, and accruals for long-term contingent losses.

**Liabilities** are carried 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 the disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses recognized during the reporting periods. Actual results could differ from those estimates.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**NOTES TO THE CONSOLIDATED STATEMENTS OF OPERATIONS**

**(1) Net Revenue**

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(millions of €)		
T-Com <sup>(1)</sup> .....	25,116	26,491	26,427
T-Mobile <sup>(1)</sup> .....	21,572	18,339	13,101
T-Systems <sup>(1)</sup> .....	7,184	6,895	7,121
T-Online <sup>(1)(2)</sup> .....	1,662	1,391	1,027
Group Headquarters & Shared Services .....	<u>304</u>	<u>573</u>	<u>633</u>
	<u>55,838</u>	<u>53,689</u>	<u>48,309</u>

(1) Net revenue according to new structure (see note (36) Segment Reporting).

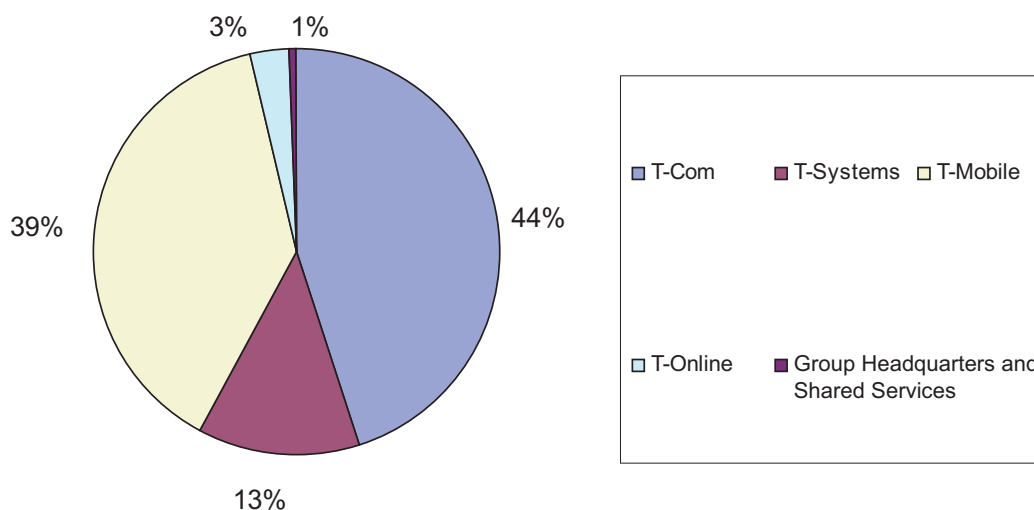
(2) Figures are calculated in accordance with German GAAP, as applied throughout the Deutsche Telekom Group, and differ from those published in the reports of T-Online International AG under International Financial Reporting Standards.

**Revenue by Geographic Area:**

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(millions of €)		
Domestic .....	34,691	35,288	35,107
International .....	<u>21,147</u>	<u>18,401</u>	<u>13,202</u>
	<u>55,838</u>	<u>53,689</u>	<u>48,309</u>
Breakdown of international net revenue:			
European Union (excl. Germany) .....	7,962	6,836	6,088
Rest of Europe .....	5,118	5,067	3,787
North America .....	7,610	6,166	3,066
Latin America .....	69	74	85
Other .....	<u>388</u>	<u>258</u>	<u>176</u>
	<u>21,147</u>	<u>18,401</u>	<u>13,202</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The percentage of the individual revenue segments in relation to net revenue is as follows:



Net revenue rose by EUR 2,149 million or 4.0 percent year-on-year despite unfavorable exchange rate trends.

This figure also includes the effect of changes in the composition of the Group, which reduced net revenue by a total of EUR 86 million.

Regulatory decisions and a weak economic environment resulted in a decrease in revenue at T-Com. Further, the deconsolidation of the cable companies contributed to the decline in revenues.

Sustained high growth in subscriber numbers was again the driving force behind the increased revenue at T-Mobile. Changes in the composition of the consolidated group (T-Mobile Netherlands) also had a positive effect on revenue growth.

Positive developments in the telecommunications sector increased revenue at T-Systems, more than offsetting the slight decline in the IT business. This increase in revenue was partially offset by the effect of deconsolidations, in particular of TeleCash and SIRIS.

Revenue growth at T-Online was driven primarily by an expanded customer base, especially for broadband services, coupled with stronger demand for content and services, and the resulting increase in time spent online.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (2) Cost of Sales

The cost of sales, which mainly relates to the T-Com and T-Mobile divisions, fell by EUR 13.1 billion year-on-year to EUR 31.4 billion.

This is primarily due to a decrease in the amortization of mobile communications licenses that is included in cost of sales. As a result of the strategic review carried out in 2002, cost of sales was impacted by nonscheduled amortization of mobile communications licenses held by T-Mobile USA and T-Mobile UK totaling EUR 11.6 billion.

Changes in the composition of the Deutsche Telekom Group in 2003 further reduced cost of sales by EUR 0.1 billion.

### (3) Selling Costs

Selling costs increased by EUR 0.2 billion year-on-year to EUR 13.5 billion, of which EUR 0.1 billion are attributable to changes in the composition of the Group. Based on net revenues generated, however, the ratio of selling costs to net revenues decreased from 24.7 percent to 24.2 percent.

The T-Mobile division accounts for the majority of selling costs and the year-on-year increase. This increase is attributable to the full-year consolidation of T-Mobile Netherlands for the first time and higher expenses for marketing and commissions. This is partially offset by lower losses on accounts receivable and provisions for doubtful accounts at T-Com in particular.

### (4) General and Administrative Costs

General and administrative costs decreased year-on-year by EUR 1.1 billion to EUR 5.0 billion. This is equivalent to a 17.9 percent reduction on the prior-year figure. The factors behind this development include efficiency improvements and a decrease in other taxes (see note (12) Other Taxes).

### (5) Other Operating Income

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<small>(millions of €)</small>		
Gain on sales of noncurrent assets (including sale of investments) .....	1,464	818	1,584
Reversal of accruals .....	804	791	1,139
Income from the reversal of valuation adjustments (including asset-backed securities) .....	688	556	288
Cost reimbursements .....	367	388	255
Foreign currency transaction gains .....	291	222	533
Insurance compensation .....	63	77	46
Refund of value-added tax (§ 15a Value-Added Tax Act - UStG) .....	54	68	85
Gain on sales of marketable securities .....	2	1	1,967
Other income .....	825	980	722
	<b>4,558</b>	<b>3,901</b>	<b>6,619</b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The increase in other operating income is due primarily to higher gains from dispositions of noncurrent assets of approximately EUR 1.5 billion. EUR 0.4 billion of this amount is attributable to the sale of the remaining cable activities, EUR 0.4 billion to the sale of shares in MTS, and approximately EUR 0.1 billion each to the sale of TeleCash, Globe Telekom, and Eutelsat.

Amounts reported in the previous year relate to the sale of Satelindo (EUR 0.2 billion) and the sale of T-Online shares (approximately EUR 0.3 billion).

The increase in income from the reversal of valuation adjustments recorded in prior years amounting to approximately EUR 0.1 billion relates primarily to the receipt of cash on residual interests from asset-backed securitization (ABS) transaction at the T-System division.

Of the total amount of other operating income, EUR 2,680 million (2002: EUR 1,342 million; 2001: EUR 1,897 million) relates to income recognized on transactions consummated in prior years.

### (6) Other Operating Expenses

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
Amortization of goodwill . . . . .	2,521	13,108	3,663
Losses from the disposition of noncurrent assets (including sale of investments) . . . . .	323	390	478
Foreign currency translation losses . . . . .	307	310	333
Other expenses . . . . .	1,933	1,107	604
	<b>5,084</b>	<b>14,915</b>	<b>5,078</b>

Other operating expenses decreased by EUR 9.8 billion year-on-year to EUR 5,084 million. This is attributable to the lower amortization of goodwill which, in 2002, consisted mainly of nonscheduled amortization on the goodwill of T-Mobile USA (EUR 8.3 billion), T-Mobile Netherlands (EUR 1.0 billion), and SIRIS (EUR 0.5 billion) (at T-Systems) primarily as a result of the strategic review.

The increase of EUR 0.8 billion in other expenses is primarily the result of Vivento personnel costs at Deutsche Telekom AG.

Of the operating expenses, EUR 395 million (2002: EUR 463 million, 2001: EUR 534 million) relates to transactions consummated in prior years.

### (7) Financial Income (Expense), Net

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
Dividend income from investments . . . . .	26	41	107
Results related to companies accounted for under the equity method (including amortization of embedded goodwill) . . . . .	(247)	(430)	(547)
<b>Income (loss) related to associated and related companies . . . . .</b>	<b>(221)</b>	<b>(389)</b>	<b>(440)</b>
Income from debt securities and long-term loan receivables . . . . .	7	171	152
Other interest and similar income . . . . .	703	1,781	408
Interest and similar expense . . . . .	(4,486)	(6,000)	(4,698)
<b>Net interest income (expense) . . . . .</b>	<b>(3,776)</b>	<b>(4,048)</b>	<b>(4,138)</b>
<b>Write-downs of financial assets and marketable securities . . . . .</b>	<b>(34)</b>	<b>(1,585)</b>	<b>(770)</b>
	<b>(4,031)</b>	<b>(6,022)</b>	<b>(5,348)</b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Net financial expense improved year-on-year by EUR 2.0 billion to EUR 4,031 million. The decrease was mainly as a consequence of the decrease in expenses (including the amortization of embedded goodwill) relating to investments in associated companies, specifically the share price-related write-downs of the net carrying amount of the shareholding in France Telecom amounting to EUR 0.6 billion, and valuation adjustments on investments in noncurrent securities totaling EUR 0.4 billion recorded in 2002. In addition, the reversal of the valuation allowance recorded in prior years for the investment in comdirect bank AG had a positive impact on the income (loss) related to associated and related companies, offset by losses relating to Toll Collect totaling EUR 0.4 billion. The net interest expense decreased primarily as a result of the reduction in debt and the recognition of interest income from the reversal of interest rate derivatives that were no longer necessary.

### (8) Income Taxes

Breakdown of results from ordinary business activities:

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
Germany .....	4,270	712	2,946
International .....	(2,872)	(27,862)	(5,507)
	<b>1,398</b>	<b>(27,150)</b>	<b>(2,561)</b>

Breakdown of the Group's income taxes, Germany and international:

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
<b>Current taxes</b>			
Germany .....	(181)	132	686
International .....	257	190	91
<b>Deferred taxes</b>			
Germany .....	(357)	(150)	(30)
International .....	56	(3,019)	4
	<b>(225)</b>	<b>(2,847)</b>	<b>751</b>

Deutsche Telekom AG's combined statutory income tax rate for 2003 amounts to 40.4 percent (compared to 39.0 percent in the two previous years) and includes corporate income taxes at a rate of 26.5 percent, the solidarity surcharge (*Solidaritätszuschlag*) of 5.5 percent on corporate income tax, and trade taxes at an average German national rate. The German Flood Victims Act (*Flutopfersolidaritätsgesetz*) resulted in a one-time increase in the corporate income tax rate in 2003 of 1.5 percentage points from 25 percent to 26.5 percent.

The Group's results from ordinary business activities amounted to EUR 1.4 billion. Deutsche Telekom AG also had net operating loss carryforwards affecting corporate income tax and trade tax net operating loss carryforwards, with the result that no taxes were incurred in the tax consolidation group. EUR 361 million of the current tax benefit reported relate to the 2002 corporate income tax of T-Mobile International AG & Co. KG as a result of the retroactive change of the legal form of the company from a stock corporation to a partnership. Further, as a result of the corporate reorganization of certain subsidiaries of T-Mobile International AG & Co. KG, the Company incurred tax deductible losses which resulted in the reduction of EUR 436 million in trade taxes during 2003. This tax benefit is offset by tax expense relating to domestic and foreign shareholdings not included in the tax consolidation group.

Deferred taxes result primarily from temporary differences between income determined under German GAAP and under applicable tax law. Changes in tax legislation beginning in the 2004 financial year limit the deductibility of tax loss carryforwards in Germany to 60% of current taxable income. As a result only 40% of the temporary differences in the Deutsche Telekom AG consolidated tax group (*Organschaft*) that are expected to reverse during the period of utilization of the net operating loss carryforwards were recognized.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The decrease in income from deferred taxes year-on-year is due to the fact that deferred tax liabilities were reversed in 2002 as a result of the strategic review and the ensuing nonscheduled amortization of FCC licenses (U.S. licenses issued by the Federal Communications Commission). There were no comparable effects in 2003.

Differences between the total income tax benefit of EUR 225 million (2002: benefit of EUR 2,847 million; 2001: expense of EUR 751 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 40.4 percent, 39.0 percent and 39.0 percent for 2003, 2002 and 2001, respectively, are as follows:

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	(millions of €)		
Expected corporate income tax at the statutory income tax rate applicable for the parent company . . . . .	565	(10,447)	(977)
Increase (decrease) in income tax due to:			
Reduction of the Group’s results without tax effect . . . . .	3,136	11,027	2,896
Increase in the Group’s results without tax effect . . . . .	(1,001)	(435)	(966)
Group results not subject to the Group’s rate of taxation . . . . .	(44)	(2,878)	(491)
Permanent and semi-permanent differences between the carrying amounts in the tax accounts and in the financial statements . . . . .	(1,809)	(34)	611
Other differences between balance sheets prepared for financial reporting and tax reporting . . . . .	(58)	(323)	0
Trade tax (e.g., long-term debt) . . . . .	(10)	247	216
Effect of domestic losses . . . . .	61	386	(1,186)
Effects of changes in tax law and adjustments due to losses . . . . .	(1,058)	(361)	676
Other . . . . .	(7)	(29)	(28)
<b>Income taxes</b> . . . . .	<b><u>(225)</u></b>	<b><u>(2,847)</u></b>	<b><u>751</u></b>
Effective income tax rate . . . . .	(16%)	11%	(30%)

At December 31, 2003, the Deutsche Telekom Group had net operating loss carryforwards and similar tax loss carryforwards affecting corporate income tax amounting to approximately EUR 17,686 million (2002: EUR 22,198 million) and trade tax net operating loss carryforwards amounting to approximately EUR 5,488 million (2002: EUR 6,448 million). With the exception of non-German net operating loss carryforwards of EUR 10,180 million, the utilization of which is limited to periods from 2005 to 2023, these net operating loss carryforwards have an unlimited carryforward period under German and local tax law.

### **(9) (Income) Loss Applicable to Minority Shareholders**

(Income) loss applicable to minority shareholders includes EUR 384 million (2002: EUR 390 million; 2001: EUR 322 million) in profits and EUR 14 million (2002: EUR 106 million, 2001: EUR 180 million) in losses. The profits in 2003 relate mainly to Matáv, HT-Hrvatske telekommunikacije, T-Mobile Czech Republic, and Slovak Telecom. The losses relate mainly to CAP Customer Advantage Program in 2003 and to T-Online International AG in 2002.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The consolidated statement of operations for all years presented was prepared using the cost-of-sales method (in accordance with § 275 (3) HGB). As a result, personnel costs and depreciation and amortization, as further described in notes (10) and (11), are no longer separately presented in the consolidated statement of operations.

### (10) Personnel Costs and Average Number of Employees

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(millions of €)		
<b>Wages and salaries:</b> .....	<b>10,571</b>	<b>10,467</b>	<b>9,313</b>
Social security contributions and expenses for pension plans and benefits:			
Social security costs .....	1,406	1,340	1,147
Pension costs <sup>(1)</sup> .....	1,746	1,497	1,486
Health care expenses .....	194	176	168
	<u><b>13,917</b></u>	<u><b>13,480</b></u>	<u><b>12,114</b></u>

(1) Includes the net periodic pension costs, plus the change in additional minimum liability (AML) and the expenses for Bundes-Pensions-Service für Post und Telekommunikation e.V. (BPS-PT).

Personnel costs increased by EUR 0.4 billion or 3.2 percent in 2003 to EUR 13.9 billion. This was attributable in particular to an increase in additional minimum liabilities (AML) for pension obligations, in addition to collective bargaining agreements that adjust wages and salaries, offset by lower costs from reduced staff levels.

### Number of Employees (Average for the Year)

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	Number	Number	Number
Civil servants .....	49,998	52,961	56,707
Non-civil servants .....	201,265	202,935	184,953
<b>Total Deutsche Telekom Group</b> .....	<u><b>251,263</b></u>	<u><b>255,896</b></u>	<u><b>241,660</b></u>
Trainees and student interns .....	9,958	9,869	8,147

### (11) Depreciation and Amortization

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(millions of €)		
Amortization of intangible assets .....	4,678	27,355	5,743
of which: amortization of goodwill .....	2,521	13,108	3,663
of which: amortization of UMTS licenses and FCC licenses .....	1,113	13,244	1,414
Depreciation of property, plant, and equipment .....	8,206	9,525	9,478
	<u><b>12,884</b></u>	<u><b>36,880</b></u>	<u><b>15,221</b></u>

Depreciation and amortization decreased during the year ended December 31, 2003 by EUR 23,996 million or 65.1 percent year-on-year to EUR 12,884 million. The decrease in the amortization of intangible assets is mainly the result of the non-recurrence of nonscheduled amortization of goodwill and mobile communications licenses as a result of the strategic review carried out in the third quarter of 2002. The reduction in amortization is a result of the lower amortization base.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Depreciation of property, plant, and equipment fell by EUR 1,319 million (13.8 percent) in the year ended December 31, 2003. In addition to deconsolidation effects (in particular from the sale of the cable business) and the disposal of real estate, this is also due to the decrease in nonscheduled depreciation. In the previous year, property, plant, and equipment was written down by approximately EUR 0.8 billion, of which EUR 0.3 billion relates to real estate, EUR 0.2 billion to submarine cables, and EUR 0.3 billion to other technical assets. Nonscheduled depreciation only amounted to EUR 0.3 billion in 2003; of this amount, EUR 0.2 billion relates to buildings for which no further business use is planned.

### (12) Other Taxes

Other taxes included in the operating results amounted to EUR 162 million, compared with EUR 364 million in 2002 and EUR 57 million in 2001. The decrease in other taxes resulted from the non-recurrence of a one-time expense in the prior year in connection with the Federal Fiscal Court ruling on the recognition of goodwill in Deutsche Telekom AG's tax accounts.

## NOTES TO THE CONSOLIDATED BALANCE SHEETS

### (13) Intangible Assets

	As of December 31,	
	2003	2002
	Net carrying amount (millions of €)	
Concessions, industrial and similar rights and assets, and licenses in such rights and assets . . . . .	20,606	23,837
of which: UMTS licenses . . . . .	10,260	11,117
of which: FCC licenses . . . . .	8,179	10,364
of which: GSM licenses . . . . .	484	535
Goodwill . . . . .	24,513	29,436
Advance payments . . . . .	74	129
	<b>45,193</b>	<b>53,402</b>

The decline in intangible assets by EUR 8.2 billion to EUR 45.2 billion is due primarily to scheduled amortization and a lesser extent the effect of foreign exchange translation losses of foreign group companies, while the investment volume decreased by EUR 4.5 billion to EUR 0.8 billion. The decrease in 2003 as compared to the high level of investments in the prior year, relates in particular to goodwill of EUR 2.7 billion as a result of the acquisition of the remaining shares in T-Systems ITS GmbH (formerly debis Systemhaus GmbH) and T-Mobile Netherlands accounting for EUR 1.7 billion.

At December 31, 2003, Deutsche Telekom did not have any indefinite-lived intangible assets. The following remaining useful lives apply to the mobile communications licenses at December 31, 2003: UMTS licenses: 13.5 to 18.0 years, FCC licenses: 17.4 years, and GSM licenses 6.0 to 18.0 years.

The development of intangible assets is shown in the statement of consolidated noncurrent assets.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(14) Property, Plant, and Equipment**

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<u>Net carrying amount</u>	
	<u>(millions of €)</u>	
Land and equivalent rights and buildings including buildings on land owned by third parties . . . . .	10,399	11,362
Technical equipment and machinery . . . . .	32,792	38,034
Other equipment, plant, and office equipment . . . . .	2,038	2,286
Advance payments and construction in progress . . . . .	<u>2,039</u>	<u>2,273</u>
	<b><u>47,268</u></b>	<b><u>53,955</u></b>

In addition to decreases arising from foreign currency effects, the EUR 6.7 billion decrease in the carrying amount of property, plant, and equipment to EUR 47.3 billion is due primarily to the sale of the remaining cable businesses, sales of real estate relating to sale-and-lease-back transactions, and further depreciation charges, combined with a decline in the volume of new capital expenditures.

The development of property, plant and equipment is shown in the statement of consolidated noncurrent assets.

**Rental and Leasing Obligations**

Minimum lease payments under leases expiring subsequent to December 31, 2003 are shown below.

	<u>Capital Leases</u>	<u>Operating leases</u>
	<u>(millions of €)</u>	
<b>Financial Year</b>		
2004 . . . . .	52	1,703
2005 . . . . .	48	1,515
2006 . . . . .	48	1,347
2007 . . . . .	47	1,125
2008 . . . . .	47	995
after 2008 . . . . .	432	5,052
<b>Total minimum lease payments . . . . .</b>	<b><u>674</u></b>	<b><u>11,737</u></b>
Imputed interest . . . . .	<u>(251)</u>	
<b>Present value of net minimum lease payments . . . . .</b>	<b><u>423</u></b>	

Capital leases relate primarily to office buildings and have terms of up to 25 years. Rental and leasing expenses totalled EUR 1.7 billion in 2003 (2002: EUR 1.7 billion and 2001: EUR 1.2 billion).

**(15) Financial Assets**

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<u>Net carrying amount</u>	
	<u>(millions of €)</u>	
Investments in unconsolidated subsidiaries . . . . .	118	149
Loans to unconsolidated subsidiaries . . . . .	1	58
Investments in associated companies . . . . .	2,386	2,593
Other investments in related companies . . . . .	496	1,021
Long-term loans to associated and related companies . . . . .	25	3
Other investments in noncurrent securities . . . . .	86	238
Other long-term loans . . . . .	<u>78</u>	<u>107</u>
	<b><u>3,190</u></b>	<b><u>4,169</u></b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The net carrying amount of investments in associated companies decreased by EUR 207 million due to currency translation adjustments affecting PTC (Poland), GSM Facilities (United States), and MTS (Russia) in particular. The decline was also due to the sale of the 11.05 percent shareholding in MTS. These factors were partly offset by the addition of shares in GSM Facilities, positive earnings contributions and the reversal of prior write-downs to the net carrying amount of the investment in comdirect bank AG.

The EUR 525 million decrease in other investments in related companies is due primarily to the sale of shares in Globe Telecom (EUR 320 million), Eutelsat (EUR 118 million), and Celcom (EUR 51 million).

Long-term loans to associated and related companies are mainly composed of shareholder loans. The additions relate mainly to loans to DeaSat.

The decrease in other investments in noncurrent securities is attributable in particular to the sale of securities from the portfolio of Deutsche Telekom Holding B.V., Amsterdam, and a valuation adjustment in Deutsche Telekom AG's securities portfolio.

The development of financial assets is shown in the statement of consolidated noncurrent assets. The list of investment holdings is filed with the Commercial Registry of the Bonn District Court (HRB 6794).

Significant investments in associated companies are shown below:

Name	As of December 31, 2003			As of December 31, 2002		
	Deutsche Telekom share (%)	Net carrying amount (millions of €)	of which: Embedded goodwill <sup>(2)</sup> (€)	Deutsche Telekom share (%)	Net carrying amount (millions of €)	of which: Embedded goodwill <sup>(2)</sup> (€)
PTC .....	49.00	1,097	877	49.00	1,287	1,122
GSM Facilities .....	29.20	592	—	25.60	586	—
MTS <sup>(1)</sup> .....	25.15	330	5	36.20	455	11
Other .....		367	107		265	52
		<u>2,386</u>	<u>989</u>		<u>2,593</u>	<u>1,185</u>

(1) Proportional market value on December 31, 2003: EUR 1,647 million (December 31, 2002: EUR 1,277 million).

(2) Net difference between carrying value and equity in net assets.

### (16) Inventories, Materials and Supplies

	As of December 31,	
	2003	2002
	Net carrying amount (millions of €)	
Raw materials and supplies .....	391	466
Work in process .....	307	350
Finished goods and merchandise .....	635	730
Advance payments .....	99	10
	<u>1,432</u>	<u>1,556</u>

Inventories, materials and supplies decreased by EUR 124 million or 8.0 percent year-on-year. This figure includes reductions of EUR 15 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 relates mainly to projects that 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Advance payments relate primarily to orders for terminal equipment, replacement modules, and replacement components.

### (17) Receivables

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<b>Net carrying amount</b>	
	<b>(millions of €)</b>	
Trade accounts receivable .....	5,318	5,840
Receivables from unconsolidated subsidiaries .....	203	171
Receivables from associated and related companies.....	<u>241</u>	<u>247</u>
	<b><u>5,762</u></b>	<b><u>6,258</u></b>

The decrease in trade accounts receivable relates in particular to the first-time asset-backed securitization at T-Mobile.

In November 2003, T-Mobile Deutschland GmbH sold without recourse certain trade accounts receivable amounting to approximately EUR 0.5 billion to a special purpose vehicle in a global assignment of debts under an asset-backed securitization program. The contract strictly 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 covered by the discounts are not utilized by the purchaser. Servicing of the receivables is performed by T-Mobile Deutschland GmbH on behalf of the purchaser.

All receivables are due within one year, with the exception of trade accounts receivables amounting to EUR 16 million.

The following table represents the annual development of the allowance for doubtful accounts:

	<u>As of</u>	<u>Charged to</u>	<u>Amounts</u>	<u>As of</u>
	<u>January 1</u>	<u>costs and</u>	<u>written</u>	<u>December 31</u>
		<u>expenses</u>	<u>off/released</u>	
		<b>(millions of €)</b>		
2001.....	790	1,167	(623)	1,334
2002.....	1,334	701	(680)	1,355
2003.....	1,355	376	(944)	787

The Company directly wrote off accounts receivable balances of EUR 282 million in 2003 (EUR 414 million in 2002; EUR 391 million in 2001).

### (18) Other Assets

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<b>Net carrying amount</b>	
	<b>(millions of €)</b>	
Tax receivables.....	1,526	1,782
Accrued interest.....	408	390
Receivables from reimbursements and loans receivable.....	120	96
Receivables from employees.....	41	46
Miscellaneous other assets.....	<u>1,067</u>	<u>1,078</u>
	<b><u>3,162</u></b>	<b><u>3,392</u></b>

The decrease in other assets results mainly to the decrease in tax receivables, which consists mainly of income taxes. The decrease in income tax receivables relates mainly to the refund of a corporate income tax receivable of Deutsche Telekom AG in June 2003. The claim for reimbursement amounting to EUR 550 million related to corporate income tax receivables from the external tax audit for the period 1997 to 1999.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(19) Marketable Securities**

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	Net carrying amount (millions of €)	
Treasury shares . . . . .	7	7
Other marketable securities . . . . .	<u>166</u>	<u>406</u>
	<u><b>173</b></u>	<u><b>413</b></u>

The number of treasury shares of 2,670,828, at December 31, 2003 was unchanged from the prior year, and is comprised as follows:

	<u>Number of Shares</u>
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 KfW, not yet issued . . . . .	<u>14,630</u>
	<u><b>2,670,828</b></u>

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 their acquisition cost of EUR 0.9 million, and written down to the lower quoted price at the balance sheet date. Treasury shares account for a total of 0.07 percent of the capital stock.

The decrease in other marketable securities compared with the previous year is mainly attributable to the reduction of Deutsche Bundespost bonds held to maintain favorable trading conditions and to the expiration of callable bonds.

**(20) Liquid Assets**

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	Net carrying amount (millions of €)	
Checks . . . . .	8	10
Cash-in-hand and deposits at the Bundesbank . . . . .	33	42
Cash in banks . . . . .	<u>9,086</u>	<u>1,853</u>
	<u><b>9,127</b></u>	<u><b>1,905</b></u>

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	Net carrying amount (millions of €)	
Original maturity less than 3 months . . . . .	8,686	1,712
Temporary cash investments (original maturity longer than 3 months) . . . . .	<u>441</u>	<u>193</u>
	<u><b>9,127</b></u>	<u><b>1,905</b></u>

Cash and cash equivalents with original maturity of less than 3 months consist primarily of fixed-term bank deposits, cash-in-hand, deposits at the Bundesbank, and checks. Temporary cash investments (with maturities longer than three months) consist almost exclusively of fixed-term bank deposits.

The development of cash and cash equivalents is shown in the consolidated statement of cash flows.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (21) Prepaid Expenses and Deferred Charges

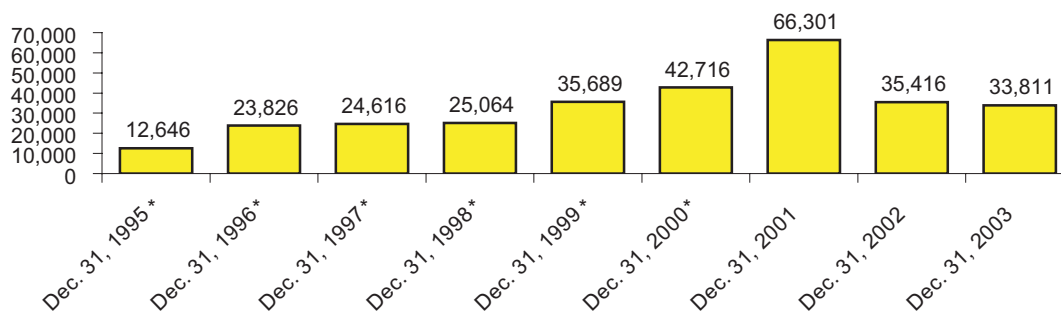
Prepaid expenses and deferred charges of EUR 772 million (Dec. 31, 2002: EUR 771 million) include discounts on loans of EUR 264 million (Dec. 31, 2002: EUR 295 million) which are amortized on a straight-line basis over the terms of the respective liabilities. Other prepaid expenses and deferred charges are also recognized for advance personnel costs and lease payments.

### (22) Shareholders' Equity

A detailed account of the development of the consolidated shareholders' equity for the years 2001, 2002, and 2003 is presented in the consolidated statements of shareholders' equity.

The development of the consolidated shareholders' equity from December 31, 1995 to December 31, 2003 is as follows:

Total shareholders' equity at year-end (millions of €)



(\*) unaudited

### (23) Capital Stock

In accordance with § 5 (1) of its Articles of Incorporation, Deutsche Telekom AG's capital stock totaled EUR 10,746 million as of December 31, 2003, and is composed of 4,197.8 million no-par value ordinary registered 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 26.03 percent at December 31, 2003; KfW's shareholding was 16.74 percent at December 31, 2003. 1,093 million individual no-par value shares (EUR 2,797 million) of the capital stock were therefore held by the Federal Republic at December 31, 2003 and 703 million (EUR 1,799 million) by KfW. 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 outstanding warrants between Deutsche Telekom and T-Mobile USA/Powertel at the time of the acquisition. As of December 31, 2003, the number of Deutsche Telekom shares deposited as collateral for the outstanding options granted to T-Mobile USA and Powertel employees amounted to 22,539,480.

#### 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 against noncash contributions in the period up to May 25, 2005. The authorization may be exercised in full or in part. Shareholders' preemptive rights are disapplied. 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, 2003, 1,168,148,391 of the 1,509,802,017 authorized no-par value shares had been issued for the acquisition of T-Mobile USA and Powertel.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Contingent Capital

The capital stock has been contingently increased by up to EUR 500,000,000, divided into 195,312,500 shares (contingent capital I). The contingent capital increase will be implemented only to the extent that

- a. the holders and creditors of conversion rights or warrants attached to convertible bonds or bonds with warrants to be issued before May 28, 2006 by Deutsche Telekom AG or its direct or indirect majority shareholdings on the basis of the authorization granted by resolution of the shareholders' meeting on May 29, 2001, exercise their conversion or option rights; or
- b. the holders and creditors obligated to convert bonds issued by May 28, 2006 by Deutsche Telekom AG or its direct or indirect majority shareholdings pursuant to the authorization granted by the resolution of the shareholders' meeting of May 29, 2001, fulfill their conversion obligation.

The new shares carry dividend rights from the beginning of the financial year in which they arise through exercise of conversion rights or options, or the fulfillment of conversion obligations. Contingent capital I was used in 2003 to issue convertible bonds amounting to approximately EUR 2.3 billion that will be converted into shares of Deutsche Telekom AG common stock at maturity (June 1, 2006). The convertible bonds were issued by Deutsche Telekom's financing company in the Netherlands — Deutsche Telekom International Finance B.V. — and are guaranteed by Deutsche Telekom AG. The securities were issued at par with a coupon of 6.5 percent. Depending on share price performance, the conversion ratio may fluctuate between 3,417.1679 to 4,237.2881 shares per bond (EUR 50,000 par value). The securities were placed with non-U.S. institutional investors outside the United States.

On the basis of the authorizing resolution adopted by the shareholders' meeting on May 29, 2001, the capital stock was contingently increased by up to EUR 307,200,000, composed of up to 120,000,000 new no-par value registered shares (contingent capital II). This contingent capital increase is exclusively for the purpose of granting stock options to members of the Board of Management of Deutsche Telekom AG, to members of Deutsche Telekom's second-tier management, and to other executives, managers, and specialists of Deutsche Telekom AG, and to members of the boards of management, members of management, and other executives, managers, and specialists of lower-tier group companies in Germany and other countries as part of the Deutsche Telekom 2001 Stock Option Plan. It will be implemented only to the extent that the holders of stock options exercise these options. The new shares carry dividend rights from 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 Company's shareholders' meeting that resolves the appropriation of net income for the preceding financial year, the new shares carry dividend rights from the beginning of the preceding financial year. No stock options granted under the 2001 Stock Option Plan had been exercised as of December 31, 2003.

On the basis of the authorizing resolution adopted by the shareholders' meeting on May 25, 2000, in conjunction with the amending resolution by the shareholders' meeting on May 29, 2001, the capital stock was contingently increased by up to EUR 2,621,237.76, composed of up to 1,023,921 new no-par value registered shares (contingent capital III). This contingent capital increase is exclusively for the purpose of granting stock options to members of the Board of Management of Deutsche Telekom AG and executives of the Company, and to members of the boards of management, members of management, and other executives of lower-tier subsidiaries as part of the Deutsche Telekom 2000 Stock Option Plan established on the basis of a resolution by the shareholders' meeting on May 25, 2000. It will only be implemented if these beneficiaries exercise their stock options. The new shares carry dividend rights from 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 Company's shareholders' meeting that resolves the appropriation of net income for the preceding financial year, the new shares carry dividend rights from the beginning of the preceding financial year. No stock options granted under the 2000 Stock Option Plan had been exercised as of December 31, 2003.

### Treasury Shares

The shareholders' meeting on May 20, 2003 rescinded the authorization of the Board of Management to acquire treasury shares resolved by the shareholders' meeting on May 28, 2002 with

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

effect from the end of the shareholders' meeting on May 20, 2003. At the same time, the Board of Management of Deutsche Telekom AG was authorized to acquire up to 419,775,242 shares, i.e., up to almost 10 percent of the capital stock, before November 19, 2004. The treasury shares acquired on the basis of this authorization may be resold on the stock exchange, used to list the Company's shares on foreign stock exchanges, offered to third parties in the course of business combinations or for the acquisition of companies, parts of companies, or interests in companies, withdrawn, offered to shareholders on the basis of a subscription offer made to all shareholders, or sold other than on the stock exchange or by the way of an offer to all shareholders. The authorizations to acquire and utilize treasury shares may be exercised in full or in parts.

### **(24) Additional Paid-In Capital**

The additional paid-in capital of the Group exceeds Deutsche Telekom AG's additional paid-in capital of EUR 24,333 million by EUR 25,759 million. This is due in part to the recognition of the new Deutsche Telekom shares issued in the course of the acquisition of T-Mobile USA and Powertel at fair value (EUR 28,680 million) instead of at their par value (EUR 2,990 million), which is permitted in the consolidated financial statements. There were also other allocations to additional paid-in capital in 2003 at Group level amounting to approximately EUR 1 million (2002: EUR 68 million) from the exercise of conversion options by former shareholders of T-Mobile USA and Powertel. The shares of Deutsche Telekom reserved for these conversion options in a trust were included in the single-entity financial statements of Deutsche Telekom AG in 2001 at the time of the appropriation of the additional paid-in capital.

### **(25) 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 adjustments from prior years.

### **(26) 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, HT-Hrvatske telekommunikacije, Matáv, Slovak Telecom, and T-Mobile Czech Republic.

### **(27) Stock-Based Compensation**

#### **Deutsche Telekom AG**

#### **2000 Stock Option Plan**

In the 2000 financial year, Deutsche Telekom granted stock options to members of the Board of Management and senior managers of Deutsche Telekom AG and to members of the boards of management and senior managers of Group companies within and outside Germany 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 adopted by the shareholders' meeting in May 2000. The closing price of Deutsche Telekom AG's common stock quoted in Xetra trading at Deutsche Börse AG, Frankfurt/Main, on the grant date was EUR 60.40 per share. The term of the options runs until July 20, 2005.

The options were not exercisable before the end of the lock-up period on July 19, 2002. The options 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 achieved when the moving thirty-day average closing price of the T-Share in Xetra trading at Deutsche Börse AG, Frankfurt/Main, exceeds the exercise price of EUR 62.69 by more than 20 percent at the end of the lock-up period.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The relative performance target is linked to share price performance relative to the performance of the Dow Jones EuroSTOXX 50<sup>®</sup> 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, preemptive rights, and other special rights (total shareholder return) exceeds the performance of the EuroSTOXX 50<sup>®</sup> Total Return Index measured on a moving thirty-day average basis.

Neither the absolute target nor the relative target had been exceeded at December 31, 2003.

Deutsche Telekom AG reserves the right, at its election, to settle the options through the payment of a cash amount (stock appreciation rights – SARs) 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 of December 31, 2003, no resolution on conversion had been passed to this effect.

As of December 31, 2003, the weighted average remaining contractual life of the outstanding options from the 2000 Stock Option Plan was approximately 1.5 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 contingent capital was reduced by the appropriate amount.

The activities relating to the stock options granted by Deutsche Telekom AG to beneficiaries of the 2000 Stock Option Plan are as follows:

	2000 Stock Option Plan					
	2003		2002		2001	
	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)
Outstanding at beginning of year . . . . .	994	62.69	1,001	62.69	1,022	62.69
Granted . . . . .	0	—	0	—	0	—
Exercised . . . . .	0	—	0	—	0	—
Forfeited . . . . .	<u>7</u>	62.69	<u>7</u>	62.69	<u>21</u>	62.69
Outstanding at end of year . . .	<u>987</u>	62.69	<u>994</u>	62.69	<u>1,001</u>	62.69
<b>Exercisable at end of year . . .</b>	<b><u>0</u></b>	—	<b><u>0</u></b>	—	<b><u>0</u></b>	—

## 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 stock options to be issued to members of the Board of Management, other executives, and specialists of the Company and lower-tier subsidiaries as part of the Deutsche Telekom 2001 Stock Option Plan. In accordance with the resolution passed by the shareholders' meeting, the allocation of the total number of options to beneficiaries is as follows:

- a maximum of 15 percent to members of the Board of Management of Deutsche Telekom AG,
- a maximum of 20 percent to members of Deutsche Telekom AG's second-tier management,
- a maximum of 15 percent to other executives, managers and specialists of Deutsche Telekom AG,
- a maximum of 15 percent to members of the boards of management of Group companies within and outside Germany,
- a maximum of 35 percent to other executives, managers and specialists of Group companies within and outside Germany.

The following conditions apply under the terms of the 2001 Stock Option Plan:

50 percent 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 percent 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 percent of the reference price. The reference price corresponds to the non-weighted average closing prices of Deutsche Telekom shares in Deutsche Börse AG's Xetra trading in Frankfurt/Main (or a successor system to the Xetra system) over the last thirty trading days before the grant of the options. If the average closing price calculated by this method is lower than the closing price of Deutsche Telekom shares in Deutsche Börse AG's Xetra trading (or in a successor system) on the grant date of the options, 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 AG reserves the right, at its own discretion, to settle the options through the payment of a cash amount (stock appreciation rights – SARs) 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 of December 31, 2003, 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 adopted by the shareholders' meeting in May 2001. The closing price of Deutsche Telekom's common stock quoted in Frankfurt in Xetra trading on the grant date was EUR 19.10 per share. The term of the options runs until August 12, 2011.

In the 2002 financial year, 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 adopted by the shareholders' meeting in May 2001. The closing price of Deutsche Telekom's common stock quoted in Frankfurt in Xetra trading on the grant date was EUR 10.30 per share. The term of the options runs until July 14, 2012.

As of December 31, 2003, the weighted average remaining contractual life of all outstanding options from the 2001 Stock Option Plan was approximately 8.1 years.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The activities relating to the stock options granted by Deutsche Telekom AG to beneficiaries of the 2001 Stock Option Plan are as follows:

	2001 Stock Option Plan					
	2003		2002		2001	
	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)	<u>Stock options</u> (in thousands)	<u>Weighted- average exercise price</u> (€)
Outstanding at beginning of year . . . . .	11,964	24.22	8,219	30.00	—	—
Granted . . . . .	0	—	3,928	12.36	8,221	30.00
Exercised . . . . .	0	—	0	—	0	—
Forfeited . . . . .	<u>196</u>	25.89	<u>183</u>	29.16	<u>2</u>	—
Outstanding at end of year . . . . .	<u>11,768</u>	24.25	<u>11,964</u>	24.22	<u>8,219</u>	30.00
<b>Exercisable at end of year.</b>	<b><u>3,964</u></b>	<b>30.00</b>	<b><u>0</u></b>	<b>—</b>	<b><u>0</u></b>	<b>—</b>

5,360 SARs were forfeited in 2003. As of December 31, 2003, 162,560 of the SARs granted between 2001 and 2003 to employees in countries in which it was not legally possible to grant stock options 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 resolution by the shareholders' meeting in March 2000, 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 214,473.00 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 price of the T-Online share in Xetra trading exceeds the exercise price by more than 40 percent. The relative performance target is linked to share price performance relative to the performance of the Dow Jones EuroSTOXX 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), exceeds the performance of the EuroSTOXX Telecom index by more than 20 percent measured on a moving thirty-day average basis.

The weighted average remaining contractual life as of December 31, 2003 was 1.5 years.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The activities relating to the stock options granted by T-Online International AG to beneficiaries of the 2000 Stock Option Plan are as follows:

	2000 Stock Option Plan					
	2003		2002		2001	
	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)
Outstanding at beginning of year . . . . .	112	37.65	117	37.65	177	37.65
Granted . . . . .	0	—	0	—	0	—
Exercised . . . . .	0	—	0	—	0	—
Forfeited . . . . .	<u>0</u>	—	<u>5</u>	37.65	<u>60</u>	37.65
Outstanding at end of year . . . . .	<u>112</u>	37.65	<u>112</u>	37.65	<u>117</u>	37.65
<b>Exercisable at end of year.</b>	<u><u>0</u></u>	—	<u><u>0</u></u>	—	<u><u>0</u></u>	—

### 2001 Stock Option Plan

The shareholders' meeting on May 30, 2001 contingently 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 boards 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 board 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 percent of the reference price. The reference price corresponds to the non-weighted average closing price of T-Online shares in Deutsche Börse AG's Xetra trading (or in a comparable successor system) on the Frankfurt Stock Exchange over the last thirty 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 T-Online shares in Deutsche Börse AG's Xetra trading (or in a successor system) on the grant date 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 until 2005.

50 percent of the options granted may only be exercised after a two-year lock-up - calculated from the grant date of the options. The remaining 50 percent 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 or compensation at the latest on August 12, 2011 and July 14, 2012 respectively. As of December 31, 2003, the weighted average remaining contractual life of the outstanding options from the 2001 Stock Option Plan was approximately 8 years.

2,369,655 options were granted on August 13, 2001 in the first tranche on the basis of the resolution adopted by the shareholders' meeting in May 2001. A further 2,067,460 options were granted in the second tranche on July 15, 2002. The exercise price, i.e., the performance target, for the first tranche is EUR 10.35 (125 percent of the reference price of EUR 8.28) and for the second tranche EUR 10.26 (125 percent of the reference price of EUR 8.21). The Board of Management decided not to issue the tranche for 2003.

On this basis, 26,410 stock options have been exercised from the 2001 tranche since August 14, 2003.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The activities relating to the stock options granted by T-Online International AG to beneficiaries of the 2001 Stock Option Plan are as follows:

	2001 Stock Option Plan					
	2003		2002		2001	
	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)
Outstanding at beginning of year . . . . .	4,415	10.31	2,348	10.35	0	—
Granted . . . . .	0	—	2,067	10.26	2,369	10.35
Exercised . . . . .	26	10.35	0	—	0	—
Forfeited . . . . .	<u>205</u>	10.35	<u>0</u>	—	<u>21</u>	10.35
Outstanding at end of year . . . . .	4,184	10.31	4,415	10.31	2,348	10.35
<b>Exercisable at end of year.</b>	<b><u>1,062</u></b>	<b>10.35</b>	<b><u>0</u></b>	—	<b><u>0</u></b>	—

### 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 adopted on September 22, 2000.

The activities relating to the stock options granted by T-Online International AG as part of the acquisition of shares are as follows:

	Ya.com 2000 Stock Option Plan					
	2003		2002		2001	
	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)	Stock options (in thousands)	Weighted- average exercise price (€)
Outstanding at beginning of year . . . . .	366	0.00	1,084	0.00	1,864	0.00
Granted . . . . .	0	—	0	—	0	—
Exercised . . . . .	363	0.00	376	0.00	692	0.00
Forfeited . . . . .	<u>3</u>	0.00	<u>342</u>	0.00	<u>88</u>	0.00
Outstanding at end of year . . . . .	<u>0</u>	0.00	<u>366</u>	0.00	<u>1,084</u>	0.00
<b>Exercisable at end of year.</b>	<b><u>0</u></b>	<b>0.00</b>	<b><u>366</u></b>	<b>0.00</b>	<b><u>1,084</u></b>	<b>0.00</b>

In its function as conversion trustee, Dresdner Bank holds 433,000 (2002: 430,000) options that may be sold under certain circumstances upon instructions 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 established 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.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

At December 31, 2003, 22.5 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 for a period of four years and have a term of up to 10 years.

The activities relating to the stock options granted since the acquisition of T-Mobile USA are as follows:

	Year ended December 31, 2003		Year ended December 31, 2002		Seven months ended December 31, 2001	
	Stock options (in thousands)	Weighted- average exercise price (\$)	Stock options (in thousands)	Weighted- average exercise price (\$)	Stock options (in thousands)	Weighted- average exercise price (\$)
Outstanding at beginning of year . . . . .	24,980	16.41	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 . . . . .	865	12.86	5,964	13.35	0	—
Exercised . . . . .	3,709	4.20	2,133	3.35	1,639	3.21
Forfeited . . . . .	1,865	21.34	941	19.51	549	17.47
Outstanding at end of year . . . . .	<u>20,271</u>	17.95	<u>24,980</u>	16.41	<u>22,090</u>	16.21
<b>Exercisable at end of year .</b>	<b><u>11,756</u></b>	<b>17.88</b>	<b><u>10,028</u></b>	<b>13.95</b>	<b><u>6,299</u></b>	<b>9.88</b>

Ranges of the exercise prices (\$)	Outstanding options as of December 31, 2003			Exercisable options as of December 31, 2003	
	Number (in thousands)	Weighted average remaining contractual life (years)	Weighted- average exercise price (\$)	Number (in thousands)	Weighted- average exercise price (\$)
0.02 – 7.60	2,750	4.2	2.79	2,840	2.79
7.60 – 15.20	7,673	7.3	12.22	2,551	11.00
15.20 – 22.80	58	5.8	17.50	58	17.50
22.80 – 30.39	8,604	6.3	26.30	5,412	26.88
30.39 – 37.99	1,186	6.1	30.97	895	30.97
<b>0.02 – 37.99</b>	<b><u>20,271</u></b>	<b>6.4</b>	<b>17.95</b>	<b><u>11,756</u></b>	<b>17.88</b>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

During 2003, 860,000 options were granted to certain key executives of T-Mobile USA under the Option Plan discussed above. These options vest based on meeting certain growth and financial performance measures and have a term of up to 10 years. Options granted, exercised and cancelled are summarized as follows:

	Year ended December 31, 2003	
	Stock options (in thousands)	Weighted- average exercise price (\$)
Outstanding at beginning of year .....	—	—
Granted .....	860	3.81
Exercised .....	(10)	3.81
Forfeited .....	—	—
Outstanding at end of year .....	850	3.81
<b>Exercisable at end of year .....</b>	<b>133</b>	<b>3.81</b>

The following table summarizes information about the stock options outstanding and exercisable at December 31, 2003:

Ranges of the exercise prices (\$)	Outstanding options as of December 31, 2003			Exercisable options as of December 31, 2003	
	Number (in thousands)	Weighted average remaining contractual life (years)	Weighted- average exercise price (\$)	Number (in thousands)	Weighted- average exercise price (\$)
0.00 – 7.60	850	9.0	3.81	133	3.81

**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 options at a conversion rate of 2.6353. The Deutsche Telekom AG shares linked to these options are administered in a trust deposit account established for the benefit of holders of Powertel stock options. The exercise price for each share of Deutsche Telekom 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 456,611 shares available at December 31, 2003. 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 962,118 shares were available for outstanding options at December 31, 2003 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 under the 1991 Option Plan.

At December 31, 2003, 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 under the Non-employee Plan.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The activities relating to the stock options granted since the acquisition of Powertel are as follows:

	Year ended December 31, 2003		Year ended December 31, 2002		Seven months ended December 31, 2001	
	Stock options (in thousands)	Weighted- average exercise price (\$)	Stock options (in thousands)	Weighted- average exercise price (\$)	Stock options (in thousands)	Weighted- average exercise price (\$)
Outstanding at beginning of period . . . . .	1,790	21.85	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 . . . . .	0	0.00	0	0.00	0	—
Exercised . . . . .	171	5.05	446	5.39	1,200	6.29
Forfeited . . . . .	<u>201</u>	28.65	<u>273</u>	27.27	<u>1,614</u>	31.42
Outstanding at end of year . . . . .	<u>1,418</u>	22.79	<u>1,790</u>	21.85	<u>2,509</u>	19.50
<b>Exercisable at end of year .</b>	<b><u>1,100</u></b>	<b>20.62</b>	<b><u>891</u></b>	<b>16.93</b>	<b><u>883</u></b>	<b>8.76</b>

Ranges of the exercise prices (\$)	Outstanding options as of December 31, 2003			Exercisable options as of December 31, 2003	
	Number (in thousands)	Weighted average remaining contractual life (years)	Weighted- average exercise price (\$)	Number (in thousands)	Weighted- average exercise price (\$)
0.02 – 7.60	394	4.1	5.60	394	5.60
7.60 – 15.20	98	4.3	9.72	99	9.72
15.20 – 22.80	19	6.1	19.97	16	19.86
22.80 – 30.39	418	6.9	26.92	226	26.91
30.39 – 37.99	<u>489</u>	6.2	35.87	<u>365</u>	35.95
<b>0.02 – 37.99</b>	<b>1,418</b>	<b>5.7</b>	<b>22.79</b>	<b>1,100</b>	<b>20.62</b>

**Matáv**

On April 26, 2002, the shareholders' meeting of Matáv approved the introduction of a new management stock option plan.

In order to satisfy the exercise of options granted, the annual shareholders' meeting of Matáv authorized Matáv's Board of Directors to purchase 17 million "A" series registered ordinary shares, each with a nominal value of HUF 100, as treasury shares.

On July 1, 2002, Matáv 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 2004/2005). The quoted fair market value of Matáv common stock 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, 2003 was 3.5 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.

## 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 Matáv are as follows:

	2003		2002	
	Stock options (in thousands)	Weighted- average exercise price (HUF)	Stock options (in thousands)	Weighted- average exercise price (HUF)
Outstanding at beginning of year . . . . .	3,965	944	0	—
Granted . . . . .	0	—	3,965	944
Exercised . . . . .	0	—	0	—
Forfeited . . . . .	<u>310</u>	944	<u>0</u>	—
Outstanding at end of year . . . . .	<u>3,655</u>	944	<u>3,965</u>	944
<b>Exercisable at end of year . . . . .</b>	<b><u>1</u></b>	<b>944</b>	<b><u>0</u></b>	<b>0</b>

### (28) 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 the level of employee 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 approaching retirement will remain unchanged. For younger employees with vested benefits, the obligations have been 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 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 are 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. VAP's obligations are therefore suspended (parallel obligation). Pension accruals are recognized for financial reporting purposes for the now 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 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. Pursuant to the VAP's business plan, Deutsche Telekom will to a certain extent continue to be delegated additional obligations and assigned the corresponding assets on a pro rata basis.

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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table shows the composition of pension obligations:

	As of December 31,	
	2003	2002
	(millions of €)	
Pension obligations:		
— Direct .....	3,163	2,927
— Indirect .....	1,286	1,007
Obligations in accordance with Article 131 GG .....	7	8
	<b>4,456</b>	<b>3,942</b>

The obligation amounts shown contain an “additional minimum liability” for individual pension plans. An additional minimum liability is a step-up amount for pension obligations relating to certain pension plans; these changes are recognized in income under German GAAP, but directly in equity under U.S. GAAP. Excluding the additional minimum liability, the accrual for pensions amounts to EUR 3,553 million (2002: EUR 3,465 million).

	As of December 31,	
	2003	2002
	(millions of €)	
Actuarial present value of benefits:		
Vested benefit obligation .....	4,455	3,978
Nonvested benefit obligation .....	486	409
<b>Accumulated benefit obligation</b> .....	4,941	4,387
Effect of projected future salary increases .....	91	85
<b>Projected benefit obligation</b> .....	5,032	4,472
Plan assets at fair value .....	(489)	(412)
<b>Projected benefit obligations in excess of plan assets</b> .....	4,543	4,060
Unrecognized net losses .....	(990)	(595)
<b>Unfunded accrued pension cost</b> .....	3,553	3,465
<b>Additional minimum liability</b> .....	903	477
<b>Total obligation</b> .....	4,456	3,942

### Calculation of Pension Accruals

	As of December 31,	
	2003	2002
	(millions of €)	
Unfunded accrued pension cost .....	3,555	3,467
Prepaid pension cost .....	(2)	(2)
<b>Accrual for pensions</b> .....	<b>3,553</b>	<b>3,465</b>

Taking into consideration the assets transferred to other entities, the pension obligations were fully disclosed.

The carrying amount of the corresponding pension accruals measured in accordance with § 6a EStG are EUR 3,674 million (2002: EUR 3,474 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:

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Assumptions for the Measurement of Benefit Obligations**

	<b>As of December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Discount rate . . . . .	5.25%	5.75%	6.00%
Projected salary increase . . . . .	2.75%-3.50%	2.75%-3.50%	2.75%-3.50%
Projected pension increase . . . . .	1.50%	1.50%	1.50%

**Assumptions for Determining the Net Periodic Pension Cost**

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
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%

**Development of the Projected Benefit Obligation**

	<b>2003</b>	<b>2002</b>
	<b>(millions of €)</b>	
<b>Projected benefit obligation, beginning of year . . . . .</b>	<b>4,472</b>	<b>4,164</b>
Service cost . . . . .	140	155
Interest cost . . . . .	251	241
Change in obligations . . . . .	24	(59)
Actuarial losses . . . . .	395	201
Total benefits actually paid . . . . .	<u>(250)</u>	<u>(230)</u>
<b>Projected benefit obligation, end of year . . . . .</b>	<b><u>5,032</u></b>	<b><u>4,472</u></b>

**Development of Plan Assets at Fair Value**

	<b>2003</b>	<b>2002</b>
	<b>(millions of €)</b>	
<b>Plan assets at fair value, beginning of year . . . . .</b>	<b>412</b>	<b>405</b>
Actual return on plan assets . . . . .	14	(20)
Contributions by employer . . . . .	87	79
Benefits actually paid through pension funds . . . . .	(58)	(52)
Change in obligations . . . . .	<u>34</u>	<u>0</u>
<b>Plan assets at fair value, end of year . . . . .</b>	<b><u>489</u></b>	<b><u>412</u></b>

**Information on Pension Plans with Accumulated Benefit Obligation Exceeding Assets:**

	<b>As of December 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(millions of €)</b>	
Projected benefit obligation . . . . .	1,813	1,533
Accumulated benefit obligation . . . . .	1,754	1,474
Transferred assets . . . . .	489	412

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Breakdown of Plan Assets:**

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
Equity securities .....	18%	20%
Debt securities .....	43%	47%
Other .....	39%	33%

**Investment Strategy**

Deutsche Telekom's investment strategy is conservative and concentrates on safeguarding liquidity and on investments in the euro region; no derivative instruments are used. Most investments are made in time deposits and fixed-rate notes. Unless regulated by the requirements of § 54 of the Insurance Supervision Act, the investment strategy is determined by investment committees which regularly review investment decisions made.

**Net Periodic Pension Cost**

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
		(millions of €)	
Service cost .....	140	155	144
Interest cost .....	251	241	228
Expected return on plan assets .....	(27)	(24)	(24)
Amortization of gains and losses .....	<u>13</u>	<u>7</u>	<u>0</u>
<b>Net periodic pension cost .....</b>	<b><u>377</u></b>	<b><u>379</u></b>	<b><u>348</u></b>

**Expected Amounts for Subsequent Years**

Expected contributions by employer in 2004 ..... EUR 87 million

**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 für Post und Telekommunikation e.V. (BPS-PT). On January 11, 2001, the fund was entered in the Register of Associations with retroactive effect to July 1, 2000. The BPS-PT works for the fund of all three companies and also handles financial administration for the Federal Republic on a trust basis. It carries out all transactions for pension and allowance payments in respect of civil servants 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 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 obliged to make an annual contribution to the special pension fund amounting to 33 percent 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 contribution is recognized as a period expense. These contributions amounted to EUR 809 million in the year ended December 31, 2003 (2002: EUR 838 million; 2001: EUR 845 million) (see note (34) Guarantees and Commitments, and Other Financial Obligations).

Under PTNeuOG, the Federal Republic compensates the special pension fund for differences 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 obligations it has assumed. The Federal Republic cannot require reimbursement from Deutsche Telekom AG for amounts paid by it to the special fund.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(29) Other Accruals

	As of December 31,	
	2003	2002
	(millions of €)	
<b>Taxes</b> .....	<b>1,762</b>	<b>2,086</b>
<b>Provisions for deferred taxes</b> .....	<b>919</b>	<b>1,646</b>
<b>Accruals other than taxes</b>		
Employee benefits		
Civil Service Health Insurance Fund .....	1,358	1,101
Personnel restructuring .....	566	558
Other obligations .....	<u>1,231</u>	<u>1,080</u>
	<b>3,155</b>	<b>2,739</b>
Outstanding invoices .....	1,849	2,540
Unused telephone units .....	524	500
Investment risks .....	399	126
Advertising cost subsidies / commissions .....	300	351
Restoration commitments .....	265	303
Loss contingencies .....	243	426
Refunds to be granted .....	230	168
Risks related to real estate .....	220	227
Litigation risks .....	209	164
Deferred maintenance .....	67	55
Other accruals .....	<u>1,105</u>	<u>824</u>
	<b>8,566</b>	<b>8,423</b>
	<b>11,247</b>	<b>12,155</b>

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. The present value of this future deficit has been determined on the basis of actuarial principles, based on the new "1998 life expectancy tables" by Prof. Dr. Klaus Heubeck ("Richttafeln 1998"), which primarily reflect the increase in average life expectancy. Deutsche Telekom is required to cover part of this deficit, and has recognized an accrual for its share. The expense for the addition to this accrual was EUR 271 million in the year ended December 31, 2003 (2002: EUR 44 million; 2001: EUR 70 million), in particular as a result of the decrease in the discount rate.

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. The personnel restructuring program has now been completed. There are, however, still contracts originating from this time which have to be fulfilled. In particular collective agreements are still used for bridging allowances and old-age part-time work and lead to the establishment of new accruals when a fixed contract is finalized.

Non-civil servants accepted severance offers in the current year.

The personnel restructuring accruals, other human resources obligations, and other accruals include accruals of EUR 662 million for restructuring measures, which developed as follows in the 2003 financial year:



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Type of restructuring activities**

	<u>Accruals as of January 1, 2003</u>	<u>Additions to accruals</u>	<u>Usage of accruals</u>	<u>Accruals as of December 31, 2003</u>
		(millions of €)		
Personnel restructuring accruals . . . . .	558	192	184	566
Contracts terminated prematurely . . . . .	62	49	30	81
Other . . . . .	<u>16</u>	<u>13</u>	<u>14</u>	<u>15</u>
	<u><b>636</b></u>	<u><b>254</b></u>	<u><b>228</b></u>	<u><b>662</b></u>

Personnel restructuring accruals mainly relate to Deutsche Telekom AG (EUR 390 million) and T-Systems CDS (EUR 24 million). Restructuring accruals for premature termination of contracts consist primarily of accruals at T-Systems CDS of EUR 68 million.

The decrease in accruals for loss contingencies in 2003 is primarily due to the reduction of prior year accruals for debt premiums at T-Mobile USA amounting to EUR 150 million. These accruals were the result of the difference between the repayment amount and the higher fair value of bonds. The repurchase of the bonds issued reduced the accrual to EUR 1 million in 2003.

The accruals for unused telephone units are recognized for charges for telephone services as yet not rendered but which have already been recognized as income.

The increase in accruals for investment risks relates primarily to our investment in Toll Collect.

**(30) Liabilities**

	<u>As of December 31, 2003</u>				<u>As of December 31, 2002</u>			
	<u>Total</u>	<u>of which due</u>			<u>Total</u>	<u>of which due</u>		
		<u>within one year</u>	<u>in one to five years</u>	<u>after 5 years</u>		<u>within one year</u>	<u>in one to five years</u>	<u>after 5 years</u>
		(millions of €)				(millions of €)		
<b>Debt</b>								
Bonds and debentures . . . . .	51,613	12,295	22,336	16,982	56,752	8,535	29,243	18,974
Liabilities to banks . . . . .	<u>3,798</u>	<u>806</u>	<u>1,928</u>	<u>1,064</u>	<u>6,292</u>	<u>1,341</u>	<u>3,534</u>	<u>1,417</u>
	<b>55,411</b>	<b>13,101</b>	<b>24,264</b>	<b>18,046</b>	<b>63,044</b>	<b>9,876</b>	<b>32,777</b>	<b>20,391</b>
<b>Other liabilities</b>								
Advances received . . . . .	402	402	—	—	414	228	186	—
Trade accounts payable . . . . .	4,175	4,143	32	—	3,833	3,807	26	—
Liabilities on bills accepted and drawn . . . . .	4	4	—	—	0	—	—	—
Payables to unconsolidated subsidiaries . . . . .	198	198	—	—	158	157	1	—
Payables to associated and related companies . . . . .	213	213	—	—	147	147	—	—
Other liabilities . . . . .	5,459	4,264	179	1,016	5,989	4,436	448	1,105
of which: from taxes . . . . .	(1,091)	(1,091)	—	—	(1,159)	(1,159)	—	—
of which: from social security . . . . .	<u>(100)</u>	<u>(100)</u>	<u>—</u>	<u>—</u>	<u>(153)</u>	<u>(153)</u>	<u>—</u>	<u>—</u>
	<u><b>10,451</b></u>	<u><b>9,224</b></u>	<u><b>211</b></u>	<u><b>1,016</b></u>	<u><b>10,541</b></u>	<u><b>8,775</b></u>	<u><b>661</b></u>	<u><b>1,105</b></u>
<b>Total liabilities . . . . .</b>	<u><b>65,862</b></u>	<u><b>22,325</b></u>	<u><b>24,475</b></u>	<u><b>19,062</b></u>	<u><b>73,585</b></u>	<u><b>18,651</b></u>	<u><b>33,438</b></u>	<u><b>21,496</b></u>

The main items under bonds and debentures relate to old bonds issued by Deutsche Bundespost amounting to EUR 9.2 billion, and bonds issued by Deutsche Telekom International Finance B.V., Amsterdam, between 2000 and 2003 with the following terms:

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Structure of the 2000 global bond:

<u>Tranche</u>	<u>Nominal amounts</u> <u>(in currency)</u>	<u>Nominal amounts</u> <u>(€)</u>	<u>Nominal interest rate</u>	<u>Maturity</u>
EUR.....	2,250,000,000	2,250,000,000	6.625%	2005
EUR.....	750,000,000	750,000,000	7.125%	2010
GBP.....	625,000,000	885,394,532	7.625%	2005
GBP.....	300,000,000	424,989,375	7.625%	2030
USD.....	3,000,000,000	2,380,196,792	8.250%	2005
USD.....	3,000,000,000	2,380,196,792	8.500%	2010
USD.....	3,500,000,000	2,776,896,223	8.750%	2030
JPY.....	90,000,000,000	667,953,888	2.000%	2005

Structure of the 2001 eurobond:

<u>Tranche</u>	<u>Nominal amounts</u> <u>(in currency)</u>	<u>Nominal amounts</u> <u>(€)</u>	<u>Nominal interest rate</u>	<u>Maturity</u>
EUR.....	4,500,000,000	4,500,000,000	6.375%	2006
EUR.....	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 percent. The change in the interest rate has already been included in the tables. If Deutsche Telekom is upgraded to at least an A- level by both agencies, the coupons will be reduced again by 0.5 percent.

Structure of the 2002 global bond:

<u>Tranche</u>	<u>Nominal amounts</u> <u>(in currency)</u>	<u>Nominal amounts</u> <u>(€)</u>	<u>Nominal interest rate</u>	<u>Maturity</u>
EUR.....	2,000,000,000	2,000,000,000	8.125%	2012
EUR.....	2,500,000,000	2,500,000,000	7.500%	2007
USD.....	500,000,000	396,699,460	9.250%	2032

The coupons of the 2002 global bond will increase by 0.5 percent if Deutsche Telekom is downgraded by Standard & Poor's and Moody's to below Baa1 / BBB+ respectively.

Structure of the 2003 USD bond

<u>Tranche</u>	<u>Nominal amounts</u> <u>(in currency)</u>	<u>Nominal amounts</u> <u>(€)</u>	<u>Nominal interest rate</u>	<u>Maturity</u>
USD.....	750,000,000	595,049,190	3.875%	2008
USD.....	1,250,000,000	991,748,651	5.250%	2013

In February 2003, Deutsche Telekom issued a mandatory convertible bond, via its financing subsidiary Deutsche Telekom International Finance B.V., generating proceeds totaling approximately EUR 2.3 billion. This mandatory convertible bond is convertible into common 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). Each bondholder has the right to convert each bond at any time between July 1, 2003 and April 30, 2006 at a conversion ratio that is equal to 3,417.1679. The bond bears interest at 6.5% per annum.

Deutsche Telekom International Finance B.V. is a wholly owned subsidiary of Deutsche Telekom AG, and its bond issuances are unconditionally and irrevocably guaranteed by Deutsche Telekom AG.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Breakdown of bonds and debentures:

Due in	Effective interest rate					Total
	up to 6%	up to 7%	up to 8%	up to 9%	over 9%	
	(millions of €)					
2004.....	2,757	3,233	6,212	93		12,295
2005.....	2,091	2,417	886	2,380		7,774
2006.....	453	4,500	2,288			7,241
2007.....	500	500	2,500		80	3,580
2008.....	3,741					3,741
after 2008.....	1,004	1,569	6,844	7,157	408	16,982
	<b>10,546</b>	<b>12,219</b>	<b>18,730</b>	<b>9,630</b>	<b>488</b>	<b>51,613</b>

Liabilities to banks (mainly loan notes and short-term loans) due in the next five years and thereafter are as follows:

Due in	Amounts
	(millions of €)
2004 .....	806
2005 .....	1,444
2006 .....	123
2007 .....	119
2008 .....	242
after 2008.....	1,064
	<b>3,798</b>

The average effective interest rate of total debt is as follows:

Bonds and debentures.....	6.82% per annum (2002: 6.69% per annum)
Liabilities to banks .....	6.12% per annum (2002: 5.74% per annum)

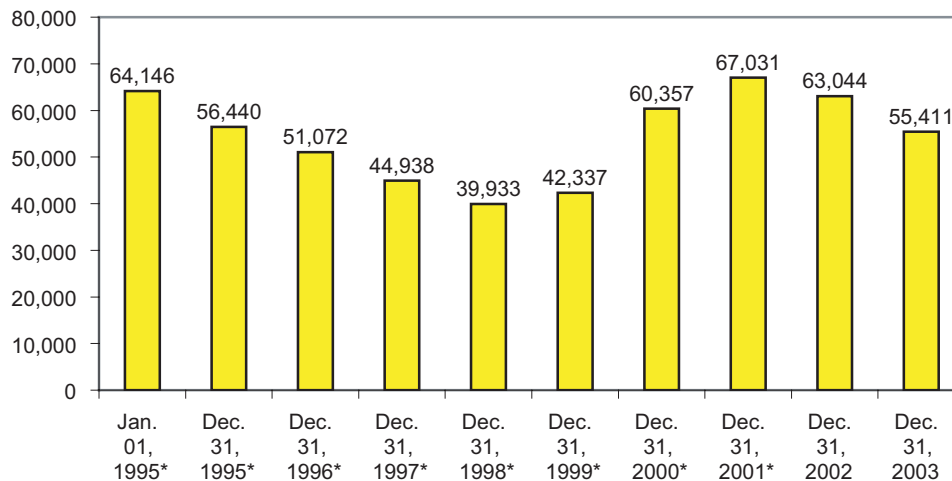
Deutsche Telekom has agreements with a number of banks pursuant to which it can draw on credit facilities of up to EUR 18.1 billion. These include syndicated loan facilities entered into by Deutsche Telekom AG and T-Mobile UK for EUR 9.0 billion (Deutsche Telekom syndicated credit) and EUR 3.9 billion (T-Mobile UK syndicated credit). Deutsche Telekom AG serves as guarantor of the T-Mobile UK syndicated loan. 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 percent. The loan commitment fee is between 0.050 and 0.200 percent and also depends on Deutsche Telekom's rating. EUR 1.0 billion of the T-Mobile UK syndicated credit has been used at December 31, 2003. This syndicated credit facility has an interest rate of 4.22 percent, excluding the loan commitment fee.

Part of the syndicated credit serves as collateral for Deutsche Telekom's commercial paper program. Deutsche Telekom may not draw on the syndicated credit in the amount of the drawings on the commercial paper drawdowns. Deutsche Telekom had not issued any commercial paper at December 31, 2003. There were no additional outstanding debts relating to the Deutsche Telekom syndicated credit at the end of 2003. Deutsche Telekom's credit facilities continue to include bilateral bank lines amounting to EUR 5.2 billion, of which EUR 0.3 billion had been used at the end of 2003 for short-term drawings and EUR 0.2 billion for guarantees.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The development of debt over time is shown below:

Debt (millions of €)



(\*) unaudited

The Company's original debt was raised principally to finance the development of the communications networks in Eastern Germany.

The increase in debt in 2001 was primarily a result of the acquisition and first-time consolidation of T-Mobile USA and Powertel.

Debt decreased by approximately EUR 4.0 billion in 2002, despite the acquisition of the remaining shares in debis Systemhaus and T-Mobile Netherlands, mainly because of cash generated from operations, divestitures of real estate and financial assets, and positive foreign currency effects.

In 2003, cash generated from operations, sales of assets, and positive foreign currency effects were the main drivers behind the further reduction in debt. New debt resulted primarily from the issuance of a U.S. dollar bond and a mandatorily convertible bond.

Financial liabilities include borrowings of EUR 17,261 million (2002: EUR 20,777 million) 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, 2003, 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 law requirements of general applicability.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Other Liabilities

	As of December 31,	
	2003	2002
	(millions of €)	
Interest .....	1,698	1,556
Rental and leasing obligations .....	425	573
Loan notes .....	799	842
Liabilities to employees .....	162	164
Other .....	<u>2,375</u>	<u>2,854</u>
	<u>5,459</u>	<u>5,989</u>

Other liabilities include taxes of EUR 1,091 million (2002: 1,159 million) and social security liabilities of EUR 100 million (2002: EUR 153 million).

Liabilities in the amount of EUR 5 million (2002: EUR 7 million) payable by subsidiary companies to banks and third parties are collateralized. Deutsche Telekom AG has provided no other collateral for 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. At December 31, 2003, this amount was EUR 11.6 billion.

### NOTES TO THE CONSOLIDATED STATEMENTS OF CASH FLOWS

The consolidated statement of cash flows has been prepared in conformity with International Accounting Standard (IAS) No. 7, Cash Flow Statements. Besides IAS 7, German Accounting Standard (GAS) No. 2, Cash Flow Statements, 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 drawing up the consolidated statement of cash flows. These current cash and cash equivalents increased by EUR 7.0 billion to EUR 8.7 billion in the year ended December 31, 2003.

This is a result of the following developments:

#### (31) Net Cash Provided by Operating Activities

Net cash provided by operating activities increased in the year ended December 31, 2003 by EUR 1.8 billion to EUR 14.3 billion.

In addition to tax refunds and lower net interest payments, this is due in particular to the improvement in operational business.

#### (32) Net Cash Used for Investing Activities

Net cash used for investing activities amounted to EUR 2.1 billion. This includes primarily investments of EUR 6.4 billion in noncurrent assets and EUR 0.3 billion in shares of fully consolidated companies. This is partially offset in particular by cash inflows from the disposal of noncurrent assets amounting to EUR 2.6 billion and the sale of shares of fully consolidated companies amounting to EUR 1.5 billion. As a result, net cash used for investing activities decreased by EUR 8.0 billion from EUR 10.0 billion in the prior year.

Investing activities declined year-on-year primarily due to lower investments in property, plant, and equipment of EUR 1.3 billion and shares of fully consolidated companies amounting to EUR 6.1 billion, in particular from the acquisitions of T-Systems ITS (EUR 4.7 billion) and T-Mobile Netherlands (EUR 1.7 billion) in the previous year. In addition, cash inflows from the sale of financial assets increased year-on-year (EUR 0.4 billion), as did cash inflows from the disposal of subsidiaries (EUR 0.8 billion). EUR 1.7 billion of the disposals relates to the sale of the Kabel Deutschland companies, and EUR 0.1 billion to the sale of T-Systems companies (mainly TELECASH); this was offset by outflows of liquid assets amounting to EUR 0.3 billion.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### (33) Net Cash Used for Financing Activities

Net cash used for financing activities increased by EUR 1.8 billion to EUR 5.2 billion in 2003.

The 2003 financing activities included a reduction in debt of EUR 5.1 billion compared with EUR 1.8 billion in 2002 resulting mainly from the repayment of U.S. dollar bonds, the reduction of a syndicated loan, and the repayment of bonds, offset by the issuances of mandatorily convertible bonds, and U.S. dollar bonds.

In addition, the 2002 amounts included a dividend payment amounting to EUR 1.6 billion, in comparison to dividend payments to minority shareholders amounting to EUR 0.1 billion in 2003.

## OTHER DISCLOSURES

### (34) Guarantees and Commitments, and Other Financial Obligations

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	<u>(millions of €)</u>	
Guarantees .....	28	47
Liabilities arising from warranty agreements .....	<u>2,199</u>	<u>927</u>
	<u><b>2,227</b></u>	<u><b>974</b></u>

The increase in liabilities arising from warranty agreements is due primarily to loan collateral guarantees by Deutsche Telekom AG for T-Mobile. This increase was partially offset by a decline in T-Mobile International AG's obligation under a QTE (Qualified Technology Equipment) lease, which decreased by EUR 140 million year-on-year to EUR 768 million due to exchange rate effects.

Deutsche Telekom AG (45 percent), DaimlerChrysler Services AG (45 percent), and Compagnie Financiere et Industrielle des Autoroutes S.A. (Cofiroute; 10 percent) – collectively the consortium – entered into an agreement with the Federal Republic of Germany, represented by the German Federal Ministry of Transport, Building and Housing (Federal Ministry of Transport), “on the collection of toll charges for the use of German highways by heavy vehicles, and the creation and operation of a toll system for the collection of highways toll charges for heavy vehicles (operating agreement)”, dated September 2002 and last amended in November 2002, under the terms of which they are obligated to set up and operate a system for the electronic collection of toll charges for heavy vehicles; this is to be performed by a project company with the legal form of a limited liability company under German law (GmbH) – Toll Collect GmbH. In addition, the parties of the consortium have undertaken, on a joint and several basis, in agreement with the Federal Republic, to maintain an equity ratio in the project company of 20 percent of the balance sheet total (calculated based on the German GAAP single-entity financial statements of the limited liability company) until August 31, 2004, and 15 percent thereafter; the total risk for Cofiroute arising from the Toll Collect project is limited to EUR 70 million.

Under the terms of the “Equity Maintenance Undertaking”, the parties of the consortium are obliged to inject additional capital in the event of negative developments within the Toll Collect project. As Deutsche Telekom AG did not expect any future injection of additional capital to be repaid during the project by any corresponding dividend from Toll Collect GmbH, accruals were recognized at December 31, 2003 for anticipated losses relating to the project (see Note (29) Other Accruals). The calculation of the accruals is based on the assumption that the system will start operation on January 1, 2005; correspondingly, foreseeable losses of income and expenses, such as contractual penalties for a delayed start of operations, were also taken into consideration.

Additional contractual penalties shall be payable if the start of operations is postponed beyond December 31, 2004. In addition, the agreement includes provisions for further contractual penalties after the approved start of operations (issuance of the preliminary operating permit) if the performance of the system is not adequate. The Federal Republic is asserting claims for damages from the parties of the consortium of EUR 156 million per month for the period September 1 to December 31, 2003 and EUR 180 million per month from January 1, 2004 for lost toll revenues. In addition, the Federal Republic is seeking contractual penalties of EUR 680 million because the



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

members of the consortium did not seek the necessary agreement of the Federal Ministry of Transport before concluding certain subcontractor agreements. Deutsche Telekom AG believes the claims of the Federal Republic are unfounded. Under the terms of the agreement, the Federal Republic may resort to arbitral proceedings for clarification of the legal position. The maximum future obligations arising from the Toll Collect project cannot be quantified with adequate certainty; it is therefore not possible to express this in figures under guarantees and commitments.

In addition, Deutsche Telekom AG has given a guarantee for bank loans to Toll Collect GmbH amounting to EUR 312 million; these are included in the table above.

### Other Financial Obligations

	As of December 31, 2003			As of December 31, 2002		
	of which due			of which due		
	Total	in the following financial year	from the second financial year after the balance sheet date	Total	in the following financial year	from the second financial year after the balance sheet date
	(millions of €)					
Present value of payments to special pension fund . . . . .	9,000	950	8,050	9,001	831	8,170
Purchase commitments for interests in other companies . . . . .	763	254	509	826	218	608
Obligations under rental and operating lease agreements . . . . .	11,737	1,703	10,034	10,050	1,813	8,237
Purchase commitment from capital projects in progress . . . . .	1,924	1,634	290	1,213	1,141	72
Commitments arising from transactions not yet settled . . . . .	869	783	86	475	364	111
Other financial obligations . . . . .	12	3	9	0	0	0
<b>Total other financial obligations . . . . .</b>	<b><u>24,305</u></b>	<b><u>5,327</u></b>	<b><u>18,978</u></b>	<b><u>21,565</u></b>	<b><u>4,367</u></b>	<b><u>17,198</u></b>

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, 2003.

The purchase commitments for interests in other companies relate mainly to Deutsche Telekom AG (EUR 510 million). The slight decrease in the commitments is marked by offsetting effects. An arbitration panel decided that T-Mobile's obligation to purchase additional shares of PTC no longer applies (2002: EUR 128 million). In addition, T-Online no longer has an obligation to contribute to a venture fund due to the inclusion of the company in the Group. New obligations result from the announcement by T-Online International AG that it will buy shares of Scout24 AG (EUR 180 million).

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 is mainly attributable to new and renewed leases for real estate and radio towers. The majority of the lease obligations are attributable to Group Headquarters & Shared Services, and to T-Mobile.

The purchase commitments for capital projects in progress are primarily attributable to Deutsche Telekom AG (EUR 1.0 billion), T-Systems (EUR 0.4 billion), and T-Mobile (EUR 0.3 billion). A

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

large number of different purchase commitments, most of which are short-term in nature, have been entered into by Deutsche Telekom AG. T-Systems has entered into commitments relating in particular to license agreements and software projects. T-Mobile's commitments include commitments to purchase network and UMTS equipment. There are detailed agreements covering the purchase quantities and periods.

The commitments arising from transactions not yet settled relate primarily to short-term purchase commitments at T-Mobile (EUR 0.8 billion). The increase in commitments is due in particular to new contracts for mobile terminals at T-Mobile Deutschland and T-Mobile UK. There are detailed agreements covering the purchase quantities and periods.

Deutsche Telekom is a party to a number of lawsuits and other proceedings arising out of the general conduct of its business, including proceedings under laws and regulations related to environmental and other matters. Litigation accruals include the costs of litigation and any probable losses. The Company does not believe that any additional costs will have a material adverse effect on the net worth, financial position, and results of the Deutsche Telekom Group.

### **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. The selling shareholder in the offering, Kreditanstalt fuer Wiederaufbau, has been dismissed from the action. Fact discovery in the U.S. class action suits is largely complete, and any remaining fact discovery is expected to be completed during the first quarter of 2004. Deutsche Telekom and the former Chairman of its Management Board have filed two motions for summary judgment seeking dismissal, respectively, of all plaintiffs' claims with respect to nondisclosure of negotiations with VoiceStream and all plaintiffs' claims with respect to alleged overstatement of real estate values. Those motions have not yet been fully briefed or argued.

Purported purchasers of Deutsche Telekom shares sold pursuant to prospectuses dated May 28, 1999 and May 26, 2000 have filed approximately 1,920 lawsuits (with approximately 11,358 plaintiffs) in Germany. The plaintiffs predominantly 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. In the recent wave of lawsuits, which were mostly filed in May 2003, many plaintiffs assert more allegations. They allege, among other things, that the purchase price for the UK cellular phone carrier One2One was unreasonably high and the prospectus did not provide information about necessary write offs to the goodwill, that the internal mid term financial plan for 2000-2004 was inaccurate, that the prospectus did not properly inform about the general risks of the international expansion, the relations to our major shareholder, the Federal Republic of Germany and the risks of the liberalization of the German telecommunication market. Further, they allege that the business prospects were described too positively and that the prospectus did not properly inform investors about the price to be paid for a UMTS- license to be bought in an auction in August 2000.

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 former presiding judge has issued a statement describing his preliminary view that it will be necessary to take evidence by obtaining an expert opinion. The former 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

However, the presiding judge changed in October 2003 and so far the Company has no indication how the new presiding judge intends to proceed. The aggregate euro amount of all shareholders' claims filed in Germany in these lawsuits is approximately EUR 73 million.

Many shareholders have also initiated conciliation proceedings with a state institution in Hamburg ("Oeffentliche Rechtsauskunfts- und Antragsstelle der Freien und Hansestadt Hamburg", "OeRA"). According to an oral information by OeRA approximately 12,000 to 15,000 shareholders have instituted conciliation proceedings. The Company expects the claims made in these conciliation proceedings to be analogous to those made in the purported prospectus liability lawsuits described above.

The Company is contesting each of the aforementioned lawsuits vigorously and has declined to participate in the conciliation proceedings. Because the lawsuits and the conciliation proceedings, which in the aggregate involve substantial damage claims, are in their preliminary stages, the plaintiffs in the U.S. class action suits have not yet responded to the motions for summary judgment and those motions have not been argued or decided, and the plaintiffs in the U.S. class action suits have not quantified the amount of damages they will seek. The Company is not in a position to predict their outcome or impact. However, the Company believes that the allegations in the lawsuits and the conciliation proceedings do not provide a basis for the recovery of damages because all required disclosures were made on a timely basis.

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 estate portfolio have been improperly established and maintained under applicable accounting principles and so were substantially overvalued in its 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 and that the Company further wrongfully paid dividends to its Shareholders in 1998. The Company believes that the book values of its 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. The Company cannot offer assurances as to the timing or outcome of the prosecutor's investigation. The investigations are being conducted with regard to certain individuals and is not directed against the Company. Adverse consequences for the 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 Company is cooperating with the investigations.

The Bonn public prosecutor is also conducting other investigations. One investigation concerns allegations that members and former members of the Management Board breached their duties by causing the Company to pay excessive consideration for VoiceStream and Powertel. Another investigation concerns allegations, that the Company wrongfully bore liability risks in connection with the June 2000 global offering by KfW of Deutsche Telekom shares. A third investigation concerns allegations of prohibited insider transactions with respect to amendments in the lock-up agreements with Sonera, allowing Sonera to sell a number of Deutsche Telekom shares. The Company understands that 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 its board members and the Company 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 with 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 the first quarter of 2000, AOL Bertelsmann brought preliminary injunction proceedings and filed a complaint against T-Online and the Company before the Hamburg District Court (*Landgericht Hamburg*) claiming that T-Online had engaged in an anti-competitive practice by bundling its

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

“By-Call” Internet access charge with the Company’s ISDN telephone access. The Hamburg District Court decided in the favor of the Company 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 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 131 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.

In connection with the current delay in the introduction of a toll collection system the Federal Republic of Germany has indicated that it will initiate arbitration proceedings against the Company, DaimlerChrysler Services AG and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) for damages arising from breach of the Operating Agreement.

### **(35) Financial Instruments**

#### **Fair Value**

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The following is a summary of the estimated fair value of Deutsche Telekom’s financial instruments:

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	As of December 31, 2003		As of December 31, 2002	
	Fair value	Net carrying amount	Fair value	Net carrying amount
	(millions of €)			
<b>Assets</b>				
Other investments in related companies . . . . .	750	496	1,169	1,021
Other long-term loans . . . . .	77	78	109	107
Other investments in noncurrent securities . . . . .	80	86	238	238
Accounts receivable . . . . .	5,874	5,874	6,258	6,258
Liquid assets . . . . .	9,127	9,127	1,905	1,905
Other investments in marketable securities . . . . .	175	173	413	413
<b>Liabilities</b>				
Bonds and debentures . . . . .	56,151	51,613	60,144	56,752
Liabilities to banks . . . . .	3,730	3,798	6,368	6,292
Other liabilities . . . . .	10,666	10,666	10,541	10,541
<b>Derivative financial instruments<sup>(1)</sup></b>				
Interest rate swaps . . . . .	(74)	(194)	67	(230)
Cross-currency interest rate swaps sold . . . . .	(712)	(231)	(488)	(190)
Foreign currency forward contracts . . . . .	(80)	(16)	12	28
Foreign currency options . . . . .	1	0	0	0

(1) Non-bracketed amounts represent assets, bracketed amounts represent liabilities.

Fair values were determined as follows:

The fair value of other investments in noncurrent assets 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 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 carrying amounts of other liabilities approximate their fair values. 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 adverse changes in the values of the underlying hedged transactions.

The fair values of other investments in related companies as well as loans to unconsolidated subsidiaries and associated companies, which have carrying amounts of EUR 523 million and EUR 1,082 million at December 31, 2003 and 2002 respectively, could not be determined, except for the investments in VocalTec and SES Global S.A., because they are not publicly traded. VocalTec and SES Global S.A. are measured at their fair values, based on share prices.

**Derivative Financial Instruments**

The Company uses derivative financial instruments for the purpose of hedging interest rate and currency exposures that arise from its ongoing business operations. The top priority in all cases in which derivatives are used is to limit the risk of the underlyings. Derivatives may therefore only be used to eliminate risk exposures, and may never be used to create new risks for speculative reasons. 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 rates 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,



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

or position being hedged. Such derivatives are monitored regularly for their effectiveness as hedge instruments. Derivative instruments designated as hedges are accounted for together with 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 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 swap foreign currency bonds or medium-term notes in required target currencies.

Gains or losses related to changes in the value of interest rate swaps are generally not recognized. Only 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 resulting 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 fair value are netted currency for currency and assigned to portfolios, and the resulting net loss is accrued. The interest differential to be paid or received on interest rate swaps is recognized in the statement of operations, as incurred, as a component of net interest expense. Gains or losses on interest rate swaps released prior to their maturity are recognized immediately 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 eliminate fluctuations in foreign currency cash flows related to capital expenditures and financial liabilities. Foreign currency forward contracts hedging firm commitments to invest in or sell a foreign entity are not recognized at the balance sheet date. Such firm commitments are recognized using the foreign exchange rate fixed by the foreign currency forward contract. Where the Company purchases call options to hedge firm commitments to invest in a foreign entity or put options for disposal of investments, the option is carried in other assets and is not measured until exercise or expiration. The option premium is included in the purchase cost of the investment when its addition is recorded, and in the proceeds from the sale when the selling price is received. 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 resulting negative portfolio values are accrued under other liabilities. Measurement 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 following is a summary of the contract or notional principal amounts outstanding and the average interest paid / received at December 31, 2003 and 2002:



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	Dec. 31, 2003				Dec. 31, 2002			
	<u>Maturity</u>	<u>Notional amount millions of €</u>	<u>Average interest rate paid</u>	<u>Average interest rate received</u>	<u>Maturity</u>	<u>Notional amount millions of €</u>	<u>Average interest rate paid</u>	<u>Average interest rate received</u>
<b>Interest rate swaps (EUR)</b>								
Receive fixed, pay variable . . . . .	2004-2010	13,664	2.12%	3.96%	2003-2010	12,019	3.26%	4.44%
Forward receive fixed, pay variable . . . . .	2007-2008	2,000	EURIBOR6M	3.86%	2005	820	EURIBOR6M	4.21%
Receive variable, pay fixed . . . . .	2005-2010	2,555	5.80%	2.20%	2003-2010	4,652	5.23%	3.07%
<b>Interest rate swaps (USD)</b>								
Receive fixed, pay variable . . . . .	2005-2007	2,539	1.23%	2.31%	2003-2008	1,144	2.11%	8.00%
Forward receive fixed, pay variable . . . . .	2007	793	USDL6M	3.22%	—	—	—	—
Receive variable, pay fixed . . . . .	2007	793	4.65%	1.22%	—	—	—	—
Forward receive variable, pay fixed . . .	2007-2008	3,015	4.70%	USDL6M	2007	2,859	5.07%	USDL6M
<b>Interest rate swaps (GBP)</b>								
Receive fixed, pay variable . . . . .	2005	283	4.18%	3.84%	—	—	—	—
Receive variable, pay fixed . . . . .	2005-2006	779	5.80%	3.83%	2003-2006	1,575	5.91%	3.94%
Forward receive variable, pay fixed . . .	—	—	—	—	2005	307	6.04%	GBPL6M
<b>Interest rate swaps (JPY)</b>								
Receive fixed, pay variable . . . . .	2005	668	0.31%	1.50%	2005	723	0.32%	1.50%
<b>Interest rate swaps (CZK)</b>								
Receive fixed, pay variable . . . . .	—	—	—	—	2004	13	3.18%	8.14%
<b>Interest rate swaps (HUF)</b>								
Receive fixed, pay variable . . . . .	2006	241	9.25%	9.61%	—	—	—	—
Forward receive variable, pay fixed . . .	—	—	—	—	2006	269	9.25%	BUBOR6M
<b>Interest rate caps/collars . . . . .</b>	—	—	—	—	2003	38	—	—
<b>Cross currency interest rate swaps . . . . .</b>	2004-2032	4,883	5.25%	2.57%	2003-2032	6,437	5.29%	3.05%
<b>Forward cross currency interest rate swaps . . . . .</b>	—	—	—	—	2006	252	BUBOR6M	EURIBOR6M
<b>Foreign currency forward contracts</b>								
Forward purchases . . . . .	2004-2008	1,190	—	—	2003-2008	1,955	—	—
Forward sales . . . . .	2004-2006	982	—	—	2003-2006	2,917	—	—
Currency options . . . . .	2004-2005	5	—	—	2003	4	—	—

The notional amounts of the derivative financial instruments do not generally represent amounts exchanged by the parties, but are merely the basis for measuring these amounts. They do not reflect the risk exposure of the financial derivatives. The amounts exchanged are calculated by reference to the notional amounts and by the other terms of the derivatives, such as interest rates, exchange rates, or other indices.

**(36) Segment Reporting**

Deutsche Telekom applies Statement of Financial Accounting Standards No. 131 “Disclosures about Segments of an Enterprise and Related Information” (SFAS 131) and the German Accounting Standard No. 3 “Segment Reporting” (GAS 3) for the calculation of segment information. These require companies to disclose information on their operational segments in accordance with their internal reporting structures. Under SFAS No. 131 and GAS 3, Deutsche Telekom has the following operational segments for which reporting is required: T-Com, T-Mobile, T-Systems, T-Online, and Group Headquarters & Shared Services. 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 measurement 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 the income before income 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. The first-time application of the cost-of-sales method at Deutsche Telekom from January 1, 2003 led to a change in the composition of income before taxes, which now includes other taxes. As no extraordinary items arose in any of the periods, the income before income taxes reported here corresponds to results from ordinary business activities.

Revenues generated and goods and services exchanged between segments are generally calculated on the basis of market prices. With the exception of depreciation and amortization, additions to and reversal of accruals, no major noncash items are shown 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 other investments in marketable securities.

Segment assets under segment reporting include the carrying amount of property, plant, and equipment, intangible assets, and financial assets. Segment investments are defined as increases in these areas. In addition, the segment assets and segment investments are shown by geographical region; assignment to the individual regions is generally determined by the location of the asset. Please refer to note (1) Net Revenues for the presentation of revenue by regions. In accordance with GAS 3, liabilities have been assigned to the segments since the 2000 financial year. As part of Group segment reporting, these include debt and other liabilities, excluding tax liabilities.

The structure of the segments was adapted to the adjusted reporting structure at the T-Com and T-Online divisions in the first quarter of 2003. DeTeMedien is no longer included under T-Online, but has been reported under T-Com since January 1, 2003. In the same way, subsequent measurement resulting from the inclusion of new shareholders at T-Online, which affects the income/loss related to associated and related companies, as well as depreciation and amortization, is no longer reported under the T-Online segment but in the reconciliation to consolidated amounts. In addition, the direct allocation of the agency business from the T-Systems segment to the T-Com and T-Mobile segments has led to a redistribution of intersegment revenue and net revenues which does not affect income. To facilitate comparison, prior-year figures have been adjusted in accordance with the aforementioned changes.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

		<u>Net revenue</u>	<u>Revenue between segments</u>	<u>Depreciation and amortization</u>	<u>Net interest income/(expense)</u>	<u>Income/(loss) related to associated and related companies</u>	<u>Income/(loss) before income taxes</u>	<u>Non-current Segment assets</u>	<u>Segment investments</u>	<u>Segment liabilities</u>	<u>Employees<sup>(2)</sup></u>
T-Com <sup>(1)</sup> . . .	2003	25,116	4,090	(5,169)	(315)	(412)	4,247	29,030	2,324	4,549	139,548
	2002	26,491	4,068	(5,539)	(562)	(304)	3,604	33,782	3,273	13,120	153,065
	2001	26,427	3,401	(5,444)	(346)	(509)	4,673				
T-Mobile <sup>(1)</sup> . .	2003	21,572	1,206	(5,196)	(992)	97	831	50,025	3,813	17,617	41,767
	2002	18,339	1,396	(27,285)	(1,005)	(427)	(23,754)	57,655	5,766	20,224	38,943
	2001	13,101	1,536	(6,324)	(3,008)	(204)	(6,441)				
T-Systems <sup>(1)</sup> .	2003	7,184	3,430	(1,499)	(39)	(4)	(138)	5,665	708	4,314	42,108
	2002	6,895	3,594	(2,616)	(98)	(20)	(1,990)	6,646	3,551	5,268	43,482
	2001	7,121	3,700	(1,372)	102	13	(389)				
T-Online <sup>(1) (3)</sup> .	2003	1,662	189	(430)	110	90	104	1,532	116	212	2,637
	2002	1,391	193	(435)	128	(265)	(471)	1,797	170	119	2,536
	2001	1,027	113	(416)	164	(381)	(820)				
Group Head quarters and Shared Services . .	2003	304	3,964	(881)	(2,874)	(3)	(4,071)	10,631	455	41,334	25,203
	2002	573	3,838	(1,298)	(2,510)	(1,093)	(4,690)	12,978	551	34,539	17,870
	2001	633	4,481	(1,447)	(1,102)	(375)	402				
Reconciliation <sup>(1)</sup> .	2003	0	(12,879)	291	334	(23)	425	(1,232)	(349)	(3,255)	—
	2002	0	(13,089)	293	(1)	135	151	(1,332)	(149)	(844)	—
	2001	0	(13,231)	(218)	52	246	14				
Group . . . . .	2003	55,838	0	(12,884)	(3,776)	(255)	1,398	95,651	7,067	64,771	251,263
	2002	53,689	0	(36,880)	(4,048)	(1,974)	(27,150)	111,526	13,162	72,426	255,896
	2001	48,309	0	(15,221)	(4,138)	(1,210)	(2,561)				

(1) According to new structure

(2) Average number of employees for the year

(3) Figures are calculated in accordance with the provisions of German GAAP, as applied throughout the Deutsche Telekom Group, and differ from those published in the reports of T-Online International AG under IFRS.

**Segments by Geographic Area**

	<u>Segment noncurrent assets</u>		<u>Segment investments</u>	
	<u>December 31, 2003</u>	<u>December 31, 2002</u>	<u>December 31, 2003</u>	<u>December 31, 2002</u>
	(millions of €)			
Germany . . . . .	46,065	51,707	3,201	6,883
European Union (excluding Germany) . . . .	16,459	20,370	824	2,694
Rest of Europe . . . . .	10,878	12,006	986	1,173
North America . . . . .	21,815	26,448	2,033	2,228
Other . . . . .	434	995	23	184
<b>Group . . . . .</b>	<b><u>95,651</u></b>	<b><u>111,526</u></b>	<b><u>7,067</u></b>	<b><u>13,162</u></b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### T-Com

The T-Com segment is responsible in particular for Deutsche Telekom's fixed-network business, where it is one of Europe's largest operators. In the upstream market, T-Com provides network-related services to all of Deutsche Telekom's divisions, as well as approximately 200 telecommunications companies. In Germany, T-Com serves residential and business customers with a broad range of products and services. Small and medium-sized enterprises (SMEs) benefit from T-Com's end-to-end, integrated IT and telecom solutions. Shareholdings in Matáv (Hungary), HT-Hrvatske telekomunikacije (Croatia), and Slovak Telecom (Slovakia) (formerly Slovenské Telekomunikácie) have given T-Com a foothold in Central and Eastern European markets. The DeTeMedien business previously shown under T-Online has been reported at T-Com since January 1, 2003. T-Com has had its own brand identity under the umbrella of the Deutsche Telekom Group since August 1, 2003.

Net revenue decreased in the year ended December 31, 2003 by EUR 1,375 million to EUR 25,116 million. This is largely attributable to the reduction in revenue as a result of the sale and ensuing deconsolidation of the subsidiaries Kabel Deutschland. In addition, regulatory decisions, further interconnection of carriers, and the weak economic environment also had an impact on revenue. By contrast, revenue in the local loop in Germany continued to grow as a result of higher access charges, the continued migration of customers from analog to more advanced ISDN lines, and the roll-out of DSL lines, slightly more than offset the decline in call revenues driven by the level of regulation and competition. Lower revenues from data communications as a result of the economic situation and from terminal equipment also had a negative impact on net revenue. Revenue generated in Eastern Europe is at the same level as in the previous year.

Revenue from business with other segments amounting to EUR 4,090 million relates mainly to network and support services billed by T-Com to other segments, and to the provision of fixed-network terminal equipment for other segments. This year's figure is on a par with the previous year.

In 2003, depreciation and amortization decreased by EUR 370 million year-on-year to EUR 5,169 million. This is primarily due to the reduced volume of depreciation following the disposal of property, plant, and equipment as part of the sale of the remaining cable business at the beginning of 2003. The reduction in capital expenditure at T-Com in Germany also had an impact on the level of depreciation and amortization. The net interest expense reflects the level of financial liabilities assigned to the segment. The decrease in the net interest expense by EUR 247 million from EUR 562 million to EUR 315 million relates in particular to the sharp decline in T-Com's debt in the year ended December 31, 2003. By contrast, the loss related to associated and related companies increased. In the year ended December 31, 2003, the loss related to associated and related companies was more heavily impacted than in 2002, primarily due to expenses arising from the Company's interest in Toll Collect; the prior-year figure was affected by valuation adjustments on loans to associated companies of Kabel Deutschland.

Despite a decline in net revenues, income before income taxes increased by EUR 643 million to EUR 4,247 million in 2003. In addition to the reasons indicated above, this increase is due to improved efficiency relating to operating expenses: in particular, decreases were achieved in rental and lease expenses, losses on accounts receivable, expenses for domestic and international upstream telecommunications services, raw materials and supplies, as well as advertising, travel and consulting expenses. In addition, income from the sale of the remaining cable companies helped to increase income before income taxes. These proceeds were partly offset, however, by expenses for transfers to accruals, mainly for restructuring and increased additions to pension accruals.

The reduction in segment assets to EUR 29,030 million is due in particular to the decline in property, plant, and equipment in connection with the sale of the remaining cable companies, as well as the depreciation of property, plant, and equipment. As in the previous year, the investments in T-Com's segment assets were mainly made in technical equipment and advance payments as well as construction in progress. These investments were driven by the expansion and upgrading of the local loop, the roll-out of the new transmission platform SDH200+, and the increasing number of DSL lines. Capital expenditure decreased further in comparison with previous years. Segment liabilities consist mainly of financial liabilities. This decrease reflects the positive development of the net worth, financial position, and results of T-Com.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### T-Mobile

In the first quarter of 2003, T-Mobile International AG and therefore all the subsidiaries and investments of T-Mobile International AG were transferred to Deutsche Telekom AG's wholly owned subsidiary "T-Mobile International Holding GmbH." T-Mobile International Holding's mobile communications companies, which are now consolidated in the T-Mobile segment, account for all the activities of the T-Mobile International group. Via these subsidiaries, T-Mobile operates a transatlantic GSM mobile communications network and thus offers the advantages of a standardized technical platform for a broad range of customers mainly in Germany, the United States, the United Kingdom, Austria, the Czech Republic, and the Netherlands. T-Mobile also holds substantial minority interests in mobile communications companies, particularly in Poland and Russia. In addition to T-Mobile International Holding as the parent company, the companies that are fully consolidated as operational subsidiaries primarily include T-Mobile Deutschland, T-Mobile UK, T-Mobile USA, T-Mobile Austria, T-Mobile Czech Republic, and T-Mobile Netherlands.

The increase in net revenue by EUR 3,233 million to EUR 21,572 million reflects in particular the considerable increase in the number of subscribers in almost all of the mobile communications networks under T-Mobile's majority control. In 2003, T-Mobile's mobile communications subsidiaries in Germany, the United States, the United Kingdom, the Czech Republic, and the Netherlands recorded a substantial increase in subscribers; even in Austria, customer levels remained stable despite a fiercely competitive environment. T-Mobile succeeded in increasing its revenue once more in 2003 despite unfavorable exchange rate trends. The full-year consolidation of T-Mobile Netherlands also had a positive effect on net revenue in 2003. T-Mobile Netherlands was only consolidated for three months in 2002.

Revenue of EUR 1,206 million from business with other segments was primarily generated within Germany through network interconnection services (so-called "mobile terminated calls").

Depreciation and amortization decreased by EUR 22,089 million year-on-year, mainly due to the non-recurrence of the need for nonscheduled amortization of licenses and goodwill totaling EUR 20,795 million that was identified as part of the strategic review carried out in 2002. In 2003, on the other hand, the T-Mobile group merely recorded nonscheduled amortization totaling EUR 61 million, as well as regular depreciation and amortization. In addition, the first-time full consolidation of T-Mobile Netherlands increased depreciation and amortization in the year ended December 31, 2003.

The net interest expense amounting to EUR 992 million is almost on par with the previous year, whereas the loss related to associated and related companies in 2002 improved by EUR 524 million, resulting in income of EUR 97 million. In contrast to the 2003 financial year, the prior-year loss related to associated and related companies was impacted for nine months in the amount of EUR 292 million by the negative contribution of T-Mobile Netherlands, which was only fully consolidated from September 30, 2002. The write-down in full of the minority interest in the Canadian company Microcell also had a negative effect amounting to EUR 51 million on this figure in 2002.

The loss before income taxes of the T-Mobile segment in 2002 improved by EUR 24,585 million, resulting in an income of EUR 831 million in 2003. On the one hand, this improvement is attributable to the non-recurrence of the nonscheduled amortization of goodwill and licenses in the previous year. On the other hand, the gain from the sale of part of the interest in the Russian company MTS amounting to approximately EUR 352 million, as well as tangible economies of scale and synergy effects, made a key contribution to improving operating performance.

Segment assets amounting to EUR 50,025 million continue to consist mainly of intangible assets, in particular mobile communications licenses and goodwill. The decline in the segment's intangible assets and property, plant, and equipment is due primarily to the exchange rate effects caused by translating the currencies of foreign subsidiaries – in particular T-Mobile USA and T-Mobile UK – and to continued amortization. In 2003, investments focused in particular on property, plant, and equipment as a result of the construction of the UMTS network in Europe, as well as the further expansion of the U.S. network. Segment liabilities consist primarily of debt; the decline is mainly attributable to the debt reduction in 2003.

### T-Systems

T-Systems provides the Deutsche Telekom Group's national and international key accounts with tailored information and communication technology (ICT) solutions. T-Systems provides the

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

infrastructure needed to do this, implements customer solutions, and operates end-to-end business processes based on these solutions if required. T-Systems is represented in over 20 countries by branch offices and its own national companies.

Net revenue increased in the year ended December 31, 2003 by EUR 289 million to EUR 7,184 million. This was primarily due to the continued positive development of the Telecommunications (TC) unit which, in turn, was largely attributable to the implementation of measures designed to improve quality in the domestic and international network services business. This was offset by the decline in net revenues in the Information Technology (IT) unit as well as the sale of interests in T-Systems SIRIS, T-Systems MultiLink, TeleCash Kommunikations-Service GmbH, and T-Systems CS in 2003.

In contrast, revenues generated with other segments fell by EUR 164 million year-on-year to EUR 3,430 million.

The decrease of EUR 1,117 million in depreciation and amortization to EUR 1,499 million is particularly attributable to the nonscheduled amortization on goodwill and property, plant, and equipment in the previous year amounting to EUR 600 million and a write-down on submarine cables in the North Atlantic and the Pacific. There were no comparable activities in the year ended December 31, 2003. The net financial expense improved in 2003 from EUR 118 million to EUR 43 million, primarily as a result of debt reduction.

In addition, the decrease of EUR 1,852 million in the loss before income taxes to EUR 138 million in 2003 is mainly attributable to the comprehensive measures implemented as part of the Triple-E program to increase efficiency and quality. Operating expenses decreased considerably in 2003 as a result of improved business processes and consistent cost management. In addition, the proceeds from the sale of T-Systems SIRIS and TeleCash Kommunikations-Service GmbH had an impact in the period under review. These were offset by expenses to the same amount, mainly as a result of losses and transaction costs relating to the sale of other subsidiaries. Factors affecting the loss before income taxes in the previous year included restructuring expenses.

Segment assets amounting to EUR 5,665 million consist mainly of intangible assets, which essentially comprise goodwill relating to the former T-Systems ITS. In 2003, segment assets decreased in particular as a result of goodwill amortization. Segment liabilities consist mainly of financial liabilities.

### **T-Online**

T-Online is one of the leading Internet service providers in Germany. T-Online operates a combined business model within the Deutsche Telekom Group, consisting of the access business as well as content, services, e-commerce, and advertising. The segment is represented by subsidiaries in France and Spain and certain other European countries. The DeTeMedien business previously shown under T-Online has been managed by the T-Com segment since January 1, 2003.

The net revenue of the T-Online segment increased in the year ended December 31, 2003 by EUR 271 million to EUR 1,662 million and thus continued the upward trend of the previous years. This development is due, in particular, to the increase in subscriber numbers in Germany, as well as the growth in demand for content and services, and the resulting increase in time spent online.

Net revenue from the internal provision of services between segments was on a par with the previous year.

Depreciation and amortization mainly consists of goodwill amortization and remained almost unchanged year-on-year at EUR 430 million. Net interest income declined year-on-year to EUR 110 million as a result of changes in the development of the capital market. By contrast, the loss related to associated and related companies of EUR 265 million in 2002 was turned around by an improvement of EUR 355 million, resulting in an income of EUR 90 million in 2003. This is primarily the result of a write-up of the shareholding in comdirect bank in the year ended December 31, 2003 due to its positive development, and the non-recurrence of nonscheduled amortization on goodwill, also relating to the shareholding in comdirect bank AG, from the previous year.

The turnaround of the loss before income taxes in 2002 to an income of EUR 104 million in 2003 after an improvement of EUR 575 million is mainly due to increased net revenues and the fact that positive income related to associated and related companies was recorded in 2003, after a loss in 2002.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The assets of the T-Online segment consist mainly of intangible assets, primarily goodwill. The decrease in segment assets during 2003 is due in particular to the amortization of goodwill. The year-on-year decline in investing activities relates mainly to investments in property, plant, and equipment, and financial assets. The increase in segment liabilities is attributable to short-term liabilities to Deutsche Telekom AG.

### Group Headquarters and Shared Services

Group Headquarters and Shared Services (GHS) includes all group units which cannot be allocated to an individual segment. Deutsche Telekom completed its reorganization to create a virtual Strategic Management Holding in the 2003 financial year. As part of this reorganization, the unit reported as Other until the first quarter of 2003 has been renamed Group Headquarters and Shared Services. GHS now focuses on strategic and cross-divisional management functions. All other operating functions not directly related to the segments' core businesses are now the responsibility of Shared Services. In particular, these include the real estate business, billing services, fleet management by DeTeFleetServices GmbH, and Vivento.

GHS's net revenue amounting to EUR 304 million consists largely of the revenues generated by the real estate companies. The year-on-year decrease is mainly due to lower revenues from project development.

The increase in revenue from the internal provision of services between segments by EUR 126 million to EUR 3,964 million relates mainly to changes in the composition of the Deutsche Telekom Group. Revenue generated by DeTeFleetServices GmbH in the 2003 financial year is set against net revenues from only six months in the previous year. This was offset by passing on cost savings in customer billing as well as price reductions at the Real Estate shared service to the operational segments.

The decrease of EUR 417 million in depreciation and amortization to EUR 881 million reflects in particular the lower amortization base as a result of the continued reduction of real estate assets. The increase of EUR 364 million in the net interest expense is due to a decline in internal net interest income. In addition, the loss related to associated and related companies decreased substantially by EUR 1,090 million to EUR 3 million in 2003. One of the main reasons for this was the valuation adjustments included in the previous year on the shares held in France Telecom (EUR 613 million) and on other investments in noncurrent securities (EUR 384 million). There were no comparable valuation adjustments in the year ended December 31, 2003.

The loss before income taxes of EUR 4,071 million was positively impacted by gains on the sale of minority interests in Eutelsat (EUR 65 million), the joint venture UMC (Ukrainian Mobile Communications), (EUR 54 million), Celcom (EUR 20 million), Globe Telecom (EUR 72 million), and Inmarsat (EUR 32 million), as well as transfer payments for T-Com staff transferred to Vivento amounting to EUR 131 million. The loss before income taxes in 2002 included higher proceeds from the sale of T-Online shares and PT Satelindo. Furthermore, additions to Civil Service Health Insurance Fund accruals due to the adjustment of the discount rate applied, increased additions to accruals for pensions and employee severance payments, and personnel costs for employees transferred to Vivento also had a negative impact in the period under review. This contrasts with expenses in the previous year arising from the sale of receivables as well as from the launch of a uniform brand for individual mobile communications companies.

The reduction in segment assets to EUR 10,631 million is attributable in particular to the decrease in property, plant, and equipment and in financial assets. This resulted primarily from the sale of further tranches of real estate assets and the sale of shares in various minority interests and other investments in noncurrent securities. GHS's investing activities in the 2003 financial year were on par with the previous year.

### Reconciliation

The items to be reconciled relate mainly to consolidation measures. As in the previous year, the reconciliation does not include any additional items for the year ended December 31, 2003. In 2001, this included a general valuation adjustment amounting to EUR 466 million, made as part of Deutsche Telekom's strategy to dispose more rapidly of 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; it is almost exclusively an element of the depreciation and amortization shown in the reconciliation.

**(37) Related Party Disclosures**

**Federal Republic of Germany and Majority Shareholdings**

Deutsche Telekom has numerous business relationships with the Federal Republic of Germany and the companies in which it holds majority shareholdings. All relationships are conducted on an arm's length basis. Key related parties include Deutsche Post AG and Kreditanstalt für Wiederaufbau (KfW).

In the 2003 financial year, Deutsche Telekom purchased goods and services amounting to EUR 0.7 billion from the **Deutsche Post World Net** group. These mainly relate to postage charges for letters and packages. In the same period, Deutsche Post World Net group purchased goods and services totaling EUR 0.5 billion from Deutsche Telekom. This amount primarily consists of IT products and services.

In addition, Deutsche Telekom AG and Deutsche Postbank AG have entered into a master credit agreement in the amount of EUR 0.2 billion. In the 2003 financial year, this credit line was drawn down to a maximum of EUR 0.1 billion. This agreement is initially valid until May 30, 2004.

Deutsche Telekom AG also has a credit facility with Deutsche Postbank AG as part of the EUR 9 billion multi-currency syndicated loan amounting to EUR 0.3 billion, which however was not utilized in the 2003 financial year.

The Company's Dutch financing subsidiary, Deutsche Telekom Finance, has taken out three loans of GBP 150 million each with **Kreditanstalt für Wiederaufbau** (total volume EUR 637 million). The loans were extended at the normal market rate of interest which is based on Deutsche Telekom AG's current rating, among other things. The loans, entered into in 2000, have an original maturity of five, eight, or ten years, respectively.

**Associated Companies**

Deutsche Telekom also has business relationships with numerous associated companies. All delivery and service relationships involving these companies were also conducted on an arm's length basis. Key associated companies include Virgin Mobile Telecoms and Toll Collect.

The Company's British mobile communications subsidiary, T-Mobile UK, generated revenue from the joint venture **Virgin Mobile Telecoms** amounting to EUR 0.3 billion. This figure relates to call charges and interconnection fees. At the same time, the contractually agreed allowance for marketing expenses, which amounted to EUR 0.2 billion in the year ended December 31, 2003, was reimbursed to Virgin Mobile Telecoms.

T-Systems generated revenues of EUR 0.1 billion from business with the **Toll Collect** joint venture. This amount consists mainly of services for the integration and implementation of hardware and software components for the toll collection system.

**Natural Persons**

No transactions have taken place between Deutsche Telekom and persons in key management positions.

**(38) Compensation of the Board of Management and the Supervisory Board**

Under the terms of their service contracts, the members of the Group Board of Management are entitled to fixed and variable, performance-related compensation components. The compensation of the members of the Board of Management is in line with market levels.

Performance-related compensation is determined on the basis of the targets agreed between the Supervisory Board General Committee and the members of the Board of Management, and the level of target achievement as determined by the General Committee at the end of the financial year.

In observance of the requirements of German commercial and accounting legislation, a total of EUR 12,996,215.92 is reported as compensation for the members of the Board of Management for the

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

past financial year. This figure includes EUR 928,386.75 of noncash compensation which is treated as noncash benefits. EUR 82,052.83 of the accruals recognized in 2002 was reversed in conjunction with the payment in the 2003 financial year of the variable compensation for the 2002 financial year.

Subject to the condition that the financial statements of Deutsche Telekom AG are approved in their current form, the members of the Board of Management shall receive the following total compensation for the 2003 financial year (fixed annual salary, variable compensation, and long-term incentives):

<u>Name</u>	<b>For the year ended December 31, 2003</b>		
	<b>Fixed annual salary</b>	<b>Variable compensation</b>	<b>Long-term incentive: Stock options granted</b>
	(amounts in €)		
Kai-Uwe Ricke.....	1,250,000	1,375,000	0
Dr. Karl-Gerhard Eick.....	937,500	1,031,250	0
Dr. Heinz Klinkhammer.....	900,000	660,000	0
Josef Brauner.....	900,000	546,000	0
René Obermann.....	700,000	770,000	0
Konrad F. Reiss (pro rata since appointment).....	711,694	898,438	0
Thomas Holtrop.....	700,000	770,000	0
Total.....	6,099,194	6,050,688	0

As in the previous year, no stock options from the 2001 Stock Option Plan were granted to the members of the Board of Management in the 2003 financial year.

There was no increase in compensation in the 2003 financial year.

Compensation paid to former members of the Board of Management and their surviving dependents totaled EUR 1,106,105. The accruals set up for ongoing pensions and pension entitlements amounted to EUR 41,000,962. Indirect pension obligations for former members of the Board of Management resulting from pensions for civil servants via the Deutsche Telekom special pension fund in accordance with § 15 (1) of the Act concerning the Legal Provisions for the former Deutsche Bundespost Staff (PostPersRG) amounted to EUR 3,393,899. No accruals were recognized for these obligations.

Deutsche Telekom has not granted any loans to current or former members of the Board of Management.

The compensation received by the members of the Supervisory Board is specified under § 13 of the Articles of Incorporation. The members of the Supervisory Board receive EUR 25,000 per year. The Chairperson of the Supervisory Board receives double, and the Deputy Chairperson one and a half times that amount. Members of the Supervisory Board who were not in office for the entire financial year shall receive one twelfth of the remuneration for each month or part thereof that they hold a seat. Members of the Supervisory Board receive an attendance fee amounting to EUR 200 for each meeting of the Supervisory Board or its committees that they have attended. The Company reimburses value-added tax payable on remuneration and expenses.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Compensation totaling EUR 593,627 was paid to the members of the Supervisory Board in the 2003 financial year; individually, the members received the following amounts:

<u>Member of the Supervisory Board</u>	<u>Compensation</u> (€)
Becker, Gert . . . . .	11,417
Brandl, Monika . . . . .	27,200
Falbisoner, Josef . . . . .	27,000
Dr. von Grünberg, Hubertus . . . . .	27,200
Holzwarth, Lothar . . . . .	27,200
Dr. Hundt, Dieter . . . . .	26,800
Dr. Leysen, André <sup>(1)</sup> . . . . .	0
Litzenberger, Waltraud . . . . .	26,800
Löffler, Michael . . . . .	27,200
Dr. Overhaus, Manfred . . . . .	29,600
Reich, Hans W. . . . .	26,400
Dr. Schinzler, Hans-Jürgen . . . . .	17,067
Dr. Schlede, Klaus G. . . . .	18,467
Schmitt, Wolfgang . . . . .	28,400
Schulze, Rüdiger <sup>(2)</sup> . . . . .	21,550
Prof. Dr. Sihler, Helmut . . . . .	11,617
Sommer, Michael . . . . .	26,600
Steinke, Ursula . . . . .	27,000
Prof. Dr. Stolte, Dieter . . . . .	26,800
Treml, Franz <sup>(3)</sup> . . . . .	19,708
Walter, Bernhard . . . . .	27,800
Wegner, Wilhelm . . . . .	30,600
Dr. Wiedeking, Wendelin . . . . .	17,267
Dr. Winkhaus, Hans-Dietrich . . . . .	19,067
Dr. Zumwinkel, Klaus . . . . .	44,867
Total . . . . .	<u><u>593,627</u></u>

(1) Dr. Leysen waived compensation for his Supervisory Board activities.

(2) In addition, Mr. Schulze received Supervisory Board compensation of EUR 7,900 from T-Mobile International AG, a wholly-owned subsidiary of Deutsche Telekom AG, for the 2003 financial year for a mandate as a member of the Supervisory Board of this company.

(3) In addition, Mr. Treml received Supervisory Board compensation of EUR 12,271 from DeTeImmobilien, Deutsche Telekom Immobilien und Service GmbH, a wholly-owned subsidiary of Deutsche Telekom AG, for the 2003 financial year for a mandate as a member of the Supervisory Board of this company.

### **(39) Proposal for Appropriation of Net Income (Loss) of Deutsche Telekom AG**

The statement of operations for the 2003 financial year reports net income of EUR 4,069,084,823.20. Of this net income, EUR 2,034,000,000.00 has been transferred to retained earnings in accordance with § 19 (3) of the Articles of Incorporation. After deducting the amount transferred to retained earnings, this results in cumulative unappropriated net income of EUR 2,035,084,823.20.

The Board of Management and the Supervisory Board of Deutsche Telekom AG will propose to the shareholders' meeting to transfer the unappropriated net income to retained earnings.

### **(40) Declaration of Conformity with the German Corporate Governance Code in Accordance with § 161 of the German Stock Corporation Act**

In accordance with § 161 of the German Stock Corporation Act, the Board of Management and the Supervisory Board submitted the mandatory declaration of conformity.

The declaration of conformity by the publicly traded subsidiary T-Online International AG has been made available to shareholders of T-Online International AG.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(41) 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, 2003 and the shareholders' equity as of December 31, 2003 and 2002 to the extent described below.

**Reconciliation of Net Income (Loss) from German GAAP to U.S. GAAP:**

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002<sup>(1)</sup></u>	<u>2001<sup>(1)</sup></u>
	(millions of €)		
<b>Net income (loss) as reported in the consolidated financial statements under German GAAP</b> .....	1,253	(24,587)	(3,454)
U.S. GAAP reconciling adjustments			
Differences in long-lived assets:			
Differences in fixed assets .....	(a) (460)	422	401
Mobile communications licenses .....	(b) 2,186	4,525	2,098
Internally developed software .....	(c) (46)	37	182
Goodwill and asset differences .....	(d) 1,908	(2,199)	(285)
Write-down of tradenames .....	(e) —	(1,038)	1,040
Effects of dilution gains .....	(f) —	(260)	(396)
Derivatives and related foreign exchange differences .....	(h) (244)	(45)	(29)
Adoption of SFAS No. 133 .....	(h) —	—	370
Accruals for personnel restructuring .....	(i) (19)	294	10
Deferral of gains on divestitures .....	(j) —	321	27
Deferred income .....	(k) (32)	(89)	(192)
Asset-backed securitizations .....	(l) (55)	175	(71)
Investments in equity investees .....	(m) 265	346	(182)
Adoption of SFAS No. 143, cumulative to December 31, 2002 .....	(n) 143	—	—
Asset retirement obligations .....	(n) (124)	—	—
Effects of full consolidation of debis, net of tax .....	(o) —	(28)	(294)
Other differences .....	(p) 783	272	230
Income taxes .....	(q) (2,590)	(117)	1,090
Minority interest .....	(r) (57)	(127)	(22)
<b>Net income (loss) in accordance with U.S. GAAP</b> .....	<u>2,911</u>	<u>(22,098)</u>	<u>523</u>
Income (loss) before cumulative effect of changes in accounting principle .....	2,827	(22,098)	297
Cumulative effect of changes in accounting principles-implementation of SFAS No. 143 in 2003 and SFAS No. 133 in 2001, net of tax .....	<u>84</u>	<u>—</u>	<u>226</u>
<b>Net income (loss) in accordance with U.S. GAAP</b> .....	<u>2,911</u>	<u>(22,098)</u>	<u>523</u>

(1) The 2002 and 2001 presentation of minority interest has been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Earnings (loss) per share in accordance with U.S. GAAP**

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Net income (loss) (millions of €)</b>			
Net income (loss) — <b>basic and diluted</b> .....	2,911	(22,098)	523
<b>Weighted average shares outstanding (in millions)</b>			
Weighted average shares outstanding German GAAP .....	4,195	4,195	3,715
Adjustment <sup>(1)(2)</sup> .....	<u>(31)</u>	<u>(36)</u>	<u>(39)</u>
Weighted average shares outstanding U.S. GAAP — <b>basic</b> .....	4,164	4,159	3,676
Dilutive effect of options .....	<u>5</u>	<u>—</u>	<u>13</u>
Weighted average shares outstanding U.S. GAAP — <b>diluted</b> .....	<u>4,169</u>	<u>4,159</u>	<u>3,689</u>
<b>Earnings (loss) per share (in €)</b>			
Basic and diluted earnings (loss) per share/ADS under U.S. GAAP ..	<u>0.70</u>	<u>(5.31)</u>	<u>0.14</u>
Earnings (loss) per share/ADS before implementation of SFAS No. 143/ SFAS No. 133 – basic and diluted .....	0.68	(5.31)	0.08
Cumulative effect from implementation of SFAS No. 143/SFAS No. 133 .....	<u>0.02</u>	<u>—</u>	<u>0.06</u>
Total basic and diluted earnings (loss) per share/ADS in accordance with U.S. GAAP .....	<u>0.70</u>	<u>(5.31)</u>	<u>0.14</u>

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- (1) 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) For the year ended December 31, 2003, the shares issued upon conversion of the outstanding mandatory convertible bonds are excluded from the computation of diluted earnings (loss) per share because they are antidilutive.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Reconciliation of Shareholders' Equity from German GAAP to U.S. GAAP:**

		<u>As of December 31,</u>	
		<u>2003</u>	<u>2002<sup>(1)</sup></u>
		(millions of €)	
<b>Shareholders' equity as reported in the consolidated financial statements under German GAAP</b> .....		33,811	35,416
<b>U.S. GAAP reconciling adjustments</b>			
Differences in long-lived assets:			
Differences in fixed assets.....	(a)	3,097	3,579
Mobile communications licenses.....	(b)	9,000	7,114
Internally developed software.....	(c)	471	529
Goodwill and asset differences.....	(d)	1,162	(315)
Effects of dilution gains.....	(f)	1,085	1,085
Unrealized gains on marketable securities.....	(g)	250	166
Derivatives and related foreign exchange differences.....	(h)	(73)	85
Accruals for personnel restructuring.....	(i)	302	316
Deferred income.....	(k)	(1,318)	(1,293)
Asset-backed securitizations.....	(l)	49	103
Investments in equity investees.....	(m)	205	(41)
Asset retirement obligations.....	(n)	25	—
Other differences.....	(p)	727	349
Income taxes.....	(q)	745	2,701
Minority interest.....	(r)	<u>(4,559)</u>	<u>(4,443)</u>
<b>Shareholders' equity in accordance with U.S. GAAP</b> .....		<u>44,979</u>	<u>45,351</u>

(1) The 2002 presentation of minority interest has been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Consolidated Statements of Shareholders' Equity in Accordance with U.S. GAAP

For the years ended December 31, 2003, 2002 and 2001  
(Amounts in millions of €)

	Capital Stock nominal value <sup>(6)</sup>	Additional paid-in capital	Accumulated Other Comprehensive Income (Loss)						Total
			Retained earnings (Accumulated deficit)	Cumulative translation adjustment account	Available- for- sale securities	Derivative instruments	Minimum pension liability	Treasury Shares	
Balance, January 1, 2001 . . . . .	7,756	24,006	13,162	(844)	2,035	—	—	(7)	46,108
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)
Total comprehensive (loss) . . . . .	—	—	—	—	—	—	—	—	(2,237)
Dividends for 2000 <sup>(7)</sup> . . . . .	—	—	(1,877)	—	—	—	—	—	(1,877)
Shares issued for acquisition of T-Mobile USA and Powertel . . . . .	2,990	28,624	—	—	—	—	—	—	31,614
Amortization of deferred stock-based compensation and tax benefit of exercised stock options . . . . .	—	96	—	—	—	—	—	—	96
Balance, December 31, 2001 . . . . .	<u>10,746</u>	<u>52,726</u>	<u>11,808</u>	<u>(1,606)</u>	<u>131</u>	<u>64</u>	<u>(158)</u>	<u>(7)</u>	<u>73,704</u>
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>(7)</sup> . . . . .	—	—	(1,539)	—	—	—	—	—	(1,539)
Shares issued for acquisitions . . . . .	—	83	—	—	—	—	—	—	83
Amortization of deferred stock-based compensation . . . . .	—	30	—	—	—	—	—	—	30
Balance, December 31, 2002 . . . . .	<u>10,746</u>	<u>52,839</u>	<u>(11,829)</u>	<u>(5,782)</u>	<u>(249)</u>	<u>(81)</u>	<u>(286)</u>	<u>(7)</u>	<u>45,351</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

	Capital Stock nominal value <sup>(6)</sup>	Additional paid-in capital	Accumulated Other Comprehensive Income (Loss)						Total
			Retained earnings (Accumulated deficit)	Cumulative translation adjustment account	Available- for- sale securities	Derivative instruments	Minimum pension liability	Treasury Shares	
Balance, January 1, 2003 . . . . .	10,746	52,839	(11,829)	(5,782)	(249)	(81)	(286)	(7)	45,351
Net income . . . . .	—	—	2,911	—	—	—	—	—	2,911
Unrealized net gains (losses) on marketable securities <sup>(1)</sup> . . . . .	—	—	—	—	92	—	—	—	92
Additional minimum pension liability <sup>(3)</sup> . . . . .	—	—	—	—	—	—	(269)	—	(269)
Net gains (losses) on derivatives <sup>(4)</sup> . . . . .	—	—	—	—	—	(100)	—	—	(100)
Reclassification of derivatives into earnings <sup>(5)</sup> . . . . .	—	—	—	—	—	91	—	—	91
Difference from currency translation . . . . .	—	—	—	(3,124)	—	—	—	—	(3,124)
Total comprehensive (loss) . . . . .	—	—	—	—	—	—	—	—	(399)
Dividends for 2002 <sup>(7)</sup> . . . . .	—	—	—	—	—	—	—	—	0
Shares issued on exercise of stock options and exchange rights . . . . .	—	15	—	—	—	—	—	—	15
Amortization of deferred stock-based compensation . . . . .	—	12	—	—	—	—	—	—	12
Balance, December 31, 2003 . . . . .	<u>10,746</u>	<u>52,866</u>	<u>(8,918)</u>	<u>(8,906)</u>	<u>(157)</u>	<u>(90)</u>	<u>(555)</u>	<u>(7)</u>	<u>44,979</u>

- (1) Unrealized net gains (losses) on marketable securities, net of tax (EUR 25 million in 2002). At December 31, 2003 net unrealized gains on available-for-sale securities were reported net of deferred taxes of EUR 425 million calculated at the applicable enacted rates for capital gains and losses in the periods during which they arose. Upon the sale of an available-for-sale security, the cumulative deferred taxes currently recorded in other comprehensive income relating to that security would be recorded in income from continuing operations.
- (2) Reclassification of realized (gain) losses included in net income, net of tax (EUR 19 million in 2001)
- (3) Additional minimum pension liability net of tax (EUR 171 million in 2003, EUR 82 million in 2002 and EUR 101 million in 2001)
- (4) Net gains (losses) on derivatives net of tax (EUR 62 million in 2003, EUR 30 million in 2002 and EUR 10 million in 2001). Unrealized gains of EUR 88 million relating to a net investment hedge, were reclassified in 2003 to Difference from currency translation.
- (5) Reclassification of derivatives into earnings net of tax (EUR 40 million in 2003)
- (6) Number of shares outstanding (in millions) are 4,169, 4,159, 3,676 and 3,030 at December 31, 2003, 2002, 2001 and 2000, respectively. The outstanding amounts differ from the amounts determined under German GAAP in 2003, 2002 and 2001 due to the treatment of shares placed in a trust as part of the acquisition of T-Mobile USA and Powertel.
- (7) The dividends per share/ADS (in €) for 2003, 2002, 2001 and 2000 were EUR 0.00 (proposed), 0.00, 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.

**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:

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
	(millions of €)	
(i) Valuation of fixed assets .....	2,816	3,060
(ii) Sale and leaseback transactions .....	(205)	(55)
(iii) ISDN boxes .....	51	102
(iv) Write-down of submarine cable and indefeasible-rights-of-use .....	211	249
(v) Capitalization of interest and other .....	<u>224</u>	<u>223</u>
	<u><b>3,097</b></u>	<u><b>3,579</b></u>

(i) Under German GAAP, the Company has written down fixed assets, primarily relating to its real estate holdings. These write-downs were not recorded under U.S. GAAP for fixed assets classified as held and used. This resulted in a difference of approximately EUR 2,693 million and EUR 2,833 million in the carrying basis of land and buildings between U.S. GAAP and German GAAP at December 31, 2003 and 2002, respectively. In addition, the Company wrote-down EUR 123 million and EUR 227 million relating to the carrying value of certain fixed assets, on the basis of the 'prudence' principle under German GAAP during 2003 and 2002, respectively. Under U.S. GAAP, this write-down did not meet the impairment criteria under SFAS No. 144, and, therefore was reversed 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) The Company entered into a series of sale and leaseback transactions primarily underlying its real estate holdings and to a substantially lesser extent equipment. 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 are recorded as liabilities, and the net book value of the sold assets remain recorded as assets. At December 31, 2003, the corresponding net book value of assets sold was EUR 2,663 million, the liability amounted to EUR 2,925 million. Additionally, approximately EUR 57 million in financing fees were capitalized as other assets related to the transactions, and are amortized over the term of the contracts. The future payments under German GAAP are included as minimum lease payments under operating leases in note (14) Property, Plant and Equipment.

(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 did not meet the criteria for capitalization did 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 were capitalized and depreciated under U.S. GAAP. The remaining net book value was EUR 51 million and EUR 102 million at December 31, 2003 and 2002, 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 U.S. 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

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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, cumulatively, an additional EUR 129 million and EUR 156 million of interest expense related to assets under construction for U.S. GAAP, in 2003 and 2002, respectively. In addition, site rental expense during the construction period is recorded as a period 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 69 million and EUR 53 million were capitalized as part of the cost of the assets in 2003 and 2002, respectively.

### **(b) Mobile Communications Licenses**

Under German GAAP, the costs of the UMTS licenses purchased in the United Kingdom, Germany and Austria, licenses obtained in the acquisition of T-Mobile USA and Powertel, and the UMTS license obtained in the acquisition of T-Mobile Netherlands 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 1,113 million, EUR 1,692 million and EUR 863 million in 2003, 2002 and 2001, respectively. The interest accumulated on borrowings through the start of network operation which represents part of the acquisition costs under U.S. GAAP, resulted in a decrease in interest expense of EUR 1.1 billion, EUR 1.2 billion and EUR 1.2 billion in 2003, 2002 and 2001, respectively.

For German GAAP purposes, nonscheduled amortization is recognized, when on an individual asset basis, an "other than temporary" decline in the value of the asset has occurred. For impairment testing of amortizing intangible assets (and other long-lived assets) under U.S. GAAP, SFAS No. 144 applies. Under that standard, assets are not necessarily individually tested, but rather are grouped at the lowest level for which identifiable cash flows are largely independent of other groups of assets and liabilities. The recoverability of an asset group is tested by comparing the estimated undiscounted cash flows for the asset group to its carrying value. If the sum of the undiscounted cash flows is less than the carrying value, an impairment has occurred and the asset group's carrying value is reduced to its fair value. For intangible assets that are not amortized for U.S. GAAP purposes, such as the licenses in the U.S., SFAS No. 142 applies. Under that standard, the assets are tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. If an asset's carrying value exceeds its fair value an impairment has occurred and the carrying value of the asset is reduced to the fair value. 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 up to four years. Under German GAAP, these costs are expensed as incurred.

Subsequent additions, modifications or upgrades to internal-use software are capitalized only to the extent that they allow the software to perform a task it previously did not perform. Software

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

maintenance and training costs are expensed in the period in which they are incurred. Also, the Company capitalizes interest associated with the development of internal-use software.

### *(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 (43) (a) Intangible Assets for additional information regarding the Company's accounting for goodwill and other intangible assets.

### **U.S. GAAP Reconciling Adjustments to the Statement of Operations**

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, 2003, 2002, and 2001. 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:

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002<sup>(1)</sup></b>	<b>2001<sup>(1)</sup></b>
	<b>(millions of €)</b>		
U.S. GAAP adjustments to German GAAP expense, (increase) decrease			
Goodwill amortization . . . . .	2,521	3,213	450
Reversal of nonscheduled amortization of goodwill under German GAAP . . . . .	—	9,865	—
Goodwill impairment charges under U.S. GAAP . . . . .	—	(14,567)	—
Intangible asset amortization expense . . . . .	(589)	(684)	(727)
Fixed asset depreciation expense . . . . .	(24)	(26)	(24)
Net effect . . . . .	<u>1,908</u>	<u>(2,199)</u>	<u>(301)</u>

(1) The 2002 and 2001 presentation of minority interest has been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**U.S. GAAP Reconciling Adjustments to Shareholders' Equity**

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>As of December 31,</u>	
	<u>2003</u>	<u>2002<sup>(1)</sup></u>
	(millions of €)	
U.S. GAAP adjustments to German GAAP amounts, increase (decrease)		
Goodwill, net book value.....	(907)	(3,114)
Intangible assets .....	4,783	4,144
Intangible asset accumulated amortization.....	(2,830)	(1,499)
Fixed assets .....	148	214
Fixed asset accumulated depreciation .....	(32)	(60)
Net effect .....	<u>1,162</u>	<u>(315)</u>

(1) The 2002 presentation of minority interest has been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

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 U.S. GAAP, 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.

**(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 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 dilution gains under German GAAP 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.

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

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

combinations totaling EUR 1,968 million have been recorded in 2000 as income with a corresponding increase in goodwill for U.S. GAAP purposes but were not recognized for German GAAP purposes.

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 goodwill was recorded since 2002 because of the implementation of SFAS No. 142. In 2002 and 2001, 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 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. No comparative impairment charge was recorded in 2003.

In 2002, the Company recognized a EUR 115 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 (35) Financial Instruments.

### **(i) Accruals for Personnel Restructuring**

Under German GAAP, the Company establishes provisions for the total costs expected to be incurred resulting from workforce reductions when those costs can be estimated. For U.S. GAAP purposes, costs associated with voluntary workforce reductions are recognized in the period of acceptance by the employee of the termination offer. In addition, prior to the adoption of SFAS 146, costs associated with involuntary workforce reductions were recognized when all the requirements to establish a restructuring accrual were fulfilled in accordance with EITF Issue 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs included in Restructuring)." In 2003, the Company adopted the provisions of SFAS 146 "Accounting for Costs Associated with Exit or Disposal Activities" for exit or disposal activities initiated after December 31, 2002. The adoption of SFAS 146 has resulted in the Company recognizing the cost associated with involuntary workforce reductions at their fair value in the period in which the liability is incurred.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### **(j) Deferral of Gains on Divestitures**

During 2000 and 2001, the Company sold its interests in the broadband cable operations located in the North Rhine-Westphalia, Hesse and Baden-Wuerttemberg regions in 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 5,862 million. Under German GAAP, the entire gains upon consummation of these sales were recognized. During 2001, interest income of EUR 62 million representing the accretion on the deferred payment notes and preference interest was recognized and EUR 389 million were recorded to write-down the deferred payment notes and 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, eliminating any valuation difference between German and U.S. GAAP for these notes since the gains associated with the deferred payment notes and preference interest were not recognized in income 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 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 income over the contract term, ranging from 20 to 25 years. A third type of contract relates to a long-term construction project. Under German GAAP, certain revenues were recognized because the Company had delivered a product and provided services in accordance with the contracts’ acceptance provisions. Under U.S. GAAP, the Company did not consider this to be the culmination of the earnings process and deferred such amounts. The product delivered and services rendered were deemed to be part of a larger group-wide contract for which no reasonably dependable estimates of total cost could be made.

### **(l) Asset-Backed Securitizations**

In December 2001, December 2002, and November 2003, the Company entered into asset-backed securitization programs for the sale of qualifying receivables at its T-Com, T-Systems and T-Mobile divisions, respectively. 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 (44) (b) Asset-Backed Securitization for additional information regarding these transactions.

Under these securitization programs, the Company retains the servicing obligation related to the sold receivables, but without remuneration. No servicing liabilities have 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 67 million in 2003 and EUR 50 million in 2002.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### *(m) 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 98 million and EUR 106 million, recorded under German GAAP in 2003 and 2002 was not recorded for U.S. GAAP purposes.

In September 2002, Deutsche Telekom AG, DaimlerChrysler Services AG, and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) (individually, the “partners” and collectively, the “consortium”) entered into an agreement with the Federal Republic of Germany (Federal Ministry of Transport) relating to the collection of toll charges for the use of German highways by heavy vehicles, and the creation and operation of a toll system for the collection of highway toll charges for heavy vehicles (the “operating agreement”). In December 2002, the consortium entered into a partnership agreement and established a separate joint venture company, Toll Collect GmbH (together “Toll Collect”), to perform under the contract. Deutsche Telekom and DaimlerChrysler Services each hold a 45 % stake in Toll Collect, with the remaining 10 % being held by Cofiroute. Toll Collect’s total assets, financial liabilities and total liabilities at December 31, 2003, calculated on the basis of U.S. GAAP, were EUR 0.8 billion, EUR 0.5 billion and EUR 1.1 billion, respectively. Deutsche Telekom’s involvement with Toll Collect includes its equity interest in Toll Collect that is recognized in the consolidated financial statements using the equity method of accounting and certain financial guarantees. Additionally, certain of our divisions may act as sub-contractors of services to Toll Collect.

Under German GAAP, the share of the Toll Collect equity losses to be recorded under the equity method is limited to the value of the investment. Therefore, Deutsche Telekom recorded approximately EUR 108 million as its share of the equity in net losses. Due to the risks associated with the financial guarantees issued for Toll Collect, Deutsche Telekom recorded a provision of approximately EUR 334 million under German GAAP.

Under U.S. GAAP, the share of the Toll Collect equity losses is not limited to the value of the investment due to the existence of the guarantees. As a result, Deutsche Telekom recorded its share of the equity in net losses of approximately EUR 230 million under U.S. GAAP, resulting in a negative investment balance of approximately EUR 143 million at December 31, 2003. The provision recorded under German GAAP has been reversed, as the effects are reflected within the share of equity losses recognized under U.S. GAAP.

In 2002 and 2001, as a result of impairment testing, an impairment charge was recorded to reduce the carrying value of the investment in comdirect bank AG to fair value for U.S. GAAP as well under German GAAP. See note (41) (f) Effects of Dilution Gains for additional information. In 2003 the Company recorded a write-up of the net carrying amount of the investment in comdirect bank AG of EUR 84 million under German GAAP which was not recorded for U.S. GAAP.

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 in 2001. Additionally, the investment in Globe Telecom was recorded at cost under German GAAP. For U.S. GAAP purposes this investment was accounted for as an equity investment as required by Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for 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 9 million in 2003 and EUR 18 million in 2002 under U.S. GAAP. In October 2003 the investment in Globe Telecom was sold. As the carrying basis for the investment under German GAAP exceeded the carrying basis under U.S. GAAP, a larger gain of EUR 94 million was recorded under U.S. GAAP.

The Company accounted for its investment in T-Mobile Netherlands 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 T-Mobile Netherlands. These differences consist of, among



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

other things, a EUR 213 million write-off of the Company's share of the UMTS licenses held by T-Mobile Netherlands in 2002 that did not meet the impairment criteria for U.S. GAAP.

The remaining differences result from the recognition of equity pickup on operating results which are based on U.S. GAAP rather than German GAAP, primarily with respect to the investment in PTC in the amount of EUR 29 million in 2003.

**(n) Asset Retirement Obligation**

On January 1, 2003, the Company adopted SFAS No. 143, *Accounting for Asset Retirement Obligations* ("SFAS No. 143"), 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 an 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 shorter of the asset's useful life or the period to the expected settlement of the retirement obligation. The liability is accreted to its present value each period through charges to operating expense.

Under German GAAP, the absolute expected cost of the asset retirement obligation is recognized ratably over the period from the inception to settlement of the liability. See note (44)(e) New U.S. GAAP Standards Adopted in 2003 for additional information regarding SFAS No. 143.

**(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 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:

	<b>For the year ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>(millions of €)</b>	
Increase in amortization expense.....	(7)	(360)
Increase in financing charges.....	(24)	(60)
Decrease in income applicable to minority interest.....	—	94
Tax benefit.....	<u>3</u>	<u>32</u>
	<u>(28)</u>	<u>(294)</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 and EUR 60 million for 2002 and 2001, 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. The differences relate primarily to accruals recorded for German GAAP following the “prudence principle” and reversed for U.S. GAAP purposes because the obligation or liability is not probable of occurring. In 2003 accruals of EUR 417 million (in 2002 EUR 188 million) were reversed.

Other adjustments of EUR 310 million (in 2002 EUR 161 million) resulting in differences between German GAAP and U.S. GAAP concerns 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.

In 2003, 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 439 million, EUR 210 million and EUR 259 million in 2003, 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 or where the reversal will occur prior to the usage of net operating loss carry forwards. 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 to the amount that is more likely than not to 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.

In 2003 the German government enacted new tax legislation. Beginning January 1, 2004, 5% of dividends received and 5% of capital gains from the sale of shares in affiliated and unaffiliated companies are taxable while losses continue to be non-deductible. The change in tax legislation led to the recognition of EUR 110 million deferred tax liabilities under U.S. GAAP due to unrealized gains and to differences between U.S. GAAP book values and tax values on certain investments.

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 and the consolidation effects of debis which are presented net of tax. See note (42) Deferred Taxes in Accordance with U.S. GAAP for additional information.

### **(r) Minority Interest**

Beginning in 2003, the presentation of the minority interest in the reconciliation of net income (loss) and shareholders' equity has changed. Prior to 2003 all reconciling items relating to non-wholly



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

owned subsidiaries were presented net of minority interest. Beginning in 2003, all reconciling items are shown gross of minority interest and the minority interest, including the minority interest under German GAAP, is deducted in a separate line item. The prior years have been restated accordingly. In addition, certain prior year amounts included in the footnotes have been reclassified to conform to the current year presentation.

**(42) Deferred Taxes in Accordance with U.S. GAAP**

Deferred tax assets and liabilities arising from temporary differences and net operating losses, in accordance with U.S. GAAP, are as follows:

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002<sup>(1)</sup></u>
	<u>(millions of €)</u>	
<b>Deferred tax assets</b>		
Current deferred tax assets		
Net operating loss carryforwards .....	401	478
Inventory .....	108	156
Accruals for loss contingencies .....	74	115
Other accruals .....	122	165
Deferred income/ deferred expense .....	54	2
Other .....	<u>110</u>	<u>211</u>
	<u>869</u>	<u>1,127</u>
Noncurrent deferred tax assets		
Goodwill .....	1,838	2,136
Net operating loss carryforwards .....	6,523	7,930
Fixed assets .....	2,106	1,420
Financial assets .....	368	623
Derivatives .....	579	74
Pension accruals .....	702	527
Civil servant health insurance accrual .....	288	429
Other accruals .....	242	304
Deferred income/ deferred expense .....	454	522
Other .....	<u>486</u>	<u>318</u>
	<u>13,586</u>	<u>14,283</u>
<b>Deferred tax assets</b> .....	<u>14,455</u>	<u>15,410</u>
<b>Deferred tax liabilities</b>		
Current deferred tax liabilities		
Accruals .....	(66)	(202)
Other .....	<u>(465)</u>	<u>(311)</u>
	<u>(531)</u>	<u>(513)</u>
Noncurrent deferred tax liabilities		
Intangible assets .....	(5,722)	(5,795)
Fixed Assets .....	(3,168)	(2,588)
Financial assets .....	(112)	(88)
Accruals .....	(122)	(25)
Derivatives .....	(225)	(127)
Deferred income/ deferred expense .....	(74)	(26)
Other .....	<u>(427)</u>	<u>(245)</u>
	<u>(9,850)</u>	<u>(8,894)</u>
<b>Deferred tax liabilities</b> .....	<u>(10,381)</u>	<u>(9,407)</u>
Net current deferred tax assets .....	338	614
Net noncurrent deferred tax assets .....	3,736	5,389
Valuation allowance <sup>(2)</sup> .....	<u>(4,893)</u>	<u>(5,652)</u>
<b>Net deferred tax assets (liabilities)</b> .....	<u>(819)</u>	<u>351</u>

(1) The 2002 amounts have been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

(2) Valuation allowance as of December 31, 2001: EUR 468 million.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

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 following table shows the development of deferred taxes from German GAAP to U.S. GAAP:

	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002<sup>(1)</sup></u>
	(millions of €)	
Net deferred tax assets (liabilities) under German GAAP .....	(919)	(1,646)
U.S. GAAP adjustments .....	<u>100</u>	<u>1,997</u>
Net deferred tax assets (liabilities) in accordance with U.S. GAAP .....	<u>(819)</u>	<u>351</u>

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(1) The 2002 amounts have been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**(43) Additional Information on the Financial Statements in Accordance with U.S. GAAP**

**(a) Intangible Assets**

Development of goodwill and other intangible assets

The following is a summary of the development of goodwill and other intangible assets from January 1, 2002 to December 31, 2003.

	Goodwill			Other intangible assets		
	German GAAP	Difference (millions of €)	U.S. GAAP	German GAAP	Difference (millions of €)	U.S. GAAP
<b>Cost<sup>(1)</sup></b>						
January 1, 2002.....	46,075	396	46,471	43,368	7,584	50,952
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.....	<u>46,875</u>	<u>(16,174)</u>	<u>30,701</u>	<u>40,908</u>	<u>(1,108)</u>	<u>39,800</u>
<b>Accumulated Amortization<sup>(1)</sup></b>						
January 1, 2002.....	(5,478)	1,765	(3,713)	(3,914)	746	(3,168)
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.....	<u>(17,439)</u>	<u>14,050</u>	<u>(3,389)</u>	<u>(16,942)</u>	<u>11,389</u>	<u>(5,553)</u>
<b>Net book value December 31, 2002<sup>(1)</sup> .....</b>	<u><b>29,436</b></u>	<u><b>(2,124)</b></u>	<u><b>27,312</b></u>	<u><b>23,966</b></u>	<u><b>10,281</b></u>	<u><b>34,247</b></u>
<b>Cost</b>						
January 1, 2003.....	46,875	(16,174)	30,701	40,908	(1,108)	39,800
Additions .....	150	(23)	127	683	1,315	1,998
Disposals.....	(969)	627	(342)	(766)	45	(721)
Consolidations, reclassifications and other.....	(41)	(32)	(73)	170	(131)	39
Foreign currency effects.....	(4,331)	(126)	(4,457)	(4,054)	(426)	(4,480)
December 31, 2003.....	<u>41,684</u>	<u>(15,728)</u>	<u>25,956</u>	<u>36,941</u>	<u>(305)</u>	<u>36,636</u>
<b>Accumulated Amortization</b>						
January 1, 2003.....	(17,439)	14,050	(3,389)	(16,942)	11,389	(5,553)
Scheduled amortization .....	(2,521)	2,521	0	(2,157)	377	(1,780)
Disposals.....	814	(788)	26	732	(102)	630
Consolidations, reclassifications and other.....	41	6	47	84	115	199
Foreign currency effects.....	1,934	25	1,959	2,022	(46)	1,976
December 31, 2003.....	<u>(17,171)</u>	<u>15,814</u>	<u>(1,357)</u>	<u>(16,261)</u>	<u>11,733</u>	<u>(4,528)</u>
<b>Net book value December 31, 2003 .....</b>	<u><b>24,513</b></u>	<u><b>86</b></u>	<u><b>24,599</b></u>	<u><b>20,680</b></u>	<u><b>11,428</b></u>	<u><b>32,108</b></u>

(1) The 2002 amounts have been reclassified to conform to the current year presentation.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Net income (loss) adjusted according to SFAS No. 142 par. 61*

The following table reconciles reported net income (loss) and basic and diluted earnings (loss) per share under U.S. GAAP in the periods 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, 2001:

	<b>For the year ended December 31,</b>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(millions of €)		
Reported net income (loss).....	2,911	(22,098)	523
Add back: Goodwill amortization .....	—	—	2,918
Add back: License amortization, net.....	—	—	336
Adjusted net income (loss) .....	<u>2,911</u>	<u>(22,098)</u>	<u>3,777</u>
Basic earnings (loss) per share:			
Reported net income (loss).....	0.70	(5.31)	0.14
Goodwill amortization .....	—	—	0.79
License amortization .....	—	—	0.09
Adjusted net income (loss) .....	<u>0.70</u>	<u>(5.31)</u>	<u>1.02</u>
Diluted earnings (loss) per share:			
Reported net income (loss).....	0.70	(5.31)	0.14
Goodwill amortization .....	—	—	0.79
License amortization .....	—	—	0.09
Adjusted net income (loss) .....	<u>0.70</u>	<u>(5.31)</u>	<u>1.02</u>

*Changes in the carrying amount of goodwill for the segments and in total for the years ended December 31, 2002 and 2003*

	<u>T-Com</u>	<u>T-Mobile</u>	<u>T-Systems</u>	<u>T-Online</u>	<u>Other</u>	<u>Total</u>
	(millions of €)					
Balance at December 31, 2001.....	2,956	33,386	4,477	1,939	0	42,758
Impairment.....	(1,657)	(12,910)	—	—	0	(14,567)
Additions, disposals and change in the composition of Deutsche Telekom Group .	<u>371</u>	<u>(1,537)</u>	<u>307</u>	<u>(26)</u>	<u>6</u>	<u>(879)</u>
Balance at December 31, 2002.....	1,670	18,939	4,784	1,913	6	27,312
Additions, disposals, translation effects and change in the composition of Deutsche Telekom Group.....	<u>(224)</u>	<u>(2,543)</u>	<u>(41)</u>	<u>12</u>	<u>83</u>	<u>(2,713)</u>
Balance at December 31, 2003.....	<u>1,446</u>	<u>16,396</u>	<u>4,743</u>	<u>1,925</u>	<u>89</u>	<u>24,599</u>

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Components of amortizable and non-amortizable intangible assets for U.S. GAAP purposes*

	As of December 31, 2003		As of December 31, 2002 <sup>(1)</sup>	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(millions of €)		(millions of €)	
<i>Amortizable intangible assets</i>				
UMTS licenses . . . . .	18,681	—	18,100	—
Other intangible assets . . . . .	<u>8,680</u>	<u>4,012</u>	<u>10,713</u>	<u>5,069</u>
Total amortizable intangible assets . . . . .	<u>27,361</u>	<u>4,012</u>	<u>28,813</u>	<u>5,069</u>

(1) The 2002 amounts have been reclassified to conform to the current year presentation.

Deutsche Telekom's U.S. GAAP carrying value of *non-amortized intangible assets*, mainly comprised of FCC licenses, amounted to approximately EUR 8.7 billion and EUR 10.5 billion at December 31, 2003 and 2002, respectively.

*Current and expected amortization expense for other identifiable intangible assets for the current year and the subsequent five years.*

	Amount (millions of EUR)
Aggregate amortization expense:	
For the year ended December 31, 2003 . . . . .	1,780
Expected amortization expense:	
For the years ending December 31, 2004 . . . . .	2,100
2005 . . . . .	1,900
2006 . . . . .	1,500
2007 . . . . .	1,300
2008 . . . . .	1,300

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, 2003. 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 and the forecasted amortization is based on the expected commercial launch date of the UMTS network.

**(b) 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.

	Note (41)	German GAAP December 31,		U.S. GAAP December 31,	
		2003	2002 <sup>(1)</sup>	2003	2002 <sup>(1)</sup>
		(millions of €)		(millions of €)	
Intangible assets . . . . .	(b),(c),(d),(f)	45,193	53,402	56,707	61,559
Property, plant and equipment, net . . .	(a),(d)	47,268	53,955	53,558	59,298
Financial assets . . . . .	(g),(h),(m),(p)	3,190	4,169	3,736	4,366
Accruals . . . . .	(h),(i),(n),(p),(q)	15,703	16,097	23,573	20,616
Debt <sup>(2)</sup> . . . . .	(a),(h),(n),(p)	55,411	63,044	58,824	64,988
Deferred income . . . . .	(k),(q)	703	723	2,294	2,134

(1) The 2002 presentation of minority interest has been reclassified to conform to the current year presentation. See note (41)(r) Minority Interest for additional information.

(2) Debt under U.S. GAAP includes EUR 48 million and EUR 58 million of amortized premiums and EUR 264 million and EUR 295 million of discounts at December 31, 2003 and 2002, 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

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

treatment because, prior to January 1, 1993, the predecessor did not maintain sufficiently detailed historical cost records. The fair market values were recorded in the opening balance sheet of Deutsche Telekom AG at January 1, 1995.

**(44) 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. In addition, the Company provides pro forma disclosure of stock based compensation, as measured under the fair value requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*.

APBO No. 25 requires no recognition of compensation expense for most of the stock-based compensation arrangements provided by the Company, namely, option grants under the fixed award plans (2001 Stock Option Plans of Deutsche Telekom AG and T-Online International AG, Matáv and T-Mobile USA, Inc.) where the exercise price is equal to the market value at the date of grant. However, APBO No. 25 requires recognition of compensation expense for variable award plans (2000 Stock Option Plans of Deutsche Telekom AG and T-Online International AG) over the vesting periods 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 periods of such grants, based on the estimated grant-date fair values of those grants.

In electing to continue to follow APBO No. 25 for expense recognition purposes, the Company is obliged to provide the expanded disclosures required under SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure* for stock-based compensation granted, including, if materially different from reported results, disclosure of pro forma net earnings and earnings per share had compensation expense relating to grants been measured under the fair value recognition provisions of SFAS No. 123. The fair value of the stock options issued in 2003, 2002 and 2001 were calculated at the grant date based on a Black-Scholes option pricing model, and based on a Monte-Carlo option pricing model for the options granted in 2000. The Monte-Carlo option pricing model was used for 2000, as the plan was considered a variable compensation plan.

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>2003</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
<b>T-Online International AG</b>	<b>2003</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



**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

<u>T-Mobile USA, Inc.</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Expected dividend yield.....	2.93% to 3.07%	2.60% to 3.85%	3.25%
Expected stock volatility.....	55%	60.0%	47.0%
Risk-free interest rate.....	3.13% to 3.98%	4.11% to 5.15%	5.50% to 5.98%
Expected lives (in years).....	6.3	7.1	7.5
Weighted average fair value per option granted during the year (in USD).....	7.31	6.12	35.57
 <u>Matáv</u>	 <u>2003</u>	 <u>2002</u>	
Expected dividend yield.....	—	1.53%	
Expected stock volatility.....	—	40%	
Risk-free interest rate.....	—	8.31%	
Expected lives (in years).....	—	1-3	
Weighted average fair value per option granted during the year (in HUF).....	—	284	

A reconciliation of the Company's net income (loss) to pro forma net income (loss), and the related pro forma earnings (loss) per share amounts, for the years ended December 31, 2003, 2002 and 2001, is provided below. 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 and Powertel, all unvested, outstanding T-Mobile USA and Powertel stock options were converted into options to acquire, from a trust established for the benefit of holders of T-Mobile USA 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 and Powertel, of which EUR 18 million, EUR 18 million and EUR 11 million were recorded as stock-based compensation expense in 2003, 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) (in millions of euro) and earnings (loss) per share (in euro) would have been as follows:

	<u>For the year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income (loss)			
As reported.....	2,911	(22,098)	523
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects.....	18	18	11
Deduct: Stock-based employee compensation expense determined under fair value based accounting method, net of related tax effects.....	<u>(67)</u>	<u>(102)</u>	<u>(71)</u>
Pro forma net income (loss).....	<u>2,862</u>	<u>(22,182)</u>	<u>463</u>
 Earnings (loss) per share			
Basic and diluted earnings (loss) per share			
As reported.....	0.70	(5.31)	0.14
Pro forma.....	0.69	(5.33)	0.13

**(b) Asset-Backed Securitizations**

The Company and its T-Com, T-Mobile and T-Systems divisions entered into agreements to sell, on a continuous basis, certain eligible trade accounts receivable to Qualifying Special Purpose Entities ("QSPEs"). 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

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 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% and 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 reduction of the loss on sale) for U.S. GAAP of EUR 14 million and EUR 20 million in 2003 and 2002, respectively.

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). 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 in the value of the retained interest (and a related reduction of the loss on sale) of EUR 77 million in 2003, EUR 133 million in 2002, and a reduction in value of the retained interest (and a related increase of the loss on sale) of EUR 21 million in 2001.

Under the T-Mobile 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 (25.5%, including a 5.5% credit loss rate). 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 reduction of the loss on sale) for U.S. GAAP of EUR 24.6 million in 2003.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Summary of Significant Cash Flows*

The table below summarizes certain cash flows received from and paid to securitization trusts under the T-Com, T-Mobile and T-Systems asset-backed securitizations:

	<b>For the year ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(millions of €)</b>		
Proceeds from sales of new receivables to QSPEs.....	20,408	17,372	1,384
Proceeds from retained interests.....	913	655	—
<b>Total cash flow received from QSPEs</b> .....	<u>21,321</u>	<u>18,027</u>	<u>1,384</u>
Proceeds from collections made on behalf of QSPEs.....	(21,467)	(18,996)	(1,616)
less proceeds from collections not yet forwarded to QSPEs .....	57	93	1,456
Payments to QSPEs of collections made on its behalf .....	(21,410)	(18,903)	(160)
Program fees paid to QSPEs .....	(32)	(57)	(6)
<b>Total cash flows forwarded to QSPEs</b> .....	<u>(21,442)</u>	<u>(18,960)</u>	<u>(166)</u>
<b>Net cash flows between QSPEs and Deutsche Telekom</b> .....	<u>(121)</u>	<u>(933)</u>	<u>1,218</u>

Sales of receivables resulted in a loss of approximately EUR 253 million, EUR 303 million and EUR 175 million in 2003, 2002 and 2001, respectively. The loss is calculated as the difference between the face value and contract value of the receivables and includes expenses related to the servicing liability.

**(c) Equity Method Investments**

Deutsche Telekom's investments in equity method affiliates amounted to EUR 2.3 billion and EUR 2.6 billion at December 31, 2003 and 2002, respectively. Deutsche Telekom recorded net income with respect to its equity method affiliates under U.S. GAAP in the amount of EUR 18 million in 2003 and net losses of EUR 85 million and EUR 653 million for the years 2002 and 2001, respectively.

The Company received dividends based on its equity interests in these companies of EUR 39 million, EUR 23 million and EUR 2.8 billion for the years 2003, 2002 and 2001, respectively.

The schedules below present summarized statements of operations for the significant investments that were accounted for under the equity method in 2001. Summarized financial information is not presented for equity method investments in 2003 and 2002, since the Company's equity investments were not deemed significant in 2003 or 2002 either individually or in the aggregate.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*Statements of Operations*

	<b>For the year ended December 31, 2001</b>							
	<u>MTS</u>	<u>PTC</u>	<u>T-Mobile Netherlands</u>	<u>Virgin Mobile</u>	<u>Telesens</u>	<u>comdirect</u>	<u>Other Equity Investments</u>	<u>Total Equity Investments</u>
	(millions of €)							
Net revenue . . . . .	926	1,187	448	264	82	236	1,422	4,565
Total expenses . . . . .	<u>(561)</u>	<u>(1,044)</u>	<u>(633)</u>	<u>(367)</u>	<u>(304)</u>	<u>(387)</u>	<u>(1,561)</u>	<u>(4,857)</u>
Income (loss) before income taxes and minority interest . . . . .	365	143	(185)	(103)	(222)	(151)	(139)	(292)
Income taxes . . . . .	<u>(108)</u>	<u>(9)</u>	<u>—</u>	<u>—</u>	<u>(23)</u>	<u>(10)</u>	<u>(80)</u>	<u>(230)</u>
Minority interest . . . . .	<u>9</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>9</u>
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 . . . . .	<u>(20)</u>	<u>(1)</u>	<u>—</u>	<u>(1)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(22)</u>
Extraordinary gains (losses), net of income taxes . . . . .	<u>2</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>2</u>
U.S. GAAP net income (loss) . . . . .	248	133	(185)	(104)	(245)	(161)	(219)	(533)
Deutsche Telekom's percentage of ownership in investee . . . . .	<u>36.20%</u>	<u>45.00%</u>	<u>49.99%</u>	<u>50.00%</u>	<u>25.92%</u>	<u>21.35%</u>	<u>—</u>	<u>—</u>
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 . . . . .	<u>(2)</u>	<u>(80)</u>	<u>(54)</u>	<u>—</u>	<u>—</u>	<u>(33)</u>	<u>—</u>	<u>(169)</u>
Intangible asset amortization . . . . .	<u>—</u>	<u>(12)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(12)</u>
Impairment charges . . . . .	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(13)</u>	<u>(226)</u>	<u>—</u>	<u>(239)</u>
Other . . . . .	<u>8</u>	<u>(27)</u>	<u>(7)</u>	<u>(2)</u>	<u>2</u>	<u>(4)</u>	<u>(79)</u>	<u>(109)</u>
Deutsche Telekom's equity in net earnings (losses) of equity investees, including consolidating adjustments, under U.S. GAAP . . . . .	<u>90</u>	<u>(59)</u>	<u>(153)</u>	<u>(54)</u>	<u>(75)</u>	<u>(297)</u>	<u>(105)</u>	<u>(653)</u>

**(d) Derivatives**

*Accounting Standard*

Deutsche Telekom adopted Statement of Financial Accounting Standards No. 133 *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), as amended, on January 1, 2001 which established 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. SFAS No. 133 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

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 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 normally are 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 its existing and forecasted debt structures, Deutsche Telekom enters into interest rate derivatives, principally interest rate swaps, to modify the interest payments on bonds, other liabilities and cash investments to adjust their risk profile to a target level of floating-rate and fixed-rate interest as defined by the Management Board.

Deutsche Telekom is exposed to foreign currency risks in connection with its investing, financing and operating activities. Since Deutsche Telekom's corporate objective is pursued through its global commercial operations (the sale of telecommunications and IT services), its 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 (for example, 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, 2003 except for our net investment in T-Mobile USA. At December 31, 2003 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 economically convert foreign currency denominated financial liabilities into the Group companies' functional currencies (primarily euro, U.S. dollar and British pound). At December 31, 2003, foreign currency denominated liabilities for which foreign currency risks were managed primarily consisted of bonds and medium term notes denominated in Japanese yen, British pound, Czech koruna and Polish zloty. 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, certain Group entities are exposed to foreign currency transaction risk related to 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### *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 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 to 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 has been reclassified into earnings over the residual period that interest payments on the floating-rate liabilities affect earnings. In 2003 the balance in accumulated other comprehensive income was completely reflected in earnings.

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 non-derivative 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 T-Mobile UK.

### *Post-Transition-Date Accounting under SFAS No. 133*

Deutsche Telekom decides on the date that it enters into a derivative contract whether it is appropriate to apply 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 2003, Deutsche Telekom had pay-variable, receive-fixed interest rate swaps to hedge the fair value risk of certain fixed rate debt. These interest rate swaps were designated as hedging instruments in qualifying, highly effective, fair-value hedging relationship of euro, British pound and U.S. dollar denominated fixed-rate liabilities.

For the years ended December 31, 2003, 2002 and 2001, Deutsche Telekom recognized in earnings no ineffectiveness for all of the fair value hedge exposures to interest rate risk. All components of the interest rate swap gain or loss were included in the assessment of the hedge effectiveness.

In 2003, Deutsche Telekom had cross-currency interest rate swaps as hedging instruments for foreign currency denominated fixed-rate liabilities, converting them into functional currency denominated variable-rate liabilities. These cross-currency interest rate swaps were designated as hedging instruments in qualifying, highly effective, fair-value hedging relationship of foreign currency denominated fixed-rate liabilities. For the year ended December 31, 2003, Deutsche Telekom recognized EUR 31 million in earnings representing hedge ineffectiveness on cross-currency interest rate swaps. All components of the cross-currency interest rate swap gain or loss were included in the assessment of the hedge effectiveness.



## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Cash Flow Hedges

#### *U.S. dollar exposures*

During 2002 and 2003, 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 2003, Deutsche Telekom reported net losses on these swaps of EUR 37 million (after taxes of EUR 24 million) in accumulated other comprehensive income.

Additionally during 2003, Deutsche Telekom reclassified from accumulated other comprehensive income to earnings a EUR 63 million loss (after taxes of EUR 40 million). EUR 59 million of this loss (after taxes of EUR 38 million) 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. These forecasted interest payments were hedged over a period of up to four years.

All components of the interest rate swap gain or loss were included in the assessment of the hedge effectiveness. Deutsche Telekom expects that approximately EUR 30 million of net losses deferred in accumulated other comprehensive income relating to these interest rate swaps will be reclassified into earnings during the next twelve months when the hedged item occurs.

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.

#### *British pound exposures*

During 2002 and 2003, 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 2003 Deutsche Telekom reported net losses on these swaps of EUR 13 million (after taxes of zero) in accumulated other comprehensive income.

Additionally during 2003, Deutsche Telekom reclassified from accumulated other comprehensive income to earnings a EUR 28 million loss (after taxes of zero). These forecasted interest payments are hedged over a period of up to two years. All components of the interest rate swap gain or loss were included in the assessment of the hedge effectiveness.

Deutsche Telekom expects that approximately EUR 16 million of net losses deferred in accumulated other comprehensive income relating to these interest rate swaps will be reclassified into earnings during the next twelve months when the hedged item occurs.

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. The ineffective portion of these swaps in 2002 was EUR 0.2 million, which was recognized as a loss under U.S. GAAP.

Additionally during 2002, 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.

### Net Investment Hedges

During 2003, Deutsche Telekom continued to hedge its 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 2003 Deutsche Telekom changed the hedging instruments. Before the change, Deutsche Telekom hedged the foreign currency exposure inherent in the redeemable preferred shares with

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

short-term foreign currency forward contracts, five-year-cross-currency interest rate swaps and U.S. dollar-denominated long term debt. Since the change, Deutsche Telekom has hedged the U.S. dollar investment in T-Mobile preferred stock almost entirely with U.S. dollar-denominated long-term debt.

During 2003, Deutsche Telekom recorded to cumulative translation adjustment, a component of other comprehensive income, a net gain of EUR 835 million (after taxes of zero) related to the derivative and nonderivative hedging instruments designated in the hedge 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, Deutsche 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 used were foreign currency forward contracts (still short-term), five-year cross-currency interest rate swaps (Deutsche Telekom pays U.S. dollar at fixed rates and receives 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 non-derivative 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 T-Mobile UK 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.

For the purpose of the balance sheet presentation in accordance with U.S. GAAP as of December 31, 2003, Deutsche Telekom reported the fair value of hedging and non-hedging derivative instrument assets of EUR 0.5 billion (2002: EUR 0.9 billion) in other non-current assets and hedging and non-hedging derivative instrument liabilities of EUR 1.3 billion (2002: EUR 1.3 billion) in other current liabilities. These amounts reflect no netting of derivative instrument assets and liabilities.

#### **(e) New U.S. GAAP Standards Adopted in 2003**

##### *SFAS No. 143*

On January 1, 2003, Deutsche Telekom adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*, ("SFAS No. 143"). Upon adoption, the Company recorded the fair value of the liabilities for asset retirement obligations and increased the carrying amount of the associated long-lived asset. The liability is being accreted to its present value each period through charges to operating expense. The capitalized asset retirement cost is being depreciated over the shorter of the related asset's useful life or the period to the expected settlement of the retirement obligation. As a result, the Company recorded a credit of EUR 84 million, representing a cumulative effect of the adoption of SFAS No. 143, net of taxes of EUR 59 million. Pro-forma effects for the year ended December 31, 2002 and 2001 assuming SFAS No. 143 was effective as of January 1, 2001, were not material to the liabilities, net income or per share amounts in accordance with U.S. GAAP.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deutsche Telekom has asset retirement obligations relating primarily to equipment and other leasehold improvements installed on leased network sites and in administrative and retail buildings. Those leases generally contain provisions that require the company and its subsidiaries to restore the sites to their original condition at the end of the lease term. The following table shows the development of the liability for asset retirement obligations for the year ended December 31, 2003.

	<b>For the year ended December 31, 2003</b> (millions of €)
Liability for asset retirement obligations at December 31, 2002 .....	295
Cumulative effect on the liability of the adoption of SFAS No. 143 .....	22
Accretion expense .....	22
New asset retirement obligations incurred .....	16
Asset retirement obligations settled .....	(3)
Revisions in estimated cash flows .....	43
Effect of currency translation .....	(8)
<b>Liability for asset retirement obligations at December 31, 2003 .....</b>	<b><u>387</u></b>

### *SFAS No. 146*

The Company accounts for exit or disposal activities that are initiated after December 31, 2002 following the provisions of Statement of Financial Accounting Standards No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” (“SFAS No. 146”). The adoption of this standard did not have a material impact on the Company’s results of operations, financial position or cash flows.

### *SFAS No. 149*

The Company adopted Financial Accounting Standards No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities” (“SFAS No. 149”) for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. SFAS No. 149 codified certain decisions made by the FASB as part of the Derivatives Implementation Group process by amending and clarifying the scope and implementation guidance of SFAS No. 133, for similar accounting treatment of contracts with comparable characteristics. The adoption of SFAS No. 149 did not have a material impact on the Company’s results of operations, financial position and cash flows.

### *SFAS No. 150*

The Company adopted Statement of Financial Accounting Standards No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” (“SFAS No. 150”) for financial instruments entered into or modified after May 31, 2003. SFAS No. 150 established standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity, including certain obligations that can or must be settled by issuance of a company’s own equity shares. SFAS No. 150 requires that certain financial instruments which previously were classified as equity, be classified as liabilities or assets. The adoption of SFAS No. 150 did not have a material impact on the Company’s results of operations, financial position and cash flows.

### *FIN 45*

The Company adopted the initial recognition and measurement provisions of the Financial Accounting Standards Board Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others”, for guarantees issued or modified after December 31, 2002, which did not have a material impact on its results of operations, financial position or cash flows.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### *(f) Recently Issued U.S. GAAP Accounting Standards*

#### *FIN 46*

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). The Company has adopted the 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. On December 24, 2003, the FASB issued a revised interpretation to FIN 46 (“FIN 46R”) to modify some of the provisions of FIN 46 and to exempt certain entities from its requirements. The Company plans to adopt the provisions of FIN 46R as of March 31, 2004 to all entities that existed prior to February 1, 2003.

The Company has identified Toll Collect as a VIE, and is still assessing whether it is the primary beneficiary.

#### *EITF 00-21*

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 to adopt the provisions of EITF 00-21, for revenue arrangements entered into on or after January 1, 2004. 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 assessing the impact that the implementation of this standard will have on its results of operations, financial position and cash flows.

#### *EITF 01-8*

On May 28, 2003, the Financial Accounting Standards Board ratified the consensus reached in the Emerging Issues Task Force Issue No. 01-8, “Determining Whether an Arrangement Contains a Lease” (“EITF 01-8”). EITF 01-8 addresses the issue of how to determine whether an arrangement contains a lease that is within the scope of SFAS No. 13, “Accounting for Leases.” EITF 01-8 requires lease accounting for contractual arrangements that explicitly or implicitly convey the right to use (or control the use of) specific property, plant or equipment. These “embedded lease” attributes exist in certain data processing outsourcing arrangements that require a substantial investment in computer hardware and terminals devoted solely to the use of a single customer, or where providers of network capacity grant rights to capacity on the basis of an indefeasible right of use. The adoption of EITF 01-8 will result in the applicability of lease accounting to agreements previously recorded as service revenues. The Company plans to adopt the provisions of EITF 01-8 for all agreements entered into after December 31, 2003, and it is not expected to have a material impact on the Company’s results of operations, financial position and cash flows.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### *(h) Subsequent Events*

#### *Acquisition of Scout24 approved by anti-trust authorities*

On December 10, 2003, the Supervisory Board of T-Online International AG approved the acquisition of 100 percent of the shares in Scout24 AG, Baar, Switzerland, from the private equity company Beisheim Holding Schweiz AG. The German and Austrian anti-trust authorities approved the transaction at the beginning of February 2004. Subject to agreed adjustments depending on the 2003 financial statements of Scout24 AG, the purchase price is approximately EUR 180 million in cash and includes the assumption of a shareholder loan. The Scout24 marketplaces are aimed at users in Germany, Switzerland, and other European countries.

#### *Sale of shares in Virgin Mobile*

At the end of January 2004, T-Mobile and Virgin Group Ltd. signed a contract agreeing that Virgin Group Ltd. would acquire T-Mobile UK's 50-percent stake in their joint venture Virgin Mobile. In return, under the terms of a new wholesale agreement, Virgin Mobile will continue to use T-Mobile UK's network for at least another 10 years; Virgin Mobile has no mobile communications network of its own. In addition, T-Mobile will share in the proceeds of a stock market flotation of Virgin Mobile if one occurs.

#### *Toll Collect*

DaimlerChrysler Services, Deutsche Telekom AG, and Compagnie Financière et Industrielle des Autoroutes S.A. (Cofiroute) reached an agreement with the Federal Republic of Germany, represented by the German Federal Ministry of Transport, Building and Housing (Federal Ministry of Transport) in September 2002 on the establishment and operation of a system for the recording and collection of toll charges for the use of German highways by commercial vehicles with a permissible total weight of more than 12 tons. Deutsche Telekom and DaimlerChrysler Services each hold a 45-percent stake in the Toll Collect consortium, with the remaining 10 percent being held by Cofiroute. The start of operations, initially scheduled for August 31, 2003, has been delayed.

The consortium has been in negotiations with the Federal Ministry of Transport. The discussions are focused in particular on the timing and the form the system will take at its launch, issues of liability, and other amendments to the agreement, as well as technical aspects of the toll collection system. The Federal Minister of Transport, Building and Housing announced on February 17, 2004 that notice of termination would be given. On February 25, 2004, Deutsche Telekom received this notice of termination dated February 19, 2004.

Under the terms of the operating agreement, the consortium then has the opportunity to remedy within two months the reasons for termination as stated, insofar as they are justified, and to agree with the Federal Ministry of Transport the remaining preconditions for continuation of the Toll Collect project before the Federal Ministry of Transport can finally terminate the agreement. Termination by the Federal Ministry of Transport would also have a negative impact on the net worth, financial position, and results of the Group.

On February 29, 2004, the consortium and the Federal Ministry of Transport agreed on modalities for continued cooperation. The agreement concerns the project plan in particular, as well as issues of liability and remuneration. The consortium and the Federal Ministry of Transport will implement the agreed amendments in the coming weeks.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

A further capital increase of EUR 80 million was carried out on February 27, 2004 to extend the financing of Toll Collect GmbH and to comply with the agreed equity guarantee. A further capital increase of EUR 150 million is planned for March 2004.

Bonn, March 11, 2004

Deutsche Telekom AG  
Board of Management

Kai-Uwe Ricke

Josef Brauner

Dr. Heinz Klinkhammer

Konrad F. Reiss

Dr. Karl-Gerhard Eick

Thomas Holtrop

René Obermann



**BEN NEDERLAND HOLDING B.V.**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**DECEMBER 31, 2001**

**BEN NEDERLAND HOLDING B.V.**

**CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2001**

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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)

**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

**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)

	<u>2001</u>	<u>2000</u>
	<u>€000</u>	<u>€000</u>
<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
Total fixed assets	<u>1,008,827</u>	<u>884,930</u>
<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	<u>26,251</u>	<u>13,166</u>
Total current assets	<u>125,710</u>	<u>119,957</u>
<b>TOTAL ASSETS</b>	<u><u>1,134,537</u></u>	<u><u>1,004,887</u></u>
<b>SHAREHOLDERS' EQUITY &amp; LIABILITIES</b>		
TOTAL SHAREHOLDERS' EQUITY	608,549	807,415
CURRENT LIABILITIES	<u>525,988</u>	<u>197,472</u>
<b>TOTAL SHAREHOLDERS' EQUITY &amp; LIABILITIES</b>	<u><u>1,134,537</u></u>	<u><u>1,004,887</u></u>

The accompanying notes form an integral part of these financial statements.

**BEN NEDERLAND HOLDING B.V.**

**CONSOLIDATED PROFIT AND LOSS ACCOUNTS  
FOR THE THREE YEARS ENDED DECEMBER 31, 2001**

(Amounts expressed in thousands of Euros)

	<u>2001</u>	<u>2000</u>	<u>1999</u>
	<u>€000</u>	<u>€000</u>	<u>€000</u>
Net sales	447,527	244,842	66,655
Cost of sales <sup>(1)</sup>	<u>(226,546)</u>	<u>(156,633)</u>	<u>(69,757)</u>
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	<u>(10,290)</u>	<u>(12,427)</u>	<u>(3,716)</u>
Extraordinary income	<u>—</u>	<u>—</u>	<u>16,504</u>
Net loss	<u>(198,866)</u>	<u>(239,379)</u>	<u>(162,429)</u>

(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.

**BEN NEDERLAND HOLDING B.V.**

**CONSOLIDATED CASH FLOW STATEMENTS  
FOR THE THREE YEARS ENDED DECEMBER 31, 2001**  
(Amounts expressed in thousands of Euros)

	<u>2001</u>	<u>2000</u>	<u>1999</u>
	€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
	<u>19,279</u>	<u>(105,476)</u>	<u>109,000</u>
Net cash used in operating activities	<u>(104,532)</u>	<u>(290,070)</u>	<u>(24,263)</u>
<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	<u>(198,952)</u>	<u>(559,561)</u>	<u>(212,526)</u>
<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	<u>316,569</u>	<u>856,492</u>	<u>236,857</u>
<b>NET INCREASE IN CASH</b>	13,085	6,861	68
<b>Cash and cash equivalents beginning of year</b>	13,166	6,305	6,237
<b>Cash and cash equivalents end of year</b>	26,251	13,166	6,305

The accompanying notes form an integral part of these financial statements.



## 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:

	<u>Domicile</u>	<u>Proportion of voting rights held</u>	
		<u>2001</u>	<u>2000</u>
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.

**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.

**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)	<u>(23)</u>	<u>23</u>
Balance at December 31	<u>—</u>	<u>23</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	—
Balance at December 31, 2001	<u>628,980</u>
<b>ACCUMULATED AMORTISATION</b>	
Balance at January 1, 2001	(42,710)
Amortisation for the year	(38,195)
Balance at December 31, 2001	<u>(80,905)</u>
Net book value at December 31, 2001	<u>548,075</u>

**5. TANGIBLE FIXED ASSETS**

	<u>Installations, machinery and equipment</u>	<u>Furniture and fixtures</u>	<u>Leasehold improvements</u>	<u>Assets under construction</u>	<u>Total</u>
	<u>€000</u>	<u>€000</u>	<u>€000</u>	<u>€000</u>	<u>€000</u>
<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>—</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>

**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>
	<u>€000</u>	<u>€000</u>
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>
	<u>€000</u>	<u>€000</u>
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>

**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>
	€000	€000
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>(10,290)</u>	<u>(12,427)</u>

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**

- 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 €1,375,000.
- 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

**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)**

	<u>2001</u>	<u>2000</u>	<u>1999</u>
<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>	<u>(185,115)</u>	<u>(224,460)</u>	<u>(169,283)</u>

**Reconciliation of shareholders' equity from Dutch GAAP to U.S. GAAP  
(Amounts in €'000)**

	<u>Dec 31, 2001</u>	<u>Dec 31, 2000</u>
<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>	<u>621,800</u>	<u>806,915</u>



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**OJSC MOBILE TELESYSTEMS  
AND SUBSIDIARIES**

**Consolidated Financial Statements  
December 31, 2003, 2002 and 2001  
Unaudited**

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## **Report of Independent Registered Public Accounting Firm**

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, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. 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 the standards of the Public Company Accounting Oversight Board (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, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 3 to the consolidated financial statements, the Group changed its method of accounting for subscriber acquisition costs in 2001.

/s/ ZAO Deloitte & Touche CIS

March 26, 2004, except for Note 24,  
as to which the date is June 15, 2004

Moscow, Russia

**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**AT DECEMBER 31, 2003 and 2002**

(Amounts in thousands of U.S. dollars, except share amounts)

	December 31,	
	2003	2002
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents (Note 5)	\$ 90,376	\$ 34,661
Short-term investments (Note 6)	245,000	30,000
Trade receivables, net (Note 7)	99,951	40,501
Accounts receivable, related parties (Note 18)	3,356	3,569
Inventory (Note 8)	67,291	41,386
Prepaid expenses	46,679	26,537
Deferred tax asset, current portion (Note 15)	44,423	12,223
VAT receivable	209,629	154,061
Other current assets	33,774	15,392
<b>Total current assets</b>	<u>840,479</u>	<u>358,330</u>
<b>PROPERTY, PLANT AND EQUIPMENT</b> , net of accumulated depreciation of \$532,268 and \$299,216, respectively (Note 9)	2,256,076	1,344,633
<b>LICENSES</b> , net of accumulated amortization of \$257,024 and \$143,402, respectively (Notes 4 and 21)	703,103	386,919
<b>OTHER INTANGIBLE ASSETS AND GOODWILL</b> , net of accumulated amortization of \$148,052 and \$78,889, respectively (Note 10)	312,677	138,090
<b>DEBT ISSUANCE COSTS</b> , net of accumulated amortization of \$4,586 and \$2,898, respectively (Note 12)	9,431	2,957
<b>INVESTMENTS IN AND ADVANCES TO ASSOCIATES</b> (Note 20)	103,585	34,034
<b>Total assets</b>	<u>\$ 4,225,351</u>	<u>\$ 2,264,963</u>

The accompanying notes to consolidated financial statements are an integral part of these statements.

**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**AT DECEMBER 31, 2003 and 2002**

(Amounts in thousands of U.S. dollars, except share amounts)

	December 31,	
	2003	2002
<b>CURRENT LIABILITIES:</b>		
Accounts payable, related parties (Note 18)	\$ 31,904	\$ 4,968
Trade accounts payable	168,039	117,623
Deferred connection fees, current portion (Note 11)	21,467	22,210
Subscriber prepayments and deposits	191,768	110,950
Debt, current portion (Note 12)	103,312	67,098
Notes payable, current portion (Note 12)	597,836	—
Capital lease obligation, current portion (Notes 13 and 18)	9,122	21,232
Income tax payable	11,128	3,987
Accrued liabilities (Note 14)	143,789	73,919
Other payables	19,604	2,225
<b>Total current liabilities</b>	<u>1,297,969</u>	<u>424,212</u>
<b>LONG-TERM LIABILITIES:</b>		
Notes payable, net of current portion (Note 12)	800,000	298,943
Debt, net of current portion (Note 12)	142,418	59,971
Capital lease obligation, net of current portion (Notes 13 and 18)	7,646	7,241
Deferred connection fees, net of current portion (Note 11)	25,177	19,694
Deferred taxes (Note 15)	180,628	87,485
<b>Total long-term liabilities</b>	<u>1,155,869</u>	<u>473,334</u>
<b>Total liabilities</b>	<u>2,453,838</u>	<u>897,546</u>
<b>COMMITMENTS AND CONTINGENCIES</b> (Note 22)		
<b>MINORITY INTEREST</b>	47,603	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, 2003 and 2002, 345,244,080 of which are in the form of ADS (Note 1)	50,558	50,558
Treasury stock (9,929,074 as of December 31, 2003 and 9,966,631 as of December 31, 2002 common shares at cost) (Note 17)	(10,197)	(10,206)
Additional paid-in capital	559,911	558,102
Unearned compensation (Note 17)	(869)	(212)
Shareholder receivable (Note 12)	(27,610)	(34,412)
Accumulated other comprehensive income (Note 2)	7,595	—
Retained earnings	1,144,522	738,214
<b>Total shareholders' equity</b>	<u>1,723,910</u>	<u>1,302,044</u>
<b>Total liabilities and shareholders' equity</b>	<u>\$ 4,225,351</u>	<u>\$ 2,264,963</u>

The accompanying notes to consolidated financial statements are an integral part of these statements.



**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**FOR THE YEARS ENDED DECEMBER 31, 2003, 2002 and 2001**  
 (Amounts in thousands of U.S. dollars, except share and per share amounts)

	2003	2002	2001
<b>NET REVENUES:</b>			
Service revenues	\$ 2,435,717	\$ 1,274,287	\$ 830,308
Connection fees	29,372	24,854	21,066
Equipment sales	81,109	62,615	41,873
	<u>2,546,198</u>	<u>1,361,756</u>	<u>893,247</u>
<b>COST OF SERVICES AND PRODUCTS</b> , exclusive of depreciation and amortization shown separately below (including related party amounts of \$37,680, \$31,607 and \$30,537, respectively):			
Interconnection and line rental	187,270	113,052	75,278
Roaming expenses	113,838	83,393	68,387
Cost of equipment	173,071	90,227	39,828
	<u>474,179</u>	<u>286,672</u>	<u>183,493</u>
<b>OPERATING EXPENSES</b> (including related party amounts of \$11,002, \$9,602 and \$8,882, respectively) (Note 19):	406,722	229,056	134,598
<b>SALES AND MARKETING EXPENSES</b> (including related party amounts of \$23,668, \$12,140 and \$8,707, respectively):	326,783	171,977	107,729
<b>DEPRECIATION AND AMORTIZATION</b>	415,916	209,680	133,318
<b>IMPAIRMENT OF INVESTMENT</b> (Note 20)	—	—	10,000
<b>Net operating income</b>	922,598	464,371	324,109
<b>CURRENCY EXCHANGE AND TRANSLATION (GAINS) LOSSES</b>	(693)	3,474	2,264
<b>OTHER EXPENSES/(INCOME)</b> (including related party amounts of \$6,161, \$5,141 and \$2,978, respectively):			
Interest income (Note 6)	(18,076)	(8,289)	(11,829)
Interest expense	106,551	44,389	6,944
Other expenses (income), net	3,420	(2,454)	(2,672)
Total other expenses (income), net	91,895	33,646	(7,557)
<b>Income before provision for income taxes and minority interest</b>	831,396	427,251	329,402
<b>PROVISION FOR INCOME TAXES</b> (Note 15)	242,480	110,417	98,128
<b>MINORITY INTEREST</b>	71,677	39,711	7,536
<b>NET INCOME</b> before cumulative effect of a change in accounting principle	517,239	277,123	223,738
Cumulative effect of a change in accounting principle, net of income taxes of \$9,644 (Note 3)	—	—	(17,909)
<b>NET INCOME</b>	<u>\$ 517,239</u>	<u>\$ 277,123</u>	<u>\$ 205,829</u>
Weighted average number of common shares outstanding	1,983,374,949	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	\$ 0.261	\$ 0.140	\$ 0.113
Net income	\$ 0.261	\$ 0.140	\$ 0.104

The accompanying notes to consolidated financial statements are an integral part of these statements.

**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

**FOR THE YEARS ENDED DECEMBER 31, 2003, 2002 and 2001**

**(Amounts in thousands of U.S. dollars, except share amounts)**

	Common Stock		Treasury Stock		Accumulated Other Comprehensive Income	Additional Paid-in Capital	Unearned Compen- sation	Share- holder Receivable	Retained Earnings	Total
	Shares	Amount	Shares	Amount						
<b>BALANCES,</b>										
December 31, 2000	1,993,326,138	50,558	(9,966,631)	(10,206)	—	552,030	—	(49,519)	258,221	801,084
Receivable from Sistema (Note 12):										
Increases for interest	—	—	—	—	—	3,764	—	(3,764)	—	—
Payments from Sistema	—	—	—	—	—	—	—	14,325	—	14,325
Net income	—	—	—	—	—	—	—	—	205,829	205,829
Dividends declared	—	—	—	—	—	—	—	—	(2,959)	(2,959)
<b>BALANCES,</b>										
December 31, 2001	1,993,326,138	50,558	(9,966,631)	(10,206)	—	555,794	—	(38,958)	461,091	1,018,279
Receivable from Sistema (Note 12):										
Increases for interest	—	—	—	—	—	2,073	—	(2,073)	—	—
Payments from Sistema	—	—	—	—	—	—	—	6,619	—	6,619
Issuance of stock options (Note 17)	—	—	—	—	—	235	(235)	—	—	—
Amortization of deferred compensation (Note 17)	—	—	—	—	—	—	23	—	—	23
Net income	—	—	—	—	—	—	—	—	277,123	277,123
<b>BALANCES,</b>										
December 31, 2002	1,993,326,138	\$ 50,558	(9,966,631)	\$(10,206)	—	\$ 558,102	\$ (212)	\$ (34,412)	\$ 738,214	\$ 1,302,044
Receivable from Sistema (Note 12):										
Increases for interest	—	—	—	—	—	807	—	(807)	—	—
Payments from Sistema	—	—	—	—	—	—	—	7,609	—	7,609
Issuance of stock options (Note 17)	—	—	—	—	—	1,002	(1,002)	—	—	—
Stock options exercised (Note 17)	—	—	37,557	9	—	—	—	—	—	9
Amortization of deferred compensation (Note 17)	—	—	—	—	—	—	345	—	—	345
Dividends declared (Note 1)	—	—	—	—	—	—	—	—	(110,931)	(110,931)
Cumulative translation adjustment net of income taxes	—	—	—	—	7,595	—	—	—	—	7,595
Net income	—	—	—	—	—	—	—	—	517,239	517,239
<b>BALANCES,</b>										
December 31, 2003	1,993,326,138	\$ 50,558	(9,929,074)	\$(10,197)	\$ 7,595	\$ 559,911	\$ (869)	\$ (27,610)	\$ 1,144,522	\$ 1,723,910

The accompanying notes to consolidated financial statements are an integral part of these statements.

**OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE YEARS ENDED DECEMBER 31, 2003, 2002 and 2001**  
**(Amounts in thousands of U.S. dollars)**

	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 517,239	\$ 277,123	\$ 205,829
Adjustments to reconcile net income to net cash provided by operating activities:			
Minority interest	71,677	39,475	7,536
Depreciation and amortization	415,916	209,680	133,318
Amortization of deferred connection fees	(29,372)	(24,854)	(20,027)
Equity in net loss of associates	(2,670)	—	—
Cumulative effect of a change in accounting principle	—	—	17,909
Gain on debt extinguishment	—	—	(2,780)
Inventory obsolescence expense	3,307	5,614	2,543
Provision for doubtful accounts	32,633	7,047	3,219
Deferred taxes	(43,001)	(18,989)	(39,964)
Non-cash expenses associated with stock bonus and stock option plans	213	23	—
Impairment of investment	—	—	10,000
Changes in operating assets and liabilities:			
Increase in trade receivables	(64,597)	(18,945)	(7,181)
Decrease/(Increase) in accounts receivable, related parties	213	(1,360)	(3,091)
Increase in inventory	(14,737)	(18,186)	(4,129)
Increase in prepaid expenses	(11,029)	(2,634)	(8,552)
Increase in VAT receivable	(50,230)	(64,154)	(59,618)
(Increase)/Decrease in other current assets	(8,122)	(7,422)	1,613
(Decrease)/Increase in accounts payable, related parties	(1,417)	81	1,049
Increase/(Decrease) in trade accounts payable	2,673	(16,058)	20,470
Increase in subscriber prepayments and deposits	76,861	46,064	49,980
Increase/(Decrease) in income tax payable	7,141	(19,778)	10,753
Increase in accrued liabilities and other payables	63,286	20,045	19,324
Net cash provided by operating activities	<u>965,984</u>	<u>412,772</u>	<u>338,201</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Acquisitions of subsidiaries, net of cash acquired	(667,206)	(143,396)	(75,858)
Purchases of property, plant and equipment	(839,165)	(502,054)	(396,667)
Purchases of intangible assets	(119,606)	(72,218)	(44,533)
Purchases of short term investments	(215,000)	—	(110,000)
Proceeds from sale of short term investments	—	55,304	195,602
Investments in and advances to associates	(69,110)	(35,557)	(10,067)
Net cash used in investing activities	<u>(1,910,087)</u>	<u>(697,921)</u>	<u>(441,523)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of notes	1,097,000	50,808	248,135
Notes issuance cost	(9,556)	(649)	(3,856)
Capital lease obligation principal paid	(22,646)	(1,804)	(7,947)
Dividends paid	(110,864)	—	(2,959)
Proceeds from loans	712,716	52,851	13,577
Loan principal paid	(677,374)	(7,008)	(13,683)
Payments from Sistema	8,269	6,619	14,325
Net cash provided by financing activities	<u>997,545</u>	<u>100,817</u>	<u>247,592</u>
Effect of exchange rate changes on cash and cash equivalents	2,273	(636)	(469)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS:</b>	<u>55,715</u>	<u>(184,968)</u>	<u>143,801</u>
<b>CASH AND CASH EQUIVALENTS, beginning of year</b>	<u>34,661</u>	<u>219,629</u>	<u>75,828</u>
<b>CASH AND CASH EQUIVALENTS, end of year</b>	<u>\$ 90,376</u>	<u>\$ 34,661</u>	<u>\$ 219,629</u>
<b>SUPPLEMENTAL INFORMATION:</b>			
Income taxes paid	\$ 286,016	\$ 147,346	\$ 129,418
Interest paid	\$ 79,824	\$ 43,438	\$ 4,096
Non-cash investing activities:			
Additions to network equipment and software under capital lease	\$ 10,928	\$ 18,917	\$ 34,072
Payable related to business acquisition (Note 4)	\$ 27,500	\$ —	\$ —

The accompanying notes to consolidated financial statements are an integral part of these statements.

## 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. DESCRIPTION OF BUSINESS

##### *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”) and Ukraine in terms of the number of subscribers and revenues. The Group has operated primarily in the GSM standard since 1994.

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, its 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 majority stakes in local GSM operators (see Note 21 Operating Licenses and Note 4 Businesses Acquired).

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. In July 2000, the Company issued a total of 17,262,204 ADS, representing 345,244,080 common shares.

##### *Ownership*

As of December 31, 2003 and 2002, MTS’ shareholders of record and their respective percentage direct interests were as follows:

	<u>2003</u>	<u>2002</u>
Joint-Stock Financial Corporation “Sistema” (“Sistema”)	41.0%	35.0%
T-Mobile Worldwide Holding GmbH (“T-Mobile”)	25.4%	36.4%
VAST, Limited Liability Company (“VAST”)	3.1%	3.1%
Invest-Svyaz-Holding, Closed Joint-Stock Company	8.0%	8.0%
ADS Holders	17.4%	17.4%
GDR Holders	5.0%	—
All executive officers and directors	0.1%	0.1%
	<u>100.0%</u>	<u>100.0%</u>

Sistema owns 51.0% equity interest in VAST, a limited liability company incorporated under the laws of the Russian Federation; the remaining 49.0% interest is held by ASVT, a Russian open joint-stock company. Sistema’s effective ownership in MTS was 50.6% and 44.6% at December 31, 2003 and 2002, respectively.

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 199,332,614 shares of MTS, representing 10.0% of outstanding common stock of MTS. On April 26, 2003, Sistema exercised its option with T-Mobile to purchase an additional 6.0% of the outstanding common stock of MTS and purchased T-Mobile’s 49.0% interest in Invest-Svyaz-Holding, bringing its interest in Invest-Svyaz-Holding to 100.0%. Concurrently with this transaction, T-Mobile sold its holding of 5.0% in MTS

on the open market in the form of Global Depositary Receipts (“GDRs”) listed on the London Stock Exchange.

In April 2003, Sistema issued \$350.0 million 10.25% notes, due in 2008. These notes are collateralized by 193,473,900 shares of common stock of MTS OJSC.

On June 30, 2003, the Group approved cash dividends of \$1.12 per ADS (\$0.056 per share) for a total of \$111.0 million. As of the date of these statements, dividends in the amount of \$96.7 million, net of tax in the amount of \$10.5 million, were paid.

On November 28, 2003, common shares of MTS OJSC were included by the Board of Moscow Interbank Currency Exchange (“MICEX”) into the MICEX “B” Quotation List.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NEW ACCOUNTING PRONOUNCEMENTS**

### *Accounting principles*

MTS maintains its accounting books and records in Russian rubles for its subsidiaries located in the Russian Federation and Ukrainian hryvnas for Ukrainian Mobile Communications (“UMC”) based on local accounting and tax legislation. 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.

The accompanying consolidated financial statements differ from the financial statements used for statutory purposes in that they reflect various adjustments, not recorded on the entities’ books, which are appropriate to present the financial position, results of operations and cash flows in accordance with U.S. GAAP. The principal adjustments are related to revenue recognition, foreign currency translation, deferred taxation, consolidation, and depreciation and valuation of property and equipment and intangible assets.

### *Basis of consolidation*

Wholly owned subsidiaries and majority owned subsidiaries where the Company has operating and financial control are consolidated. Those ventures where the Company exercises significant influence, but does not exercise operating and financial control are accounted for by the equity method. All significant intercompany accounts and transactions are eliminated upon consolidation. The Company’s share in net income of unconsolidated affiliates was insignificant for each of the three years in the period ended December 31, 2003, and is included in other income in the accompanying consolidated statements of operations. Results of operations of subsidiaries acquired are included in the consolidated statements of operations from the date of their acquisition.

As of December 31, 2003 and 2002, MTS has investments in the following significant operating and holding entities:

	Accounting Method	December 31,	
		2003	2002
Rosico <sup>(1)</sup>	Consolidated	—	100.0 %
ACC	Consolidated	100.0%	100.0 %
Telecom XXI	Consolidated	100.0%	100.0 %
Telecom-900	Consolidated	100.0%	100.0 %
SCS-900	Consolidated	88.5%	51.0 %
FECS-900	Consolidated	60.0%	60.0 %
Uraltel	Consolidated	99.8%	53.2 %
MTS Finance <sup>(2)</sup>	Consolidated	100.0%	100.0 %
BM Telecom	Consolidated	100.0%	100.0 %
Kuban-GSM	Consolidated	100.0%	52.7 %
Dontelecom	Consolidated	100.0%	100.0 %
MTS-Barnaul	Consolidated	100.0%	100.0 %
BIT	Consolidated	100.0%	100.0 %
MTS-Capital	Consolidated	100.0%	—
UMC	Consolidated	100.0%	—
Sibchallenge	Consolidated	100.0%	—
TSS	Consolidated	100.0%	—
Volgograd Mobile	Equity	50.0%	—
Astrakhan Mobile	Equity	50.0%	—
Mar Mobile GSM	Consolidated	100.0%	—
Primtelefon	Equity	50.0%	—
MSS	Consolidated	83.5%	83.5
ReCom	Consolidated	53.9%	53.9
TAIF Telcom	Consolidated	52.7%	—
UDN-900	Consolidated	51.0%	51.0 %
Novitel	Consolidated	51.0%	51.0 %
MTS Belarus	Equity	49.0%	49.0 %

<sup>(1)</sup> On June 9, 2003, the Group's wholly owned subsidiary, Rosico, merged into MTS OJSC pursuant to a shareholders' resolution approving the transaction.

<sup>(2)</sup> Represents beneficial ownership.

#### *Translation methodology*

Effective January 1, 2003, the Russian economy ceased to be considered hyperinflationary. Management believes that the U.S. dollar is the appropriate functional currency because the majority of its revenues, costs, property and equipment purchased, and debt are either priced, incurred, payable or otherwise measured in U.S. dollars. Each of the legal entities domiciled in Russia, Ukraine and Belarus maintains its records and prepares its financial statements in the local currency, principally either Russian ruble, Ukrainian hryvna or Belarusian ruble, in accordance with the requirements of local statutory accounting and tax legislation.



Translation (re-measurement) of financial statements denominated in local currencies into U.S. dollars has been performed in accordance with the provisions of Statement of Financial Accounting Standard (“SFAS”) No. 52 “Foreign currency translation.”

For subsidiaries of the Group where functional currency is the U.S. dollar, 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.

For UMC and Kuban-GSM where functional currency is the local currency, Ukrainian hryvna and Russian ruble, respectively, a “new cost basis” for all non-monetary assets has been established as of January 1, 2003. All year end balance sheet items have been translated into U.S. dollars at the period end exchange rate. Revenues and expenses have been translated at period average exchange rate. Cumulative translation adjustments in the amount of \$7,595, net of income taxes were recorded directly in the consolidated statement of shareholders’ equity.

#### *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.

Examples of significant estimates include the allowance for doubtful accounts, the recoverability of intangible assets and other long-lived assets, and valuation allowances on deferred tax assets.

#### *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.

#### *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 and accessories, held for sale and spare parts, to be used for equipment maintenance within next twelve months and other inventory items.

Telephones and accessories, held for sale, are written down to their market values based on specific monthly reviews of significant inventoried items and are expensed as cost of equipment.

### *Value-added taxes ("VAT")*

Value-added taxes related to sales are payable to the tax authorities on an accrual basis based upon invoices issued to the customer. VAT incurred for purchases may be reclaimed, subject to certain restrictions, against VAT related to sales.

### *Property, plant and equipment*

Property, plant and equipment with a useful life of more than one year are 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 that extend useful lives are capitalized.

### *License costs*

License costs are capitalized as a result of (a) purchase price allocated to licenses acquired in business combinations (see Note 4 Businesses Acquired) and (b) licenses purchased directly from government organizations, which require license payments.

Our current operating licenses do not provide for automatic renewal upon expiration, and 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 a straight-line basis over three to ten years starting from the date such license area becomes commercially operational.

Upon adoption of SFAS No. 142, "Goodwill and Other Intangible Assets" on January 1, 2002, the Group reclassified \$22.0 million relating to the 1998 acquisition of Rosico from goodwill to licenses.

### *Other intangible assets and Goodwill*

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. Telephone numbering capacity costs

with finite contractual life are being amortized over five to ten years and the rights to use premises are being amortized over ten years.

Software costs are amortized over four years. Acquired customer base is amortized over the estimated average subscriber life from 30 to 70 months. Other intangible assets are being amortized over three to four years. All finite-life intangible assets are being amortized using the straight-line method.

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. Amortization of deferred numbering capacity costs starts immediately upon the purchase of numbering capacity.

Goodwill represents the excess of the cost of business acquired over the fair market value of identifiable net assets at the date of acquisition, namely fair value of workforce-in-place acquired in the purchase of UMC (see Note 4 Business Acquired).

Goodwill is reviewed annually, as of the beginning of the fourth quarter, for impairment or whenever it is determined that impairment indicators exist. The Company determines whether an impairment has occurred by assigning goodwill to the reporting unit identified in accordance with SFAS No. 142, and comparing the carrying amount of the reporting unit to the fair value of the reporting unit. If a goodwill impairment has occurred, the Company recognizes a loss for the difference between the carrying amount and the implied fair value of goodwill. To date, no impairment of goodwill has occurred.

#### *Leasing arrangements*

The Group accounts for leases based on the requirements of SFAS No. 13, "Accounting for Leases." Majority of the Group's operating leases are for the premises. Certain subsidiaries of the Group lease switches, base stations and other cellular network equipment as well as billing systems. For capital leases, the present value of future minimum lease payments at the inception of the lease is reflected as an asset and 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.

#### *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 3 Change in Accounting Principle).

#### *Investments impairment*

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.

For the three years in the period ended December 31, 2003, no such impairments have occurred, except as discussed in Note 20 Investments In and Advances to Associates.

#### *Debt issuance costs*

Debt issuance costs are amortized using the effective interest method over the terms of the related debt.

#### *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 compares 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 the assets, MTS records 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. For the three years in the period ended December 31, 2003, no such impairments have occurred.

#### *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 services are actually provided or title to equipment passes to customer, 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 subscriber, the destination of the call and the service utilized.

Value-added service 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 \$153,271, \$83,393 and \$52,639 for the years ended December 31, 2003, 2002 and 2001, respectively.

#### *Prepaid phone cards*

MTS sells to subscribers prepaid 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 prepaid phone card is purchased, MTS records the receipt of cash as a subscriber prepayment. 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 prepaid phone card has expired.

In 2002, MTS introduced a new line of prepaid 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 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 39 months in Russia and 47 months in Ukraine (see also Note 11 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 when title passes to the customer. MTS records estimated returns as a direct reduction of sales at the time the related sales are recorded.

In Ukraine, MTS also from time to time sells handsets at prices below cost. MTS recognizes these subsidies in cost of equipment when sale is recorded.

#### *Expense recognition*

Expenses incurred by MTS in relation to the provision of wireless communication services mainly 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 fees are recorded as roaming expenses, as MTS acts as the principal in the transaction with the subscriber and bears the risk of non-collection from the subscriber. Roaming fees are charged to MTS subscribers based on Group's existing tariffs and recorded as service revenues.

The costs of handsets and accessories, whether sold to subscribers through the distribution channel or as part of the service contract, are expensed when title passes to the customer. Any fees paid to dealers as 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, 2003, 2002 and 2001 were \$102,018, \$48,624 and \$42,715, respectively, and are reflected as a component of sales and marketing expenses in the accompanying consolidated statements of operations.

#### *Government pension fund*

Subsidiaries of the Group contribute to the local state pension fund and social fund, on behalf of all its employees.

In Russia, starting from January 1, 2001 all social contributions, including contributions to the pension fund, were substituted with a unified social tax ("UST") calculated by the application of a regressive rate from 35.6% to 2% of the annual gross remuneration of each employee. UST is allocated to three social funds, including the pension fund, where the rate of contributions to the pension fund vary from 28% to 2%, respectively, depending on the annual gross salary of each employee. The contributions are expensed as incurred.

In Ukraine the subsidiary of the Group is required to contribute a specified percentage of each employee payroll up to a fixed limit to Pension Fund, Unemployment Fund and Social Security Fund.

#### *Earnings per share*

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 4,797,410 stock options outstanding as of December 31, 2003.



The following is the reconciliation of the share component for basic and diluted EPS:

	<b>December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Weighted average number of common share outstanding	1,983,374,949	1,983,359,507	1,983,359,507
Dilutive effect of stock options	1,727,131	405,946	30,133
Weighted average number of common shares and potential shares outstanding	<u>1,985,102,080</u>	<u>1,983,765,453</u>	<u>1,983,389,640</u>

*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. The fair value of our publicly traded long-term notes as of December 31, 2003 ranged from 103.6% to 110.2% of the principal amount. As of December 31, 2003, fair value of other fixed rate debt including capital lease obligation approximated its carrying value. The fair value of variable rate debt is equivalent to carrying value.

*Comprehensive income*

Comprehensive income is defined as net income plus all other changes in net assets from non-owner sources. The following is a reconciliation of comprehensive income, net of income taxes:

	<b>December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net income	\$ 517,239	\$ 277,123	\$ 205,829
Cumulative translation adjustment	7,595	—	—
Total comprehensive income	<u>\$ 524,834</u>	<u>\$ 277,123</u>	<u>\$ 205,829</u>

*Comparative information*

Certain prior years 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." Under the requirements of these statements compensation to employees and non-employee directors is measured 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.

If the Group had elected to recognize compensation costs based on the fair values of options at the date of the grant, net income and earning per share amounts would have been as follows:

	<u>December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income as reported	\$ 517,239	\$ 277,123	205,829
Pro-forma effect of the application of fair value method of accounting for stock options	(727)	(460)	(129)
Pro-forma net income	<u>\$ 516,512</u>	<u>\$ 276,663</u>	<u>\$ 205,700</u>
Earnings per share—basic and diluted			
As reported	\$ 0.261	\$ 0.140	\$ 0.104
Pro-forma	\$ 0.260	\$ 0.140	\$ 0.104

#### *Recently adopted accounting pronouncements*

In June 2001, Financial Accounting Standard Board (“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 is 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 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. The Group adopted SFAS No. 143 effective January 1, 2003. The adoption of SFAS No. 143 did not have a material impact on the Group’s financial position or results of operations.

In April 2002, FASB issued SFAS No. 145, “Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections”. SFAS No. 4, “Reporting Gains and Losses from Extinguishments 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 eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required sale-leaseback accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. Following the adoption of the requirements of SFAS No. 145 effective January 1, 2003, MTS reclassified a gain on the extinguishment of a credit facility with OJSC AB Inkombank of \$2.8 million and the related income tax expense of \$0.7 million from extraordinary gain on debt repayment to other income and income tax expense, respectively, in the consolidated statement of operations for the year ended December 31, 2001.

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 liability. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. The Group adopted the provisions of SFAS No. 146 effective January 1, 2003. The adoption of SFAS No. 146 did not have a material impact on the Group’s financial position or results of operations.

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 recognizes, 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 Group adopted the initial recognition and measurement provisions of this interpretation on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not have a material impact on the Group’s financial position or results of operations.

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. The Group adopted the requirements of EITF Issue No. 00-21 prospectively for arrangements entered into after June 15, 2003. The adoption of EITF Issue No. 00-21 did not have a material impact on the Group’s financial position or results of operations.

In April 2003, FASB issued SFAS No. 149, “Amendments of FASB Statements No. 133 on Derivative Instruments and Hedging Activities.” SFAS No. 149 clarifies under what circumstances a contract with an initial investment meets the characteristic of a derivative, clarifies when a derivative contains a financing component, amends the definition of an underlying and certain other existing pronouncements. The Group adopted the requirements of SFAS No. 149 for contracts entered into or modified and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 did not have a material impact on the Group’s financial position or results of operations.

In May 2003, FASB issued SFAS No. 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”. SFAS No. 150 requires issuers to classify as liabilities (or assets in some circumstances) certain classes of freestanding financial instruments that embody obligations for the issuer, including mandatory redeemable financial instruments, obligations to repurchase the issuer’s equity shares by transferring assets and certain obligations to issue a variable number of shares. The Group adopted the requirements of SFAS No. 150 effective July 1, 2003. The adoption of SFAS No. 150 did not have a material impact on the Group’s financial position or results of operations.

#### *New accounting pronouncements*

In December 2003, FASB issued a revision to Interpretation No. 46, “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51” (“FIN 46R” or the “Interpretation”). FIN 46R clarifies the application of ARB 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. FIN 46R requires the consolidation of these entities, known as variable interest entities (“VIEs”), by the primary beneficiary of the entity. The primary beneficiary is the entity, if any, that will absorb a majority of the entity’s expected losses, receive a majority of the entity’s expected residual returns, or both.

Among other changes, the revisions of FIN 46R (a) clarified some requirements of the original FIN 46, which had been issued in January 2003, (b) eased some implementation problems, and (c) added new scope exceptions. FIN 46R deferred the effective date of the Interpretation for public

companies, to the end of the first reporting period ending after March 15, 2004, except that all public companies must at a minimum apply the provisions of the Interpretation to entities that were previously considered “special-purpose entities” under the FASB literature prior to the issuance of FIN 46R by the end of the first reporting period ending after December 15, 2003.

The Group is evaluating whether the adoption of FIN 46 will have a material impact on its financial position, cash flows and results of operations. The Group did not enter into any transactions under the scope of FIN 46R after February 1, 2003.

In December 2003, the Securities Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 updates portions of the interpretive guidance included in Topic 13 of the codification of Staff Accounting Bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The Group believes it is following the guidance of SAB 104.

### 3. 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.

### 4. BUSINESSES ACQUIRED

#### *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 \$49.7 million. 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)
Purchase price	<u>\$ 49,742</u>

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 \$26.8 million 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 and licenses to provide GSM-900/1800 mobile services in the Novosibirsk region, Altai Republic, Sverdlovsk region and Khabarovsk region.

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)
Purchase price	<u>\$ 26,812</u>

In November 2002, MTS acquired the remaining 19% of Telecom-900 from Invest-Svyaz-Holding, a shareholder of the Group and a wholly owned subsidiary of Sistema, for a cash consideration of \$6.9 million. The acquisition was accounted for using the purchase method of accounting. The allocation of the purchase price increased recorded license costs by \$2.7 million.

On August 13, 2003, Telecom-900 completed the purchase of the 43.7% and 2.95% stakes in Uraltel for a cash consideration of \$35.7 million. The transaction increased Telecom-900’s ownership in Uraltel to 99.85%. The acquisition was accounted using purchase method of accounting. The allocation of purchase price increased recorded license cost by \$24.5 million.

In November 2003, the Group completed the purchase of the 30% stake in SCS-900 from Sibirtelecom for cash consideration of \$28.6 million. The Group’s acquisition of this stake increased its ownership in SCS-900 to 81.0%. On December 29, 2003, the Group acquired for cash consideration of \$9.3 million a 100% stake in ILIT LLC, a company which owns a 7.5% stake in SCS-900, increasing its ownership in SCS-900 to 88.5%. The acquisition was accounted using purchase method of accounting. The allocation of purchase price increased recorded license cost by \$25.7 million.

License costs are amortized over the remaining contractual terms of the respective license, ranging from 6 to 10 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 cash consideration of \$71.4 million. At the date of acquisition, Kuban-GSM had approximately 500,000 subscribers. It operates in thirteen major cities throughout the south of the European part of the Russian Federation, including Sochi, 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	80,848
License costs	62,549
Acquired customer base	3,561
Current liabilities	(31,289)
Non-current liabilities	(19,827)
Deferred taxes	(15,866)
Minority interest	(20,327)
Purchase price	<u>\$ 71,400</u>

In October 2002, MTS exercised its option to buy additional 353 shares for \$5.0 million payable in cash, increasing its ownership in Kuban-GSM 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 \$4.4 million, increased acquired customer base by \$0.2 million, and decreased minority interest by \$0.5 million.

In September 2003, the Group acquired 100.0% of Kubtelesot for cash consideration of \$107.0 million. Kubtelesot owned 47.3% of Kuban-GSM, and the Group's purchase of this stake increased its ownership in Kuban-GSM to 100.0%. The acquisition was accounted for using the purchase method of accounting. The allocation of purchase price increased recorded license cost by \$57.5 million, increased acquired customer base by \$8.4 million, and decreased minority interest by \$59.0 million.

License costs are amortized over the remaining contractual term of the license of approximately 5 years at the date of the first acquisition. Acquired customer base is amortized over the average remaining subscribers life of approximately 70 months.

### *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 \$41.0 million 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)
Purchase price	<u>\$ 41,000</u>

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, a closed joint-stock company, for cash consideration of \$15.0 million (including 33.33% acquired from Sistema for \$7.5 million). 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 using the purchase method. The purchase price was allocated as follows:

Current assets	\$ 3,422
Non-current assets	8,401
License costs	14,739
Current liabilities	(5,849)
Non-current liabilities	(357)
Deferred taxes	(3,675)
Minority interest	(1,681)
Purchase price	<u>\$ 15,000</u>

In October 2002, the Group completed the acquisition of the remaining 33.33% of the outstanding common stock of Dontelecom for \$7.5 million. The acquisition was accounted for using the purchase method of accounting. The purchase increased the recorded license costs by \$7.3 million.

License costs are amortized over the remaining contractual term of the license of approximately 3 years at the date of the acquisition.

#### *UMC acquisition*

On March 4, 2003, MTS acquired 57.7% of the outstanding voting interest of UMC, a provider of mobile services in Ukraine, for cash consideration of \$199.0 million, including the acquisition of 16.3% of the outstanding voting interest from Deutsche Telekom AG, a related party, for \$55.0 million. Acquisition costs relating to the transaction of \$1.4 million were capitalized. In connection with the acquisition, MTS also assumed debt of UMC with face value of approximately \$65.0 million, with the

fair value of approximately \$62.0 million. At the date of acquisition, UMC had approximately 1.8 million subscribers.

The acquisition was accounted for using the purchase method. For convenience, MTS consolidated UMC from March 1, 2003. Purchase price allocation is as follows:

Current assets	\$ 82,293
Non-current assets	272,721
License costs	82,200
Acquired customer base	30,927
Current liabilities	(63,551)
Non-current liabilities	(78,580)
Deferred taxes	(27,425)
Minority interest	(99,581)
Purchase price	<u>\$ 199,004</u>

MTS paid \$171.5 million of the purchase price in cash and agreed to pay the balance of the purchase price of \$27.5 million to Cetel B.V., a wholly owned subsidiary of Deutsche Telekom AG, within one year. The amount payable accrues interest of 9% per annum.

MTS also had an option agreement with Ukrtelecom to purchase its remaining 26.0% stake in UMC, exercisable from February 5, 2003 to November 5, 2005, with an exercise price of \$87.6 million. On June 4, 2003, MTS exercised its call option. As a result of the transaction, MTS' ownership in UMC increased from 57.7% to 83.7%. The acquisition was accounted for using purchase method of accounting. The allocation of purchase price increased recorded license cost by \$10.2 million, increased acquired customer base by \$13.9 million, and decreased minority interest by \$66.4 million.

In addition, MTS entered into a put and call option agreement with TDC Mobile International A/S ("TDC") for the purchase of its 16.3% stake in UMC. The exercise period of the call option was from May 5, 2003 to November 5, 2004, and the put option was exercisable from August 5, 2003 to November 5, 2004. The call option price was \$85.0 million plus interest accrued from November 5, 2002 to the date of the exercise at 11% per annum; the price of the put option was calculated based on reported earnings of UMC prior to the exercise and was subject to a minimum amount of \$55.0 million. On June 25, 2003, MTS notified TDC of its intent to exercise its rights under the put and call option agreement. The purchase was completed during July 2003. MTS paid cash consideration of approximately \$91.7 million to purchase the remaining 16.3% stake in UMC. The acquisition was accounted for using purchase method of accounting. The allocation of purchase price increased recorded license cost by \$52.7 million, increased acquired customer base by \$8.7 million, and decreased minority interest by \$43.8 million.

The UMC license costs are amortized over the remaining contractual terms of the licenses of approximately 9 to 13 years at the date of the acquisition, acquired customer base is amortized over the average remaining subscribers life of approximately 47 months. Other acquired intangible assets, represented mostly by software, are amortized over their respective useful lives of 3 to 10 years.

In accordance with SFAS No. 141 "Business Combinations," the Group recognized \$8.0 million of goodwill relating to workforce-in-place.

UMC is one of the two leading mobile operators in Ukraine, operating under nationwide GSM 900/1800 and NMT 450 licenses. As at the date of purchase of the controlling stake, it was providing services to approximately 1.8 million subscribers.

*TAIF Telcom acquisition*

In April 2003, MTS acquired 51.0% of the common shares of TAIF Telcom, a Russian open joint-stock company, for cash consideration of \$51.0 million and 50.0% of the preferred shares of TAIF Telcom for cash consideration of \$10.0 million. In May 2003, MTS acquired an additional 1.7% of the common shares of TAIF Telcom for cash consideration of \$2.3 million. In connection with the acquisitions, MTS also assumed indebtedness of approximately \$16.6 million that is collateralized by telecom equipment.

MTS also entered into call and put option agreements with the existing shareholders of TAIF Telcom to acquire the remaining 49.0% of common shares and 50.0% of preferred shares of TAIF Telcom. The exercise period for the call option on common shares is 48 months from the acquisition date and for the put option on common shares is 36 months following an 18 month period after the acquisition date. The call and put option agreements for the common shares stipulate a minimum purchase price of \$49.0 million plus 8% per annum commencing from the acquisition date. The exercise period for the call option on preferred shares is 48 months following a 24 month period after the acquisition date and for the put option on preferred shares it is a 24 month period after the acquisition date. The call and put option agreements for the preferred shares stipulate a minimum purchase price of \$10.0 million plus 8% per annum commencing from the acquisition date.

If all of the options are exercised, MTS' share in TAIF Telcom will increase to 100.0%.

The purchase price allocation was as follows:

Current assets	\$ 3,870
Non-current assets	48,391
License costs	68,407
Current liabilities	(26,099)
Non-current liabilities	(5,550)
Deferred taxes	(16,814)
Minority interest	(8,965)
Purchase price	<u>\$ 63,240</u>

License costs acquired are amortized over the remaining contractual terms of the licenses of approximately 4 years.

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.

*Sibachallenge acquisition*

On August 22, 2003, MTS completed the purchase of 100.0% of Sibachallenge, a cellular operator in the Krasnoyarsk region, for cash consideration of \$45.5 million, paid a finder's fee of \$2.0 million

and assumed net debt of approximately \$6.6 million. Sibachallenge holds licenses to provide GSM-900/1800 and DAMPS mobile services in the Krasnoyarsk region of Siberia, the Republic of Khakasiya, and in the Taimyr Autonomous region, all of which are located in the Siberian part of Russia. At the date of acquisition, Sibachallenge had approximately 132,000 subscribers.

The purchase price allocation was as follows:

Current assets	\$ 4,078
Non-current assets	16,678
License costs	52,625
Current liabilities	(6,405)
Non-current liabilities	(6,628)
Deferred taxes	(12,894)
Purchase price	<u>\$ 47,454</u>

License costs acquired are amortized over the remaining contractual terms of the licenses of approximately 8 years.

#### *Tomsk Cellular Communications acquisition*

In September 2003, MTS purchased 100.0% of Siberian operator Tomsk Cellular Communications (“TSS”) for cash consideration of \$47.0 million. TSS holds licenses to provide GSM-900/1800 mobile cellular communications in the Tomsk region. At the date of acquisition, TSS had approximately 183,000 subscribers.

The acquisition was accounted for using the purchase method. The purchase price allocation was as follows:

Current assets	\$ 3,299
Non-current assets	11,412
License costs	49,282
Current liabilities	(4,543)
Non-current liabilities	(105)
Deferred taxes	(12,345)
Purchase price	<u>\$ 47,000</u>

License costs acquired are amortized over the remaining contractual terms of the licenses of approximately 8 years.

#### *Acquisitions of various regional companies*

In August 2003, the Group reached an agreement to acquire, in a series of related transactions, equity interests in five Russian regional mobile phone operators from MCT Corporation for a total of \$71.0 million. The Group agreed to purchase a 43.7% stake in Uraltel (described above) and 100.0% of Vostok Mobile BV, which holds a 50.0% stake in Primtelefon.

The Group also agreed to purchase Vostok Mobile South, which holds 50.0% stakes in Astrakhan Mobile and Volgograd Mobile, as well as an 80.0% stake in Mar Mobile GSM. The Group also entered into agreements to acquire the remaining 20.0% of Mar Mobile GSM and another 2.95% stake in Uraltel from existing shareholders unrelated to MCT Corporation for approximately \$1.0 million.

On August 26, 2003, the Group completed the acquisition of Vostok Mobile BV and recorded a 50.0% stake investment in Primtelefon using equity method of accounting.

On October 14, 2003, the Group completed the purchase of Vostok Mobile South and thus acquired a 50.0% stake in Volgograd Mobile and Astrakhan Mobile and an 80.0% stake in Mar Mobile GSM. Also, in a separate transaction the Group completed the acquisition of the remaining 20.0% stake in Mar Mobile GSM from existing shareholders unrelated to MCT corporation, thus consolidating a 100.0% ownership in the company.

*Pro-forma results of operations (unaudited)*

The following unaudited pro forma financial data for the years ended December 31, 2003 and 2002, give effect to the acquisitions of UMC, TAIF Telcom, Sibchallenge, TSS, Kuban-GSM and other various regional companies as if they had occurred at the beginning of the respective years.

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>Pro-forma:</b>		
Net revenues	\$ 2,640,856	\$ 1,714,532
Net operating income	925,149	544,917
Net income	583,222	342,595
Earnings per share, basic and diluted	\$ 0.294	\$ 0.173

The pro-forma information is based on various assumptions and estimates. The pro-forma information is not necessarily indicative of the operating results that would have occurred if the Group acquisitions had been consummated as of January 1, 2003 and 2002, nor is it necessarily indicative of future operating results. The pro-forma information does not give effect to any potential revenue enhancements or cost synergies or other operating efficiencies that could result from the acquisitions. The actual results of operations of these companies are included in the consolidated financial statements of the Group only from the respective dates of acquisition.

## 5. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2003 and 2002 comprised of the following:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
Ruble current accounts	\$ 40,597	\$ 19,860
Ruble deposits	20,201	—
U.S. dollar deposits	886	7,999
U.S. dollar current accounts	20,130	6,404
Other	8,562	398
Total cash and cash equivalents	<u>\$ 90,376</u>	<u>\$ 34,661</u>

## 6. SHORT-TERM INVESTMENTS

Short-term investments, denominated in U.S. dollars, as of December 31, 2003 comprised of the following:

	<u>Annual interest rate</u>	<u>Maturity date</u>	<u>December 31, 2003</u>
	OJSC Moscow Bank of Reconstruction and Development	4.8%	February 2, 2004
OJSC Moscow Bank of Reconstruction and Development	8.0%	October 4, 2004	10,000
OJSC Moscow Bank of Reconstruction and Development	8.4%	October 21, 2004	19,100
OJSC Moscow Bank of Reconstruction and Development	8.4%	November 23, 2004	5,000
OJSC Moscow Bank of Reconstruction and Development	8.4%	December 5, 2004	5,900
OJSC Moscow Bank of Reconstruction and Development	8.4%	December 20, 2004	5,000
Total short-term investments			<u>\$ 245,000</u>

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
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>

OJSC Moscow Bank of Reconstruction and Development is a related party (see also Note 18 Related Party).



## 7. TRADE RECEIVABLES

Trade receivables as of December 31, 2003 and 2002 were as follows:

	December 31,	
	2003	2002
Accounts receivable, subscribers	\$ 87,149	\$ 29,505
Accounts receivable, roaming	26,500	17,266
Allowance for doubtful accounts	(13,698)	(6,270)
Trade receivables, net	<u>\$ 99,951</u>	<u>\$ 40,501</u>

The following table summarizes the changes in the allowance for doubtful accounts for the years ended December 31, 2003, 2002 and 2001:

	December 31,		
	2003	2002	2001
Balance, beginning of year	\$ 6,270	\$ 5,178	\$ 1,959
Provision for doubtful accounts	32,633	7,047	3,219
Accounts receivable written off	(25,205)	(5,955)	—
Balance, end of year	<u>\$ 13,698</u>	<u>\$ 6,270</u>	<u>\$ 5,178</u>

## 8. INVENTORY

Inventory as of December 31, 2003 and 2002 comprised of the following:

	December 31,	
	2003	2002
Spare parts for base stations	\$ 26,635	\$ 15,519
Handsets and accessories	23,499	18,056
Other inventory	17,157	7,811
Inventory	<u>\$ 67,291</u>	<u>\$ 41,386</u>

Obsolescence expense for the years ended December 31, 2003, 2002 and 2001 amounted to \$3,307, \$5,614 and \$2,543, respectively, and was included in operating expenses in the accompanying consolidated statements of operations.

## 9. PROPERTY, PLANT AND EQUIPMENT

The net book value of property, plant and equipment as of December 31, 2003 and 2002 was as follows:

	December 31,	
	2003	2002
Network and base station equipment (including leased network and base station equipment of \$66,311 and \$55,383 respectively)	\$ 1,775,180	\$ 959,465
Leasehold improvements	6,582	4,299
Office equipment, computers, software and other (including leased office equipment, computers and software of \$1,923 and \$1,739, respectively)	147,395	68,271
Buildings	144,680	96,420
Vehicles	11,611	7,607
Property, plant and equipment, at cost	2,085,448	1,136,062
Accumulated depreciation (including accumulated depreciation on leased equipment of \$23,343 and \$13,420, respectively)	(532,268)	(299,216)
Equipment for installation	334,264	313,222
Construction in-progress	368,632	194,565
Property, plant and equipment, net	<u>\$ 2,256,076</u>	<u>\$ 1,344,633</u>

Depreciation expenses during the years ended December 31, 2003, 2002 and 2001 amounted to \$233.1 million, \$116.0 million and \$73.7 million, respectively, including depreciation expenses for leased property, plant and equipment in the amount of \$7.6 million, \$3.4 million and \$1.6 million, respectively.

## 10. OTHER INTANGIBLE ASSETS

Intangible assets at December 31, 2003 and 2002 comprised of the following:

	Useful lives	December 31, 2003			December 31, 2002		
		Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
<b>Amortized intangible assets:</b>							
Acquired customer base	30 to 70 months	\$ 81,289	\$ (18,307)	\$ 62,982	\$ 7,410	\$ (955)	\$ 6,455
Rights to use premises	10 years	19,638	(10,476)	9,162	11,752	(8,352)	3,400
Numbering capacity with finite contractual life, software and other	3 to 10 years	338,222	(119,269)	218,953	184,237	(69,582)	114,655
		<u>439,149</u>	<u>(148,052)</u>	<u>291,097</u>	<u>203,399</u>	<u>(78,889)</u>	<u>124,510</u>
<b>Unamortized intangible assets:</b>							
Numbering capacity with indefinite contractual life		13,047	—	13,047	13,047	—	13,047
Goodwill		8,533	—	8,533	533	—	533
Total other intangible assets		<u>\$ 460,729</u>	<u>\$ (148,052)</u>	<u>\$ 312,677</u>	<u>\$ 216,979</u>	<u>\$ (78,889)</u>	<u>\$ 138,090</u>

As a result of a 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 telecommunication operators in Moscow. Costs of acquiring numbering capacity with finite contractual life are amortized over period of five to ten years in accordance with the terms of the contract entered into to acquire such capacity. Numbering capacity with indefinite contractual life is not amortized.

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 for the years ended December 31, 2003, 2002 and 2001 amounted to \$69.2 million, \$30.0 million and \$17.5 million, respectively. Based on the amortizable intangible assets existing at December 31, 2003, the estimated amortization expense is \$122.7 million during 2004, \$90.0 million during 2005, \$51.3 million during 2006, \$15.9 million during 2007, \$3.1 million during 2008 and \$8.1 million thereafter. Actual amortization expense to be reported in future periods could differ from these estimates as a result of new intangible assets acquisitions, changes in useful lives and other relevant factors.

#### 11. DEFERRED CONNECTION FEES

Deferred connection fees for the years ended December 31, 2003 and 2002 were as follows:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
Balance at beginning of the year	\$ 41,904	\$ 47,412
Payments received and deferred during the year	34,112	19,346
Amounts amortized and recognized as revenue during the year	(29,372)	(24,854)
Balance at end of the year	<u>46,644</u>	<u>41,904</u>
Less current portion	<u>21,467</u>	<u>22,210</u>
Non-current portion	<u>\$ 25,177</u>	<u>\$ 19,694</u>

MTS defers initial connection fees from the moment of initial signing of the contract with subscribers and recognizes the revenue over the estimated average subscriber life (see Note 2 Summary of Significant Accounting Policies and New Accounting Pronouncements).

## 12. DEBT

At December 31, 2003 and 2002, debt comprised of the following:

	Currency	Annual interest rate (Actual rate at December 31, 2003)	December 31, 2003	December 31, 2002	Available credit facilities as of December 31, 2003
9.75% Notes due 2008	USD	9.75%	\$ 400,000	\$ —	\$ —
8.38% Notes due 2010	USD	8.375%	400,000	—	—
10.95% Notes due 2004	USD	10.95%	299,640	298,943	—
Floating Rate Notes due 2004	USD	LIBOR+4% (5.15%)	298,196	—	—
<b>Total notes</b>			<b>\$1,397,836</b>	<b>\$ 298,943</b>	\$ —
<b>Less current portion</b>			<b>597,836</b>	—	n. a.
<b>Total long-term notes</b>			<b>\$ 800,000</b>	<b>\$ 298,943</b>	n. a.
ING Bank (Eurasia)	USD	LIBOR+4.15% (5.30%)	\$ 60,000	\$ —	\$ —
Dresdner Bank	USD	LIBOR+3.20%-3.35% (4.35%-4.50%)	15,400	39,280	600
Ericsson	USD	LIBOR+4% (5.15%)	23,400	30,150	—
Deutsche Telekom AG	USD	LIBOR+5%-7% (6.22%-8.22%)	7,981	—	—
TDC Mobile International A/S	USD	LIBOR+5%-7% (6.22%-8.22%)	6,838	—	—
Citibank	USD	LIBOR+3.5% (4.65%)	10,000	9,000	—
West LB	EUR	EURIBOR+2% (4.17%)	5,092	4,000	—
KFW	EUR	LIBOR+0.95%-4% (2.41%-5.46%)	4,313	—	—
HSBC	USD	LIBOR+2.75% (3.88%)	25,000	—	—
Hermes Credit Facility	EUR	EURIBOR + 0.65% (2.82)%	55,550	—	3,700
AVAL bank	UAH	10-16%	10,890	—	9,110
Motorola	USD	LIBOR + 1.5% (2.72%)	1,361	6,181	—
Guta Bank	USD	7%-15%	1,511	—	—
International Moscow Bank	RUR	13.4%	10,864	—	1,019
International Moscow Bank	USD	LIBOR+3.45% (4.60%)	—	5,000	—
MBRD	RUR	18.5%	1,220	—	448
Ruble denominated debt	RUR	13.4%-20%	5,860	30,334	7,500
Other debt	USD	7%-15%	450	3,124	—
<b>Total debt</b>			<b>\$ 245,730</b>	<b>\$ 127,069</b>	<b>\$ 22,377</b>
<b>Less current portion</b>			<b>103,312</b>	<b>67,098</b>	n. a.
<b>Total long-term debt</b>			<b>\$ 142,418</b>	<b>\$ 59,971</b>	n. a.

## *The Notes*

On December 21, 2001, MTS Finance S.A. (“MTS Finance”), a 100% beneficially owned subsidiary of MTS, registered under the laws of Luxembourg, issued \$250.0 million 10.95% (effective interest rate of 11.25%) notes at the price of 99.254%. Proceeds received from the notes, net of underwriting discount, were \$248.1 million. Related debt issuance costs in the amount of \$3.9 million were capitalized. On March 20, 2002, MTS Finance issued additional \$50.0 million 10.95% (effective interest rate of 10.25%) 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 \$0.6 million were capitalized. All the notes are fully and unconditionally 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.

On January 30, 2003, MTS Finance issued \$400.0 million 9.75% notes at par. These notes are fully and unconditionally guaranteed by MTS OJSC and mature on January 30, 2008. MTS Finance is required to make interest payments on the notes semi-annually in arrears on January 30 and July 30, commencing on July 30, 2003. The notes are listed on the Luxembourg Stock Exchange. Proceeds received from the notes were \$400.0 million and related debt issuance costs of \$3.9 million were capitalized.

On August 5, 2003, MTS Finance issued \$300.0 million notes bearing interest at floating rate 3 months LIBOR + 4% (5.15% at December 31, 2003) at the price of 99% (effective interest rate of 6.19% at December 31, 2003). These notes are fully and unconditionally guaranteed by MTS OJSC and mature on August 7, 2004. MTS Finance is required to make interest payments on the notes quarterly, commencing on November 5, 2003. The notes are listed on the Luxembourg Stock Exchange. Proceeds received from the notes, net of underwriting discount, were \$297.0 million and related debt issuance costs of \$1.8 million were capitalized.

On October 14, 2003, MTS Finance issued \$400.0 million notes bearing interest at 8.375% at par. The cash proceeds, net of issuance costs of approximately \$4.6 million, amounted to \$395.4 million. These notes are fully and unconditionally guaranteed by MTS OJSC and will mature on October 14, 2010. MTS Finance is required to make interest payments on the notes semi-annually in arrears on April 14 and October 14 of each year, commencing on April 14, 2004. The notes are listed on the Luxembourg Stock Exchange.

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 \$6.0 million 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 + 4% (5.15% at December 31, 2003). 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 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 enters into a long-term, ruble-denominated promissory notes with nil% interest and maturities from 2049 to 2052 to repay a portion of the funding from Sistema. The carrying value of these notes is insignificant at December 31, 2003 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, 2003, Sistema has made payments under this obligation in the amount of \$55.6 million, 36.5 million of which are repayable in the form of long-term, ruble denominated promissory notes with nil% interest. Amounts receivable from Sistema under this indemnification are recorded as shareholder receivable in the accompanying consolidated balance sheets.

At December 31, 2003 and 2002, \$23.4 million and \$30.2 million were outstanding, respectively, under the Ericsson Loan.

On February 25, 2003 Ericsson assigned all of its rights and obligations under the Ericsson Loan to Salomon Brothers Holding Company, Inc.

#### *Dresdner Bank credit facilities*

In November 2001, Telecom XXI entered into a credit facility with Dresdner Bank CJSC (“Dresdner Bank”) to borrow up to \$20.0 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 + 3.2% (4.35% at December 31, 2003) per annum. Default interest is 12% per annum. The loan was fully repaid in November 2003.

In December 2001 and April 2002, UDN-900 entered into credit agreements with Dresdner Bank, expiring on April 2004. As of December 31, 2003 and 2002, the amounts outstanding under these agreements were \$5.4 and \$4.3 million, respectively. These borrowings bear interest at LIBOR + 3.2% (4.35% December 31, 2003) per annum and are guaranteed by MTS OJSC.

In July 2002, MTS OJSC entered into a credit facility with Dresdner Bank. The credit facility allows borrowings up to \$12.0 million with the final repayment date no later than June 1, 2004. The amount advanced under the facility bears interest of LIBOR + 1.95% (3.10% at December 31, 2003) per annum. Default interest is 12% per annum. As of December 31, 2003 and 2002, nil and \$5.0 million was outstanding under this credit facility, respectively.



In October 2002, MSS entered into a credit agreement with Dresdner Bank to borrow up to \$10.0 million. As of December 31, 2003 and 2002 \$10.0 million was outstanding under this agreement. Borrowings under this agreement bear interest of LIBOR + 3.35% (4.50% at December 31, 2003) per annum and mature in October 2004. The loan is guaranteed by MTS OJSC.

*ING bank (Eurasia)*

In September 2003, UMC entered into a \$60.0 million syndicated credit facility with ING Bank (Eurasia) ZAO, ZAO Standard Bank and Commerzbank Aktiengesellschaft with an interest rate of LIBOR + 4.15% (5.30% at December 31, 2003). The loan is guaranteed by MTS OJSC. The proceeds were used by UMC to refinance its existing indebtedness. The loan is payable in 8 equal quarterly installments starting from September 2004. As of December 31, 2003 the principal outstanding under this credit facility is \$60.0 million.

*Deutsche Telekom AG and TDC Mobile International A/C*

The credit facilities with Deutsche Telekom AG and TDC bear interest at LIBOR + 5% (6.22% at December 31, 2003) and LIBOR + 7% (8.22% at December 31, 2003) and are redeemable in five equal quarterly installments commencing April 2003. During the year UMC paid \$2.1 million of interest on Deutsche Telekom loan. At December 31, 2003 the unpaid balance on these loans was \$14.8 million. The amounts outstanding under these facilities were guaranteed by MTS OJSC. The debt was fully repaid in April 2004.

*KFW*

On December 21, 1998, UMC entered into two loan agreements with KFW, a German bank, for EUR 1.9 million (approximately \$2.4 million as of December 31, 2003) and EUR 10.9 million (approximately \$13.6 million as of December 31, 2003). These loans bear interest at LIBOR + 4% (5.46% at December 31, 2003) and LIBOR + 0.95% (2.41% at December 31, 2003) per annum, respectively, and mature on March 31, 2004 and February 28, 2005, respectively. At December 31, 2003 the unpaid balance on these loans was \$4.3 million.

*HSBC Bank LLC*

In October 2003, TAIF Telcom entered into a \$25.0 million credit facility with HSBC Bank LLC which is guaranteed by MTS OJSC. The facility bears interest at LIBOR + 2.75% (3.88% at December 31, 2003) and is redeemable in ten equal quarterly installments commencing on June 2004. The loan is subject to certain restrictive covenants including, but not limited to, restriction on the amount of dividends paid by TAIF Telcom until MTS owns 100% of TAIF Telcom's outstanding common stock. At December 31, 2003 the outstanding balance is \$25.0 million.

*Hermes Credit Facility (HECF)*

On December 30, 2003, UMC entered into Hermes Credit Facility with ING BHF Bank and Commerzbank to finance the acquisition of GSM equipment from Siemens Aktiengesellschaft. The aggregate amount available under this credit facility is EUR 47.4 million (\$59.3 million at December 31, 2003). The loan is guaranteed by MTS OJSC and bears interest at EURIBOR + 0.65% (2.82% at December 31, 2003). The amount outstanding will be redeemable in 10 equal semi-annual

installments, starting on July 31, 2004 or earlier, depending on the fulfillment on the credit agreement terms by the borrower. The balance outstanding at December 31, 2003 is EUR 44.5 million (\$55.6 million).

#### *AVAL Bank*

On December 31, 2003, UMC had the balance of \$10.9 million of overdraft with AVAL bank. The short-term overdraft facility is limited to 110.0 million hryvnas (\$20.0 million at December 31, 2003), bears interest at 10–16% per annum and matures on June 30, 2004.

#### *Citibank credit facility*

In November 2002, Telecom XXI entered into a credit facility with Citibank. Amounts borrowed under the credit facility and outstanding at December 31, 2003 must be repaid in June 2004 and bear interest of LIBOR + 3.5% (4.65% at December 31, 2003) per annum. Overdue amounts bear an additional 3% per annum. At December 31, 2003, \$10.0 million is outstanding under this facility. The amount is guaranteed by MTS OJSC.

#### *Guta Bank*

In January 2003, TAIF Telcom entered into a credit facility agreement with Guta Bank to finance the purchase of telecommunications equipment. The maximum amount allowed to be borrowed under the facility is approximately \$2.2 million. The loan bears interest at 7% to 15% per annum and matures in February 2007. The amount outstanding under this facility was \$1.5 million as of December 31, 2003. The loan is collateralized by equipment with a net book value of \$2.9 million as of December 31, 2003.

#### *International Moscow Bank*

In February 2002, SCS-900 entered into a credit facility agreement with the International Moscow Bank to borrow up to \$5.0 million for the purpose of current operations and financing of investment outlay, including payments for contract with Ericsson Radio Systems AB. The amount bears interest at LIBOR + 3.45% (4.60% at December 31, 2003). The default interest rate is 7.5% per annum. The debt was redeemed in May 2003.

On June 9, 2003, Kuban-GSM entered into a 350.0 million ruble (approximately \$11.9 million at December 31, 2003) credit facility with International Moscow Bank. Amounts borrowed under this facility mature in June 2005 and have an interest rate of 13.4% until June 2004.

As of December 31, 2003, approximately \$10.9 million was outstanding under this facility. The loan is collateralized by equipment with book value of approximately \$15.5 million at December 31, 2003.

#### *Moscow Bank of Reconstruction and Development (MBRD)*

In 2003, Dontelecom entered into a ruble denominated loan agreement with MBRD, a related party. The amounts borrowed under this loan bear interest at rate of 18.5% and payable in June 2004. During the year 2003, Dontelecom paid interest of \$0.1 million. As of December 31, 2003, the total amount payable under this loan agreement amounted to \$1.2 million.

During the year 2003, MTS OJSC signed several short-term loan agreements with MBRD. Amounts borrowed were payable during the period of one to two months. During the year interest expense on these loans was approximately \$0.3 million.

*Rosbank loan*

In February and March 2003, Kuban-GSM entered into ruble-denominated credit facilities with Rosbank permitting borrowings of up to approximately 245.0 million rubles (approximately \$8.3 million at December 31, 2003). Borrowings under this agreement bear interest at rates varying from 18% to 20% per annum and are secured by a pledge of equipment. The facilities mature in February 2005 and March 2005. As of December 31, 2003 the amount outstanding under this agreement was \$0.8 million.

*WestLB International loan*

In July 2002, MTS-P, a wholly owned subsidiary of the Company, entered into a credit facility agreement with WestLB International S.A. As of December 31, 2003 and 2002, the amount of borrowings under this agreement was \$5.0 and \$4.0 million, respectively. Amounts outstanding under this agreement bear interest of EURIBOR + 2% (4.17% at December 31, 2003) 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.

*Motorola loan*

In October 1997, MSS issued promissory notes to Motorola Inc. for delivery and installation of GSM 900 cellular equipment in the Omsk region in the amount of \$5.4 million. These promissory notes were due to be repaid on various dates through September 2001. On November 27, 2001, MSS entered into an agreement to restructure this liability. This restructuring established a new repayment schedule under which the notes and the accrued interest as of November 27, 2001 are being repaid in regular installments from February 2002 to May 2004, imputing an interest rate of approximately 2.7%. MSS' total payments under this agreement have not changed by greater than 10% due to this restructuring. As of December 31, 2003, the amount payable under these promissory notes was \$1.4 million.

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 loan was fully repaid in January 2003.

The following table presents aggregate scheduled maturities of debt principal outstanding as of December 31, 2003:

Payments due in the year ended December 31,	
2004	\$ 701,148
2005	69,974
2006	48,014
2007	16,128
2008	408,302
Thereafter	400,000
	<u>\$ 1,643,566</u>

### 13. 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, 2003:

Payments due in the year ended December 31,	
2004	\$ 12,741
2005	7,217
2006	1,779
2007	32
2008	33
Thereafter	277
Total minimum lease payments (undiscounted)	22,079
Less amount representing interest	(5,311)
Present value of net minimum lease payments	16,768
Less current portion of lease payable	(9,122)
Non-current portion of lease payable	<u>\$ 7,646</u>

For a schedule by years of future minimum lease payments under capital leases to Invest-Svyaz-Holding, a shareholder of the Group and a wholly owned subsidiary of Sistema, together with the present value of the net minimum lease payments as of December 31, 2003, see Note 18 Related Parties.

#### 14. ACCRUED LIABILITIES

Accrued liabilities at December 31, 2003 and 2002 were comprised of the following:

	December 31,	
	2003	2002
VAT	\$ 33,545	\$ 29,393
Interest payable	32,911	1,500
Taxes other than income	31,139	31,810
Other accruals	46,194	11,216
Total accrued liabilities	<u>\$ 143,789</u>	<u>\$ 73,919</u>

#### 15. INCOME TAX

MTS' provision for income taxes was as follows for the respective periods ended:

	December 31,		
	2003	2002	2001
Current provision for income taxes	\$ 285,481	\$ 129,406	\$ 138,092
Deferred income tax benefit	(43,001)	(18,989)	(39,964)
Total provision for income taxes	<u>\$ 242,480</u>	<u>\$ 110,417</u>	<u>\$ 98,128</u>

From January 1, 2001, MTS' statutory income tax rate was 35%. 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 recognition of a net deferred tax benefit of approximately \$22 million in 2001.

From January 1, 2004, UMC statutory income tax rate changes from 30% to 25% as a result of changes in Ukrainian legislation.

The statutory income tax rate reconciled to MTS' effective income tax rate is as follows for the respective periods ended:

	December 31,		
	2003	2002	2001
Statutory income tax rate for year	24.0%	24.0%	35.0%
Adjustments:			
Expenses not deductible for tax purposes	2.3	2.1	13.6
Tax allowance generated from investment in infrastructure	—	—	(8.3)
Effect of decrease in income tax rate	—	—	(6.6)
Effect of higher tax rate of subsidiary	0.9	—	—
Currency exchange and translation	1.6	—	—
Other	0.4	(0.3)	(3.9)
Effective income tax rate	<u>29.2%</u>	<u>25.8%</u>	<u>29.8%</u>

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, 2003 and 2002:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
<b>Assets (liabilities) arising from tax effect of:</b>		
<b>Deferred tax assets</b>		
Depreciation of property, plant and equipment	\$ 19,171	\$ 13,606
Deferred connection fees	8,805	10,057
Allowance for doubtful accounts	14,157	1,505
Loss carryforward (Rosico and MSS)	7,113	10,033
Other	<u>25,158</u>	<u>8,050</u>
	74,404	43,251
Valuation allowance	<u>(7,113)</u>	<u>(12,695)</u>
Total deferred tax assets	<u>67,291</u>	<u>30,556</u>
<b>Deferred tax liabilities</b>		
Licenses acquired	\$ (170,162)	\$ (91,606)
Other	<u>(33,334)</u>	<u>(14,212)</u>
Total deferred tax liabilities	<u>(203,496)</u>	<u>(105,818)</u>
Net deferred tax liability	<u>\$ (136,205)</u>	<u>\$ (75,262)</u>
Net deferred tax assets, current	\$ 44,423	\$ 12,223
Net deferred tax liability, long term	\$ (180,628)	\$ (87,485)

Net change in valuation allowance for the years ended December 31, 2003 and 2002 were \$5.6 million and \$13.2 million, respectively.

As of December 31, 2003 and 2002, Rosico and MSS were entitled to loss carryforwards in the amounts of \$29,638 and \$41,803, respectively. These loss carryforwards resulted in deferred tax assets at December 31, 2003 and 2002 in the amounts of \$7,113 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. While Rosico was merged into MTS OJSC in June 2003, the Group has still recorded a valuation allowance for the entire amount of the available tax loss carryforward related to Rosico as MTS has not yet performed all procedures necessary to determine what amounts will be available for deductions in the future. In addition in 2002 the Group recorded a valuation allowance for the lower of cost or market provision in the amount of \$2,662 since it was more likely than not that the tax asset will not be realized.

The Group does not record a deferred tax liability related to undistributed earnings of UMC, as it intends to permanently reinvest these earnings. The undistributed earnings of UMC as of December 31, 2003 were \$327.8 million.

## **16. 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, 2003 and 2002 which is distributable under Russian legislation totaled 13,423.0 million rubles (\$437.4 millions), 10,759.0 million rubles (\$343.3 million) and 8,587.0 million rubles (\$294.4 million), respectively.

## 17. STOCK BONUS AND STOCK OPTION PLANS

On April 27, 2000, MTS established a stock bonus plan and stock option plan for selected officers, key employees and key advisors. Under this plan, directors, key employees and key advisors received the right to participate in a stock option plan under which they may receive options to purchase up to 9,966,631 of MTS common shares.

During 2003, 2002 and 2001, MTS made several grants pursuant to its stock option plan to employees and directors of the Group. These options are generally vested over a two year period from the date of the grant, contingent on continuous employment with the Company. A summary of the status of the Group's stock option plan is presented below:

	Shares	Weighted average exercise price, U.S. dollar
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
Outstanding at December 31, 2002	4,648,421	1.42
Granted	1,952,632	2.43
Exercised	(37,557)	1.31
Exchanged for cash award	(1,746,310)	1.31
Forfeited	(19,776)	1.31
Outstanding at December 31, 2003	4,797,410	1.87

None of the options outstanding at December 31, 2003 and 2002 were exercisable. Options outstanding at December 31, 2003, have exercise price ranging from \$1.49 to \$2.43 per share and their weighted average remaining contractual life was approximately one year at December 31, 2003.

During 2003 19,776 stock options were forfeited, and 1,746,310 options were exchanged for cash consideration of \$2.9 million that was included in operating expenses in the consolidated statements of operations. Since the date of the grant total options amounted to 1,913, nil and 45,344 related to 2003, 2002 and 2001 grants, respectively have been forfeited.

Fair values of options granted in 2003, 2002 and 2001 were 1.02 U.S. dollars, \$0.50 and \$0.36 per share, respectively, and were estimated using the Black-Scholes option pricing model. The risk free rates applied for 2003, 2002 and 2001 were 5.2%, 6.1% and, 15.5%, respectively. The following assumptions were applied to options granted in 2003, 2002 and 2001, respectively: (i) expected dividend yields of approximately 3.0%; (ii) expected volatility rates of 40.0%, 50.0% and 45.0%, and (iii) expected lives of 2 years.

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.

## 18. RELATED PARTIES

Related party balances as of December 31, 2003 and 2002 comprised of the following:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
<b>Accounts receivable:</b>		
T-Mobile for roaming	\$ 853	\$ 1,374
Strom Telecom for software	1,074	—
Receivables from investee companies	1,429	2,195
Total accounts receivable, related parties	<u>\$ 3,356</u>	<u>\$ 3,569</u>
<b>Accounts payable:</b>		
Cetel B.V. for UMC shares	\$ 27,500	\$ —
MGTS for interconnection	704	630
Telmos for interconnection	—	184
MTU-Inform for interconnection	2,398	4,154
Sundry payables	1,302	—
Total accounts payable, related parties	<u>\$ 31,904</u>	<u>\$ 4,968</u>

Transactions with major related parties are described below.

### *OJSC 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, 2003, MTS’ cash position at MBRD amounted to \$279.7 million including \$265.2 million in time deposits and \$14.5 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, 2003, 2002 and 2001 amounted to \$9.9 million, \$5.1 million and \$3.0 million, respectively, and was included as a component of interest income in the accompanying consolidated statements of operations.

Loans transactions with MBRD are described in Note 12 Debt.

### *Rosno OJSC*

MTS arranged medical insurance for its employees and insured its property in the amounts of approximately \$874.0 million, \$781.0 million and \$612.0 million in 2003, 2002 and 2001, respectively, with Rosno OJSC, whose significant shareholder is Sistema. Insurance premiums paid to Rosno OJSC for the years ended December 31, 2003, 2002 and 2001, amounted to \$16.9 million, \$4.9 million and \$8.0 million, respectively, including premiums paid for medical insurance amounting to \$5.0 million, \$3.6 million and \$2.5 million, respectively. Management believes that all of the insurance contracts with Rosno OJSC have been entered at market terms.

#### *Maxima Advertising Agency (Maxima)*

In 2001, 2002 and 2003, MTS had agreements for advertising services with Maxima. Advertising fees paid to Maxima for the years ended December 31, 2003, 2002 and 2001, were \$24.7 million, \$13.1 million and \$8.7 million, respectively. Maxima is related to MTS through MTS' directors who are also members of Maxima's board of directors.

#### *Telmos*

In 2003, 2002 and 2001, 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, 2003, 2002 and 2001, were approximately \$1.6 million, \$1.3 million and \$4.0 million, respectively. Management believes that these arrangements are at market terms.

#### *Moscow City Telephone Network (MGTS)*

In 2003, 2002 and 2001, 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, 2003, 2002 and 2001, were approximately \$5.0 million, \$4.4 million and \$1.5 million, respectively. In 2002 and 2001, MTS also purchased buildings from MGTS and paid \$2.0 million and \$2.6 million, respectively. Management believes that all these transactions were made at market terms. Sistema is the majority shareholder of MGTS.

#### *MTU-Inform*

In 2003, 2002 and 2001, MTS had interconnection and line rental agreements with MTU-Inform, a subsidiary at Sistema. Amounts paid under these agreements for the years ended December 31, 2003, 2002, and 2001, amounted to approximately \$26.6 million, \$24.1 million and \$29.0 million, respectively. In 2003, 2002 and 2001 MTS also purchased telephone numbering capacity from MTU-Inform. Payments under these agreements for the years ended December 31, 2003, 2002 and 2001, amounted to \$0.5 million, \$1.6 million and \$4.7 million, respectively. Management believes that these agreements are at market terms.

#### *Comstar*

In 2003 and 2002, MTS had interconnection and line rental agreements with Comstar, a subsidiary of Sistema. Amounts paid under these agreements for the years ended December 31, 2003, and 2002, amounted to approximately \$4.0 million, and \$3.2 million, respectively. Management believes that these agreements are at market terms.

#### *T-Mobile*

In 2003, 2002 and 2001, the Group had non-exclusive roaming agreements with T-Mobile, a shareholder of the Group. Payments made by MTS under these roaming agreements were approximately \$1.1 million, \$1.0 million and \$0.7 million for the years ended December 31, 2003, 2002 and 2001, respectively.

As discussed in Note 12, UMC had \$8.0 million payable to Deutsche Telecom AG, parent company of T-Mobile. As discussed in Note 4, at December 31, 2003 MTS had a payable related to the purchase of UMC for \$27.5 million to Cetel B.V., a wholly owned subsidiary of Deutsche Telecom AG.

#### *Invest-Svyaz-Holding*

In 2003, 2002 and 2001, MTS entered into agreements with Invest-Svyaz-Holding, a shareholder of MTS and a wholly owned subsidiary of Sistema, 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 one year are classified as current liabilities, and the remaining balance as long-term liabilities. The interest rate implicit in these leases varies from 11% 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, 2003:

Payments due in the year ended December 31,	
2004	\$ 9,518
2005	6,786
2006	1,732
Total minimum lease payments (undiscounted)	18,036
Less amount representing interest	(4,892)
Present value of net minimum lease payments	13,144
Less current portion of lease obligations	(6,223)
Non-current portion of lease obligations	<u>\$ 6,921</u>

In addition to the above lease transactions, the Group guarantees debt of Invest-Svyaz-Holding in the amount of \$21.6 million to a third party, which is used by Invest-Svyaz-Holding primarily to finance its leases to the Group. For the year ended December 31, 2003 leases to the Group amounted to approximately 99% of revenues of Invest-Svyaz-Holding.

For the year ended December 31, 2003, principal and interest paid to Invest-Svyaz-Holding were \$5.4 million and \$3.3 million, respectively. Principal and interest paid to Invest-Svyaz-Holding for the year ended December 31, 2002 were \$2.9 million and \$1.4 million. 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 \$0.5 million and \$0.1 million, respectively. Management believes that these agreements are at market terms.

#### *Strom Telecom*

During 2003 the Group entered into three agreements, for a total amount up to \$32.3 million with Strom Telecom, an associate of Sistema. Pursuant to these contracts, the Group purchased a billing system, a communication software support system and equipment for approximately \$23.7 million.

See Note 4 Businesses Acquired for other related parties transactions.

## 19. OPERATING EXPENSES

Operating expenses for 2003, 2002 and 2001, consisted of the following:

	<u>December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Salaries and social contributions	\$ 156,808	\$ 84,706	\$ 44,425
General and administrative	42,530	26,549	21,569
Taxes other than income taxes	40,432	39,119	25,312
Repair and maintenance	39,406	20,361	10,578
Provision for doubtful accounts	32,633	7,047	3,219
Rent	31,968	15,578	9,479
Billing and data processing	22,067	9,549	2,981
Consulting expenses	11,361	7,692	2,093
Insurance	7,351	6,774	5,258
Other operating expenses	22,166	11,681	9,684
Total operating expenses	<u>\$ 406,722</u>	<u>\$ 229,056</u>	<u>\$ 134,598</u>

## 20. INVESTMENTS IN AND ADVANCES TO ASSOCIATES

At December 31, 2003 and 2002, the Group's investments in and advances to associates included, respectively, the following:

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
MTS Belarus—loans receivable	\$ 51,481	\$ 30,089
MTS Belarus—equity investment	5,884	2,455
Primtelefon—equity investment	31,174	—
Astrakhan Mobile and Volgograd Mobile—equity investment	5,806	—
Astrakhan Mobile and Volgograd Mobile—loans receivable	6,850	—
Volgograd Mobile—loans receivable	204	—
MSS—note receivable	827	—
Receivables from other investee companies	1,359	1,490
Total investments in and advances to associates	<u>\$ 103,585</u>	<u>\$ 34,034</u>

### *MTS Belarus*

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 \$10.0 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 agreement and expensed its initial \$10.0 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 continued investing in MTS Belarus.

As of December 31, 2003 and 2002, the Group provided MTS Belarus with a total of \$51.5 million and \$30.1 million in loans, respectively. These loans bear interest at 3% to 11% per annum. All loans outstanding as of December 31, 2002 have been repaid according to the original terms.

Based on projected future cash flows as well as other factors, management believes that no impairment of the Group's investments in Belarus is required as of December 31, 2003.

#### *Primtelefon, Astrakhan Mobile and Volgograd Mobile*

As described in Note 4 Businesses Acquired, in August 2003 the Group purchased equity interests in various Russian regional mobile operators, including stakes in Primtelefon, Astrakhan Mobile and Volgograd Mobile, as a part of its strategic business plans.

## **21. OPERATING LICENSES**

In connection with providing telecommunication services, the Group has been issued various operating licenses by the Ministry of Information Technologies and Communications. In addition to the licenses received directly from the Ministry of Information Technologies and Communications, the Group was granted access to various telecommunication licenses through acquisitions. At December 31, 2003 and 2002, recorded values of the Group's telecommunication licenses were as follows:

	<u>December 31,</u> <u>2003</u>	<u>December 31,</u> <u>2002</u>
Moscow license area (MTS OJSC)	\$ 255,812	\$ 255,812
North-Western region (Telecom XXI)	74,639	74,639
Krasnodar and Adigeya regions (Kuban-GSM)	124,396	66,919
Bashkortostan Republic (BM Telecom)	48,932	48,932
Five regions of Asian Russia (Telecom-900)	84,395	34,237
Rostov region (Dontelecom)	22,067	22,067
Krasnoyarsk region, Taimyr region and Khakassia Republic (Sibchallenge)	52,625	—
Tomsk region (TSS)	49,282	—
Tatarstand Republic (TAIF Telcom)	68,407	—
Ukraine (UMC)	151,857	—
Seven regions of European Russia	19,503	19,503
Other	8,212	8,212
Licenses, at cost	<u>960,127</u>	<u>530,321</u>
Accumulated amortization	<u>(257,024)</u>	<u>(143,402)</u>
Licenses, net	<u>\$ 703,103</u>	<u>\$ 386,919</u>



Amortization expense for the years ended December 31, 2003, 2002 and 2001 amounted to \$113.6 million, \$63.7 million and \$42.1 million, respectively.

Based on the licenses existing at December 31, 2003, the estimated amortization expense is \$149.5 million during 2004, \$145.3 million during 2005, \$140.7 million during 2006, \$106.6 million during 2007, \$63.4 million during 2008 and \$97.6 million thereafter. Actual amortization expense to be reported in future periods could differ from these estimates as a result of new intangible assets acquisitions, changes in useful lives and other relevant factors.

The following table summarizes GSM-900/1800 telecommunication licenses held by the Group at December 31, 2003:

License region	GSM-900		GSM-1800	
	Licensee	Expiry date	Licensee	Expiry date
<b>Moscow License Area</b>				
Moscow	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Moscow Region	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
<b>St. Petersburg License Area</b>				
St. Petersburg	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Leningrad Region	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
<b>Regional License Areas</b>				
<b>European Russia</b>				
Adygeya Republic	Kuban-GSM	April 28, 2008	Kuban-GSM	April 28, 2008
Arkhangelsk	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Bashkortostan Republic	BM Telecom	August 22, 2007	BM Telecom	August 22, 2007
Belgorod	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Belgorod	ReCom	May 15, 2008		
Bryansk	ReCom	May 15, 2008	MTS OJSC	April 28, 2008
Chuvashia Republic <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Dagestan Republic <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Ivanovo	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Ingushetia Republic <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Kabardino-Balkar Republic <sup>(1)</sup>	—	—	MTS OJSC	December 30, 2013
Kaliningrad	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Kalmykia Republic <sup>(1)</sup>	BIT	January 25, 2011	MTS OJSC	December 30, 2013
Kaluga	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Karachaevo-Cherkesia Republic <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Karelia	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Kirov	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Komi Republic	MTS OJSC	August 22, 2007	MTS OJSC	April 28, 2008
Komi-Permyatsk <sup>(1)</sup>	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Kostroma	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Krasnodar Region	Kuban-GSM	May 30, 2007	Kuban-GSM	May 30, 2007
Kursk	ReCom	May 15, 2008	MTS OJSC	April 28, 2008
Lipetsk	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Lipetsk	ReCom	May 15, 2008	—	—
Mari-El Republic <sup>(1)</sup>	Mar Mobile GSM	January 15, 2012	Mar Mobile GSM	January 15, 2012

Mordovia Republic <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Murmansk	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Nenetsk region	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Nizhny Novgorod	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Novgorod	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Orel	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Orel	ReCom	May 15, 2008	—	—
Orenburg	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Perm	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Rostov	Dontelecom	July 1, 2005	Dontelecom	July 1, 2005
Pskov	MTS OJSC	October 1, 2006	—	—
Pskov	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Ryazan	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Samara <sup>(1)</sup>	MTS OJSC	December 30, 2012	MTS OJSC	December 30, 2012
Saratov	MTS OJSC	July 11, 2012	MTS OJSC	July 11, 2012
Severnaya Osetia-Alania Republic	—	—	MTS OJSC	December 30, 2013
Smolensk	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Stavropol region <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Tambov	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Tatarstan Republic	TAIF Telcom	June 26, 2007	TAIF Telcom	June 26, 2007
Tula	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Tver	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Udmurt Republic	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Udmurt Republic	UDN-900	February 21, 2007	—	—
Ulyanovsk <sup>(1)</sup>	—	—	MTS OJSC	December 30, 2013
Vladimir	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Vologda	TelecomXXI	April 28, 2008	TelecomXXI	April 28, 2008
Voronezh	ReCom	May 15, 2008	MTS OJSC	April 28, 2008
Yaroslavl	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008

### Asian Russia

Altai Region	MTS-Barnaul	September 8, 2010	MTS-Barnaul	September 8, 2010
Altai Republic	SCS-900	July 19, 2011	MTS OJSC	December 30, 2013
Amur region	ACC	January 10, 2007	ACC	January 10, 2007
Chelyabinsk	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Chukotka <sup>(1)</sup>	BIT	July 19, 2011	—	—
Evenkia autonomous region <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Kemerovo <sup>(1)</sup>	MTS OJSC	December 30, 2013	MTS OJSC	December 30, 2013
Khabarovsk	FECS-900	January 10, 2007	FECS-900	January 10, 2007
Khakassia Republic	Sibchallenge	September 13, 2011	Sibchallenge	September 13, 2011
Khanty Mansiysk region	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Krasnoyarsk region	Sibchallenge	December 21, 2010	Sibchallenge	September 13, 2011
Kurgan	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Novosibirsk	SCS-900	February 21, 2007	SCS-900	February 21, 2007
Omsk	MSS	December 20, 2006	MSS	December 20, 2006
Sakhalin <sup>(1)</sup>	BIT	July 19, 2011	—	—
Sverdlovsk Region	Uraltel	March 1, 2006	Uraltel	March 1, 2006
Sverdlovsk Region	—	—	MTS OJSC	April 28, 2008

Taimyr autonomous region	Sibchallenge	December 21, 2010	Sibchallenge	September 13, 2011
Tomsk	TSS	June 5, 2008	TSS	June 5, 2008
Tyumen	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008
Tyva Republic <sup>(1)</sup>	BIT	July 19, 2011	MTS OJSC	December 30, 2013
Yamalo-Nenetsk region <sup>(1)</sup>	MTS OJSC	April 28, 2008	MTS OJSC	April 28, 2008

## Ukraine

Ukraine	UMC	December 3, 2013	UMC	December 3, 2013
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<sup>(1)</sup> Our regional license areas in which the licensee has not commenced commercial operations as at December 31, 2003.

Each of the Group's licenses, except the licenses covering the Moscow license area, contains a requirement for service to be commenced and for subscriber number and territorial coverage targets to 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.

The Group's operating licences do not provide for automatic renewal. The Group has limited experience with the renewal of its existing licenses. However, management believes that licenses required for the Group's operations will be renewed upon expiration.

## 22. COMMITMENTS AND CONTINGENCIES

**Capital Commitments**—As of December 31, 2003, MTS had executed non-binding purchase agreements in the amount of approximately \$266.1 million to subsequently acquire property, plant and equipment.

**Operating lease**—The Group has entered into lease agreements of space for telecommunication equipment and offices, which expire in various years up to 2052. Rental expenses under these operating leases of \$32.0 million, \$15.6 million and \$9.5 million for the years ended December 31, 2003, 2002 and 2001, respectively, are included in operating expenses in the accompanying statements of operations. Future minimum lease payments due under non-cancelable leases at December 31, 2003 were:

Payments due in the year ended December 31,

2004	\$ 10,248
2005	4,497
2006	2,924
2007	1,932
2008	1,376
Thereafter	12,389
Total	<u>\$ 33,366</u>

**Operating licenses**—When MTS commenced its operations in 1994, licenses generally contained certain provisions for unspecified fees to be paid for utilization of frequencies. Most of MTS current licenses now provide for payments to be made for finance telecommunication infrastructure

improvements, which in the aggregate could total approximately \$110.2 million, as at December 31, 2003. However, a decision on the terms and conditions of such payments has not been finalized. Accordingly, MTS has not made any payments to date pursuant to any of current operating licenses. Further, management believes that MTS 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, MTS has not recorded a contingent liability in the accompanying financial statements.

**Provision for doubtful accounts**—The increase in the provision for doubtful accounts to \$32.6 million at December 31, 2003 from \$7.0 million at December 31, 2002 was primarily attributable to a \$16.7 million provision related to dealer and subscriber fraud. Certain dealers and subscribers together fraudulently exploited billing time lags by placing a sizeable amount of domestic and international long-distance calls using subscriber accounts registered under false names. MTS discovered the fraud in March 2003 and has taken measures to prevent further fraud of this nature.

**Issued guarantees**—As of December 31, 2003, the Group has issued guarantees to third party banks for the loans taken by Invest-Svyaz-Holding, a shareholder of the Group and a wholly owned subsidiary of Sistema for a total amount of \$21.6 million (see also Note 18 Related Parties). The Group issued additional guarantees on behalf of MTS-Belarus, an equity investee, for the total amount of \$14.5 million. Under these guarantees the Group could be potentially liable for a maximum amount of \$36.1 million in case of the borrower's default under the obligations. The guarantees expire by August 2005.

As of December 31, 2003, no event of default has occurred under any of the guarantees issued by the Group.

**Contingencies**—The Russian economy continues to display certain traits consistent with that of an emerging market. These characteristics have in the past included higher than normal inflation, insufficient liquidity of the capital markets, and the existence of currency controls which cause the national currency to be illiquid outside of Russia. The continued success and stability of the Russian economy will be subject to the government's continued actions with regard to supervisory, legal, and economic reforms.

On January 1, 2004, a new Law on telecommunications came into effect in Russia. The law sets the legal basis for the telecommunications business in Russia and defines the status that state bodies have in the telecommunications sector. The Group cannot predict with any certainty how the new law will affect MTS. The new law creates a new interconnect pricing regime in 2004 that should be more transparent and unified and it creates a universal service charge calculated as a percentage of revenue which will be introduced from 2005. The new law may increase the regulation of the MTS's operations and until the time when appropriate regulations consistent with the new law are promulgated, there will be a period of confusion and ambiguity as regulators interpret the legislation.

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 that is 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, 2003, substantially all of the tax declarations of the Group for the preceding three years were open to further review.

In the ordinary course of business, MTS may be party to various legal and tax proceedings, and subject to claims, certain of which relate to the developing markets and evolving fiscal and regulatory environments in which MTS operates. In the opinion of management, the MTS's liability, if any, in all pending litigation, other legal proceeding or other matters, will not have a material effect upon the financial condition, results of operations or liquidity of MTS.

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.

### **23. 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.

Intercompany eliminations presented below consist primarily of the following items: intercompany sales transactions, elimination of gross margin in inventory and other intercompany transactions conducted under the normal course of operations.

At December 31, 2003, the Group has several operating segments, of which three are reportable segments—MTS OJSC (merged with Rosico), UMC and Telecom XXI. UMC is located in Ukraine whereas all other operating segments are located in RF.

	<u>Year ended December 31,</u>		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Revenue:</b>			
MTS OJSC	\$ 1,471,198	\$ 1,044,877	\$ 831,857
UMC <sup>(1)</sup>	394,038	—	—
Telecom XXI	210,460	79,166	—
Other	601,171	291,143	64,780
Intercompany eliminations	(130,669)	(53,430)	(3,390)
<b>Total revenue</b>	<b><u>\$ 2,546,198</u></b>	<b><u>\$ 1,361,756</u></b>	<b><u>\$ 893,247</u></b>
<b>Depreciation and amortization:</b>			
MTS OJSC	\$ 199,946	\$ 144,004	\$ 114,923
UMC <sup>(1)</sup>	66,392	—	—
Telecom XXI	36,782	17,343	—
Other	114,484	48,333	18,395
Intercompany eliminations	(1,688)	—	—
<b>Total depreciation and amortization</b>	<b><u>\$ 415,916</u></b>	<b><u>\$ 209,680</u></b>	<b><u>\$ 133,318</u></b>
<b>Operating income:</b>			
MTS OJSC	\$ 527,837	\$ 365,698	\$ 316,894
UMC <sup>(1)</sup>	131,704	—	—
Telecom XXI	80,632	2,331	—
Other	198,176	100,531	8,039
Intercompany eliminations	(15,751)	(4,189)	(824)
<b>Total operating income</b>	<b><u>\$ 922,598</u></b>	<b><u>\$ 464,371</u></b>	<b><u>\$ 324,109</u></b>
Total operating income	\$ 922,598	\$ 464,371	\$ 324,109
Currency exchange and translation losses (gains)	(693)	3,474	2,264
Interest income	(18,076)	(8,289)	(11,829)
Interest expense	106,551	44,389	6,944
Other (income)/expenses	3,420	(2,454)	(2,672)
<b>Income before provision for income taxes and minority interest</b>	<b><u>831,396</u></b>	<b><u>427,251</u></b>	<b><u>329,402</u></b>
<b>Additions to long-lived assets:</b>			
MTS OJSC	\$ 389,446	\$ 360,598	\$ 415,336
UMC <sup>(1)</sup>	900,465	—	—
Telecom XXI	174,128	175,361	—
Other	566,475	169,378	176,211
<b>Total additions to long-lived assets</b>	<b><u>\$ 2,030,514</u></b>	<b><u>\$ 705,337</u></b>	<b><u>\$ 591,547</u></b>

<sup>(1)</sup> Acquired in March 2003.



	<u>As of December 31,</u>	
	<u>2003</u>	<u>2002</u>
Long-lived assets:		
MTS OJSC	\$ 1,454,570	\$ 1,288,062
UMC <sup>(1)</sup>	648,812	—
Telecom XXI	288,256	150,533
Other	899,920	435,236
Intercompany eliminations	(19,702)	(4,189)
Total long-lived assets	<u>\$ 3,271,856</u>	<u>\$ 1,869,642</u>
Total assets:		
MTS OJSC	\$ 3,245,545	\$ 1,908,018
UMC <sup>(1)</sup>	394,470	—
Telecom XXI	296,042	130,011
Other	558,091	557,801
Intercompany eliminations	(268,797)	(330,867)
Total assets	<u>\$ 4,225,351</u>	<u>\$ 2,264,963</u>

<sup>(1)</sup> Acquired in March 2003.

#### 24. SUBSEQUENT EVENTS

**Acquisition of additional interests**—In March 2004, MTS acquired an additional 11% shares in SCS-900. The value of consideration equals \$8.5 million. SCS provides GSM mobile services in the Novosibirsk region and Altay Republic.

On April 16, 2004, MTS acquired an additional 40% stake in FECS-900 from Far East Telecommunications Company OJSC, increasing its ownership in the company to 100%. The value of consideration equals \$8.3 million. FECS-900 provides GSM-900/1800 services under the MTS brand in the Khabarovsk region.

On April 13, 2004 MTS acquired an additional 7.5% stake in MSS from Sibirtelecom OJSC, increasing its ownership in the company to 91.0%. The value of consideration paid equals \$2.2 million. MSS provides GSM-900/1800 services under MTS brand in the Omsk region.

The purchase price allocation for these acquisitions has not been finalized at the date of these statements.

**Payment to Cetel B.V.**—On March 17, 2004, MTS settled a balance of \$27.5 million due to Cetel B.V., a wholly owned subsidiary of Deutsche Telecom AG, due for UMC acquisition (see Note 4 Business Acquired).

**License expansions**—In December 2003, at the open tender organized by the State Committee for Radio Frequencies and the Ministry of Defense MTS acquired additional GSM-900/1800 frequency licenses to operate in 11 new regions of Russia. MTS has also received 900 MHz license extensions to existing licenses in several regions. The term of the 900/1800 MHz GSM license for the Moscow Region has been extended until December 2008.

Total purchase consideration paid for the licenses and extensions identified above was less than \$0.1 million.

**Additional loan facility**—In April 2004, the Group entered into a short-term loan facility with Credit Suisse First Boston International in the amount of \$200.0 million. The proceeds were used to repay the floating rate notes. Amounts outstanding under the loan facility agreement bear interest at LIBOR + 2.25% per annum.

**Redemption of the floating rate notes**—On May 5, 2004 the Group redeemed all of the outstanding \$300.0 million floating rate notes, issued on August 5, 2003 in the principal amount plus accrued interest thereon to the date of redemption.

**UMC**—During 2003, MTS acquired 100% of the outstanding voting interest of UMC (see also Note 4 Business Acquisition) from various parties. On June 7, 2004, the General Prosecutor of Ukraine filed a claim against MTS and others in the Kiev Commercial Court seeking to unwind the sale by Ukrtelecom of its 51% stake in UMC to MTS. The complaint also seeks an order that would prohibit MTS from alienating 51% of its stake in UMC until the claim is resolved. As of the date of these statements MTS has started the process of evaluating the claim. The Company believes that it acquired UMC in full compliance with Ukrainian law and intends to vigorously defend its acquisition of UMC.

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**POLSKA TELEFONIA CYFROWA SP. Z O.O.**

**CONSOLIDATED FINANCIAL STATEMENTS  
TOGETHER WITH REPORTS OF  
INDEPENDENT PUBLIC ACCOUNTANTS  
FOR THE YEARS ENDED  
DECEMBER 31, 2003 (UNAUDITED), DECEMBER 31, 2002 (UNAUDITED)  
AND DECEMBER 31, 2001**

**POLSKA TELEFONIA CYFROWA SP. Z O.O.**

**CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED  
DECEMBER 31, 2003 (UNAUDITED), 2002 (UNAUDITED)  
AND 2001**

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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



**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Consolidated Income Statements**  
for the years ended December 31, 2003, December 31, 2002 and December 31, 2001  
(in thousands of PLN)

	<u>Notes</u>	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
<b>Net sales</b>	6	5,601,277	4,929,824	4,344,896
<b>Cost of sales</b>	7	<u>(3,594,121)</u>	<u>(2,989,193)</u>	<u>(2,727,437)</u>
<b>Gross margin</b>		<b>2,007,156</b>	<b>1,940,631</b>	<b>1,617,459</b>
<b>Operating expenses</b>	7	<u>(845,788)</u>	<u>(790,115)</u>	<u>(785,429)</u>
<b>Operating profit</b>		<b>1,161,368</b>	<b>1,150,516</b>	<b>832,030</b>
<b>Non-operating items</b>				
Interest and other financial income	8	336,577	266,454	316,616
Interest and other financial expenses	9	<u>(763,233)</u>	<u>(848,132)</u>	<u>(694,546)</u>
<b>Profit before taxation</b>		<b>734,712</b>	<b>568,838</b>	<b>454,100</b>
<b>Taxation charge</b>	10	<u>(80,790)</u>	<u>(222,362)</u>	<u>(26,879)</u>
<b>Net profit for the year</b>		<b><u>653,922</u></b>	<b><u>346,476</u></b>	<b><u>427,221</u></b>

The accompanying notes are an integral part of these consolidated financial statements.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**  
**as at December 31, 2003 and December 31, 2002**  
**(in thousands of PLN)**

	<u>Notes</u>	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
<b>Current assets</b>			
Cash and cash equivalents	26	20,880	54,412
Short-term investments and other financial assets	11	110,538	12,143
Debtors and prepayments	12	751,122	620,749
Inventory	13	185,866	234,545
		<u>1,068,406</u>	<u>921,849</u>
<b>Long-term assets</b>			
Property, plant and equipment	14	3,023,831	3,438,686
Intangible fixed assets	15	2,829,980	2,651,130
Financial assets	16	248,373	171,288
Deferred costs and other long-term assets	17	122,880	82,091
		<u>6,225,064</u>	<u>6,343,195</u>
<b>Total assets</b>		<u><b>7,293,470</b></u>	<u><b>7,265,044</b></u>
<b>Current liabilities</b>			
Accounts payable	18	290,405	285,277
Amounts due to State Treasury	18	69,385	57,756
Interest-bearing liabilities	18	101,445	121,122
Accruals	20	220,595	185,569
Deferred income and other liabilities	18	211,787	224,358
		<u>893,617</u>	<u>874,082</u>
<b>Long-term liabilities</b>			
Interest-bearing liabilities	19	3,811,750	4,583,365
Non-interest-bearing liabilities	19	118,357	165,159
Deferred tax liability	10	290,563	268,171
Provisions for liabilities and charges	20	91,952	21,740
		<u>4,312,622</u>	<u>5,038,435</u>
<b>Total liabilities</b>		<u><b>5,206,239</b></u>	<u><b>5,912,517</b></u>
<b>Capital and reserves</b>			
Share capital	21	471,000	471,000
Additional paid-in capital		409,754	409,754
Hedge reserve		(3,262)	(86,649)
Accumulated profit		1,209,739	558,422
		<u>2,087,231</u>	<u>1,352,527</u>
<b>Total equity and liabilities</b>		<u><b>7,293,470</b></u>	<u><b>7,265,044</b></u>

The accompanying notes are an integral part of these consolidated financial statements.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(in thousands of PLN)**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
<b>Net profit before taxation</b>	<b>734,712</b>	<b>568,838</b>	<b>454,100</b>
<b>Adjustments for:</b>			
Depreciation and amortization	942,272	909,983	850,572
Charge to provision and write-offs of doubtful debtors	33,242	29,224	67,626
Charge to provision for inventory	4,136	7,333	11,151
Charge to provision for construction in progress	13,223	—	—
Other provisions long-term	25,762	1,089	7,744
Foreign exchange (gains)/losses, net and changes in financial instruments fair value	90,067	145,394	(91,609)
Loss/(gain) on disposal of tangibles and intangibles	12,874	10,804	(1,582)
Interest expense, net	336,589	436,283	469,539
<b>Operating cash flows before working capital changes</b>	<b>2,192,877</b>	<b>2,108,948</b>	<b>1,767,541</b>
Decrease/(increase) in inventory	44,543	(74,764)	31,025
Increase in debtors, prepayments and deferred cost	(174,761)	(101,165)	(129,383)
Increase in trade payables and accruals	124,038	90,529	24,560
<b>Cash from operations</b>	<b>2,186,697</b>	<b>2,023,548</b>	<b>1,693,743</b>
Interest paid	(501,754)	(482,978)	(450,820)
Interest received	14,798	17,182	15,213
Income taxes paid	(98,357)	(1,618)	(1,325)
Realization of financial instruments	(78,784)	(32,973)	(94,411)
<b>Net cash from operating activities</b>	<b>1,522,600</b>	<b>1,523,161</b>	<b>1,162,400</b>
<b>CASH FLOWS USED IN INVESTING ACTIVITIES:</b>			
Purchases of intangible fixed assets	(127,274)	(257,314)	(1,372,058)
Purchases of tangible fixed assets	(287,811)	(379,923)	(1,128,118)
Proceeds from short-term investments	—	91,456	199,699
Proceeds from sale of equipment and intangibles	11,201	18,344	25,250
<b>Net cash used in investing activities</b>	<b>(403,884)</b>	<b>(527,437)</b>	<b>(2,275,227)</b>
<b>CASH FLOWS (USED IN)/FROM FINANCING ACTIVITIES:</b>			
(Repayment of)/net proceeds from Bank Credit Facilities	(468,708)	(322,201)	1,288,594
Repayment of Loan Facility	—	—	(836,158)
(Redemption of)/proceeds from the Notes	(709,621)	(655,622)	704,141
<b>Net cash (used in)/from financing activities</b>	<b>(1,178,329)</b>	<b>(977,823)</b>	<b>1,156,577</b>
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>(59,613)</b>	<b>17,901</b>	<b>43,750</b>
<b>Effect of foreign exchange changes on cash and cash equivalents</b>	<b>114</b>	<b>(12)</b>	<b>(362)</b>
<b>Cash and cash equivalents at beginning of period (see Note 26)</b>	<b>54,400</b>	<b>36,511</b>	<b>(6,877)</b>
<b>Cash and cash equivalents at end of period (see Note 26)</b>	<b>(5,099)</b>	<b>54,400</b>	<b>36,511</b>

The accompanying notes are an integral part of these consolidated financial statements.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Consolidated Statements of Changes in Equity**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(in thousands of PLN)**

	<u>Share Capital</u>	<u>Additional paid-in capital</u>	<u>Hedge reserve</u>	<u>Accumulated profit/(loss)</u>	<u>Total</u>
<b>Balance as at January 1, 2001</b>	<b>471,000</b>	<b>409,754</b>	—	<b>(193,807)*</b>	<b>686,947</b>
Effects 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><u>471,000</u></b>	<b><u>409,754</u></b>	<b><u>(96,955)</u></b>	<b><u>211,946</u></b>	<b><u>995,745</u></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	—	—	(17,717)	—	(17,717)
reclassified and reported in net profit	—	—	30,210	—	30,210
deferred tax on reclassified item	—	—	(8,459)	—	(8,459)
deferred tax change in rates	—	—	6,272	—	6,272
Net profit for the period	—	—	—	346,476	346,476
<b>Balance as at December 31, 2002</b>	<b><u>471,000</u></b>	<b><u>409,754</u></b>	<b><u>(86,649)</u></b>	<b><u>558,422</u></b>	<b><u>1,352,527</u></b>
<b>Balance as at January 1, 2003</b>	<b>471,000</b>	<b>409,754</b>	<b>(86,649)</b>	<b>558,422</b>	<b>1,352,527</b>
Cash flow hedge:					
net fair value gain, net of tax	—	—	75,886	—	75,886
hedging instrument replacement, net of tax	—	—	(7,833)	—	(7,833)
reclassified and reported in net profit	—	—	20,388	—	20,388
deferred tax on reclassified item	—	—	(5,505)	—	(5,505)
deferred tax change in rates	—	—	451	—	451
Net profit for the period	—	—	—	653,922	653,922
Effect of subsidiary closing (see Note 2)	—	—	—	(2,605)	(2,605)
<b>Balance as at December 31, 2003</b>	<b><u>471,000</u></b>	<b><u>409,754</u></b>	<b><u>(3,262)</u></b>	<b><u>1,209,739</u></b>	<b><u>2,087,231</u></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.

The accompanying notes are an integral part of these consolidated financial statements.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(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 the 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 not earlier than on January 1, 2004 and not later than on January 1, 2006 (see Notes 2, 3.5 and 15).

The principal activities of the Company are not significantly seasonal or cyclical

*Authorization of the consolidated financial statements*

These consolidated financial statements have been issued by the Company's Board of Directors on March 17, 2004.

**2. Significant events in 2003**

On January 20, 2003 the Company has been informed that Telekomunikacja Polska SA ("TP SA") lodged cassation to the Supreme Court against the Antimonopoly Court's judgement relating to international traffic rates terminating in the Company's network. The Supreme Court rejected the cassation lodged by TP SA on March 9, 2004 (see also Note 4).

On February 12, 2003 the Company repurchased on the market the principal amount of EUR 3,000 thousand of the 10 7/8% Notes – 1.5% of the total initial principal amount (see Note 19a).

On March 7, 2003 the Company repurchased on the market the principal amount of EUR 2,000 thousand of the 10 7/8% Notes – 1.0% of the total initial principal amount (see Note 19a).

On June 30, 2003 the Company exercised its call option and repurchased the outstanding amount of 10 3/4% Notes at the principal value of USD 126,215 thousand (see Notes 3.2 and 19a).

On July 1, 2003 the Company was informed that Tele2 (a local operator) had placed a request to the Office for Telecommunication and Post Regulation ("OTPR"), the Regulator for the Telecommunication Market in Poland, for setting interconnection rates between Tele2 and the Company's network. On October 16, 2003 the Company and Tele2 signed an interconnection agreement, the rates agreed related to future interconnect traffic which are based on market rates.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(in thousands of PLN)**

**2. Significant events in 2003 (cont.)**

On July 10, 2003 the Company submitted a joint application with other operators to the OTRP to shift UMTS start obligations to January 2006 from January 2005, at the same time leaving the option to start in 2004 unchanged.

On September 9, 2003, the Regulator for the Telecommunication Market in Poland issued a favourable decision to move the UMTS launch deadlines. The Company is required to begin providing commercial UMTS services not later than January 1, 2006. At the same time, the Regulator modified certain provisions of the UMTS license as follows:

- Moved the date for achieving a 20 percent population coverage of the UMTS services from December 31, 2005 to December 31, 2007.
- Removed the requirement to achieve 40 percent population coverage.

On October 31, 2003 the Company has liquidated its wholly-owned subsidiary PTC International Finance B.V. (see Note 3.2) as a result of repurchasing of the remaining 10 ¾% Notes in June 2003.

In November 2003 the Polish Parliament approved the reduction of the corporate income tax rate from 27 percent to 19 percent for the year 2004 and thereafter.

In November 2003 the Company repurchased on the market the principal amount of EUR 2,000 thousand (0.7% of the total initial principal amount) of the 11¼% Notes and EUR 21,465 thousand of the 10 7/8% Notes (10.7% of the total initial principal amount) (see Note 19a).

In November 2003 the Company changed its Notes refinancing plans and effectively shortened the term of coupon payments exposure (see Notes 5a and 23).

In December 2003 the Company repurchased on the market the principal amount of EUR 12,508 thousand (4.2% of the total initial principal amount) of 11 ¼% Notes and EUR 4,420 thousand of 10 7/8% Notes (2.2% of the total initial principal amount) (see Note 19a). The Company will apply the Luxembourg Stock Exchange to delist the principal amount of the all repurchased in 2003 11 ¼% Notes and 10 7/8% Notes.

In December 2003, as a result of refinancing decision, the Company discontinued hedge accounting in relation to part of the coupon payments on EUR denominated Notes that will not occur (see Notes 5a and 23). As at December 31, 2003 PLN 55,115 previously recognized in equity and relating to coupons that as a result of refinancing plans, are no longer expected to occur, has been reported as financial income in the income statement for 2003.

In December 2003, the Company received a decision of the Regulator for Telecommunication Market in Poland together with Antimonopoly Office that it is considered a significant operator on the Polish telecommunications market in relation to interconnect. This decision was not effective as at the day of the authorization of the consolidated financial statements as the Company is appealing against this decision. As at the day of the authorization of the consolidated financial statements no decision concerning the appeal has been issued.



**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(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 the 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 International Financial Reporting Standards (“IFRS”) issued by the International Accounting Standards Board (“IASB”).

The differences between IFRS and generally accepted accounting principles in the United States (“US GAAP”) and their effect on the net results for the years ended December 31, 2003, 2002 and 2001 have been presented in Note 29 to these consolidated financial statements.

The consolidated financial statements have been prepared under the historical cost convention, modified by the revaluation of financial assets and financial liabilities held for trading or designated as hedging items.

The preparation of the consolidated financial statements in conformity with 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 reported amounts of revenue and expenses during the reporting period. Although those estimates are based on the Management’s best knowledge of current events and actions, actual results ultimately may differ from these estimates.

The IFRS standards that were mandatory as at December 31, 2003 were applied to these consolidated financial statements.

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(in thousands of PLN)**

**3. Principal Accounting Policies (cont.)**

**3.2. Group Accounting**

The attached consolidated financial statements include the financial statements of Polska Telefonia Cyfrowa Sp. z o.o. and its wholly owned subsidiary PTC International Finance (Holding) B.V. (consolidated).

All intercompany balances and transactions are eliminated on 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. had no subsidiaries of its own. In 2003 the Company liquidated its wholly-owned subsidiary PTC International Finance B.V. The subsidiary was incorporated for the purpose of issuing 10 ¾% Notes which were fully repurchased by the Company in June 2003 (see Notes 2 and 19a). As a result of the liquidation the net assets of the subsidiary have been transferred to the Company's consolidated income statement for the year ended December 31, 2003 as other financial income.

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.

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. As a result, 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.

**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, a large part of its short-term liabilities and some of long-term liabilities are denominated in PLN. Therefore, the Management has designated the PLN as the reporting (functional) currency of the Company. The accompanying consolidated financial statements are reported in PLN thousand (unless stated otherwise).

**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.

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**3. Principal Accounting Policies (cont.)**

**3.4. Property, plant and equipment (cont.)**

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:

	<u>Annual rate in %</u>	<u>Estimated Useful Lives in years</u>
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 the 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.

**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 amortization. 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 an interest expense over the period of credit unless it is capitalized to 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 their estimated useful lives, being the period of usage from the date of operational start-up of the underlying service until the end of the licence term, 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.

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**3. Principal Accounting Policies (cont.)**

**3.5. Intangible Fixed Assets (cont.)**

Computer software

Costs associated with maintaining computer software programmes are recognized as an expense as incurred. Costs that are directly associated with the 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 costs 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, 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 this is not possible to do so, it is determined for the 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 the 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 the weighted average cost formulas.

The Company writes down the cost of inventories to net realizable value. 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.

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**3. Principal Accounting Policies (cont.)**

**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 the fair value of consideration received less transaction costs plus the call options initial value. They are amortized according to effective interest rates. Any difference between the 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 the Bank Credit Facility are classified as intangible assets.

**3.11 Advertising expenses**

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 the 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 tax base.

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**3. Principal Accounting Policies (cont.)**

**3.12. Deferred income tax (cont.)**

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.

**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. In 2003 the Company revised its estimation of the asset retirement obligation (see Note 20).

**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 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. In the following cases:

- hedge fails the effectiveness test,
- hedging instrument is sold, terminated or exercised,
- the Management decides to undesignate

the Company retains in equity the cumulative gains or losses which were previously reported directly in equity until the forecasted transaction occurs.

The reclassification to the income statement may take place when a previously forecasted transaction is no longer expected to occur.



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**3. Principal Accounting Policies (cont.)**

**3.14. Derivatives (cont.)**

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 the 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 (“CC 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 the 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 the 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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**3. Principal Accounting Policies (cont.)**

**3.15. Measurement base for financial assets and liabilities (cont.)**

The table below presents the measurement categorization of financial assets and liabilities

<i>Category</i>	<i>Balance sheet item</i>	<i>Measurement</i>
<u>Financial assets</u>		
Held for trading	Cash and cash equivalents,	Fair value
	Derivatives: Forward contracts, Note options, Index swaps,	Fair value model using market data
	Currency options	
Held to maturity	Short-term investments	Amortized cost
Loans and receivables originated by the Company	Trade and other debtors	Original recorded cost
Hedging derivatives	CC swaps	Fair value model using market data
	Forward contracts	Fair value model using market data
<u>Financial liabilities</u>		
Held for trading	Forward contracts	Fair value model using market data
	Index swaps	Fair value model using market data
	Non-trading liabilities	
Non-trading liabilities	License liabilities	Amortized cost
	Construction payables	Amortized cost
	Trade and other creditors	Amortized 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	CC swaps	Fair value model using market data
	Forward contracts	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 the 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 the recognition of multiple-element transactions and their presentation in the IFRS consolidated financial statements as initiated by SAB 101 and further interpretations, including SAB 104.

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**3. Principal Accounting Policies (cont.)**

**3.16. Revenue recognition (cont.)**

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 those transactions are recognized in the income statement as incurred.

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, to the extent of cash received.	<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 the 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 subsidiary 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.

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**3. Principal Accounting Policies (cont.)**

**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 cost of those assets. The borrowing costs capitalized are only those incurred during the period of construction or production of qualifying assets.

**3.19. 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.

**3.20. Presentation of Cash Flow Statement**

The Company reconsidered the nature of the overdraft facility as an integral part of the Company's cash management and included the overdraft balance of PLN 25,979 and PLN 12 in cash and cash equivalents in consolidated statements of cash flows for the years ended December 31, 2003 and December 31, 2002, respectively.

**3.21. New accounting standards**

The Company will implement effective from January 1, 2004 the new revenue recognition policy, which adopts best industry practices, based on EITF 00-21. As a result of new revenue recognition policy implementation the revenue and costs related to sales of phones and activation will be recognized in income statement immediately when incurred, except for the contracts where fair value analysis will indicate revenue (and costs) deferral.

The Company is planning to implement changes to IFRS mandatory from January 1, 2005 and is currently analyzing the potential influence of new standards, including: IFRS 1 "First-time Adoption of International Financial Reporting Standards" (effective from January 1, 2004), IFRS 2 "Share-based Payments", IAS 1 "Presentation of Financial Statements", IAS 2 "Inventories", IAS 8 "Accounting Policies, Changes in Accounting Estimates and Errors", IAS 10 "Event After the Balance Sheet Date", IAS 15 "Information Reflecting the Effects of Changing Prices" (withdrawn as at January 1, 2005), IAS 16 "Property, Plant and Equipment", IAS 17 "Leases", IAS 21 "The Effects of Changes in Foreign Exchange Rates", IAS 24 "Related Party Disclosures", IAS 27 "Consolidated and Separate Financial Statements", IAS 28 "Accounting for Investments in Associates", IAS 31 "Interests in Joint Ventures", IAS 32 "Financial Instruments: Disclosure and Presentation", IAS 33 "Earnings per Share" IAS 36 "Impairment of Assets", IAS 38 "Intangible Assets", IAS 39 "Financial Instruments: Recognition and Measurement" and IAS 40 "Investment Property"

As at the date of authorization of the consolidated financial statements the impact of the new standards has not yet been determined.

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**3. Principal Accounting Policies (cont.)**

**3.22. Change in estimates**

In 2003 the Company changed its estimation of the asset retirement obligations. As a result of this change the Company increased the gross asset at the amount of PLN 44,449, the provision for retirement and restoration costs at the amount of PLN 59,629 and increased the depreciation costs by PLN 17,520 and interest expense by PLN 15,180 in the twelve month period ended December 31, 2003. The depreciation of the asset is calculated using the straight-line method over the useful life of the network equipment related assets.

**3.23. Cash and cash equivalents**

Cash comprises cash on hand and demand deposits. Cash equivalents are short term highly liquid investments that are readily convertible to known amount of cash and which are subject to insignificant risk of changes in value.

**4. Events after the balance sheet date**

On January 22, 2004 the Company concluded the selection process of vendor who will supply for the development of its third generation mobile network. Siemens Information and Communication Mobile Group was selected as a supplier of advanced UMTS technology, to be implemented in the Warsaw area.

On March 9, 2004 the Supreme Court rejected the cassation lodged by TP SA in 2003 against the Antimonopoly Court's judgement relating to international traffic rates terminating in the Company's network (see 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 cash flow and balance sheet risk, which is later submitted to the Management Board and Supervisory Board's Finance Committee.

The ultimate responsibility for agreeing the details of the annual hedging strategy rests with the Management Board and the Supervisory Board's Finance Committee 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's Finance Committee must approve any actions taken to hedge cash flow and balance sheet risk.

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**5. Financial risk management (cont.)**

**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 at managing to within acceptable limits both the volatility of cash flows, in PLN terms, arising from fluctuations in the exchange rate of the PLN against other currencies and 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”).

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’s Finance Committee 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,
- CC swaps,
- foreign exchange options (“currency options”).

Prior to 2003, the Company hedged its long-term foreign exchange exposure arising from coupon payments on EUR and USD denominated Notes with use of CC swaps (see Notes 3.14 and 23). In November 2003 the Company changed its Notes refinancing plans and effectively shortened term of coupon payments exposure. As a result maturity of some outstanding CC swap cash flows exceeded the planned date of Notes refinancing. In order to match those CC swap cash flows with the new refinancing plan the Company restructured the outstanding CC swaps. All USD CC swaps were terminated while the remaining planned coupon payments were hedged by new forwards. In respect to EUR CC swaps, cash flows due after Notes refinancing would hedge other expected exposures than coupon payments. The fair value changes of those CC swaps are reflected in the income statement.

Prior to 2003 the Company hedged its short- and medium-term foreign exchange exposure arising from anticipated Notes repayments of a part of principal on EUR denominated Notes on the respective first call dates by concluding foreign exchange forwards subordinated to Bank Credit Facilities (see Notes 19b and 23).



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**5. Financial risk management (cont.)**

**a. Foreign exchange risk (cont.)**

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).

**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, 2003 based on fixed interest rate are as follows (see Note 19a):

- the 11 ¼ Notes with a face value of USD 150,000,000
- the 11 ¼ Notes with a face value of EUR 268,242,000
- the 10 7/8 Notes with a face value of EUR 156,615,000

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 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).

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**5. Financial risk management (cont.)**

**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. The Company generally does not require collateral from its customers.

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 estimation of existing 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, 2003, 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.

The balance of financial assets, short-term investments and other financial assets as at December 31, 2003, representing the total financial credit exposure, is presented in Notes 11 and 16.

**6. Net sales**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Service revenues and fees	5,411,402	4,753,445	4,123,555
Sales of handsets and accessories	189,875	176,379	221,341
	<u><b>5,601,277</b></u>	<u><b>4,929,824</b></u>	<u><b>4,344,896</b></u>

The Company operates in one segment (providing cellular telecommunication services and the ancillary sale of cellular handsets and accessories) and in one market (the Republic of Poland). The main sources of the Company's revenue are airtime charges, consisting primarily of monthly service fees (from incoming and outgoing calls), and charges for voice calls and non-voice services that originate or terminate in the Company's network, and calls placed by the Company's subscribers on foreign networks ("roaming calls").

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**6. Net sales (cont.)**

In 2003 the Company netted PLN 30,329 cost from revenue related to premium calls and premium SMS, as a result of adoption principals of EITF 99-19. The netting is applied to premium calls and premium SMS, when the Company is acting as an agent providing telecommunication services without being the primary obligor in delivery of the relevant service.

**7. Costs and expenses**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Cost of sales:			
Cost of services sold	2,356,497	2,018,636	1,778,687
Cost of sales of handsets and accessories	1,237,624	970,557	948,750
	<u>3,594,121</u>	<u>2,989,193</u>	<u>2,727,437</u>
Operating expenses:			
Selling and distribution costs	610,179	545,404	585,463
Administration and other operating costs	235,609	244,711	199,966
	<u>845,788</u>	<u>790,115</u>	<u>785,429</u>
	<u><b>4,439,909</b></u>	<u><b>3,779,308</b></u>	<u><b>3,512,866</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 151,112, PLN 147,133 and PLN 129,053 for the years ended December 31, 2003, December 31, 2002 and December 31, 2001, respectively.

The following costs and expenses were included in cost of sales:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
External services	1,396,939	1,083,417	869,995
Merchandise sold	1,235,771	969,642	949,805
Depreciation and amortization	842,116	822,993	790,796
Staff costs	79,310	80,626	81,315
Other	39,985	32,515	35,526
	<u><b>3,594,121</b></u>	<u><b>2,989,193</b></u>	<u><b>2,727,437</b></u>

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**7. Costs and expenses (cont.)**

The following costs and expenses were included in selling and distribution costs:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
External services including advertising costs	297,221	252,651	292,367
Staff costs	185,258	183,887	158,700
Depreciation and amortization	69,035	58,441	40,213
Other including bad debt expense	58,665	50,425	94,183
	<u><b>610,179</b></u>	<u><b>545,404</b></u>	<u><b>585,463</b></u>

The following costs and expenses were included in administration costs:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
External services	94,505	103,437	87,100
Staff costs	85,655	84,031	77,904
Depreciation and amortization	31,121	28,549	19,563
Other	24,328	28,694	15,399
	<u><b>235,609</b></u>	<u><b>244,711</b></u>	<u><b>199,966</b></u>

**8. Interest and other financial income**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Gains on valuation of derivatives	167,826	130,081	81,944
Foreign exchange gains	152,901	119,191	207,911
Interest income	14,798	17,182	26,761
Other financial income	1,052	—	—
	<u><b>336,577</b></u>	<u><b>266,454</b></u>	<u><b>316,616</b></u>

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**9. Interest and other financial expenses**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Foreign exchange losses	339,230	344,551	54,020
Interest expense	348,133	446,673	496,300
Losses on valuation of derivatives	71,564	50,115	144,226
Other financial expenses	4,306	6,793	—
	<u><b>763,233</b></u>	<u><b>848,132</b></u>	<u><b>694,546</b></u>

**10. Taxation**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Polish current tax (charge)/benefit	(88,410)	402	—
Polish deferred tax benefit/(charge)	8,893	(220,744)	(25,460)
Foreign current tax charge	(1,273)	(2,020)	(1,419)
Tax charge	<u><b>(80,790)</b></u>	<u><b>(222,362)</b></u>	<u><b>(26,879)</b></u>

Tax loss carry forwards available as at December 31, 2003 amounted to PLN 89,353. The loss can be fully offset against taxable income in year 2004.

According to the Polish tax regulations, the tax rates in effect in 2003 was 27% and 28% for both 2002 and 2001. The tax rate for 2004 and the following years is set to be 19% (see Note 2). The Company recognized the effect of the change in the income tax rate on deferred tax in the income statement for the period ended December 31, 2003.

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**10. Taxation (cont.)**

The reconciliation between tax charge and the product of accounting profit or loss multiplied by the applicable statutory tax rates is as follows:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Profit before taxation	734,712	568,838	454,100
Tax rate	27%	28%	28%
Tax charge using statutory rate	<u>(198,372)</u>	<u>(159,274)</u>	<u>(127,148)</u>
Non-taxable differences	(43,055)	(15,649)	12,309
Change in temporary differences for which realization is not probable	15,779	10,871	32,653
Effect of different tax rates and rules in foreign entities	(1,375)	803	1,881
Change in enacted tax rates	128,182	(68,184)	51,803
Refiling of previous years' tax return	3,631	402	—
Adjustments to deferred taxes	<u>14,420</u>	<u>8,669</u>	<u>1,623</u>
Tax charge	<u><b>(80,790)</b></u>	<u><b>(222,362)</b></u>	<u><b>(26,879)</b></u>

The deferred tax expense credited to equity after reclassification a part related to CC swaps and forward contracts to the income statement was PLN 765 in 2003, and deferred tax income credited to equity in 2002 and 2001 was PLN 4,703 and PLN 27,346, respectively.

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**10. Taxation (cont.)**

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>
Deferred tax assets in Poland:		
Tax loss carry forward	16,977	138,659
Bad debt provision	38,306	71,524
Asset retirement provision	6,213	—
Accrued interest	8,625	37,729
Unrealized foreign exchange loss, net	43,388	1,661
Financial instruments, net	—	27,449
Accrued expenses	25,246	51,040
Inventory provision	7,199	9,094
Accrued advertising	3,265	5,677
Revenue recognition	21,227	—
	<u>170,446</u>	<u>342,833</u>
Temporary differences for which realization is not probable (“valuation allowance”)	<u>(20,959)</u>	<u>(46,568)</u>
	149,487	296,265
Deferred tax liabilities in Poland:		
Book versus tax basis of GSM /UMTS licenses	(360,826)	(498,295)
Book versus tax basis of fixed assets	(47,929)	(66,141)
Financial instruments, net	(31,295)	—
Net deferred tax liability	<u><b>(290,563)</b></u>	<u><b>(268,171)</b></u>

The amounts of valuation allowance as at December 31, 2003 and December 31, 2002 consist primarily of the bad debt provision for which tax deductibility is uncertain. The valuation allowance as at December 31, 2001 amounted to PLN 54,585.

**11. Short-term investment and other financial assets**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Forward contracts	68,289	—
Currency options	20,826	—
CC swaps	10,040	—
Trade contract derivatives	7,784	8,445
Index swaps	3,599	3,698
	<u><b>110,538</b></u>	<u><b>12,143</b></u>



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**11. Short-term investment and other financial assets (cont.)**

Currency options are used to reduce the risk of currency fluctuation and are valued based on the market value (see Note 23).

Trade contract derivatives represent short-term portion of the derivatives separated from trade contracts (see also Notes 3.14, 16, 18 and 23).

Index swaps represent short-term portion of the derivatives bifurcated from Finance lease (see Notes 3.9, 3.14, 19c and 23).

**12. Debtors and prepayments**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Trade debtors and accrued revenue	808,902	710,130
Prepaid expenses	12,260	18,412
Other debtors	13,623	10,427
Amounts due from State Treasury	11,908	2,213
Accounts receivable from shareholders	3,939	1,332
	<u>850,632</u>	<u>742,514</u>
Provision for doubtful debtors	(99,510)	(121,765)
	<u><b>751,122</b></u>	<u><b>620,749</b></u>

Movements of the provision for doubtful debtors were as follow:

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>	<u>As at December 31, 2001</u>
Opening balance	(121,765)	(183,940)	(221,821)
Increase	(66,445)	(86,333)	(138,842)
Write off	55,498	91,399	105,507
Release	33,202	57,109	71,216
Closing balance	<u><b>(99,510)</b></u>	<u><b>(121,765)</b></u>	<u><b>(183,940)</b></u>

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**13. Inventory**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Cellular handsets	118,323	163,470
Network spare parts and accessories	67,543	71,075
	<u><b>185,866</b></u>	<u><b>234,545</b></u>

**14. Property, plant and equipment**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Land and buildings	219,340	224,546
Plant and equipment	2,171,110	2,544,135
Motor vehicles	5,617	17,343
Other fixed assets	535,214	537,254
Construction in progress	92,550	115,408
	<u><b>3,023,831</b></u>	<u><b>3,438,686</b></u>

During the year ended December 31, 2003 the Company capitalized PLN 2,713 of foreign exchange losses, PLN 3,590 of interest expense and PLN 287 of hedging gains on CC swaps and forward contracts and 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 expenses on CC swaps.

The effective capitalization rate used to determine borrowing costs to be capitalized was 20.2% in 2003 and 19.0% in 2002.

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14. **Property, plant and equipment (cont.)**

The movement in each year was as follows:

	<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	<u>246,705</u>	<u>4,238,496</u>	<u>37,950</u>	<u>696,271</u>	<u>115,408</u>	<u>5,334,830</u>
<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	<u>22,159</u>	<u>1,694,361</u>	<u>20,607</u>	<u>159,017</u>	<u>—</u>	<u>1,896,144</u>
<b>Net book value as at December 31, 2002</b>	<b><u>224,546</u></b>	<b><u>2,544,135</u></b>	<b><u>17,343</u></b>	<b><u>537,254</u></b>	<b><u>115,408</u></b>	<b><u>3,438,686</u></b>

	<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, 2003	246,705	4,238,496	37,950	696,271	115,408	5,334,830
Additions	—	4,660	—	6,858	279,710	291,228
Asset retirement obligation	—	—	—	44,449	—	44,449
Transfers	887	233,534	2,898	47,286	(284,605)	—
Disposals	—	(45,509)	(17,272)	(4,462)	(4,740)	(71,983)
As at December 31, 2003	<u>247,592</u>	<u>4,431,181</u>	<u>23,576</u>	<u>790,402</u>	<u>105,773</u>	<u>5,598,524</u>
<b>Depreciation</b>						
As at January 1, 2003	22,159	1,694,361	20,607	159,017	—	1,896,144
Charge	6,093	603,950	7,450	82,664	—	700,157
Charge from asset retirement obligation	—	—	—	17,520	—	17,520
Provision for construction in progress	—	—	—	—	13,223	13,223
Disposals	—	(38,240)	(10,098)	(4,013)	—	(52,351)
As at December 31, 2003	<u>28,252</u>	<u>2,260,071</u>	<u>17,959</u>	<u>255,188</u>	<u>13,223</u>	<u>2,574,693</u>
<b>Net book value as at December 31, 2003</b>	<b><u>219,340</u></b>	<b><u>2,171,110</u></b>	<b><u>5,617</u></b>	<b><u>535,214</u></b>	<b><u>92,550</u></b>	<b><u>3,023,831</u></b>

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**14. Property, plant and equipment (cont.)**

In 2003, as a result of change in estimation of the asset retirement obligation, the Company capitalized the cost at the amount of PLN 44,449 to the network equipment and increased the depreciation costs by PLN 17,520 (see Notes 3.13, 3.22 and 20).

Property, plant and equipment held under capital leases without later improvements (included in the previous schedule):

	<u>As at</u> <u>December 31, 2003</u>			<u>As at</u> <u>December 31, 2002</u>		
	<u>Land</u>	<u>Buildings</u>	<u>Other</u>	<u>Land</u>	<u>Buildings</u>	<u>Other</u>
Cost	6,293	197,806	990	6,293	197,806	990
Accumulated depreciation	—	(24,697)	(438)	—	(18,848)	(338)
Net	<u>6,293</u>	<u>173,109</u>	<u>552</u>	<u>6,293</u>	<u>178,958</u>	<u>652</u>

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, 2003 gross value and accumulated depreciation of the improvements amounted to PLN 42,419 (as at December 31, 2002 PLN 41,430) and PLN 3,332 (as at December 31, 2002 PLN 3,069), respectively.

**15. Intangible fixed assets**

	<u>As at</u> <u>December 31,</u> <u>2003</u>	<u>As at</u> <u>December 31,</u> <u>2002</u>
GSM and UMTS licenses	2,523,010	2,335,836
Computer and network software	284,640	287,323
Trademark	104	118
Transaction costs	22,226	27,853
	<u>2,829,980</u>	<u>2,651,130</u>

During the year ended December 31, 2003 the Company capitalized to intangible fixed assets PLN 109,136 of foreign exchange losses, PLN 171,438 of interest expense and PLN 16,273 of hedging gains on CC swaps and forward contracts. During the year 2003 the Company recognized in income statement financial expenses at the amount of PLN 46,624 as an excess of foreign exchange losses over the amount treated as an adjustment to interest cost. 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 on CC swaps.

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 14.6%.

The Company has no intangible assets generated internally.

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**15. Intangible fixed assets (cont.)**

The movement in each year was as follows:

	<u>GSM &amp; UMTS Licenses</u>	<u>Computer and network software</u>	<u>Trade Mark</u>	<u>Transaction costs</u>	<u>Total</u>
<b>Cost</b>					
As at January 1, 2002	2,448,862	468,941	206	35,137	2,953,146
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	540,336
Charge	77,127	150,157	14	6,739	234,037
Transfers	—	(57)	—	—	(57)
Disposals	—	(36,005)	—	—	(36,005)
Other	—	—	—	2,486	2,486
As at December 31, 2002	<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>
<b>Cost</b>					
As at January 1, 2003	2,718,714	629,957	206	43,050	3,391,927
Additions	—	141,037	—	6,446	147,483
Disposals	—	(24,651)	—	—	(24,651)
Capitalization of borrowing costs	264,301	—	—	—	264,301
As at December 31, 2003	<u>2,983,015</u>	<u>746,343</u>	<u>206</u>	<u>49,496</u>	<u>3,779,060</u>
<b>Amortization</b>					
As at January 1, 2003	382,878	342,634	88	15,197	740,797
Charge	77,127	139,277	14	8,177	224,595
Disposals	—	(20,208)	—	—	(20,208)
Other	—	—	—	3,896	3,896
As at December 31, 2003	<u>460,005</u>	<u>461,703</u>	<u>102</u>	<u>27,270</u>	<u>949,080</u>
<b>Net book value as at December 31, 2003</b>	<b><u>2,523,010</u></b>	<b><u>284,640</u></b>	<b><u>104</u></b>	<b><u>22,226</u></b>	<b><u>2,829,980</u></b>

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**15. Intangible fixed assets (cont.)**

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 of one year prior to its expiry 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 by 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 2007 and the Company is no longer obliged to meet the original 40% population coverage requirement (see Note 2).

The above-described GSM 900 license, GSM 1800 license, UMTS license and the Lease Lines licenses are not transferable assets.

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**16. Financial assets**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Note options	123,307	127,029
Trade contract derivatives	28,823	38,207
Forward contracts	39,988	5,638
CC swaps	55,115	414
Long term receivables	1,140	—
	<u><b>248,373</b></u>	<u><b>171,288</b></u>

Note options are prepayment options separated from the Notes.

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**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
Multiple-element transaction costs	118,344	76,011
Other deferred costs	3,322	4,939
	121,666	80,950
Other long-term assets	1,214	1,141
	<u><b>122,880</b></u>	<u><b>82,091</b></u>

Multiple-element transaction costs represent the deferred costs from non-separable contracts (see Note 3.16).



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**18. Current liabilities**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
<b>Accounts payable</b>		
Trade creditors	146,676	154,808
Construction payables	142,223	125,728
Accounts payable to shareholders	1,506	4,741
	<u>290,405</u>	<u>285,277</u>
<b>Amounts due to State Treasury</b>	<b>69,385</b>	<b>57,756</b>
<b>Interest-bearing liabilities</b>		
Interest accrued on Notes	56,915	76,483
Interest accrued on Bank Credit Facilities	3,415	26,557
Finance lease payable (see Note 19c)	15,136	18,070
Overdraft facilities	25,979	12
	<u>101,445</u>	<u>121,122</u>
<b>Accruals (see Note 20)</b>	<b>220,595</b>	<b>185,569</b>
<b>Deferred income and other liabilities</b>		
Deferred income	183,247	153,100
CC swaps	—	43,051
Forward contracts (see Notes 3.14 and 23)	22,091	22,258
Social fund	3,890	3,603
Deposits from subscribers	2,364	1,969
Payroll	195	377
	<u>211,787</u>	<u>224,358</u>
	<u><b>893,617</b></u>	<u><b>874,082</b></u>

The social fund is an employer's obligation arising from 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 benefit of the employees.

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**19. Long-term liabilities**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
<b>Interest-bearing liabilities</b>		
Long-term Notes	2,510,042	2,950,039
Bank Credit Facilities	535,933	990,217
UMTS license liability	576,875	438,550
Finance lease payable	155,129	164,045
Index swaps (see Notes 3.9, 3.14, 19c and 23)	33,771	40,514
	<b>3,811,750</b>	<b>4,583,365</b>
<b>Non-interest-bearing liabilities</b>		
Multiple-element transaction revenue	118,344	76,011
Other non-interest bearing long-term liabilities	13	—
CC swaps	—	89,148
	<b>118,357</b>	<b>165,159</b>
<b>Deferred tax liability</b> (see Note 10)	<b>290,563</b>	<b>268,171</b>
<b>Provisions for liabilities and charges</b> (see Note 20)	<b>91,952</b>	<b>21,740</b>
	<b><u>4,312,622</u></b>	<b><u>5,038,435</u></b>

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**19. Long-term liabilities (cont.)**

**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.

	<b>11 ¼% Notes</b>	<b>11 ¼% Notes</b>	<b>10 7/8% Notes</b>
<b>Issuance date</b>	November 23, 1999	November 23, 1999	May 8, 2001
<b>Issuer</b>	PTC International Finance II S.A.	PTC International Finance II S.A.	PTC International Finance II S.A.
<b>Nominal value</b>	EUR 268* million	USD 150 million	EUR 157 ** million
<b>Coupon</b>	11 ¼	11 ¼	10 7/8
<b>Interest payment</b>	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>	December 1, 2009	December 1, 2009	May 1, 2008
<b>Registered</b>	in the United States (SEC); Luxembourg Stock Exchange	in the United States (SEC); Luxembourg Stock Exchange	in the United States (SEC); Luxembourg Stock Exchange
<b>Market price as at December 31, 2003 (% of nominal value)</b>	109.50	110.00	110.00
<b>Carrying amount as at December 31, 2003 (including interest)</b>	1,255,315	552,897	758,745

On June 30, 2003 the Company called all the outstanding 10 ¾% Notes with a principal amount of USD 126,215 thousand, constituting 49.85% of the initial total amount of the Notes, at the price of 103.583%. The costs related to the redemption of 10 ¾% Notes incurred by the Company amounted to PLN 26,423, which include PLN 17,867 of premium cost and PLN 6,691 of 10 ¾% Note call option written off. The Notes were redeemed from investors on July 1, 2003 by the trustee.

\* In 2003 the Company repurchased on the market 4.9% of the total principal amount of the 11 ¼% Notes of EUR 14,508 thousand. The principal amount of the repurchased Notes has been delisted from the Luxembourg Stock Exchange. The amount of EUR 268,242 thousand of the 11 ¼% Notes remain outstanding as at December 31, 2003 and continue to be listed on the Luxembourg Stock Exchange.

\*\* In 2003 the Company repurchased on the market the principal amount of EUR 30,885 thousand of the 10 7/8% Notes (15.4% of the total initial principal amount). The principal amount of the repurchased Notes has been delisted from the Luxembourg Stock Exchange. The amount of EUR 156,615 thousand of the 10 7/8% Notes remain outstanding as at December 31, 2003 and continue to be listed on the Luxembourg Stock Exchange.

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**19. Long-term liabilities (cont.)**

**a. Notes (cont.)**

The total financial cost related to open market buy backs of EUR 11 ¼% Notes and 10 7/8% Notes amounted to PLN 20,194.

The Company has right to the following call options embedded in the respective Notes:

	<b>11 ¼% Notes</b>	<b>10 7/8% Notes</b>
<b>Period 1</b>		
<b>Date</b>	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
<b>Redemption price range</b>	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 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 also have 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 or 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 is withdrawn, (2) substantially all the assets of the Company are sold or (3) certain changes in the 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.

As at December 31, 2003 the balance outstanding under the Main Bank Facility Agreement amounted to PLN 535.9 million, which consisted of PLN 250 million of the domestic tranche, USD 26 million and EUR 40 million of the multi-currency tranche.

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**19. Long-term liabilities (cont.)**

**b. Bank Credit Facilities (cont.)**

The main terms of the Main Bank Facility Agreement are as follows:

Facilities limits	equivalent of EUR 550 million available under two tranches: the multi-currency tranche amounting to EUR 292.5 million and the 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: the multi-currency tranche amounting to EUR 20 million and the 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, 2003 the Supplemental Bank Facility was not drawn.

In addition under Bank Credit Facilities the Company is obliged to satisfy as at December 31, 2003 the following covenants:

- Senior Debt to earnings before interest, tax, depreciation and amortization costs ("EBITDA")\* at the level below 3.5:1.0
- 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 2.25:1.0

\*EBITDA calculated as operating profit increased by the amortization and depreciation expenses.

As at the balance sheet date the Company met these covenants with comfortable margin.

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**19. Long-term liabilities (cont.)**

**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).

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, 2003 include future indexing of minimal lease payments.

	As at December 31, 2003				
	<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	30,376	18,839	11,537	15,136	(3,599)
Later than 1 year and not later than 5 years	130,894	86,273	44,621	49,512	(4,891)
Later than 5 years	208,631	64,352	144,279	105,617	38,662
	<b>369,901</b>	<b>169,464</b>	<b>200,437</b>	<b>170,265</b>	<b>30,172</b>

	As at December 31, 2002				
	<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>

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**19. Long-term liabilities (cont.)**

**d. License fee payables**

The fees for the Company's UMTS license was denominated in EUR and payable in installments. These deferred payments have been discounted at 12.06% for short-term and 12.11% for long-term installments of the UMTS license, which approximated the Company's borrowing rate for EUR as at the date of acquisition of the license. As at December 31, 2003 the value of the UMTS license liability amounted to PLN 577 million. The 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, 2003 was as follow:

	<b>EUR'000</b> <b>nominal</b>	<b>EUR'000</b> <b>discounted</b>	<b>PLN'000</b> <b>discounted</b>
Between 2 and 5 years	60,000	41,772	197,040
Over 5 years	<u>330,000</u>	<u>80,525</u>	<u>379,835</u>
	<b><u>390,000</u></b>	<b><u>122,297</u></b>	<b><u>576,875</u></b>

The maturity of license fee payable as at December 31, 2002 was as follow:

	<b>EUR'000</b> <b>nominal</b>	<b>EUR'000</b> <b>discounted</b>	<b>PLN'000</b> <b>discounted</b>
Between 2 and 5 years	45,000	29,477	118,502
Over 5 years	<u>345,000</u>	<u>79,610</u>	<u>320,048</u>
	<b><u>390,000</u></b>	<b><u>109,087</u></b>	<b><u>438,550</u></b>



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**20. Accruals and Provisions for liabilities and charges**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
<b>Accruals</b>	<b>220,595</b>	<b>185,569</b>
<b>Provisions for liabilities and charges</b>		
Provision for loyalty program		
Opening balance	21,740	20,652
Increase	26,042	13,498
Decrease	(21,123)	(12,410)
Closing balance	26,659	21,740
Provisions for dismantlement and restoration costs (see Note 3.4, 3.13, 14)	59,629	—
Other provisions for liabilities and charges	5,664	—
	<u><b>91,952</b></u>	<u><b>21,740</b></u>

The balance of accruals includes mainly operating costs not invoiced and employee bonuses.

The provision for dismantling and restoration costs results from the change of estimation made by the Company in year 2003 (see Note 3.4).

**21. Capital**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>
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
	<u><b>880,754</b></u>	<u><b>880,754</b></u>

As at December 31, 2003 Company's shareholder structure was as follows:

	<u>Number of shares</u>	<u>Number of votes</u>	<u>Nominal value of shares</u>	<u>Percentage of share capital</u>
Elektrim Telekomunikacja Sp. z o.o.	226,079	226,079	226,079	47.9998%
T – Mobile Deutschland GmbH	105,975	105,975	105,975	22.5%
MediaOne International B.V.	105,975	105,975	105,975	22.5%
Polpager Sp. z o.o.	18,840	18,840	18,840	4.0%
Carcom Warszawa Sp. z o.o.	8,949	8,949	8,949	1.9%
Elektrim Autoinvest S.A.	5,181	5,181	5,181	1.1%
Elektrim S.A.	1	1	1	0.0002%
	<u>471,000</u>	<u>471,000</u>	<u>471,000</u>	<u>100%</u>

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**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.

	As at and for the year ended December 31, 2003	As at and for the year ended December 31, 2002	As at and for the year ended December 31, 2001
<u>Elektrim S.A.</u>			
Inter-company receivables	9	—	93
Inter-company payables and accruals	34	25	23
Inter-company sales	120	310	741
Inter-company purchases	231	242	272
<u>Elektrim Telekomunikacja Sp. z o.o. ("ET")</u>			
Inter-company receivables	8	—	—
Inter-company payables and accruals	518	368	—
Inter-company sales	94	161	38
Inter-company purchases	1,970	2,039	—
<u>T-Mobile Deutschland GmbH, T-Mobile International AG ("T-Mobile")</u>			
Inter-company receivables	3,922	1,332	521
Inter-company payables and accruals	5,770	6,447	2,897
Inter-company sales	27,556	23,809	24,365
Inter-company purchases	28,340	24,866	22,128
<u>MediaOne International B.V. ("MediaOne")</u>			
Inter-company purchases	—	—	278
<u>Vivendi Telecom International ("Vivendi")</u>			

There were no material transactions with Vivendi Telecom International.

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**23. Derivative financial instruments**

<u>Type of derivate</u>	<u>Forward contracts</u>	<u>Note options</u>	<u>Currency options</u>	<u>CC swaps</u>	<u>Index swaps</u>	<u>Trade contracts derivatives</u>	<u>Total</u>
<b>Balance as at January 1, 2003</b>							
<b>asset/(liability)</b>	(16,620)	127,029	—	(131,785)	(36,816)	46,652	(11,540)
Cash paid/(received) on realization	(17,970)	—	20,045	89,194	(5,314)	(7,171)	78,784
Changes in the fair value together with realization reported in the income statement	124,567	(3,722)	781	(10,718)	11,958	(2,874)	119,992
Changes in the fair value reported in shareholders' equity (hedge reserve)	(3,791)	—	—	118,464	—	—	114,673
<b>Balance as at December 31, 2003</b>							
<b>asset/(liability)</b>	<b><u>86,186</u></b>	<b><u>123,307</u></b>	<b><u>20,826</u></b>	<b><u>65,155</u></b>	<b><u>(30,172)</u></b>	<b><u>36,607</u></b>	<b><u>301,909</u></b>

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.

Maturity of forward contracts is as follow:

	<u>Currency</u>	<u>Notional value in currency</u>	<u>Carrying value asset/(liability)</u>
Within 1 year	USD	184 million	(22,091)
Within 1 year	EUR	115 million	68,289
Between 1 and 2 years	EUR	60 million	39,988
			<b><u>86,186</u></b>

Note options represent the estimated fair values of call options embedded in the Company's Notes. Upon exercise of the call option or upon redemption of the Notes by other means, the fair value of the relevant call option is written back to the income statement immediately. Any reduced interest payments resulting from the redemption of the relevant Notes are recognized as they accrue.

Call option value will be written down in line with planned bonds buy-backs and refinancing.

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**23. Derivative financial instruments (cont.)**

On March 18, 2003 a new treaty on avoidance of double taxation between Poland and the Netherlands became law. The new treaty will provide for a 5 percent withholding tax on interest payments whereas previously no tax was due. The Republic of Poland has requested an exemption period to the European Union ("EU") Directive 2003/49/EC of June 3, 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states providing for no withholding taxes to be levied on interest payments between EU members from January 1, 2004. Should Poland be granted the exemption and should the Company be unable to identify reasonable measures to avoid payment of the withholding tax, the Company may become entitled to redeem the 10 7/8% Notes and 11 1/4% Notes at face value plus accrued interests and therefore the Company's Management may decide to execute this tax redemption option. No decision has been taken in this respect as at the date of the authorization of the consolidated financial statements.

In November 2003 the Company has purchased the currency options in order to reduce the risk arising from currency fluctuation. The premium paid represents the initial option value.

CC swaps are designated (except for the contract described below) as hedges against exposure to changes in future cash flows arising from the foreign exchange risk on the future interest coupon payments.

The following CC swaps have been entered into by the Company:

<u>Issuance date</u>	<u>Notional in currency</u>	<u>Notional in PLN</u>	<u>PTC payes</u>	<u>PTC receives</u>	<u>Maturity date</u>
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
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.

As presented in Note 5a, in November 2003 the Company changed its Notes refinancing plans and effectively shortened the term of coupon payments exposure. As a result the maturity of some outstanding CC swap cash flows would exceed the planned date of Notes refinancing. In order to match those CC swap cash flows with the new refinancing plan the Company restructured outstanding CC swaps. The USD CC swaps were terminated resulting in PLN 24,522 of the cumulative losses which were previously reported directly in equity being reclassified, because the forecasted transaction is no longer expected to occur.

In respect to EUR CC swaps, cash flows due after Notes refinancing would hedge other exposure than coupon payments namely EUR borrowings used for refinancing of part of EUR denominated Notes. The Company discontinued hedge accounting in relation to part of the coupon payments on EUR denominated Notes that are no longer expected to occur (see Notes 5a). As at December 31, 2003 PLN 55,115 thousand previously recognized in equity has been reported as financial income in the income statement for 2003, because the forecasted transaction is no longer expected to occur.

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**23. Derivative financial instruments (cont.)**

The market value of CC swaps related to the 10 ¾% Notes redeemed in June 2003 amounted to a liability of PLN 28,750 and was written off to income in June 2003 at the date of the Notes redemption. In relation to the remaining fixed USD cash flows due to the Company from the counterparty between January 2004 and July 2005 the Company does not apply hedge accounting. The change in fair value of those hedges was taken to income and classified as a forward in assets after the last 10 ¾% Note coupon was paid. In November 2003 this transaction was terminated resulting in PLN 24,271 of finance cost being reclassification of the cumulative losses which were previously reported directly in equity, because the forecasted transaction is no longer expected to occur.

**24. Financial commitments**

**a. Operating leases (not included in liabilities)**

In 2003 the Company entered into the operating lease agreements for cars fleet management. The minimum annual rentals payable on this agreements are as follows:

	<b>As at December 31, 2003</b>
Not later than 1 year	6,714
Later than 1 year and not later than 5 years	20,593
	<b>27,307</b>

The minimum annual rentals payable on operating leases (both cancelable and non-cancelable) are as follows:

	<b>As at December 31, 2003</b>	<b>As at December 31, 2002</b>	<b>As at December 31, 2001</b>
Not later than 1 year	113,250	112,563	118,654
Later than 1 year and not later than 5 years	351,047	354,935	361,141
Later than 5 years	173,845	210,353	257,698
	<b>638,142</b>	<b>677,851</b>	<b>737,493</b>
Unlimited agreements (yearly)	23,147	20,884	22,610

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**24. Financial commitments (cont.)**

**a. Operating leases (not included in liabilities) (cont.)**

Assets under operating leases include primarily network sites, office space, retail outlets and warehouses.

**b. Capital equipment commitments (not included in liabilities)**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>	<u>As at December 31, 2001</u>
Authorized and contracted	127,839	166,982	393,841
Authorized and not contracted	812,511	574,057	709,780
	<u><b>940,350</b></u>	<u><b>741,039</b></u>	<u><b>1,103,621</b></u>

**25. Dividend restriction**

The Company's statutory financial statements are prepared in accordance with PAS. Dividends may only be distributed from the net profit reported in the unconsolidated Polish annual statutory financial statements.

As at December 31, 2003 the Company was in compliance with all covenants necessary to allow payment of dividends.

As at the day of authorization of the consolidated financial statements the Company's Shareholders' Meeting has not made a decision regarding 2003 profit distribution.

**26. Supplementary cash flow information**

Cash and cash equivalents consist of cash on hand, balances deposited with banks and short-term, highly liquid investments.

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>	<u>As at December 31, 2001</u>
Balances deposited with banks:			
Current accounts	14,612	13,127	10,416
Term deposits with original maturity of less than 90 days	3,551	40,482	25,609
Social fund cash	2,533	620	301
Cash on hand	184	183	185
Cash and cash equivalents	20,880	54,412	36,511
Bank overdraft	(25,979)	(12)	—
Cash and cash equivalents including overdrafts	<u><b>(5,099)</b></u>	<u><b>54,400</b></u>	<u><b>36,511</b></u>

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**27. Employment**

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>	<u>As at December 31, 2001</u>
Headcount at the year end	3,803	3,702	3,684

**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, 2003 and 2002, in million PLN. The carrying amounts in the table are included in the balance sheet under the indicated captions.

	<u>As at December 31, 2003</u>		<u>As at December 31, 2002</u>	
	million PLN		million PLN	
	Carrying amount	Fair value	Carrying amount	Fair value
<b>Financial Assets</b>				
Cash and cash equivalents	21	21	54	54
Short-term investments and other financial assets	111	111	12	12
Debtors and accrued revenue	713	713	600	600
Financial assets (long-term)	248	248	171	171
<b>Financial Liabilities</b>				
Current liabilities and accruals	599	593	645	645
Long-term liabilities	3,749	4,356	4,531	4,758

**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.



**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
**for the years ended December 31, 2003, December 31, 2002 and December 31, 2001**  
**(in thousands of PLN)**

**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.

Reconciliation of consolidated net income:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Net income under IFRS	653,922	346,476	427,221
US GAAP adjustments:			
(a) Removal of foreign exchange differences capitalized for IFRS	(91,766)	(109,601)	107,075
(b) Depreciation and amortization of foreign exchange differences	9,738	9,528	9,268
(c) Revenue recognition (SAB 101/EITF 00-21)	(96)	(45)	1,151
(d) SFAS 133/IAS 39	(5,682)	(62,217)	(28,072)
(f) Asset retirement obligations	24,285	—	—
(g) Reclassification of CC swaps	(8,673)	—	—
(h) Deferred tax on above	8,732	25,821	(8,367)
	<u>          </u>	<u>          </u>	<u>          </u>
Net income under US GAAP before cumulative effect of changes in accounting principles	590,460	209,962	508,276
Changes in accounting principles adjustments:			
(d) SFAS 133/IAS 39 implementation	—	—	(35,158)
(e) Transaction costs	—	—	7,220
(f) SFAS 143 cumulative effect	(24,285)	—	—
(h) Deferred tax on above	4,614	—	6,470
	<u>          </u>	<u>          </u>	<u>          </u>
Net income under US GAAP	<u><b>570,789</b></u>	<u><b>209,962</b></u>	<u><b>486,808</b></u>

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
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**29. Differences between IFRS and US GAAP (cont.)**

Reconciliation of comprehensive income:

	<u>Year ended December 31, 2003</u>	<u>Year ended December 31, 2002</u>	<u>Year ended December 31, 2001</u>
Net income under US GAAP	570,789	209,962	486,808
Other comprehensive gain/(loss) (Hedge Reserve)	86,800	4,408	(96,955)
Effect of subsidiary closing (see Note 2)	<u>(2,605)</u>	<u>—</u>	<u>—</u>
Total comprehensive income under US GAAP after subsidiary closing	<u><b>654,984</b></u>	<u><b>214,370</b></u>	<u><b>389,853</b></u>

Reconciliation of consolidated shareholders' equity:

	<u>As at December 31, 2003</u>	<u>As at December 31, 2002</u>	<u>As at December 31, 2001</u>
Consolidated shareholders' equity under IFRS	2,087,231	1,352,527	995,745
US GAAP adjustments:			
(a) Removal of foreign exchange differences capitalized for IFRS	(193,356)	(101,590)	8,011
(b) Depreciation and amortization on above	51,499	41,761	32,233
(c) Revenue recognition (SAB 101/EITF 00-21)	(579)	(483)	(438)
(d) SFAS 133/IAS 39	(95,971)	(90,289)	(56,869)
(f) Asset retirement obligations	24,285	—	—
(g) Reclassification of CC swaps	(8,673)	—	—
(h) Deferred tax on above	26,631	17,899	(1,299)
(j) Hedge reserve	<u>(2,485)</u>	<u>(5,898)</u>	<u>—</u>
Consolidated shareholders' equity under US GAAP before cumulative effect of changes in accounting principles	1,888,582	1,213,927	977,383
Changes in accounting principles adjustments:			
(d) SFAS 133/IAS 39 implementation	—	—	28,797
(f) SFAS 143	(24,285)	—	—
(h) Deferred tax on above	4,614	—	(6,623)
Consolidated shareholders' equity under US GAAP	<u><b>1,868,911</b></u>	<u><b>1,213,927</b></u>	<u><b>999,557</b></u>

**POLSKA TELEFONIA CYFROWA SP. Z O.O. AND SUBSIDIARIES**  
**Notes to the Consolidated Financial Statements**  
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**29. Differences between IFRS and US GAAP (cont.)**

**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 and hedging gains and 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 and hedging gains and losses in the Company's IFRS consolidated financial statements. Since under US GAAP these foreign exchange differences and hedging gains and losses 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/EITF 00-21)**

Under IFRS the Company continues the revenue recognition policy applied to prior periods for multi element arrangements.

Under US GAAP, the Company implemented for the arrangements entered into on or after July 1, 2003 principles of EITF 00-21. EITF 00-21 gives detailed interpretation relating to revenue recognition and addresses certain aspects of the accounting of the elements of the multiple-deliverable arrangements as separate units of accounting.

As a result of implementation of EITF 00-21 the Company has identified multiple element arrangements as it pertains to the sale of handsets and the delivery of service. The effect in the income and expenses for the arrangements entered in the period from July 1, 2003 till December 31, 2003 that are deferred and recognized ratably over the average expected life of the customer under IFRS are immediately recognized in income statement account under US GAAP. Total revenues of PLN 58,646 and related costs of PLN 58,646 have thus been recorded for US GAAP.

The arrangements entered into before July 1, 2003 are settled under SAB 101 till termination.

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**29. Differences between IFRS and US GAAP (cont.)**

**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 as embedded derivatives 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 a portion (or the entire amount) of the cumulative effect should be classified to 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 60,524 as at December 31, 2003, PLN 71,258 as at December 31, 2002 and PLN 83,645 as at December 31, 2001.

**f. SFAS No. 143**

On January 1, 2003 the Company adopted SFAS No. 143 "Accounting for Asset Retirement Obligations" ("SFAS No. 143"). Upon adoption, the Company recorded the fair value of the liabilities for asset retirement obligations and increased the carrying amount of the associated long-lived asset. The liability is being accreted to its present value each period through charges to operating expense. The capitalized asset retirement cost is being depreciated over the shorter of the related asset's useful life or the period to the expected settlement of the retirement obligation. As a result, the Company recorded an expense of PLN 19,671, representing a cumulative effect of the adoption of SFAS No. 143, net of taxes of PLN 4,614. Pro-forma effects for the year ended December 31, 2002 and 2001 assuming SFAS No. 143 was effective as of January 1, 2001, were not material to the liabilities, net income or per share amounts in accordance with US GAAP.

The Company has asset retirement obligations relating primarily to equipment and other leasehold improvements installed in leased network sites. Those leases generally contain provisions that require the Company to restore the sites to their original condition at the end of the lease term.

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**29. Differences between IFRS and US GAAP (cont.)**

**f. SFAS No. 143 (cont.)**

The development of the liability for asset retirement obligations for the year ended December 31, 2003 is presented below:

Cumulative effect change in adoption of accounting principle on liability as at January 1, 2003:	54,011
Accretion expense	4,075
New assets retirement obligations incurred	<u>1,543</u>
<b>Liability for asset retirement obligations as at December 31, 2003</b>	<b><u>59,629</u></b>

**g. Reclassification of CC swaps**

Under IFRS the Company discontinued hedge accounting and recognized in the income statement for 2003 PLN 55,115 of gains previously recognized in equity (see Notes 2, 5a and 23). Under US GAAP the cumulative gains at the amount of PLN 8,673 resulting from the hedge accounting discontinuance have been retained as hedge reserve pending completion of forecasted replacement financing cash-flows.

**h. 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, 2003 the Company recognized PLN 99,930 of net current deferred tax asset (PLN 234,320 as at December 31, 2002 and PLN 210,978 as at December 31, 2001) and PLN 360,896 of net long-term deferred tax liability (PLN 484,592 as at December 31, 2002 and PLN 271,021 as at December 31, 2001).

Under IFRS changes in the 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.

**i. 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.

**j. 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 accumulated other comprehensive income. A sum of other comprehensive income and net income for the period represents comprehensive income for the period.

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**(in thousands of PLN)**

**29. Differences between IFRS and US GAAP (cont.)**

**k. 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. Under IFRS the Company presents the overdraft facility in cash and cash equivalents in consolidated statements of cash flows (see Note 3.20) while under US GAAP the overdraft facility should be presented under financing activity.

**l. New accounting standards**

The implementation of the Statements No. 145 "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Correction", No. 146 "Accounting for Costs Associated with Exit or Disposal Activities" and FASB issued Interpretation No. 45 ("FIN 45") "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" from January 1, 2003 has not caused material changes to the Company's consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46 ("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 potential rewards from changes in the values of the VIE's assets and liabilities). The Company has adopted the 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. On December 24, 2003, the FASB issued a revised interpretation to FIN 46 ("FIN 46R") to modify some of the provisions of FIN 46 and to exempt certain entities from its requirements. The Company adopted the provisions of FIN 46R to SPEs as at December 31, 2003, and plans to adopt the modified provisions of FIN 46R to all entities that are not SPE as at March 31, 2004. The determination of expected losses and expected residual returns is complex and requires the development of cash flow models. As described in Note 19c, the Company has a single finance lease agreement with Office Park Ltd. The lessor has been considered as a SPE due to single finance lease agreement, however the Company applies lease accounting to this arrangement and the related assets and liabilities are already reflected in the Company's consolidated financial statements. The Company is also reviewing certain dealers contracts to decide if they are VIE. The process of determination of potential VIE has not been finalized yet due to complexity of the analysis.

The Company implemented EITF 00-21 for arrangements entered into on or after July 1, 2003 (see Note 29c).

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**Virgin Mobile Telecoms Limited**

**Report and Financial Statements**

**31 December 2003 (Unaudited)**

**Virgin Mobile Telecoms Limited**

**Report and financial statements 2003**

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## **Virgin Mobile Telecoms Limited**

### **Directors' report**

The directors present their annual report and the financial statements for the year ended 31 December 2003.

### **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 £458,281,000 (2002 – £287,720,000) and £89,890,000 (2002 – £1,996,000) respectively. Details of the group's financial position as at 31 December 2003 are given in the group's Consolidated Balance Sheet.

No equity dividends were paid or proposed. A preference dividend of £9,011 (2002 – £9,011) per share totalling £2,703,300 (2002 – £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 £1,852,000 (2002 – £1,235,000) 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.

### **Financial position**

As at 31 December 2003 the group had net liabilities of £69,863,000 (2002 – £159,753,000). The group is currently being financed by its previous shareholder, T-Mobile (see notes 25 and 26 to the financial statements), and the Virgin Group (see notes 25 and 26 to the financial statements). On 18 May 2004 the group repaid in full the syndicated bank loan (see note 16 to the financial statements). During 2003 the group repaid £25,588,000 of the syndicated bank loan and £69,412,000 was outstanding as at 31 December 2003. Following a renegotiation of the group's loans in January 2004 the T-Mobile loan is repayable in eight quarterly instalments commencing 31 March 2006, although this may be repaid earlier if the Virgin Group loan is repaid earlier than the T-Mobile repayment instalments are due. The Virgin Group loan is repayable upon demand, but the Virgin Group have indicated that they will not demand repayment of this loan during the next twelve months such that the group will not be able to meet its liabilities as they fall due.

### **Directors**

The directors who served during the year were as follows:

Sir Richard C.N. Branson	(Chairman – appointed as Chairman by rotation on 9 August 2003)
Julia S Chain	(resigned on 29 January 2004)
Thomas Dannenfeldt	(appointed on 30 June 2003; resigned on 29 January 2004)
Harris Jones	(Chairman – resigned as director and Chairman on 30 June 2003)
Brian J McBride	(Chairman – appointed as director and Chairman on 30 June 2003; resigned as Chairman by rotation on 9 August 2003; resigned as director on 29 January 2004)
Gordon D McCallum	
Andrew R Peters	(resigned on 30 June 2003)
Robert W Samuelson	
William E Whitehorn	(alternate director to Richard Branson)

Details of directors' share interests are given in Note 7 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.

## **Virgin Mobile Telecoms Limited**

### **Directors' report**

#### **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**

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.

#### **Auditors**

On 1 August 2003, Deloitte & Touche transferred their business to Deloitte & Touche LLP, a limited liability partnership incorporated under the Limited Liability Partnerships Act 2000. The company's consent has been given to treating the appointment of Deloitte & Touche as extending to Deloitte & Touche LLP under the provisions of section 26(5) of the Companies Act 1989. 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

11 June 2004

## **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, for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

**Virgin Mobile Telecoms Limited**

**Consolidated profit and loss account  
Year ended 31 December 2003**

	<b>Note</b>	<b>2002 £'000</b>	<b>2003 £'000</b>
Turnover before exceptional item		442,039	287,720
Exceptional turnover	4	<u>16,242</u>	<u>—</u>
<b>Turnover</b>	2	458,281	287,720
Cost of sales		<u>(238,403)</u>	<u>(175,682)</u>
<b>Gross profit</b>		219,878	112,038
Administrative expenses before exceptional item		(128,963)	—
Exceptional operating costs	4	<u>(23,575)</u>	<u>—</u>
Administrative expenses		<u>(152,538)</u>	<u>(107,202)</u>
Operating profit before exceptional items		74,673	4,836
Exceptional items (net)	4	<u>(7,333)</u>	<u>—</u>
<b>Operating profit</b>		67,340	4,836
Finance charges (net)	3	<u>(10,629)</u>	<u>(11,841)</u>
<b>Profit (loss) on ordinary activities before taxation</b>	5	56,711	(7,005)
Tax on loss on ordinary activities	8	<u>33,179</u>	<u>9,001</u>
<b>Profit (loss) for the financial year</b>		89,890	1,996
Finance costs of non-equity shares		<u>(4,555)</u>	<u>(3,938)</u>
<b>Retained profit/(loss) for the year</b>		<u><u>85,335</u></u>	<u><u>(1,942)</u></u>

All amounts derive from continuing operations.  
There were no other recognised gains and losses in either year.

**Virgin Mobile Telecoms Limited**

**Consolidated balance sheet  
31 December 2003**

	<u>Note</u>	<u>2003 £'000</u>	<u>2002 £'000</u>
<b>Fixed assets</b>			
Tangible assets	10	28,730	24,828
<b>Current assets</b>			
Stocks	12	6,567	5,671
Debtors	13	70,570	43,705
Deferred tax asset	13	42,180	9,001
Cash at bank and in hand		<u>46,599</u>	<u>13,110</u>
		165,916	71,487
<b>Creditors: amounts falling due within one year</b>	14	<u>(263,250)</u>	<u>(112,924)</u>
<b>Net current liabilities</b>		<u>(97,334)</u>	<u>(41,437)</u>
<b>Total assets less current liabilities</b>		(68,604)	(16,609)
<b>Creditors: amounts falling due after more than one year</b>	15	<u>(1,259)</u>	<u>(143,144)</u>
<b>Net liabilities</b>		<u><u>(69,863)</u></u>	<u><u>(159,753)</u></u>
<b>Capital and reserves</b>			
Called up share capital	17	19	19
Share premium account	18	30,036	30,036
Profit and loss account	18	<u>(99,918)</u>	<u>(189,808)</u>
<b>Accumulated deficit</b>	19	<u><u>(69,863)</u></u>	<u><u>(159,753)</u></u>
Accumulated deficit may be analysed as:			
Equity interests		(115,530)	(200,865)
Non-equity interests		<u>45,667</u>	<u>41,112</u>
		<u><u>(69,863)</u></u>	<u><u>(159,753)</u></u>

These financial statements were approved by the Board of Directors on 11 June 2004 and signed on its behalf by:  
Gordon D. McCallum  
Director



**Virgin Mobile Telecoms Limited**

**Company balance sheet  
31 December 2003**

	<u>Note</u>	<u>2003 £'000</u>	<u>2002 £'000</u>
<b>Fixed assets</b>	10	28,644	23,735
Tangible assets	11	—	—
Investments		28,644	23,735
 <b>Current assets</b>	12	6,567	5,671
Stocks	13	75,703	49,399
Debtors	13	40,390	8,852
Deferred tax asset		<u>46,598</u>	<u>13,109</u>
Cash at bank and in hand		169,258	77,031
 <b>Creditors: amounts falling due within one year</b>	14	<u>(263,101)</u>	<u>(112,778)</u>
<b>Net current liabilities</b>		<u>(93,843)</u>	<u>(35,747)</u>
<b>Total assets less current liabilities</b>		(65,199)	(12,012)
<b>Creditors: amounts falling due after more than one year</b>	15	<u>(53)</u>	<u>(141,729)</u>
<b>Net liabilities</b>		<u><u>(65,252)</u></u>	<u><u>(153,741)</u></u>
 <b>Capital and reserves</b>			
Called up share capital	17	19	19
Share premium account	18	30,036	30,036
Profit and loss account	18	<u>(95,307)</u>	<u>(183,796)</u>
<b>Accumulated deficit</b>		<u><u>(65,252)</u></u>	<u><u>(153,741)</u></u>
Accumulated deficit may be analysed as:			
Equity interests		(110,919)	(194,853)
Non-equity interests		<u>45,667</u>	<u>41,112</u>
		<u><u>(65,252)</u></u>	<u><u>(153,741)</u></u>

These financial statements were approved by the Board of Directors on 11 June 2004 and signed on its behalf by:

Gordon D. McCallum  
Director

**Virgin Mobile Telecoms Limited**

**Consolidated cash flow statement  
Year ended 31 December 2003**

	<u>Note</u>	<u>2003</u> <u>£'000</u>	<u>2002</u> <u>£'000</u>
<b>Net cash inflow from operating activities</b>	20	82,812	34,712
Returns on investments and servicing of finance	21	(4,291)	(7,746)
Capital expenditure and financial investment	21	<u>(19,211)</u>	<u>(18,315)</u>
<b>Cash inflow before financing</b>		59,310	8,651
Financing	21	<u>(25,821)</u>	<u>(5,255)</u>
<b>Increase in cash in the year</b>	22	<u><u>33,489</u></u>	<u><u>3,396</u></u>

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 1. Accounting policies

The financial statements are prepared in accordance with applicable United Kingdom accounting standards. The particular accounting policies adopted, all of which have been applied consistently throughout the current and prior year, are described below.

#### Basis of preparation

The financial statements are prepared under the historical cost convention.

The group has considered the implication of adopting Financial Reporting Standard 5 “Reporting the Substance of Transactions”, Application Note G “Revenue Recognition” for the first time in the year ending 31 December 2003. The group has determined that Application Note G does not have a material impact on its financial results and has continued to adopt the accounting policies as set out below.

#### 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.

Handset, and other equipment, revenue is recognised based on the amounts receivable 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.

#### 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

## **Virgin Mobile Telecoms Limited**

### **Notes to the accounts**

**Year ended 31 December 2003**

#### **1. Accounting policies (Continued)**

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.

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. The finance cost charged in the period for non-equity shares is written back through the profit and loss reserve if the company is unable to pay the dividend.

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 1. Accounting policies (Continued)

##### 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 segment with two types of product, service and equipment.

#### 3. Finance charges (net)

	<b>2003</b>	<b>2002</b>
	<b>£'000</b>	<b>£'000</b>
Bank loans and overdrafts	(5,969)	(6,944)
Finance lease interest	(16)	(57)
Interest payable to related companies	(5,566)	(5,362)
Interest payable and similar charges	(11,551)	(12,363)
Interest receivable and similar income	922	522
	<u>(10,629)</u>	<u>(11,841)</u>

#### 4. Exceptional operating items

	<b>2003</b>	<b>2002</b>
	<b>£'000</b>	<b>£'000</b>
Revenue for previously withheld marketing support contributions	16,242	—
Long term bonus	(23,575)	—
	<u>(7,333)</u>	<u>—</u>

At the end of 2002, T-Mobile were withholding certain amounts for marketing support contributions. As a result of the settlement of various disputes involving Virgin Mobile, T-Mobile and certain

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 4. Exceptional operating items (Continued)

Virgin Group companies, Virgin Mobile was entitled to receive certain amounts for previously withheld marketing support contributions that would be determined following future proceedings. The amount has now been determined with certainty and £16,242,000 has been recognised as turnover in the results for the year ended 31 December 2003 for disputed marketing support contributions for the periods ended prior to 31 December 2002 and the year 31 December 2003.

The expense for £23,575,000 relates to the implementation of the long term bonus paid to selected employees as a reward for growing the business in the period from launch to 31 December 2003.

#### 5. Profit (loss) on ordinary activities before taxation

Profit (loss) on ordinary activities before taxation is stated after charging:

	<u>2003</u> <u>£'000</u>	<u>2002</u> <u>£'000</u>
Depreciation and amounts written off tangible fixed assets		
– Owned assets	12,997	11,071
– Leased assets	322	215
Operating lease rentals		
– Leasehold property	1,187	1,179
Auditors' remuneration for audit services	<u>168</u>	<u>151</u>

Amounts payable to the auditors by the company and its subsidiary undertaking in respect of non-audit services were £160,000 (2002 – £491,000).

#### 6. Staff costs

The average monthly number of employees (including executive directors) was:

	<u>2003</u> <u>No.</u>	<u>2002</u> <u>No.</u>
Distribution	112	43
Marketings	49	45
Administration	<u>1,133</u>	<u>1,039</u>
	<u>1,294</u>	<u>1,127</u>

Their aggregate remuneration comprised:

	<u>£ '000</u>	<u>£ '000</u>
Wages and salaries	56,508	27,921
Social security costs	3,006	2,432
Other pension costs (see note 24)	955	776
	<u>60,469</u>	<u>31,129</u>

Included in the above for the year ended 31 December 2003 is an exceptional operating expense of £23,575,000 (2002 – £nil) relating to the implementation of the long term bonus paid to selected employees as a reward for growing the business in the period from launch to 31 December 2003 (see note 4).

#### 7. 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 (2002 – £45,000) consultancy fee for these executive services. The total amount of directors' remuneration and other benefits were £90,000 (2002 – £90,000).

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 7. Directors' remuneration, interests and transactions (Continued)

##### *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.

#### 8. Tax on profit (loss) on ordinary activities

The tax credit comprises:

	<b>2003</b>	<b>2002</b>
	<b>£'000</b>	<b>£'000</b>
<b>Current tax</b>		
UK corporation tax	—	—
<b>Total current tax</b>	—	—
<b>Deferred tax</b>		
Origination and reversal of timing differences	33,179	9,001
<b>Total deferred tax (see note 13)</b>	33,179	9,001
<b>Total tax credit on profit (loss) on ordinary activities</b>	<u>33,179</u>	<u>9,001</u>

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:

	<b>2003</b>	<b>2002</b>
	<b>£'000</b>	<b>£'000</b>
Profit (loss) on ordinary activities before tax	56,711	(7,005)
Tax on profit (loss) on ordinary activities at standard UK corporation tax rate of 30% (2002 – 30%)	17,013	(2,102)
Effects of:		
Expenses not deductible for tax purposes	231	158
Depreciation in excess of capital allowances	219	3,346
Utilisation of brought forward losses	<u>(17,463)</u>	<u>(1,402)</u>
	<u>—</u>	<u>—</u>

#### 9. Profit (loss) attributable to Virgin Mobile Telecoms Limited

The retained profit for the financial period dealt with in the accounts of the company, Virgin Mobile Telecoms Limited, was £83,934,000 (2002 – loss of £630,000). As permitted by Section 230 of the Companies Act 1985, no separate profit and loss account is presented in respect of the company.



Virgin Mobile Telecoms Limited

Notes to the accounts  
Year ended 31 December 2003

10. Tangible fixed assets

Group	Leasehold improvements £'000	Fixtures and fittings £'000	Office equipment £'000	Computer systems £'000	Total £'000
<b>Cost</b>					
At 1 January 2003	7,795	704	299	48,361	57,159
Additions	2	62	113	18,341	18,518
Transfer to current assets	—	—	—	(2,594)	(2,594)
At 31 December 2003	<u>7,797</u>	<u>766</u>	<u>412</u>	<u>64,108</u>	<u>73,083</u>
<b>Accumulated depreciation</b>					
At 1 January 2003	6,578	651	262	24,840	32,331
Charge for the year	1,133	40	44	12,102	13,319
Transfer to current assets	—	—	—	(1,297)	(1,297)
At 31 December 2003	<u>7,711</u>	<u>691</u>	<u>306</u>	<u>35,645</u>	<u>44,353</u>
<b>Net book value</b>					
At 31 December 2003	<u>86</u>	<u>75</u>	<u>106</u>	<u>28,463</u>	<u>28,730</u>
At 31 December 2002	<u>1,217</u>	<u>53</u>	<u>37</u>	<u>23,521</u>	<u>24,828</u>
<b>Company</b>					
<b>Cost</b>					
At 1 January 2003	447	704	299	48,361	49,811
Additions	—	62	113	18,341	18,516
Transfer to current assets	—	—	—	(2,594)	(2,594)
At 31 December 2003	<u>447</u>	<u>766</u>	<u>412</u>	<u>64,108</u>	<u>65,733</u>
<b>Accumulated depreciation</b>					
At 1 January 2003	323	651	262	24,840	26,076
Charge for the year	124	40	44	12,102	12,310
Transfer to current assets	—	—	—	(1,297)	(1,297)
At 31 December 2003	<u>447</u>	<u>691</u>	<u>306</u>	<u>35,645</u>	<u>37,089</u>
<b>Net book value</b>					
At 31 December 2003	<u>—</u>	<u>75</u>	<u>106</u>	<u>28,463</u>	<u>28,644</u>
At 31 December 2002	<u>124</u>	<u>53</u>	<u>37</u>	<u>23,521</u>	<u>23,735</u>

Tangible fixed assets include computer equipment and office equipment at a cost of £663,000 (2002 – £644,000) and net book value of £19,000 (2002 – £322,000) in respect of assets held under a finance lease.

Computer systems for the group and company includes £5,119,000 (2002 – £15,314,000) of assets in the course of construction.

£1,297,000 was transferred to current assets representing amounts owing from T-Mobile in respect of assets in the course of development.

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 11. 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 Great Britain.

#### 12. Stocks

	<u>Group</u>		<u>Company</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
Finished goods held for resale	6,567	5,671	6,567	5,671

#### 13. Debtors

	<u>Group</u>		<u>Company</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
Trade debtors	33,898	27,542	33,898	27,542
Amounts owed by other related companies (see note 25)	33,619	13,019	33,619	13,019
Amounts owed by subsidiary undertaking	—	—	6,154	6,689
Prepayments and accrued income	3,053	3,144	2,032	2,149
	<u>70,570</u>	<u>43,705</u>	<u>75,703</u>	<u>49,399</u>
Deferred tax asset	<u>42,180</u>	<u>9,001</u>	<u>40,390</u>	<u>8,852</u>

A group deferred tax asset of £42,180,000 has been recognised at 31 December 2003 (2002 – £9,001,000). 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 £42,180,000 in respect of tax losses and tax allowances should be recognised. As at 31 December 2003 there was no deferred tax asset which was not recognised (31 December 2002 – a deferred tax asset of £49,908,000 was not recognised in respect of certain tax losses and tax allowances as there remained a high enough degree of uncertainty regarding the future for these assets not to be regarded as more likely than not to reverse at that time).

A company deferred tax asset of £40,390,000 has been recognised at 31 December 2003 (2002 - £8,852,000).

#### 14. Creditors: amounts falling due within one year

	<u>Group</u>		<u>Company</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
Bank loans	69,412	23,000	69,412	23,000
Obligations under finance lease contract	6	233	6	233
Trade creditors	10,114	21,203	10,114	21,203
Amounts owed to other related companies (see note 25)	78,105	1,842	78,105	1,842
Other taxation and social security	6,314	5,415	6,375	5,478
Other creditors	1,159	392	1,159	392
Accruals and deferred income	98,140	60,839	97,930	60,630
	<u>263,250</u>	<u>112,924</u>	<u>263,101</u>	<u>112,778</u>

During the year ending 31 December 2003 the company has repaid £25,588,000 of the syndicated loan facility. The company's arrangements regarding bank and shareholder loans have changed post year end (see note 26). The loan facility is secured on the share capital and assets of the group

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 15. Creditors: amounts falling due after more than one year

	Group		Company	
	2003 £'000	2002 £'000	2003 £'000	2002 £'000
Obligations under finance lease contract	13	—	13	—
Bank loans	—	72,000	—	72,000
Amounts owed to other related companies (see note 25)	—	69,676	—	69,676
Accruals and deferred income	1,246	1,468	40	53
	<u>1,259</u>	<u>143,144</u>	<u>53</u>	<u>141,729</u>

The net finance lease obligations to which the group and company are committed and which are secured on the related assets are:

	Group and Company	
	2003 £'000	2002 £'000
In one year or less	6	233
Between one and two years	13	—
	<u>19</u>	<u>233</u>

#### 16. 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 which 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, and interest rate exposure and liquidity risks. 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, 58 per cent of the syndicated loan was at fixed rates after taking account of interest rate swaps.

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.

**Virgin Mobile Telecoms Limited**

**Notes to the accounts**

**Year ended 31 December 2003**

**16. Derivatives and other financial instruments (Continued)**

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.

*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 2003 was as follows:

	<u>2003</u>		
	<u>Total £'000</u>	<u>Floating rate £'000</u>	<u>Fixed rate £'000</u>
<b>Currency</b>			
Sterling			
– Borrowings	144,673	104,654	40,019
– Non-equity shares	30,050	—	30,050
Total	<u>174,723</u>	<u>104,654</u>	<u>70,069</u>

The profile at 31 December 2002 for comparison purposes was as follows:

	<u>2002</u>		
	<u>Total £'000</u>	<u>Floating rate £'000</u>	<u>Fixed rate £'000</u>
<b>Currency</b>			
Sterling			
– Borrowings	164,909	89,676	75,233
– Non-equity shares	30,050	—	30,050
Total	<u>194,959</u>	<u>89,676</u>	<u>105,283</u>

Further analysis of the interest rate profile at 31 December 2003 and at 31 December 2002 is as follows:

	<u>2003 Fixed rate</u>	
	<u>Weighted average interest rate (%)</u>	<u>Weighted average period for which rate is fixed Years</u>
<b>Currency</b>		
Sterling		
– Borrowings	<u>7.0</u>	<u>0.3</u>

Virgin Mobile Telecoms Limited

Notes to the accounts

Year ended 31 December 2003

16. Derivatives and other financial instruments (Continued)

	<u>2003 Fixed rate</u>	
	<u>Weighted average interest rate (%)</u>	<u>Weighted average period for which rate is fixed Years</u>
<b>Currency</b>		
Sterling		
– Borrowings	<u>7.4</u>	<u>1.0</u>

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.

The interest rate on the 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 2003, after taking into account the effects of forward foreign exchange contracts the company had no currency exposures (2002 – £nil).

*Maturity of financial liabilities*

The maturity profile of the group's financial liabilities at 31 December 2003 was as follows:

	<u>Non-equity shares £'000</u>	<u>Borrowings £'000</u>	<u>Total £'000</u>
In one year or less (see note 26)	—	144,673	144,673
In more than one year but not more than two years	—	—	—
In more than two years but not more than five years	—	—	—
In more than five years	30,050	—	30,050
Total	<u>30,050</u>	<u>144,673</u>	<u>174,723</u>

The profile at 31 December 2002 for comparison purposes was as follows:

	<u>Non-equity shares £'000</u>	<u>Borrowings £'000</u>	<u>Total £'000</u>
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
Total	<u>30,050</u>	<u>164,909</u>	<u>194,959</u>

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 16. Derivatives and other financial instruments (Continued)

##### *Borrowing facilities*

The group had undrawn committed borrowing facilities at 31 December 2003 and 31 December 2002 in respect of which all conditions precedent had been met, as follows:

	<u>2003</u> <u>£'000</u>	<u>2002</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	10,000	15,000
Total	<u>10,000</u>	<u>15,000</u>

##### *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 2003 and 31 December 2002.

	<u>2003</u>		<u>2002</u>	
	<u>Book value</u> <u>£'000</u>	<u>Fair value</u> <u>£'000</u>	<u>Book value</u> <u>£'000</u>	<u>Fair value</u> <u>£'000</u>
<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	144,660	146,582	23,233	23,751
Long term borrowings	30,063	30,063	72,000	75,738
<b>Derivative financial instruments held to manage the interest rate and currency profile</b>				
Interest rate swaps	168	331	375	1,778
Forward foreign exchange contracts	<u>—</u>	<u>—</u>	<u>—</u>	<u>(165)</u>

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 group believes that the fair value of the shareholder loans (see note 25) and the cumulative redeemable preference shares approximate their book value. As at 31 December 2002, the fair value of the shareholder loans and the cumulative redeemable preference shares were not presented as they were not publicly traded and the timing and nature of repayments were uncertain.

##### *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.

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 16. Derivatives and other financial instruments (Continued)

An analysis of these unrecognised gains and losses is as follows:

	<b>2003</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 2003	165	1,403	1,238
Gains and losses arising in previous years that were recognised in 2003	(165)	(1,328)	(1,163)
Gains and losses arising before 1 January that were not recognised in 2003	—	75	75
Gains and losses arising in 2003 that were not recognised in 2003	—	88	88
Unrecognised gains and losses on hedges at 31 December 2003	<u>—</u>	<u>163</u>	<u>163</u>
Of which:			
Gains and losses expected to be recognised in 2004	<u>—</u>	<u>163</u>	<u>163</u>
Gains and losses expected to be recognised in 2005 or later	<u>—</u>	<u>—</u>	<u>—</u>

An analysis of these unrecognised gains and losses in 2002 is as follows:

	<b>2002</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 2002	287	1,313	1,026
Gains and losses arising in previous years that were recognised in 2002	(287)	(1,116)	(829)
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	165	1,206	1,041
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>

#### 17. Called up share capital

	<b>2003</b>	<b>2002</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
	<u>5,019,900</u>	<u>5,019,900</u>
<b>Called up, allotted and fully paid</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
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
	<u>19,573</u>	<u>19,573</u>



## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 17. Called up share capital (Continued)

The shareholders funds attributable to non-equity shares is the nominal value of the respective non-equity shares plus £45,653,000 (2002 – £41,098,000) 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 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.

See note 26 for changes to called up share capital since the balance sheet date.

**Virgin Mobile Telecoms Limited**

**Notes to the accounts**

**Year ended 31 December 2003**

**18. Reserves**

<b>Group</b>	<b>Share premium account £'000</b>	<b>Profit and loss account £'000</b>	<b>Total £'000</b>
At 1 January 2003	30,036	(189,808)	(159,772)
Retained profit for the year	—	85,335	85,335
Finance costs of non-equity shares	—	4,555	4,555
At 31 December 2003	<u>30,036</u>	<u>(99,918)</u>	<u>(69,882)</u>

<b>Company</b>	<b>Share premium account £'000</b>	<b>Profit and loss account £'000</b>	<b>Total £'000</b>
At 1 January 2003	30,036	(183,796)	(153,760)
Retained profit for the year	—	83,934	83,934
Finance costs of non-equity shares	—	4,555	4,555
At 31 December 2003	<u>30,036</u>	<u>(95,307)</u>	<u>(65,271)</u>

**19. Reconciliation of movements in group shareholders' funds**

	<b>2003 £'000</b>	<b>2002 £'000</b>
Retained profit (loss) for the year	85,335	(1,942)
Finance cost of non-equity shares	4,555	3,938
Net movement to accumulated deficit	89,890	1,996
	(159,753)	(161,749)
Closing accumulated deficit	<u>(69,863)</u>	<u>(159,753)</u>

**20. Reconciliation of operating loss to operating cash flows**

	<b>2003 £'000</b>	<b>2002 £'000</b>
Operating profit	67,340	4,836
Depreciation charges	13,319	11,286
Increase in stocks	(896)	(744)
Increase in debtors	(25,573)	(4,701)
Increase in creditors	28,622	24,035
<b>Net cash inflow (outflow) from operating activities</b>	<u>82,812</u>	<u>34,712</u>

**21. Analysis of cash flows**

	<b>2003 £'000</b>	<b>2002 £'000</b>
<i>Returns on investments and servicing finance</i>		
Interest received	922	522
Interest paid	(5,202)	(8,220)
Interest element of finance lease rentals	(11)	(48)
<b>Net cash outflow</b>	<u>(4,291)</u>	<u>(7,746)</u>
<i>Capital expenditure and financial investment</i>		
Purchase of tangible fixed assets	<u>(19,211)</u>	<u>(18,315)</u>
<i>Financing</i>		
Repayment of loans secured on share capital and assets of the group	(25,588)	(5,000)
Repayment of capital element of finance lease	(233)	(255)
<b>Net cash outflow</b>	<u>(25,821)</u>	<u>(5,255)</u>

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 22. Analysis and reconciliation of net debt

	1 January 2003 £'000	Cash flow £'000	Other non-cash changes £'000	31 December 2003 £'000
Cash in hand, at bank	13,110	33,489	—	46,599
Debt due within one year and after one year	(164,676)	25,588	(5,566)	(144,654)
Finance lease	(233)	233	(19)	(19)
Net debt	<u>(151,799)</u>	<u>59,310</u>	<u>(5,585)</u>	<u>(98,074)</u>
			2003 £'000	2002 £'000
Increase in cash in the period			33,489	3,396
Cash used to repay debt			25,588	5,000
Cash used to repay finance lease			233	255
Change in net debt resulting from cash flows			59,310	8,651
Other non-cash changes			(5,585)	(5,362)
Movement in net debt in period			53,725	3,289
Net debt brought forward			(151,799)	(155,088)
Net debt at 31 December			<u>(98,074)</u>	<u>(151,799)</u>

The non-cash changes represent the interest on the shareholder loans that is rolled up into the principal on a quarterly basis (see note 16).

#### 23. Financial commitments

Annual minimum lease commitments:

	Group		Company	
	Land and buildings 2003 £'000	2002 £'000	Land and buildings 2003 £'000	2002 £'000
Expiry date				
– within one year	—	—	—	—
– between two and five years	—	—	—	—
– after five years	1,092	1,092	240	240
	<u>1,092</u>	<u>1,092</u>	<u>240</u>	<u>240</u>

The group and company have £nil (2002 – £776,000) of capital commitments contracted but not provided for.

#### 24. Pension arrangements

The company operates a defined contribution scheme for which the pension cost charge for the year amounted to £955,000 (2002 – £776,000).

#### 25. Related party transactions

T-Mobile, through T-Mobile (UK) Limited, and The Virgin Group, through Bluebottle Investments S.A. and Bluebottle Investment Inc, were joint venture partners in Virgin Mobile during the year. This relationship has changed since the balance sheet date (see note 26). The following transactions occurred with these partners in the year.

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 25. Related party transactions (Continued)

##### *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 £37,621,000 (2002 – £34,838,000) was outstanding as at 31 December 2003. Interest has been rolled up to the principal quarterly. Total interest for the year payable to T-Mobile is £2,783,000 (2002 – £2,609,000). As at 31 December 2003, there were no fixed repayment dates. However a repayment schedule has been agreed since the balance sheet date (see note 26).

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 £6,973,000 (2002 – £5,888,000) and of this £1,226,000 remained unpaid as at 31 December 2003 (2002 – £3,528,000).

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 £45,051,000 (2002 – £15,161,000) of which a net amount of £21,005,000 (2002 – £8,538,000) remained outstanding as at 31 December 2003.

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 £5,921,000 (2002 – £11,716,000). £369,000 (2002 – £1,717,000) of this total remained outstanding from T-Mobile as at 31 December 2003.

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 £3,000 (2002 – £395,000). As at 31 December 2003, a net amount of £178,000 (2002 – £1,464,000) was owing from the company to T-Mobile. In addition, a further £1,297,000 was owing from T-Mobile to the company in respect of assets in the course of development.

T-Mobile provides three directors of the company and receives a £45,000 (2002 – £45,000) annual consultancy fee for these executive services. An amount of £109,000 (2002 – £64,000) remained outstanding at the end of 31 December 2003.

##### *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 £37,621,000 (2002 – £34,838,000) was outstanding as at 31 December 2003. Interest has been rolled up to the principal quarterly. Total interest for the year payable to companies within the Virgin Group was £2,783,000 (2002 – £2,681,000). As at 31 December 2003, there were no fixed repayment dates. Since the balance sheet date, the company and the Virgin Group have agreed that the loan is repayable upon demand subject to the syndicated bank loan having been repaid in full (see note 26).

During the period, handset, airtime vouchers and other stock items were sold through retailers who are members of the Virgin Group. These sales, net of charges with respect to the distribution channels, amounted to £19,484,000 (2002 – £22,991,000) of which £12,461,000 (2002 – £7,756,000) remained outstanding as at 31 December 2003.

Members of the Virgin Group performed additional services including printing, brand licensing and promotion, which were recharged on to the company. These amounted to £5,353,000 (2002 – £5,446,000) of which £2,797,000 (2002 – £1,408,000) remained unpaid as at 31 December 2003.

Virgin Management Limited provides three directors of the company and receives a £45,000 (2002 – £45,000) annual consultancy fee for these executive services. An amount of £8,000 (2002 – £19,000) remained outstanding at the end of 31 December 2003.

## Virgin Mobile Telecoms Limited

### Notes to the accounts

Year ended 31 December 2003

#### 25. Related party transactions (Continued)

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. Post balance sheet events

On 29 January 2004, the company, T-Mobile (UK) Limited and the Virgin Group shareholders announced that the three organisations had settled all outstanding litigation and established new agreements between the company and T-Mobile, with the approval of the bank syndicate.

The company and T-Mobile have entered into an enhanced telecoms supply agreement running for a minimum of ten years which provides substantial benefits for both the company and T-Mobile. Features include:

- the company maintaining its position in voice and text services with a long term, non-exclusive deal, including improved access to 2.5 and 3G services; and
- the end of the monthly marketing support contribution and the introduction of the company receiving inbound, as well as outbound, revenues.

Separately, the Virgin Group shareholders acquired T-Mobile's stake in the company and the 485,000 preference voting A' shares of £0.02 each were reclassified as 485,000 non-voting preference B' shares of £0.01 each and 485,000 zero dividend voting C' shares of £0.01 each. The loan facilities previously provided by T-Mobile and the Virgin Group remain in place. These loans are not repayable until the syndicated bank loan has been repaid in full. The T-Mobile loan is repayable in eight quarterly instalments commencing 31 March 2006, although this may be repaid earlier if the Virgin Group loan is repaid earlier than the T-Mobile repayment instalments are due. The Virgin Group loan is repayable upon demand, but the Virgin Group have indicated that they will not demand repayment of this loan during the next twelve months such that the group will not be able to meet its liabilities as they fall due. The bank facility agreement has been revised with all scheduled repayments now falling due within one year.

Also, on 18 May 2004 the group repaid in full the syndicated bank loan.

**VIRGIN MOBILE TELECOMS LIMITED**

**Report and Financial Statements (Unaudited)**

**31 December 2002**

**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.

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**

## 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

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.

## 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

## **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.

**VIRGIN MOBILE TELECOMS LIMITED**  
**CONSOLIDATED PROFIT AND LOSS ACCOUNT (UNAUDITED)**  
**According to U.K. GAAP**  
**Year ended 31 December 2002**

	<u>Note</u>	<u>2002</u>	<u>2001</u>
		<u>£'000</u>	<u>£'000</u>
<b>TURNOVER</b>	2	287,720	173,860
Cost of sales		<u>(175,682)</u>	<u>(127,771)</u>
<b>GROSS PROFIT</b>		112,038	46,089
Administrative expenses		<u>(107,202)</u>	<u>(93,794)</u>
<b>OPERATING PROFIT (LOSS)</b>		4,836	(47,705)
Finance charges (net)	3	<u>(11,841)</u>	<u>(11,234)</u>
<b>LOSS ON ORDINARY ACTIVITIES BEFORE TAXATION</b>	4	(7,005)	(58,939)
Tax on loss on ordinary activities	7	<u>9,001</u>	<u>—</u>
<b>PROFIT (LOSS) FOR THE FINANCIAL YEAR</b>		1,996	(58,939)
Finance costs of non-equity shares		<u>(3,938)</u>	<u>(3,597)</u>
<b>Retained loss for the year</b>		<u>(1,942)</u>	<u>(62,536)</u>

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.

**VIRGIN MOBILE TELECOMS LIMITED**  
**CONSOLIDATED BALANCE SHEET (UNAUDITED)**  
**According to U.K. GAAP**  
**31 December 2002**

	<u>Note</u>	<u>2002</u>	<u>2001</u>
		<u>£'000</u>	<u>£'000</u>
<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
		<u>71,487</u>	<u>48,390</u>
<b>CREDITORS: amounts falling due within one year</b>	13	<u>(112,924)</u>	<u>(60,699)</u>
<b>NET CURRENT LIABILITIES</b>		<u>(41,437)</u>	<u>(12,309)</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		(16,609)	4,489
<b>CREDITORS: amounts falling due after more than one year</b>	14	<u>(143,144)</u>	<u>(166,238)</u>
<b>NET LIABILITIES</b>		<u>(159,753)</u>	<u>(161,749)</u>
<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	<u>(189,808)</u>	<u>(191,804)</u>
<b>ACCUMULATED DEFICIT</b>	18	<u>(159,753)</u>	<u>(161,749)</u>
Accumulated deficit may be analysed as:			
Equity interests		(200,865)	(198,923)
Non-equity interests		<u>41,112</u>	<u>37,174</u>
		<u>(159,753)</u>	<u>(161,749)</u>

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.



**VIRGIN MOBILE TELECOMS LIMITED**  
**COMPANY BALANCE SHEET (UNAUDITED)**  
**According to U.K. GAAP**  
**31 December 2002**

	<u>Note</u>	<u>2002</u> £'000	<u>2001</u> £'000
<b>FIXED ASSETS</b>			
Tangible assets	9	23,735	13,387
Investments	10	—	—
		<u>23,735</u>	<u>13,387</u>
<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
		<u>77,031</u>	<u>54,657</u>
<b>CREDITORS: amounts falling due within one year</b>	13	<u>(112,778)</u>	<u>(60,480)</u>
<b>NET CURRENT LIABILITIES</b>		<u>(35,747)</u>	<u>(5,823)</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		(12,012)	7,564
<b>CREDITORS: amounts falling due after more than one year</b>	14	<u>(141,729)</u>	<u>(164,613)</u>
<b>NET LIABILITIES</b>		<u>(153,741)</u>	<u>(157,049)</u>
<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	<u>(183,796)</u>	<u>(187,104)</u>
<b>ACCUMULATED DEFICIT</b>		<u>(153,741)</u>	<u>(157,049)</u>
Accumulated deficit may be analysed as:			
Equity interests		(194,853)	(194,223)
Non-equity interests		41,112	37,174
		<u>(153,741)</u>	<u>(157,049)</u>

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.

**VIRGIN MOBILE TELECOMS LIMITED**  
**CONSOLIDATED CASH FLOW STATEMENT (UNAUDITED)**  
**According to U.K. GAAP**  
**Year ended 31 December 2002**

	<u>Note</u>	<u>2002</u>	<u>2001</u>
		<u>£'000</u>	<u>£'000</u>
<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	<u>(18,315)</u>	<u>(8,836)</u>
<b>Cash inflow (outflow) before financing</b>		8,651	(67,109)
Financing	20	<u>(5,255)</u>	<u>74,858</u>
<b>Increase in cash in the year</b>	21	<u><u>3,396</u></u>	<u><u>7,749</u></u>

The accompanying notes are an integral part of this consolidated cash flow statement.

## **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.

## 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.

## 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.

**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:

	<b>£'000</b>	<b>£'000</b>
Wages and salaries	27,921	18,660
Social security costs	2,432	1,648
Other pension costs (see note 23)	776	549
	<b>31,129</b>	<b>20,857</b>

**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).

**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>	<u>9,001</u>	<u>—</u>
<b>Total tax credit on loss on ordinary activities</b>	<u>9,001</u>	<u>—</u>

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	<u>(3,504)</u>	<u>(3,722)</u>
	<u>—</u>	<u>—</u>

**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.



**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) — (Continued)**  
**Year ended 31 December 2002**

**9. TANGIBLE FIXED ASSETS**

<u>Group</u>	<u>Leasehold improvements</u> £'000	<u>Fixtures and fittings</u> £'000	<u>Office equipment</u> £'000	<u>Computer systems</u> £'000	<u>Total</u> £'000
<b>Cost</b>					
At 1 January 2002	7,792	662	273	29,116	37,843
Additions	<u>3</u>	<u>42</u>	<u>26</u>	<u>19,245</u>	<u>19,316</u>
At 31 December 2002	<u>7,795</u>	<u>704</u>	<u>299</u>	<u>48,361</u>	<u>57,159</u>
<b>Accumulated depreciation</b>					
At 1 January 2002	4,108	476	179	16,282	21,045
Charge for the year	<u>2,470</u>	<u>175</u>	<u>83</u>	<u>8,558</u>	<u>11,286</u>
At 31 December 2002	<u>6,578</u>	<u>651</u>	<u>262</u>	<u>24,840</u>	<u>32,331</u>
<b>Net book value</b>					
At 31 December 2002	<u>1,217</u>	<u>53</u>	<u>37</u>	<u>23,521</u>	<u>24,828</u>
At 31 December 2001	<u>3,684</u>	<u>186</u>	<u>94</u>	<u>12,834</u>	<u>16,798</u>
 <u>Company</u>	 <u>Leasehold improvements</u> £'000	 <u>Fixtures and fittings</u> £'000	 <u>Office equipment</u> £'000	 <u>Computer systems</u> £'000	 <u>Total</u> £'000
<b>Cost</b>					
At 1 January 2002	447	662	273	29,116	30,498
Additions	<u>—</u>	<u>42</u>	<u>26</u>	<u>19,245</u>	<u>19,313</u>
At 31 December 2002	<u>447</u>	<u>704</u>	<u>299</u>	<u>48,361</u>	<u>49,811</u>
<b>Accumulated depreciation</b>					
At 1 January 2002	174	476	179	16,282	17,111
Charge for the year	<u>149</u>	<u>175</u>	<u>83</u>	<u>8,558</u>	<u>8,965</u>
At 31 December 2002	<u>323</u>	<u>651</u>	<u>262</u>	<u>24,840</u>	<u>26,076</u>
<b>Net book value</b>					
At 31 December 2002	<u>124</u>	<u>53</u>	<u>37</u>	<u>23,521</u>	<u>23,735</u>
At 31 December 2001	<u>273</u>	<u>186</u>	<u>94</u>	<u>12,834</u>	<u>13,387</u>

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**

	<u>Group</u>		<u>Company</u>	
	<u>2002</u> £'000	<u>2001</u> £'000	<u>2002</u> £'000	<u>2001</u> £'000
Finished goods held for resale	<u>5,671</u>	<u>4,927</u>	<u>5,671</u>	<u>4,927</u>

**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) — (Continued)**  
**Year ended 31 December 2002**

**12. DEBTORS**

	<u>Group</u>		<u>Company</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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
	<u>52,706</u>	<u>33,749</u>	<u>58,251</u>	<u>40,017</u>

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**

	<u>Group</u>		<u>Company</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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
	<u>112,924</u>	<u>60,699</u>	<u>112,778</u>	<u>60,480</u>

**14. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR**

	<u>Group</u>		<u>Company</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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.

## 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:

	<u>Group and Company</u>	
	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>
In one year or less	233	255
Between one and two years	—	233
	<u>233</u>	<u>488</u>

#### **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.

**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 £'000	Floating rate £'000	Fixed rate £'000
<b>Currency</b>			
Sterling			
— Borrowings	164,909	89,676	75,233
— Non-equity shares	30,050	—	30,050
Total	194,959	89,676	105,283

The profile at 31 December 2001 for comparison purposes was as follows:

	2001		
	Total £'000	Floating rate £'000	Fixed rate £'000
<b>Currency</b>			
Sterling			
— Borrowings	164,802	89,314	75,488
— Non-equity shares	30,050	—	30,050
Total	194,852	89,314	105,538

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
<b>Currency</b>		
Sterling		
— Borrowings	7.4	1.0

	2001	
	Fixed rate	
	Weighted average interest rate (%)	Weighted average period for which rate is fixed Years
<b>Currency</b>		
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.

**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) — (Continued)**  
**Year ended 31 December 2002**

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:

	<u>Non-equity shares</u>	<u>Borrowings</u>	<u>Total</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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
Total	<u>30,050</u>	<u>164,909</u>	<u>194,959</u>

The profile at 31 December 2001 for comparison purposes was as follows:

	<u>Non-equity shares</u>	<u>Borrowings</u>	<u>Total</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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
Total	<u>30,050</u>	<u>164,802</u>	<u>194,852</u>

***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:

	<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
Total	<u>15,000</u>	<u>15,000</u>

**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.

	<u>2002</u>		<u>2001</u>	
	<u>Book value</u>	<u>Fair value</u>	<u>Book value</u>	<u>Fair value</u>
	£'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

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:

	<u>2002</u>		
	<u>Gains</u>	<u>Losses</u>	<u>Net</u>
	£'000	£'000	£'000
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	(287)	(1,116)	(829)
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	165	1,206	1,041
Unrecognised gains and losses on hedges at 31 December 2002	165	1,403	1,238
Of which:			
Gains and losses expected to be recognised in 2003	165	1,251	1,086
Gains and losses expected to be recognised in 2004 or later	—	152	152

**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:

	2001		
	Gains	Losses	Net
	£'000	£'000	£'000
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**

	2002	2001
	£	£
<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
	5,019,900	5,019,900
<b>Called up, allotted and fully paid</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
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

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

**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**

<u>Group</u>	<u>Share premium account</u>	<u>Profit and loss account</u>	<u>Total</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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	<u>30,036</u>	<u>(189,808)</u>	<u>(159,772)</u>



**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) — (Continued)**  
**Year ended 31 December 2002**

<u>Company</u>	<u>Share premium account</u>	<u>Profit and loss account</u>	<u>Total</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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	<u>30,036</u>	<u>(183,796)</u>	<u>(153,760)</u>

**18. RECONCILIATION OF MOVEMENTS IN GROUP SHAREHOLDERS' FUNDS**

	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>
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	<u>(161,749)</u>	<u>(102,810)</u>
Closing accumulated deficit	<u>(159,753)</u>	<u>(161,749)</u>

**19. RECONCILIATION OF OPERATING LOSS TO OPERATING CASH FLOWS**

	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>
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>	<u>34,712</u>	<u>(54,065)</u>

**20. ANALYSIS OF CASH FLOWS**

	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>
<i>Returns on investments and servicing finance</i>		
Interest received	522	483
Interest paid	(8,220)	(4,619)
Interest element of finance lease rentals	(48)	(72)
<b>Net cash outflow</b>	<u>(7,746)</u>	<u>(4,208)</u>
<i>Capital expenditure and financial investment</i>		
Purchase of tangible fixed assets	<u>(18,315)</u>	<u>(8,836)</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)
<b>Net cash (outflow) inflow</b>	<u>(5,255)</u>	<u>74,858</u>

**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO THE ACCOUNTS (unaudited) — (Continued)**  
**Year ended 31 December 2002**

**21. ANALYSIS AND RECONCILIATION OF NET DEBT**

	<u>1 January</u> <u>2002</u>	<u>Cash</u> <u>flow</u>	<u>Other</u> <u>non-cash</u> <u>changes</u>	<u>31</u> <u>December</u> <u>2002</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
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	<u>(155,088)</u>	<u>8,651</u>	<u>(5,362)</u>	<u>(151,799)</u>
		<u>2002</u>	<u>2001</u>	
		<u>£'000</u>	<u>£'000</u>	
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		<u>(151,799)</u>	<u>(155,088)</u>	

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:

	<u>Group</u>		<u>Company</u>	
	<u>Land and buildings</u>		<u>Land and buildings</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
Expiry date				
— within one year	—	—	—	—
— between two and five years	—	—	—	—
— after five years	1,092	1,092	240	240
	<u>1,092</u>	<u>1,092</u>	<u>240</u>	<u>240</u>

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

## 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.

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.

## **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.

**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

**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
	48,390	28,226
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
	25,260	27,720
	73,650	55,946
<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
	64,397	68,709
Deferred revenue	6,972	5,114
Capital lease	233	—
Bank loan	100,000	25,000
Due to other related companies	64,314	58,659
	235,916	157,482
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
'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)
	(199,426)	(135,099)
Shareholders' equity and cumulative redeemable preference shares	(162,266)	(101,536)
	73,650	55,946

The accompanying notes are an integral part of these consolidated financial statements.



**VIRGIN MOBILE TELECOMS LIMITED**

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**31 December 2001, 2000 and 1999**

	<b>Year ended 31 December 2001</b>	<b>Year ended 31 December 2000</b>	<b>Period from incorporation to 31 December 1999 (11 month period)</b>
	<b>£'000</b>	<b>£'000</b>	<b>£'000</b>
<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)
<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
<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)	—	—
<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)
<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.

**VIRGIN MOBILE TELECOMS LIMITED**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**31 December 2001, 2000 and 1999**

	<u>Share capital</u>	<u>Accumulated Deficit</u>	<u>Total Shareholders' Funds/ (Deficit)</u>
	<u>£'000</u>	<u>£'000</u>	<u>£'000</u>
At incorporation	—	—	—
Shares issued	5	—	5
Net loss attributable to equity shareholders	—	(27,185)	(27,185)
<b>Balance, 31 December 1999</b>	<u>5</u>	<u>(27,185)</u>	<u>(27,180)</u>
Net loss attributable to equity shareholders	—	(107,919)	(107,919)
<b>Balance, 31 December 2000</b>	<u>5</u>	<u>(135,104)</u>	<u>(135,099)</u>
Increase of share capital	14	—	14
Net loss attributable to equity shareholders	—	(64,341)	(64,341)
<b>Balance, 31 December 2001</b>	<u><u>19</u></u>	<u><u>(199,445)</u></u>	<u><u>(199,426)</u></u>

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.

**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	<u>(9,172)</u>	<u>(15,605)</u>	<u>(13,764)</u>
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	<u>(156)</u>	<u>—</u>	<u>—</u>
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>	7,749	(9,216)	11,181
<b>Cash and cash equivalents, beginning of year</b>	<u>1,965</u>	<u>11,181</u>	<u>—</u>
<b>Cash and cash equivalents, end of year</b>	<u><u>9,714</u></u>	<u><u>1,965</u></u>	<u><u>11,181</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

## 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.

**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

**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 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.

## 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

**VIRGIN MOBILE TELECOMS LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**31 December 2001, 2000 and 1999**

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
At 31 December 2001	<u>7,792</u>	<u>662</u>	<u>273</u>	<u>29,809</u>	<u>38,536</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
At 31 December 2001	<u>4,108</u>	<u>476</u>	<u>179</u>	<u>16,466</u>	<u>21,229</u>
<b>Net book value</b>					
At 31 December 2001	<u>3,684</u>	<u>186</u>	<u>94</u>	<u>13,343</u>	<u>17,307</u>
At 31 December 2000	<u>6,127</u>	<u>379</u>	<u>193</u>	<u>15,516</u>	<u>22,215</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>164,547</u>	<u>83,659</u>

As at 31 December 2001, contractual maturities of the Group's indebtedness were as follows:

	<u>Capital lease</u>	<u>Bank loan</u>	<u>Due to other related companies</u>
	£'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
Total	<u>488</u>	<u>100,000</u>	<u>64,314</u>



**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**

	<b>2001</b>	<b>2000</b>
	£	£
<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
	<b>19,900</b>	<b>19,900</b>

	<b>2001</b>	<b>2000</b>	
	<b>Called-up and fully paid</b>	<b>Called-up and fully-paid</b>	<b>Called-up</b>
	£	£	£
<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
	<b>19,570</b>	<b>5,122</b>	<b>19,570</b>

**'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.

**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:

	<u>31 December 2001</u>	<u>31 December 2000</u>	<u>31 December 1999</u>
	<u>£’000</u>	<u>£’000</u>	<u>£’000</u>
Balance, beginning of the year/period	33,563	30,642	—
Share capital	—	—	—
Share premium	—	—	30,036
Financing cost — cumulative dividend	<u>3,597</u>	<u>2,921</u>	<u>606</u>
Balance, end of the year	<u><u>37,160</u></u>	<u><u>33,563</u></u>	<u><u>30,642</u></u>

**7 Financial instruments**

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.

**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
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)
	—	—	—

**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	<u>—</u>	<u>—</u>	<u>—</u>

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)

## 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
	<u>13,081</u>	<u>14,184</u>

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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**For the years ended 31 December 2003 and 2002**

**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
AS OF DECEMBER 31, 2003 AND 2002**

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## Income statement

### Income statement of comdirect bank group according to IFRS/IAS

€ thousand	Notes	1.1. to 31.12.	
		2003	2002
Interest income		84,889	99,220
Interest expenses		27,682	35,324
<b>Net interest income before provisions</b>	<b>(22)</b>	<b>57,207</b>	<b>63,896</b>
Provision for possible loan losses	(23)	35	-2,037
<b>Net interest income after provisions</b>		<b>57,242</b>	<b>61,859</b>
Commission income		96,686	79,024
Commission expenses		13,579	1,882
<b>Net commission income</b>	<b>(24)</b>	<b>83,107</b>	<b>77,142</b>
Trading profit/loss		0	-285
Income/loss from investments and securities portfolio	(25)	4,760	1,200
Administrative expenses	(26)	112,494	138,138
Other operating result	(27)	6,487	2,917
<b>Profit from ordinary activities</b>		<b>39,102</b>	<b>4,695</b>
Extraordinary result and restructuring costs		0	-23,295
<b>Pre-tax profit/loss</b>		<b>39,102</b>	<b>-18,600</b>
Taxes on income	(28)	15,741	-8,836
<b>After-tax profit/loss</b>		<b>23,361</b>	<b>-9,764</b>
<b>Net profit/loss</b>		<b>23,361</b>	<b>-9,764</b>
Transfer to reserves/transfer from reserves		-880	9,764
<b>Consolidated profit</b>		<b>22,481</b>	<b>0</b>

## Earnings per share

Earnings per share		1.1. to 31.12.	
		2003	2002
Net profit/loss	€thousand	23,361	-9,764
Average number of ordinary shares	Shares	140,500,729	140,500,000
<b>Basic earnings per share</b>	<b>€</b>	<b>0.17</b>	<b>-0.07</b>
<b>Diluted earnings per share</b>			
Net profit/loss	thousand	23,361	-9,764
Adjustment to the number of ordinary shares issued due to outstanding option rights	Shares	416,204	395,349
Weighted average shares outstanding (diluted)	Shares	140,916,933	140,895,349
<b>Diluted earnings per share</b>	<b>€</b>	<b>0.17</b>	<b>-0.07</b>

## Balance sheet

### Balance sheet of comdirect bank group according to IFRS/IAS

<b>Assets</b>			
<b>€ thousand</b>			
		<b>as of 31.12.</b>	
	<b>Notes</b>	<b>2003</b>	<b>2002</b>
Cash reserve	(29)	1,749	5,181
Claims on banks	(30)	1,310,434	1,294,419
Claims on customers	(31)	183,773	175,421
Provision for possible loan losses	(32)	-5,766	-6,355
Investments and securities portfolio	(33)	1,893,862	1,057,701
Intangible assets	(34)	11,905	14,094
Fixed assets	(35)	20,860	28,175
Tax assets	(37)	0	11,701
Other assets	(38)	9,313	8,936
<b>Total assets</b>		<b>3,426,130</b>	<b>2,589,273</b>

### Liabilities and equity

<b>Liabilities and equity</b>			
<b>€ thousand</b>			
		<b>as of 31.12.</b>	
	<b>Notes</b>	<b>2003</b>	<b>2002</b>
Liabilities to banks	(39)	0	14,913
Liabilities to customers	(40)	2,774,791	1,948,680
Provisions	(41)	18,556	21,108
Tax liabilities	(42)	7,370	0
Other liabilities		24,509	24,247
Subordinated capital	(43)	16,617	16,617
<b>Equity</b>		<b>584,287</b>	<b>563,708</b>
Subscribed capital		140,503	140,500
Capital reserve		367,240	367,221
Retained earnings			
Legal reserve		0	0
Other revenue reserves		55,359	55,658
Revaluation reserve		-1,296	329
Consolidated profit		22,481	0
<b>Total liabilities and equity</b>		<b>3,426,130</b>	<b>2,589,273</b>

## Statement of changes in equity

€ thousand	Subscribed capital	Capital reserve	Retained earnings	Revaluation reserve	Consolidated profit/loss	Total 2003	Total 2002
<b>Equity as of 1.1.</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>
Issue of new shares	3	19	—	—	—	22	0
Changes in revaluation reserve pursuant to IAS 39	—	—	—	-1,625	—	-1,625	-754
Changes in the difference arising from currency translation	—	—	-1,179	—	—	-1,179	-1,635
Allocation to reserves/transfer from reserves	—	0	880	—	—	880	-12,013
Consolidated profit	—	—	—	—	22,481	22,481	0
<b>Equity as of 31.12.</b>	<b>140,503</b>	<b>367,240</b>	<b>55,359</b>	<b>-1,296</b>	<b>22,481</b>	<b>584,287</b>	<b>563,708</b>

No use was made of the authorisation of the annual general meeting on 7 May, 2003 to purchase own shares for the purpose of securities trading pursuant to Art. 71, (1), No. 7, German Stock Corporation Act (AktG) in financial year 2003.

No use was also made of the resolution of the annual general meeting on 7 May, 2003 for the authorisation to purchase own shares for other purposes than securities trading pursuant to Art. 71, (1), No. 8, AktG in financial year 2003.

Resulting from the exercise of option rights, a total of 3,350 new no-par-value bearer shares of comdirect bank AG were issued as part of our stock option programme. Each of these shares carries a proportion of the share capital in the sum of one euro. The relevant additional payment established in connection with the stock option programme was allocated to the capital reserve pursuant to Art. 270, German Commercial Code (HGB).

## Cash flow statement

€ thousand	1.1. to 31.12.	
	2003	2002
<b>Net profit/loss</b>	<b>23,361</b>	<b>-9,764</b>
Non-solvent items and transfer to cash flow from operating activities contained in the result before profit transfer		
Depreciation charges, valuation allowances, additions to fixed assets and financial investments and change in provisions	13,952	-5,001
Loss/gain from the sale of financial investments and fixed assets	67	455
Other adjustments (on balance)	-48,240	-59,966
<b>Sub-total</b>	<b>-10,860</b>	<b>-74,276</b>
Change in assets and liabilities from operating activities after adjustment for non-solvent items		
Claims		
on banks	-16,147	392,538
on customers	-8,905	87,561
Securities	-846,101	-183,058
Other assets from operating activities	11,003	6,490
Liabilities		
to banks	-14,913	14,913
to customers	826,111	-340,647
Other liabilities and equity from operating activities	4,116	-22,537
Interest and dividends received	77,356	96,843
Interest paid	-27,682	-35,324
Income tax payments	-2,805	-112
<b>Cash flow from operating activities</b>	<b>-8,827</b>	<b>-57,609</b>
<b>Changes in funds from investing activities (on balance)</b>	<b>6,552</b>	<b>1,043</b>
Proceeds from capital increases	22	0
<b>Cash flow from financing activities</b>	<b>22</b>	<b>0</b>
<b>Cash and cash equivalents as at the end of the previous period</b>	<b>5,181</b>	<b>72,005</b>
Cash flow from operating activities	-8,827	-57,609
Cash flow from investing activities	6,552	1,043
Cash flow from financing activities	22	0
Effects from deconsolidation	0	-8,623
Effects of changes in exchange rates	-1,179	-1,635
<b>Cash and cash equivalents as at the end of the period</b>	<b>1,749</b>	<b>5,181</b>

Cash and cash equivalents correspond to the balance-sheet item cash reserve and include cash on hand and balances held at central banks.

## Notes

### Basis of accounting principles

The consolidated financial statements of comdirect bank as of 31 December, 2003 were prepared in accordance with the International Financial Reporting Standards (IFRS)/International Accounting Standards (IAS), which were approved and published by the International Accounting Standards Board (IASB)/International Accounting Standards Committee (IASC), and interpreted by the International Financial Reporting Interpretations Committee (IFRIC)/Standing Interpretations Committee (SIC).

A summary of all the regulations that have been applied can be found on pages 51 et seq.

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 IFRS/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 obligations (Prime Standard) of the Deutsche Börse AG for the sub-section of the regular market.

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, 2002 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. 132, pages 12,264 to 12,308 of 19 July, 2003.

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 by both business lines and by geographic market appears as part of the notes, on pages 82-84 (notes no. 50-51).

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 investments and securities portfolio. All financial instruments are shown in the balance sheet according to the method “trade date accounting.”

With the exception of comdirect private finance AG, all the companies included in the consolidation prepared their financial statements as of 31 December, 2003.

comdirect private finance AG prepared its financial statements for the short business year from 1 January, 2003 through 30 September, 2003. The company began operations on 1 October, 2003. We adjusted the financial statements for the short business year as of the reference date 31 December, 2003 pursuant to IAS 27.

## **(2) IAS, SIC and GASB rules applied**

Within the comdirect group and within the Commerzbank group, to which it belongs, only those IFRSs/IASs and SICs are applied for accounting and measurement purposes, which had been approved and published by 31 December, 2003.

The consolidated financial statements are based on the IASB framework and the following IASs relevant for comdirect:

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 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

We did not apply IAS 2, 11, 15, 20, 23, 26, 28, 29, 31, 34, 40 and 41 since they are either not relevant for us or are not applicable in the consolidated financial statements.

In addition to the Standards listed, we have taken into consideration the following SIC interpretations relevant for us in our consolidated financial statements:

		relates to:
SIC-6	Costs of modifying existing software (framework)	IASB 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 two subsidiaries, comdirect ltd, London/United Kingdom and comdirect private finance AG, Quickborn, and one special fund, a special purpose entity (SPV) in accordance with SIC-12.

comdirect bank AG holds 100% of the shares of the subsidiaries and the special purpose entity.

A detailed presentation of the operative holdings appears on page 88.

### **(4) Principles of consolidation**

The consolidation of the capital accounts is based on the book-value method, whereby the historical cost of the holding in the subsidiary is set off against the proportion of the subsidiary's equity as of the date of acquisition.

Intra-group expenses and income, as well as claims and liabilities, are eliminated as part of the consolidation.

Holdings in subsidiaries that are not included in the consolidation due to their minor importance are shown at historical cost in the investments and securities portfolio.

### **(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 cost.

comdirect nets translation gains and losses from the consolidation of the capital accounts against retained earnings.

The annual financial statement prepared by our subsidiary comdirect ltd 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 comdirect bank group is the British pound (GBP). The GBP exchange rate as of 31 December, 2003 was 0.7048 (previous year: 0.6500).

#### **(6) Claims**

All claims on banks and customers originated by comdirect bank group are shown at amortised costs without valuation allowances.

Claims not originated by comdirect – promissory notes – that are not held for trading purposes are included in the item investments and securities portfolio.

Valuation allowances to claims appear under provision for possible loan losses.

#### **(7) Provision for possible loan losses**

We fully provide for the particular credit risks associated with banking business by forming individual valuation allowances, country valuation allowances and global valuation allowances.

Valuation allowances were formed exclusively for claims on customers in the 2003 consolidated financial statements.

Throughout the group, the relevant individual valuation allowances have been formed on the scale of the potential default to cover credit-standing risks related to claims on customers.

In business year 2003, comdirect bank group has formed country valuation allowances for the first time. These are only applied to claims in which security is provided via securities involving an enhanced transfer risk (country risk). We have reviewed the respective claim after deduction of the security that we have issued – without taking into consideration the securities involving an enhanced transfer risk – and formed a corresponding country valuation allowance based on the existing risk volume.

We cover latent credit risks by means of global valuation allowances. Past loan losses serve as a yardstick for the scale on which such valuation allowances have to be formed.

The provision for possible loan losses is shown separately from claims.

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) Investments and securities portfolio**

Under investments and securities portfolio, we show all the securities which we have assigned solely to the “available-for-sale” category.

In addition, in accordance with IAS 39, we include in investments and securities portfolio all the claims on customers not originated by comdirect bank, in particular promissory notes.

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.

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. Realised gains and losses only affect the income statement when the holdings are sold or written-off.

The earnings resulting from the sale or maturity of financial instruments, which are attributable to the category “available-for-sale”, amounted to €4,889 thousand at the end of business year 2003. Corresponding losses amounted to €15 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 €38,175 thousand as of the end of business year 2003.

### **(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 using the straight-line method and according to schedule against earnings over a period of five years.

In the course of the website relaunch, extraordinary write-down was effected in the business year to intangible assets in the amount of €324 thousand.

### **(10) Fixed assets**

The item fixed assets shows land and buildings, the office furniture and equipment and purchased software.

All the fixed assets are capitalised at historical cost. Office furniture and equipment as well as purchased software are depreciated using the straight-line method and according to schedule to reflect their probable useful economic lives.

In determining the useful life, its likely physical wear and tear, its technical obsolescence as well as legal and contractual restrictions are taken into consideration.

All fixed assets are depreciated over a period of 3 to 14 years.

Gains and losses arising from the sale of fixed assets are shown in the income statement under other operating result.

In the course of the website relaunch, extraordinary depreciation was effected in the business year to fixed assets in the amount of €280 thousand.

#### **(11) Other assets**

Other assets principally 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**

For the Board of Managing Directors provision for old age is made both directly and through contributions to Versicherungsverein des Bankgewerbes a. G. (BVV), Berlin.

The members of the Board of Managing Directors earn a right to a pension for their work as member of the Board of Managing Directors at 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.

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.

Payment of the contributions to BVV are recognised as personnel costs for the current period.

The commitments similar to those for pensions include deferred compensations, by which a specific group of employees gives up a portion of its gross salary for old-age pension benefits later on.

comdirect bank AG insured by means of a contractual trust agreement old-age pension commitments which are not covered against insolvency by Pensions-Sicherungs-Verein (PSV) in business year 2003.

In this connection, the trustee required for a bilateral trust was established by Commerzbank AG in the form of the Commerzbank Pension-Trust e. V. in business year 2002.

In business year 2003, comdirect bank AG made the first allocation to the trust's assets in the amount of €168 thousand.

In accordance with IAS 19, this pledged asset in the current value to be agreed upon is set off against the allocations to the pension provisions.

#### **(15) Other provisions**

Other provisions were formed on the scale deemed necessary for liabilities of uncertain amount towards third parties and for anticipated losses related to immatured contracts.

#### **(16) Income taxes**

Current tax assets and liabilities are calculated by applying the valid tax rates at which a refund from or a payment to, the relevant fiscal authorities is expected.

Deferred taxes were formed in accordance with IAS 12. Temporary differences are the result of the discrepancy between assigned values in accordance with IFRS/IAS and the respective tax rate that was applied. These temporary differences are measured using the German income-tax rates, which can be expected to apply for the period in which they are realised.

Deferred taxes on as yet unused losses carried forward are shown in the balance sheet if taxable profits are likely to occur at the same tax unit.

Deferred tax assets and liabilities are formed and carried such that – depending on the treatment of the underlying item – they are recognised either under taxes on income in the income statement or they are set off against the relevant equity items with no effect on the income statement.

Deferred tax assets and liabilities are netted against one another, 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.

In business year 2003, turnover tax unity was maintained only with Commerzbank AG, Frankfurt am Main.

A breakdown of this item into current and deferred taxes can be found in these notes on page 65, note 28.

### **(17) 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 Mai, 2005.

In addition, since the resolution adopted on 11 May, 2000, and entered into the commercial register on 31 May, 2000, conditional capital of up to €3,600 thousand was created in order to service up to 3,600,000 subscription rights as part of the bank's stock option programme (conditional capital I).

As of 31 December, 2003, conditional capital I amounts to €3,596,650 due to the issue of 3,350 new bearer shares of comdirect bank AG.

Through the resolution adopted on 7 May, 2003, and its entry into the commercial register on 17 July, 2003, an additional conditional capital of €30,000 thousand was created (conditional capital II).

The conditional capital II will only be effected to the extent that the holders of any bonds with warrants and/or convertible bonds may exercise their option or conversion rights.

The Board of Managing Directors is authorised to issue, with the approval of the Supervisory Board, bearer shares of bonds with warrants and/or convertible bonds as mentioned above in either one or several tranches, by a maximum amount of €300,000. The term of these bonds is limited to a maximum of 20 years. This authorisation is limited until 6 May, 2008.

### **(18) Appropriation of profits**

Basis for the appropriation of profits is the national legislation, especially the German Commercial Code and the Stock Corporation Act.

For business year 2003, comdirect bank AG reported a distributable profit according to federal legislation in the amount of €2,480,536.00.

The Board of Managing Directors and the Supervisory Board will propose to the annual general meeting a dividend payment in the amount of €0.16 per no-par-value bearer share.

The consolidated profit of comdirect bank group based on the applied IFRS/IAS also amounts to €2,481 thousand for business year 2003.

### **(19) Earnings per share**

Earnings per share are calculated in accordance with IAS 33 and based on the net profit for the year. Both the earnings per share and the diluted earnings per share are shown below the income statement.

In working out the earnings per share, we have set off the net profit for the year against the average number of shares in the financial year.

The diluting effects result from a stock option programme launched in July 2000 with a maximum of 3,600,000 subscription rights, of which approximately 2.4 million option rights had been issued in four tranches per 31 December, 2003.

In calculating the diluted results, we also set off the two subsets of rights under the stock option programme 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) Stock option programme**

Under the stock option programme as approved by the annual general meeting resolution of 11 May, 2000, up to 3,600,000 subscription rights may be issued.

Eligible participants are members of the Board of Managing Directors of comdirect bank AG, members of the executive bodies of affiliated companies, as well as executives and selected members of staff of comdirect bank AG and affiliated companies.

The Board of Managing Directors of comdirect bank AG individually selects the eligible participants. Where members of the Board of Managing Directors are concerned, the Supervisory Board of the company makes the decision.

The subscription rights may be granted at any time, but only until 1 July, 2005.

A total of 2,408,810 subscription rights in four tranches were issued through 31 December, 2003. Of these subscription rights issued, a total of 521,057 have expired.

The subscription rights are equally divided into two subsets, which are different with regard to the exercise hurdles and the exercise price. Half of the subscription rights are thus always granted as subset A, and the other half always as subset B.

Eligible participants receive the right to purchase one no-par-value bearer share of comdirect bank AG, which carries a proportion of the share capital in the sum of one euro, per subscription right under the stipulated conditions.

Subscription rights may only be exercised if stipulated targets are attained.

**The following applies for subset A:** The comdirect bank share outperforms the Prime Financial Services Price Index (previously NEMAX 50 Price Index) by more than five percentage points.

**The following applies for subset B:** The absolute rise in the price of the comdirect bank share for subscription rights granted in 2000 is at least 25% compared to the issuing price and for subscription rights granted beginning in 2001 or later a rise of at least 20% compared to an average price determined prior to the time that they were granted.

The price that an eligible participant has to pay to comdirect bank AG when exercising a subscription right corresponds to:

- for subset A:

the daily rate at the time of exercise minus 1% for every full percentage point by outperformance of the index of over five percentage points, but at least 90% from the daily rate for options granted between 2000 and 2002 or 70% from the daily rate for options granted in 2003

- for subset B:

the daily rate at the time of exercise minus 1% for every full percentage point by which an absolute rise in the price of com-direct bank share developed better, but at least 50%, of the daily rate.

3,350 subscription rights were exercised in business year 2003. All subscription rights were apportionable to subset A. For these exercised subscription rights, the same number of no-par-value bearer shares of comdirect bank AG were issued.

As a result, the share capital of comdirect bank AG was increased by €3,350.00 and the relevant payment established in connection with the stock option programme was allocated to the capital reserve pursuant to Art. 270, HGB. The amount of the payment in business year 2003 totalled €9,151.00.

## **(21) Relations with affiliated companies**

comdirect bank AG 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 had a fixed term of five years until 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 2003 business year:

- Trading Services
- Processing Services
- Printing services
- Payments and cash dispenser service
- IT services
- Other services

On 8 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 since 31 December, 2002, may be terminated giving six months' notice before the end of the calendar year.

Outside of the general agreement, a separate agreement was concluded with Commerzbank on 7 September, 2000, covering the usage of the electronic security trading system "Warrant Trading System (WTS)." The agreement was concluded for an indefinite period and can be terminated at any time without giving notice.

Within the general agreement, a new service agreement "Determination of Risk Ratios" was concluded on 7 January, 2003. As part of this service agreement, Commerzbank furnishes the daily determination of risk ratios based on data provided by comdirect bank AG.

comdirect bank AG is party to an agreement of Commerzbank with 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.

On 29 May, 2000, comdirect bank AG concluded an agreement with Commerzbank concerning the cash receiving office and depository services for the shares of comdirect bank AG.

comdirect currently offers its customers approximately 4,600 funds from more than 80 investment companies, including investment companies of the Commerzbank group. In the 2003 business year, comdirect received commissions on portfolio holdings and sales at prevailing market rates from the investment companies of the Commerzbank group.

On 12 November, 2003, an agreement was concluded between Commerz Service Gesellschaft für Kundenbetreuung mbh (CSG), a 100% subsidiary of Commerzbank, and comdirect bank AG. In this agreement, both parties mutually agree to exchange services with regard to the areas of customer service, technical hotline and employee delegations.

In addition, comdirect bank AG unilaterally makes available to CSG personnel, technical and organisational resources. This provision of services was put into writing with a service agreement signed on 25 March, 2003.

Commerzbank and CSG received compensation in line with market rates for the goods and services they provided for comdirect.

When forming comdirect ltd, London/United Kingdom, in 1999, comdirect bank AG pledged to ensure compliance with the specific equity capital requirements of that country.

No new equity was injected to comdirect ltd in business year 2003.

comdirect ltd concluded an agreement with Lloyds TSB Bank plc., London, regarding the provision of services in securities dealings. In this context, comdirect bank AG has written a guarantee bond vis -à-vis Lloyds TSB Bank plc., submitted with a maximum amount of GBP3m, 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.

Commerzbank AG, London Branch, is co-signatory of a leasing agreement between comdirect ltd and Woodchester Investment Limited/Woodchester Lease Management Services Limited. Accordingly, it is jointly liable together with comdirect ltd for all tenant's duties. On account of a "counter-indemnity," comdirect bank AG is contractually bound to keep Commerzbank AG free from all obligations resulting from this agreement.

In business year 2003, comdirect bank AG acquired 100% of an inventory company that was renamed to comdirect private finance AG with its registration on 15 September, 2003.

comdirect private finance AG received equity of €4,950 thousand from comdirect bank AG in business year 2003.

As part of setting up the company, comdirect bank AG supported comdirect private finance AG. So far as services from third parties were used for the activities listed, comdirect was reimbursed for any payments made in this regard.

As security for the offices leased by comdirect private finance AG, comdirect bank AG submitted leasing guarantees for each office. The volume as of 31 December, 2003, amounted to a total of €1 thousand. The guarantees were allotted at prevailing market conditions.

To safeguard against repayment claims of insurance companies in the case of the cancellation of an agreement, comdirect bank AG submitted comfort letters for comdirect private finance AG. As a rule, the comfort letter is the prerequisite for a full repayment of the acquisition commissions and lean settlement processes.

comdirect bank AG and comdirect private finance AG concluded a profit and loss transfer agreement on 26 January, 2004 subject to the approval of the annual general meetings of both companies. The profit and loss transfer agreement is to correspond with the business year of comdirect private finance AG and will be valid retroactively as of 1 October, 2003.

With an agreement dated 9 January, 2003, comdirect bank AG acquired a holding in WST-Broker GmbH, Frankfurt am Main. WST-Broker GmbH routes customer's orders to execution on the exchanges with face to face trading on behalf of comdirect bank AG.



## Notes to the income statement

### (22) Net interest income

€ thousand	2003	2002	Change in %
Interest and dividends from shares and other variable-yield securities held in the “available-for-sale” portfolio	344	1,004	-65.7
Interest income from fixed-income securities held in the “available-for-sale” portfolio and from government-inscribed debt	37,831	35,615	6.2
Other interest income including discount surplus	46,714	62,601	-25.4
<b>Interest income</b>	<b>84,889</b>	<b>99,220</b>	<b>-14.4</b>
Interest on profit-sharing certificates outstanding and subordinated liabilities	1,494	840	77.9
Other interest expenses	26,188	34,484	-24.1
<b>Interest expenses</b>	<b>27,682</b>	<b>35,324</b>	<b>-21.6</b>
<b>Total</b>	<b>57,207</b>	<b>63,896</b>	<b>-10.5</b>

### (23) Provision for possible loan losses

The provisions of the comdirect bank group break down as follows:

€ thousand	2003	2002	Change in %
Allocations to provisions	-2,762	-3,485	-20.7
Write-back of provisions	2,904	1,556	86.6
Direct write-downs	-122	-118	3.4
Income received on written-down claims	15	10	50.0
<b>Total</b>	<b>35</b>	<b>-2,037</b>	<b>-101.7</b>

### (24) Net commission income

€ thousand	2003	2002	Change in %
Securities transactions	81,339	75,659	7.5
Payment transactions	1,640	1,406	16.6
Other commissions	128	77	66.2
<b>Total</b>	<b>83,107</b>	<b>77,142</b>	<b>7.7</b>

## (25) Income/loss from investments and securities portfolio

Under the net result on investments and securities portfolio, the disposal proceeds and the gains and losses on “available-for-sale” securities, claims not originated by the bank, investments, investments in associated companies and holdings in subsidiaries which have not been consolidated are shown.

€ thousand	2003	2002	Change in %
Result on “available-for-sale” securities portfolio	4,574	1,200	281.2
Result on disposals and measurements of investments, investments in associated companies and holdings in subsidiaries	186	0	—
<b>Total</b>	<b>4,760</b>	<b>1,200</b>	<b>296.7</b>

All the investments, investments in associated companies and holdings in subsidiaries which have not been consolidated were subjected to an impairment test as of 31 December, 2003. Overall no relevant adjustments occurred.

## (26) Administrative expenses

The comdirect bank group’s administrative expenses consist of personnel costs, other administrative expenses, and depreciation on office furniture and equipment, and also on other intangible assets.

### Personnel costs

€ thousand	2003	2002	Change in %
Wages and salaries	26,273	32,263	-18.6
Compulsory social-security contributions	4,113	5,555	-26.0
Expenses for pensions and other employee benefits	1,287	903	42.5
<b>Total</b>	<b>31,673</b>	<b>38,721</b>	<b>-18.2</b>

### Breakdown of expenses for pensions and other employee benefits

€ thousand	2003	2002	Change in %
Costs of company pension scheme	1,280	900	42.2
Contributions to Versicherungsverein des Bankengewerbes a. G. (BVV)	7	3	133.3
<b>Total</b>	<b>1,287</b>	<b>903</b>	<b>42.5</b>

## Other administrative expenses

€ thousand	2003	2002	Change in %
Marketing costs	12,364	14,530	-14.9
Communication costs	4,042	10,792	-62.5
Consulting costs	9,396	8,956	4.9
External services	17,942	23,477	-23.6
Sundry operating expenses	20,553	18,402	11.7
<b>Total</b>	<b>64,297</b>	<b>76,157</b>	<b>-15.6</b>

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

€ thousand	2003	2002	Change in %
Office furniture and equipment	10,989	14,742	-25.5
Intangible assets	5,535	8,518	-35.0
<b>Total</b>	<b>16,524</b>	<b>23,260</b>	<b>-29.0</b>

## (27) Other operating result

The other operating result primarily comprises income from recoverable input taxes and income from the writing-back of provisions.

€ thousand	2003	2002	Change in %
<b>Other operating expenses</b>	<b>1,702</b>	<b>1,529</b>	<b>11.3</b>
Payments to settle customers' complaints/provisions for process risks in Online Investment	795	462	72.1
Losses on the disposal of property, plant and equipment	67	455	-85.3
Sundry expense items	840	612	37.3
<b>Other operating income</b>	<b>8,189</b>	<b>4,446</b>	<b>84.2</b>
Income from recoverable input taxes	1,061	1,361	-22.0
Income from the writing-back of provisions and accruals	4,257	1,228	246.7
Gains on the disposal of non-current assets	225	498	-54.8
Income from service level agreements	1,327	0	—
Sundry expense items	1,319	1,359	-2.9
<b>Total</b>	<b>6,487</b>	<b>2,917</b>	<b>122.4</b>

## (28) Taxes on income

€ thousand	2003	2002	Change in %
Current taxes on income	8,846	102	8,572.5
Deferred taxes	6,895	-8,938	-177.1
<b>Total</b>	<b>15,741</b>	<b>-8,836</b>	<b>-278.1</b>

Taxes on income include deferred tax expenses of €6,566 thousand from the writing-back of capitalised advantages deriving from loss carry-forwards, which were used in business year 2003.

### Transitional presentation of taxes on income

€ thousand	2003
<b>Profit from ordinary activities</b>	<b>39,102</b>
multiplied by the German income-tax rate of 37.08%	
= Calculated income-tax paid in business year	14,499
- Effects to differing tax rates	356
+ Non-deductible expenses with regard to the sale of holdings	352
+ Non-application of tax losses carried forward	1,599
- Other effects	353
<b>Total</b>	<b>15,741</b>

The income-tax rate selected as a basis for the transitional presentation is made up of the corporate income-tax rate of 26.5% introduced in Germany for 2003, plus the solidarity surcharge of 5.5%, and a rate of 14.5% for trade earnings tax. With the deductibility of trade earnings tax taken into consideration, the German income-tax rate is roughly 37.08%.

## Notes to the balance sheet

### (29) Cash reserve

Cash reserve includes the following items:

€ thousand	31.12.2003	31.12.2002	Change in %
Cash on hand	139	123	13.0
Balances held at central banks	1,610	5,058	-68.2
<b>Total</b>	<b>1,749</b>	<b>5,181</b>	<b>-66.2</b>

The minimum reserve requirement to be met at the end of December 2003 totalled €52,389 thousand

(2002: €38,257 thousand).

### (30) Claims on banks

€ thousand	31.12.2003	Total		Due on demand		Other claims	
		31.12.2002	Change in %	31.12.2003	31.12.2002	31.12.2003	31.12.2002
German banks	1,159,686	1,192,167	-2.7	560,349	657,867	599,337	534,300
Foreign banks	150,748	102,252	—	150,748	95,746	0	6,506
<b>Total</b>	<b>1,310,434</b>	<b>1,294,419</b>	<b>1.2</b>	<b>711,097</b>	<b>753,613</b>	<b>599,337</b>	<b>540,806</b>

Claims on banks include foreign-currency amounts equal to €150,056 thousand (2002: €95,746 thousand).

Claims on banks primarily consist of overnight money and fixed-term deposits (€1,269,398 thousand/2002: €1,293,095 thousand, incl. occurred interest).

### (31) Claims on customers

€ thousand	31.12.2003	Total		Due on demand		Other claims	
		31.12.2002	Change in %	31.12.2003	31.12.2002	31.12.2003	31.12.2002
<b>Claims on domestic customers</b>	<b>179,339</b>	<b>172,644</b>	<b>3.9</b>	<b>177,941</b>	<b>172,644</b>	<b>1,398</b>	<b>0</b>
Private customers	179,339	172,644	3.9	177,941	172,644	1,398	0
<b>Claims on foreign customers</b>	<b>4,434</b>	<b>2,777</b>	<b>59.7</b>	<b>4,434</b>	<b>2,777</b>	<b>0</b>	<b>0</b>
Private customers	4,434	2,777	59.7	4,434	2,777	0	0
<b>Total</b>	<b>183,773</b>	<b>175,421</b>	<b>4.8</b>	<b>182,375</b>	<b>175,421</b>	<b>1,398</b>	<b>0</b>

All claims on private customers are deemed to be due on demand. Claims on customers include €164,427 thousand (2002: €163,185 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 €440 thousand (2002: €196 thousand).

(32) Provision for possible loan losses

€thousand	Individual valuation allowances		Country valuation allowances		Global valuation allowances			Total		Change in %
	31.12.2003	31.12.2002	31.12.2003	31.12.2002	31.12.2003	31.12.2002	31.12.2003	31.12.2002		
<b>Balance as of 1 January</b>	<b>-6,306</b>	<b>-4,905</b>	<b>0</b>	<b>0</b>	<b>-49</b>	<b>-31</b>	<b>-6,355</b>	<b>-4,936</b>	<b>-28.7</b>	
Allocations	-1,744	-3,467	-254	0	-764	-18	-2,762	-3,485	20.7	
Deductions	3,351	2,066	0	0	0	0	3,351	2,066	-62.2	
of which utilised	447	510	0	0	0	0	447	510	12.4	
of which reversals	2,904	1,556	0	0	0	0	2,904	1,556	-86.6	
<b>Provision for possible loan losses as of 31 December</b>	<b>-4,699</b>	<b>-6,306</b>	<b>-254</b>	<b>0</b>	<b>-813</b>	<b>-49</b>	<b>-5,766</b>	<b>-6,355</b>	<b>9.3</b>	

The adjusted value of non-interest bearing and non-productive claims amounts to €3,808 thousand (2002: €4,339 thousand).

comdirect bank group made a direct write-down of €122 thousand (2002: €118 thousand) and recorded receipts on written-down claims in an amount of €15 thousand (2002: €10 thousand).

The total balance of risk provisions for credit default risks breaks down as:

€thousand	31.12.2003	31.12.2002
German borrowers	-4,674	-6,236
Foreign borrowers	-25	-70
<b>Total</b>	<b>-4,699</b>	<b>-6,306</b>

### (33) Investments and securities portfolio

The item investments and securities portfolio consists of all bonds, notes and other fixed-income securities, shares and other variable-yield securities not held for trading purposes, as well as investments, holdings in subsidiaries not included in the consolidation and claims not originated by the bank – promissory notes.

The financial instruments shown in the investments and securities portfolio are allocated to the category “available-for-sale” and, with the exception of investments and holdings in subsidiaries not included in the consolidation, are valued at market prices.

€ thousand	31.12.2003	31.12.2002	Change in %
Bonds, notes and other fixed-income securities of the “available-for-sale” portfolio	1,816,568	1,012,377	79.4
Money-market instruments	452,437	0	—
issued by public-sector borrowers	0	0	—
issued by other borrowers	452,437	0	—
Bonds and notes	1,364,131	1,012,377	34.7
issued by public-sector borrowers	27,693	24,031	15.2
issued by other borrowers	1,336,438	988,346	35.2
Shares and other variable-yield securities of the portfolio “available-for-sale”	14,668	31,658	-53.7
Investments	0	866	-100.0
Holdings in subsidiaries	27	12,800	-99.8
Claims on customers not originated by the company – promissory notes –	62,599	0	—
<b>Total</b>	<b>1,893,862</b>	<b>1,057,701</b>	<b>79.1</b>

As part of the securities lending business, financial instruments with a total market value of €13,954 thousand were lent as of the balance-sheet date on 31 December, 2003.

In January 2003, comdirect bank AG invested in WST-Broker GmbH, Frankfurt am Main, in the sum of €7 thousand. This company is to be excluded from the consolidation pursuant to IAS 27 since control does not exist.

On 29 August, 2003, Nasdaq Germany suspended trading. The investment in Nasdaq Germany in the amount of €866 thousand was therefore written down at a pro-memoria figure. In this context, comdirect bank AG transferred its holdings in the amount of 7.5% to Bremer Wertpapierbörse Holding AG (BWB) on 11 August, 2003.

The annual general meeting of comdirect bank S.p.A. i.L. declared the winding up of the business as completed on 22 May, 2003. The remaining assets of the company ascertained as part of the final balance of the liquidation was paid out to comdirect as the sole shareholder of comdirect bank S.p.A. i.L. in December 2003, after withdrawal from the Italian commercial register.

### (34) Intangible assets

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>	<b>Change in %</b>
Other intangible assets	11,905	14,094	-15.5

Changes in intangible assets are shown in the schedule of assets (note 36).

### (35) Fixed assets

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12. 2002</b>	<b>Change in %</b>
Land and buildings	3,309	3,309	0.0
Office and furniture equipment	17,551	24,866	-29.4
<b>Total</b>	<b>20,860</b>	<b>28,175</b>	<b>-26.0</b>

Changes in fixed assets are shown in the schedule of assets (note 36).



**(36) Schedule of assets**

	Land and buildings	Office furniture and equipment	
€ thousand		Software	Other
<b>Book value as of 1 January, 2003</b>	<b>3,309</b>	<b>3,548</b>	<b>21,318</b>
Costs of acquisition/manufacture as of 1 January, 2003	3,309	15,154	58,262
Additions 2003	0	492	3,281
Disposals 2003	0	-71	-1,020
Costs of acquisition/manufacture as of 31 December, 2003	3,309	15,575	60,523
Cumulative write-downs as of 1 January, 2003	0	11,606	36,944
Additions 2003	0	1,852	9,137
Disposals 2003	0	-37	-955
Cumulative write-downs as of 31 December, 2003	0	13,421	45,126
<b>Book value as of 31 December, 2003</b>	<b>3,309</b>	<b>2,154</b>	<b>15,397</b>

	Intangible assets	Investments	Holdings in subsidiaries
€ thousand			
<b>Book value as of 1 January, 2003</b>	<b>14,094</b>	<b>866</b>	<b>12,800</b>
Costs of acquisition/manufacture as of 1 January, 2003	39,795	11,366	12,800
Additions 2003	3,346	0	27
Disposals 2003	0	-866	-12,800
Costs of acquisition/manufacture as of 31 December, 2003	43,141	10,500	27
Cumulative write-downs as of 1 January, 2003	25,701	10,500	0
Additions 2003	5,535	866	0
Disposals 2003	0	-866	0
Cumulative write-downs as of 31 December, 2002	31,236	10,500	0
<b>Book value as of 31 December, 2003</b>	<b>11,905</b>	<b>0</b>	<b>27</b>

Additions to write-downs in business year 2003 relate to extraordinary write-downs of €604 thousand, that were made as part of the website relaunch. These are included in office furniture and equipment and intangible assets of the group.

### (37) Tax assets

Tax assets break down as follows:

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>	<b>Change in %</b>
Claims on the tax authorities from income taxes	0	8,512	-100.0
Deferred tax claims	0	3,189	-100.0
<b>Total</b>	<b>0</b>	<b>11,701</b>	<b>-100.0</b>

Deferred tax claims and liabilities are netted out, since they are both due to the same tax authority. As a result, we show deferred tax claims in business year 2003 (see also note 42).

Deferred tax claims were created in connection with the following balance-sheet items:

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>
Provision for possible loan losses	0	1
Investments and securities portfolio	0	-2,361
Intangible assets	0	-4,796
Fixed assets	0	162
Provisions	0	3,617
Equity	0	6,566
<b>Total</b>	<b>0</b>	<b>3,189</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%), which is valid again beginning in 2004, plus the solidarity surcharge (5.5%) and the trade tax (12.7%) taken together. This yields a domestic income-tax rate of 35.7%.

### (38) Other assets

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>	<b>Change in %</b>
Deferred items	2,790	3,111	-10.3
Sundry assets	6,523	5,825	12.0
<b>Total</b>	<b>9,313</b>	<b>8,936</b>	<b>4.2</b>

Other assets break down as follows:

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>
Claims on group companies	882	4,709
Claims on affiliated companies	14	9
Other	5,627	1,107
<b>Total</b>	<b>6,523</b>	<b>5,825</b>

**(39) Liabilities to banks**

€ thousand	Total			Due on demand		Other liabilities	
	31.12.2003	31.12.2002	Change in %	31.12.2003	31.12.2002	31.12.2003	31.12.2002
German banks	0	1,926	-100.0	0	1,926	0	0
Foreign banks	0	12,987	-100.0	0	12,987	0	0
<b>Total</b>	<b>0</b>	<b>14,913</b>	<b>-100.0</b>	<b>0</b>	<b>14,913</b>	<b>0</b>	<b>0</b>

**(40) Liabilities to customers**

€ thousand	Total			Due on demand		With agreed maturity or withdrawal period	
	31.12.2003	31.12.2002	Change in %	31.12.2003	31.12.2002	31.12.2003	31.12.2002
Liabilities to domestic private customers	2,577,648	1,822,191	41.5	1,600,471	1,749,450	977,177	72,741
Liabilities to foreign private customers	197,143	126,489	55.9	182,773	123,982	14,370	2,507
<b>Total</b>	<b>2,774,791</b>	<b>1,948,680</b>	<b>42.4</b>	<b>1,783,244</b>	<b>1,873,432</b>	<b>991,547</b>	<b>75,248</b>

Foreign-currency amounts equal to €143,237 thousand (2002: €85,067 thousand).

Through the German banks' depositor protection fund of the German banking association Bundesverband deutscher Banken e. V., Cologne, each customer of comdirect bank AG is insured for deposits of up to €63 million. In addition, comdirect bank AG is a member of Entschädigungseinrichtung deutscher Banken GmbH.

**(41) Provisions**

€ thousand	31.12.2003	31.12.2002	Change in %
Provisions for pensions and similar commitments	3,520	2,470	42.5
Other provisions	15,036	18,638	-19.3
<b>Total</b>	<b>18,556</b>	<b>21,108</b>	<b>-12.1</b>

The changes in provisions for pensions were as follows:

€ thousand	as of 1.1.2003	Utilised/ change	Depreciation	Allocation	as of 31.12.2003
Pension expectations of active employees	2,470	0	0	1,050	3,520

The allocations to pension provisions in 2003 break down as follows:

Service cost:	€983 thousand
Interest cost:	€162 thousand
Cost arising from changes in actuarial assumptions:	€74 thousand
Assets to be offset:	-€169 thousand

In business year 2003, comdirect bank AG made the first allocation to the assets of Commerzbank Pension-Trust e.V. In accordance with IAS 19, we set off these assets in the current values to be agreed upon against the allocations to the pension provisions.

Actuarial gains and losses are amortised over three years (2003: €74 thousand).

Parameters	31.12.2003	31.12.2002	31.12.2001
Calculatory interest rate	5.50%	5.75%	5.75%
Changes in salaries	3.25%	2.75%	3.00%
Changes in pensions	1.25%	1.50%	1.50%

Changes in other provisions:

€ thousand	as of 1.1.2003	Utilised/ change	Depreciation	Allocation	as of 31.12.2003
Provisions for staff	2,753	2,699	24	3,123	3,153
Provisions for anniversary bonuses	40	0	0	5	45
Provisions for non-income-related taxes	542	0	0	18	560
Provisions for contingent losses	8,162	1,678	1,920	3,641	8,205
Provisions for restructuring	6,455	6,081	0	1,124	1,498
Other provisions	686	362	245	1,496	1,575
<b>Total</b>	<b>18,638</b>	<b>10,820</b>	<b>2,189</b>	<b>9,407</b>	<b>15,036</b>

Provisions for staff mainly relate to provisions for bonuses. The provisions for staff will probably be used in the 2004 financial year.

Changes in provisions for contingent losses break down as follows:

€ thousand	as of 1.1.2003	Utilised/ change	Depreciation	Allocation	as of 31.12.2003
Implementation of the com one programme for the future	6,318	1,346	1,911	0	3,061
Products & Advertising	0	0	0	3,641	3,641
Restructuring	1,507	4	0	0	1,503
Other	337	328	9	0	0
<b>Provisions for contingent losses</b>	<b>8,162</b>	<b>1,678</b>	<b>1,920</b>	<b>3,641</b>	<b>8,205</b>

The scale of the contingent losses for the implementation of the com one programme for the future and for products & advertising were measured on the basis of the information about expected expenses that was available when the financial statements were prepared.

#### (42) Tax liabilities

Tax liabilities are comprised as follows:

€ thousand	31.12.2003	31.12.2002	Change in %
<b>Current tax liabilities</b>	<b>6,005</b>	<b>0</b>	—
Provisions for income taxes	6,005	0	—
<b>Deferred tax liabilities</b>	<b>1,365</b>	<b>0</b>	—
<b>Total</b>	<b>7,370</b>	<b>0</b>	—

Deferred tax claims and liabilities are netted out, since they are both due to the same tax authority. As a result, we show deferred tax claims in business year 2003 compared to business year 2002 (see also note 37).

Deferred tax liabilities were created in connection with the following balance-sheet items:

€ thousand	31.12.2003	31.12.2002
Provision for possible loan losses	-7	0
Investments and securities portfolio	1,312	0
Intangible assets	4,304	0
Fixed assets	-260	0
Provisions	-2,951	0
Equity	-1,033	0
<b>Total</b>	<b>1,365</b>	<b>0</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%), which is valid again beginning in 2004, plus the solidarity surcharge (5.5%) and the trade tax (12.7%) taken together. This yields a domestic income-tax rate of 35.7%.

### (43) Subordinated capital

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>	<b>Change in %</b>
Subordinated liabilities	6,391	6,391	0.0
of which: maturing within two years	6,391	0	—
Profit-sharing certificates outstanding	10,226	10,226	0.0
of which: maturing within two years	10,226	0	—
<b>Total</b>	<b>16,617</b>	<b>16,617</b>	<b>0.0</b>

Subordinated liabilities meet 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.

As end-2003, we held the following subordinated liabilities:

<b>Start of maturity</b>	<b>Amount € thousand</b>	<b>Interest rate per 31.12.2003</b>	<b>Maturity date</b>	<b>Issuer</b>
1996	6,391	3.66%	2006	Commerzbank AG

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 business year, comdirect bank AG incurred interest expenses on subordinated liabilities of €34 thousand (2002: €27 thousand).

The subordinated liability in the amount of €6,391 thousand was cancelled by mutual agreement in accordance with the agreement to revoke a debt dated 17 December, 2003 on the expiration of 31 December, 2003. After expiration of 31 December, 2003, the subordinated liability was reduced. With a letter dated 8 December, 2003, the Bundesanstalt für Finanzdienstleistungsaufsicht, the German financial authority, approved this reduction pursuant to Art. 10 (5a), sentence 5, KWG.

As of the end of business year 2003, we held the following profit-sharing certificates

<b>Start of maturity</b>	<b>Amount € thousand</b>	<b>Interest rate per 31.12.2003</b>	<b>Maturity date</b>	<b>Issuer</b>
1998	10,226	6.00%	2006	Commerzbank AG

During the business year, comdirect bank AG incurred interest expenses on profit-sharing certificates of €1,260 thousand (2002: €13 thousand).

Interest from profit-sharing certificates outstanding is paid only insofar as such payments do not lead to an accounting loss. In the case of such a situation, interest payments are to be made in the following business years. The claims of the holders of the profit-sharing certificates are subordinated to the claims of other creditors.

The profit-sharing certificate in the amount of €10,226 thousand was cancelled by mutual agreement in accordance with the agreement to revoke a debt dated 15 December, 2003 on the expiration of 31 December, 2003. After adoption of the financial statements showing a distributable profit, the profit-sharing certificate will be reduced. With a letter dated 2 December, 2003, the Bundesanstalt für Finanzdienstleistungsaufsicht, the German financial authority, approved this reduction pursuant to Art. 10 (5), sentence 4, KWG.

**(44) Maturities, by remaining lifetime**

€ thousand	Total	Remaining lifetimes as of 31.12.2003				
		Due on demand and unlimited in time	Up to three months	Three months to one year	One to five years	More than five years
Claims on banks	1,310,434	711,097	354,337	185,000	60,000	0
Claims on customers	183,773	182,375	1,398	0	0	0
Bonds, notes and other fixed-income securities of the “available-for-sale” portfolio	1,816,568	0	51,261	537,197	1,132,062	96,048
Claims on customers not originated by the bank – promissory notes –	62,599	2,113	0	0	60,486	0
<b>Total</b>	<b>3,373,374</b>	<b>895,585</b>	<b>406,996</b>	<b>722,197</b>	<b>1,252,548</b>	<b>96,048</b>
Liabilities to banks	0	0	0	0	0	0
Liabilities to customers	2,774,791	1,783,244	751,053	237,852	2,642	0
Subordinated capital	16,617	0	16,617	0	0	0
<b>Total</b>	<b>2,791,408</b>	<b>1,783,244</b>	<b>767,670</b>	<b>237,852</b>	<b>2,642</b>	<b>0</b>

€ thousand	Total	Remaining lifetimes as of 31.12.2002				
		Due on demand and unlimited in time	Up to three months	Three months to one year	One to five years	More than five years
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>

Time remaining to maturity is considered as the period between the balance-sheet date and the contractual maturity of the claim or the obligation.



**(45) Claims on/liabilities to affiliated companies**

<b>€ thousand</b>	<b>31.12.2003</b>	<b>31.12.2002</b>	<b>Change in %</b>
Claims on banks	338,495	341,463	-0.9
Liabilities to banks	0	14,913	-100.0
Subordinated capital	16,617	16,617	0.0
<b>Total</b>	<b>355,112</b>	<b>372,993</b>	<b>-4.8</b>

**(46) Interest-rate risks**

	<u>Interest assets</u>		<u>Interest liabilities</u>		<u>Interest gap € million</u>	<u>Interest differential % points</u>
	€ million	interest in %	€ million	interest in %		
Up to one year	2,196	2.72	2,728	1.66	-532	1.06
One to five years	906	3.58	485	3.33	421	0.25
More than five years	59	4.17	0	0.00	59	4.17
	<u>GBP million</u>	<u>interest in %</u>	<u>GBP million</u>	<u>interest in %</u>	<u>GBP million</u>	<u>% points</u>
Up to one year	4	3.65	0	0.00	4	3.65

**(47) Number of employees at the end of the reporting period**

	<u>31.12.2003</u>			<u>31.12.2002</u>			<u>Change (Total) in %</u>
	Total	Female	Male	Total	Female	Male	
<b>Employees at the end of the reporting period</b>	<b>589</b>	<b>276</b>	<b>313</b>	<b>922</b>	<b>450</b>	<b>472</b>	<b>-36</b>
In Germany	512	254	258	859	431	428	-40
Abroad	77	22	55	63	19	44	22
At comdirect bank AG	503	253	250	859	431	428	-41
of which:							
in the call centre	184	101	83	366	184	182	-50
in the back office	133	93	40	225	154	71	-41
in other areas	186	59	127	268	93	175	-31

The details listed above with regard to our employees include both full-time and part-time personnel.

**(48) Income statement of comdirect bank group according to IFRS/IAS on a year-to-year comparison**

<b>€ thousand</b>	<b>01.01. to 31.12.2003</b>	<b>01.01. to 31.12.2002</b>	<b>01.01. to 31.12.2001</b>	<b>01.01. to 31.12.2000</b>
Interest income	84,889	99,220	138,621	121,046
Interest expenses	27,682	35,324	64,538	63,329
<b>Net interest income before provisions</b>	<b>57,207</b>	<b>63,896</b>	<b>74,083</b>	<b>57,717</b>
Provision for possible loan losses	35	-2,037	-2,074	-1,966
<b>Net interest income after provisions</b>	<b>57,242</b>	<b>61,859</b>	<b>72,009</b>	<b>55,751</b>
Commission income	96,686	79,024	96,957	192,656
Commission expenses	13,579	1,882	3,939	1,793
<b>Net commission income</b>	<b>83,107</b>	<b>77,142</b>	<b>93,018</b>	<b>190,863</b>
Trading profit/loss	0	-285	-29	-133
Income/loss from investments and securities portfolio	4,760	1,200	344	0
<b>Administrative expenses</b>	<b>112,494</b>	<b>138,138</b>	<b>224,317</b>	<b>220,951</b>
Personnel costs	31,673	38,721	51,432	43,513
Other administrative expenses	64,297	76,157	144,179	159,162
Marketing costs	12,364	14,530	55,356	59,148
Communication costs	4,042	10,792	16,552	19,929
Consulting costs	9,396	8,956	12,510	22,105
External services	17,942	23,477	28,992	38,675
Sundry operating expenses	20,553	18,402	30,769	19,305
Depreciation on office furniture and equipment and intangible assets	16,524	23,260	28,706	18,276
Other operating result	6,487	2,917	6,659	35
<b>Profit from ordinary activities</b>	<b>39,102</b>	<b>4,695</b>	<b>-52,316</b>	<b>25,565</b>
Extraordinary result and restructuring costs	0	-23,295	-98,264	0
<b>Pre-tax profit/loss</b>	<b>39,102</b>	<b>-18,600</b>	<b>-150,580</b>	<b>25,565</b>
Taxes on income	15,741	-8,836	10,077	23,371
<b>After-tax profit/loss</b>	<b>23,361</b>	<b>-9,764</b>	<b>-160,657</b>	<b>2,194</b>
Profit/loss attributable to minority interests	0	0	0	484
<b>Net profit/loss</b>	<b>23,361</b>	<b>-9,764</b>	<b>-160,657</b>	<b>2,678</b>

(49) Income statement of comdirect bank group according to IFRS/IAS on a quarterly comparison

€thousand	2003			
	Q1	Q2	Q3	Q4
Interest income	20,854	19,566	18,883	25,586
Interest expenses	5,484	3,925	4,071	14,202
<b>Net interest income before provisions</b>	<b>15,370</b>	<b>15,641</b>	<b>14,812</b>	<b>11,384</b>
Provision for possible loan losses	-370	-247	0	652
<b>Net interest income after provisions</b>	<b>15,000</b>	<b>15,394</b>	<b>14,812</b>	<b>12,036</b>
Commission income	18,720	24,208	28,085	25,673
Commission expenses	2,793	3,207	3,817	3,762
<b>Net commission income</b>	<b>15,927</b>	<b>21,001</b>	<b>24,268</b>	<b>21,911</b>
Trading profit/loss	0	0	0	0
Income/loss from investments and securities portfolio	775	2,224	492	1,269
<b>Administrative expenses</b>	<b>27,961</b>	<b>28,351</b>	<b>24,689</b>	<b>31,493</b>
Personnel costs	8,101	7,934	6,808	8,830
Other administrative expenses	16,126	16,434	13,667	18,070
Marketing costs	3,031	2,439	2,661	4,233
Communication costs	1,697	858	778	709
Consulting costs	2,038	1,972	880	4,506
External services	4,832	4,420	3,820	4,870
Sundry operating expenses	4,528	6,745	5,528	3,752
Depreciation on office furniture and equipment and intangible assets	3,734	3,983	4,214	4,593
Other operating result	957	98	1,938	3,494
<b>Profit from ordinary activities</b>	<b>4,698</b>	<b>10,366</b>	<b>16,821</b>	<b>7,217</b>
Extraordinary result and restructuring costs	0	0	0	0
<b>Pre-tax profit/loss</b>	<b>4,698</b>	<b>10,366</b>	<b>16,821</b>	<b>7,217</b>
Taxes on income	2,275	4,164	6,093	3,209
<b>After-tax profit/loss</b>	<b>2,423</b>	<b>6,202</b>	<b>10,728</b>	<b>4,008</b>
<b>Net profit/loss</b>	<b>2,423</b>	<b>6,202</b>	<b>10,728</b>	<b>4,008</b>

€thousand	2002			
	Q1	Q2	Q3	Q4
Interest income	25,110	25,592	24,821	23,697
Interest expenses	8,457	8,916	9,698	8,253
<b>Net interest income before provisions</b>	<b>16,653</b>	<b>16,676</b>	<b>15,123</b>	<b>15,444</b>
Provision for possible loan losses	-130	-37	-296	-1,574
<b>Net interest income after provisions</b>	<b>16,523</b>	<b>16,639</b>	<b>14,827</b>	<b>13,870</b>
Commission income	22,592	17,964	19,621	18,847
Commission expenses	648	62	557	615
<b>Net commission income</b>	<b>21,944</b>	<b>17,902</b>	<b>19,064</b>	<b>18,232</b>
Trading profit/loss	-169	-116	0	0
Income/loss from investments and securities portfolio	318	530	308	44
<b>Administrative expenses</b>	<b>38,911</b>	<b>33,459</b>	<b>33,201</b>	<b>32,567</b>
Personnel costs	11,249	9,533	10,343	7,596
Other administrative expenses	22,129	18,025	17,102	18,901
Marketing costs	3,868	3,319	3,475	3,868
Communication costs	3,603	2,385	1,968	2,836
Consulting costs	1,984	2,130	3,226	1,616
External services	6,233	6,030	5,244	5,970
Sundry operating expenses	6,441	4,161	3,189	4,611
Depreciation on office furniture and equipment and intangible assets	5,533	5,901	5,756	6,070
Other operating result	593	742	812	770
<b>Profit from ordinary activities</b>	<b>298</b>	<b>2,238</b>	<b>1,810</b>	<b>349</b>
Extraordinary result and restructuring costs	0	0	-31,967	8,672
<b>Pre-tax profit/loss</b>	<b>298</b>	<b>2,238</b>	<b>-30,157</b>	<b>9,021</b>
Taxes on income	2,118	134	-9,910	-1,178
<b>After-tax profit/loss</b>	<b>-1,820</b>	<b>2,104</b>	<b>-20,247</b>	<b>10,199</b>
<b>Net profit/loss</b>	<b>-1,820</b>	<b>2,104</b>	<b>-20,247</b>	<b>10,199</b>

**(50) Segment reporting by business lines**

€ thousand	1.1. to 31.12.2003			
	comdirect online	comdirect offline	Group management/ consolidation/ others	comdirect bank group total
Net interest income before provisions	57,184	23	0	57,207
Provision for possible loan losses	35	0	0	35
Net interest income after provisions	57,219	23	0	57,242
Net commission income	83,094	13	0	83,107
Trading profit/loss	0	0	0	0
Income/loss from investments and securities portfolio	4,760	0	0	4,760
Administrative expenses	109,044	4,209	-759	112,494
Other operating result	7,217	29	-759	6,487
<b>Profit/loss from ordinary activities</b>	<b>43,246</b>	<b>-4,144</b>	<b>0</b>	<b>39,102</b>
Extraordinary result and restructuring costs	0	0	0	0
<b>Pre-tax profit/loss</b>	<b>43,246</b>	<b>-4,144</b>	<b>0</b>	<b>39,102</b>
Taxes on income	14,828	-1,033	1,946	15,741
<b>After-tax profit/loss</b>	<b>28,418</b>	<b>-3,111</b>	<b>-1,946</b>	<b>23,361</b>
<b>Net profit/loss</b>	<b>28,418</b>	<b>-3,111</b>	<b>-1,946</b>	<b>23,361</b>
Acquisition costs of segment	6,385	734		7,119
Depreciation on segment assets	16,507	17		16,524
Cost/income ratio	71.6	6,475.4		74.2%
Segment income	195,252	89	-782	194,559
Segment expenses	152,006	4,233	-782	155,457
Segment assets	3,383,978	1,839	-1,765	3,384,052
Segment debt	2,776,556	0	-1,765	2,774,791

Allocation to the segments is based on the business lines of the comdirect bank group. Determination of the business lines was carried out in compliance with IAS 14 and its principles of materiality. A comparative presentation is not available for the primary reporting since comdirect private finance AG did not begin operations until 1 October, 2003.

**(51) Segment reporting by geographical markets**

€ thousand	1.1. to 31.12.2003			
	comdirect Germany	comdirect Europe without Germany	Group management/ consolidation/ others	comdirect bank group total
Net interest income before provisions	54,157	3,050	0	57,207
Provision for possible loan losses	35	0	0	35
Net interest income after provisions	54,192	3,050	0	57,242
Net commission income	76,764	6,343	0	83,107
Trading profit/loss	0	0	0	0
Income/loss from investments and securities portfolio	4,760	0	0	4,760
Administrative expenses	98,620	13,874	0	112,494
Other operating result	6,487	0	0	6,487
<b>Profit/loss from ordinary activities</b>	<b>43,583</b>	<b>-4,481</b>	<b>0</b>	<b>39,102</b>
Extraordinary result and restructuring costs	0	0	0	0
<b>Pre-tax profit/loss</b>	<b>43,583</b>	<b>-4,481</b>	<b>0</b>	<b>39,102</b>
Taxes on income	15,741	0	0	15,741
<b>After-tax profit/loss</b>	<b>27,842</b>	<b>-4,481</b>	<b>0</b>	<b>23,361</b>
<b>Net profit/loss</b>	<b>27,842</b>	<b>-4,481</b>	<b>0</b>	<b>23,361</b>
Acquisition costs of segment assets	7,119	0		7,119
Depreciation on segment assets	14,411	2,113		16,524
Cost/income ratio	69.4%	147.7%		74.2%
Segment income	183,742	10,817		194,559
Segment expenses	140,159	15,298		155,457
Segment assets	3,233,552	150,500		3,384,052
Segment debt	2,631,559	143,232		2,774,791

## Segment reporting by geographical markets

€ thousand	1.1. to 31.12.2002			
	comdirect Germany	comdirect Europe without Germany	Group management/ consolidation/ others	comdirect bank group total
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
Income/loss from investments and securities portfolio	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 result 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>
<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	87.2%	317.5%	—	96.2%
Segment income	177,972	5,936	-1,503	182,405
Segment expenses	162,006	16,904	0	178,910
Segment assets	2,430,426	95,941	0	2,526,367
Segment debt	1,878,527	85,066	0	1,963,593

## (52) Other liabilities

Rental and leasing agreements concluded by comdirect bank group will lead to expenses of €5,553 thousand during 2004 business year, €3,242 thousand for each of the years 2005 to 2008, and €2,037 thousand as of the year 2009.

## (53) Off-balance-sheet commitments

€ thousand	31.12.2003	31.12.2002	Change in %
Contingent liabilities			
from guarantees and indemnity agreements			
Leasing guarantees	81	0	—

## (54) Letter of comfort

On the part of comdirect bank AG, letters of comfort were submitted for comdirect private finance AG, a fully-owned subsidiary of comdirect bank AG, vis-à-vis insurance companies with which comdirect private finance AG has concluded product delivery agreements.

comdirect bank AG therein obliges itself to the benefit of comdirect private finance AG that the company, as subsidiary of comdirect bank AG, will be managed and financially endowed and will remain endowed in such a manner that at all times it is able to meet in a timely manner its possible obligations of repayment of commissions and fees resulting from the brokerage of insurance business stemming from the commission and fee agreements with the insurance companies.

This letter of comfort is in effect until a profit and loss transfer agreement is concluded between comdirect bank AG and comdirect private finance AG. It is valid at most until 31 December, 2005.

These letters of comfort are subject to the laws of the Federal Republic of Germany. Place of jurisdiction is Hamburg, Federal Republic of Germany.

comdirect private finance AG started operating activities on October 1, 2003. As a consequence, the principle of materiality was applied in this case.

No additional letters of comfort were submitted for comdirect private finance AG or for other subsidiaries consolidated in the financial statements and special purpose vehicles.



**(55) 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).

**(56) The company's boards**

**Supervisory Board**

**Martin Blessing**

Frankfurt am Main  
Chairman of the Supervisory Board  
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 Supervisory Board  
of Commerzbank AG,  
Frankfurt am Main

**Rainer Beaujean**

Darmstadt  
Member of the Board of Managing Directors  
of T-Online International AG,  
Darmstadt

**Angelika Kierstein**

Quickborn  
Chairman of Staff Council  
of comdirect bank AG  
Commercial employee

**Dr. Eric Strutz**

Frankfurt am Main  
CFO of Commerzbank AG,  
Frankfurt am Main  
(Appointment to member of the Board of  
Managing Directors of Commerzbank AG  
as of 1 April, 2004)

**Maria Xiromeriti**

Quickborn  
Deputy Chairman of Staff Council  
of comdirect bank AG  
Commercial employee

**Board of Managing Directors**

**Dr. Achim Kassow**, CEO

**Dr. Andre Carls**

**Hans-Joachim Nitschke** (until 6 November, 2003)

### (57) 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:

€ thousand	31.12.2003	31.12.2002	Change in %
<b>Board of Managing Directors</b>	<b>1,559</b>	<b>961</b>	<b>62</b>
of which: non-variable	1,188	700	70
of which: variable	371	261	42
<b>Supervisory Board</b>	<b>23</b>	<b>23</b>	<b>0</b>
of which: non-variable	23	23	0
of which: variable	0	0	—
<b>Former members of the Board of Managing Directors</b>	<b>615</b>	<b>200</b>	<b>208</b>

Neither advance payments nor loans were extended. comdirect did not take on any contingent liabilities.

### Components with long-term incentive effect

Details on the value of the subscription rights from the stock option programme granted to members of the Board of Managing Directors:

	Number	Value per option €	31.12.2003 Total value € thousand
Tranche 1, subset A	0	0.59	0
Tranche 1, subset B	0	0.00	0
Tranche 2, subset A	6,750	0.73	5
Tranche 2, subset B	6,750	0.00	0
Tranche 3, subset A	32,500	0.73	24
Tranche 3, subset B	32,500	3.66	119
Tranche 4, subset A	45,000	0.00	0
Tranche 4, subset B	45,000	0.00	0
<b>Total tranches</b>	<b>168,500</b>		<b>148</b>

As of the balance-sheet date, no exercise window existed for any of the tranches.

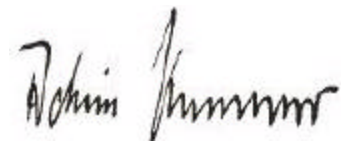
To determine a value as per the balance-sheet date of the subscription rights from the stock option programme, we met the following assumptions:

- 1.) The exercise price of the option is the XETRA closing price of the comdirect bank share on 30 December, 2003 of €7.33
- 2.) The final quotation of the Prime Financial Services Price Index is 285.22.

## Holdings

Name	Domicile	Share of capital held in %		Equity in thousand
comdirect ltd	London/United Kingdom	100.0	GBP	9,857
comdirect nominee ltd	London/United Kingdom	100.0	GBP	(1.00)
comdirect private finance AG	Quickborn/Germany	100.0	EUR	5,000
WST-Broker GmbH	Frankfurt am Main/Germany	54.0	EUR	50

Quickborn, 16 February, 2004  
The Board of Managing Directors



Dr. Achim Kassow



Dr. Andre Carls

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**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
For the years ended 31 December 2002 and 2001**

**COMDIRECT BANK AKTIENGESELLSCHAFT**

**CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
AS OF DECEMBER 31, 2002 AND 2001**

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**INCOME STATEMENT OF  
COMDIRECT BANK GROUP  
ACCORDING TO IAS (UNAUDITED)**

	<u>Notes</u>	<u>1.1.-31.12.2002</u> <u>(€ thousand)</u>	<u>1.1.-31.12.2001</u> <u>(€ thousand)</u>
<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>		4,695	(52,316)
Extraordinary results and restructuring costs	(27)	(23,295)	(98,264)
<b>Pre-tax profit/loss</b>		(18,600)	(150,580)
Taxes on income	(28)	(8,836)	10,077
<b>After-tax profit/loss</b>		(9,764)	(160,657)
<b>Net loss</b>		(9,764)	(160,657)
Transfer to reserves/Transfer from reserves		9,764	160,657
<b>Consolidated profit/loss</b>		<u>0</u>	<u>0</u>
<b>EARNINGS PER SHARE</b>			
		<u>1.1.-31.12.2002</u>	<u>1.1.-31.12.2001</u>
<b>EARNINGS PER SHARE</b>			
Net loss	(€thousand)	(9,764)	(160,657)
Average number of ordinary shares	Shares	140,500,000	140,500,000
<b>Basic earnings per share</b>	€	<u>(0.07)</u>	<u>(1.14)</u>
		<u>1.1.-31.12.2002</u>	<u>1.1.-31.12.2001</u>
<b>DILUTED EARNINGS PER SHARE</b>			
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>	€	<u>(0.07)</u>	<u>(1.14)</u>

**BALANCE SHEET OF  
COMDIRECT BANK GROUP  
ACCORDING TO IAS (UNAUDITED)**

<u>ASSETS</u>	<u>Notes</u>	<u>as of 31.12.2002</u>	<u>as of 31.12.2001</u>
		(€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><u>2,589,273</u></b>	<b><u>2,974,011</u></b>
<u>LIABILITIES AND EQUITY</u>	<u>Notes</u>	<u>as of 31.12.2002</u>	<u>as of 31.12.2001</u>
		(€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><u>2,589,273</u></b>	<b><u>2,974,011</u></b>



**STATEMENT OF CHANGES IN EQUITY  
OF COMDIRECT BANK GROUP  
(UNAUDITED)**

	<u>Subscribed capital</u>	<u>Capital reserve</u>	<u>Retained earnings</u>	<u>Revaluation reserve</u>	<u>Consolidated profit/loss</u>	<u>Total 2002</u>	<u>Total 2001</u>
	(€thousand)						
<b>Equity as of 1.1</b>	<b><u>140,500</u></b>	<b><u>394,327</u></b>	<b><u>42,200</u></b>	<b><u>1,083</u></b>	<b><u>0</u></b>	<b><u>578,110</u></b>	<b><u>739,698</u></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><u>140,500</u></b>	<b><u>367,221</u></b>	<b><u>55,658</u></b>	<b><u>329</u></b>	<b><u>0</u></b>	<b><u>563,708</u></b>	<b><u>578,110</u></b>

**CASH FLOW STATEMENT  
OF COMDIRECT BANK GROUP  
(UNAUDITED)**

	<u>1.1.-31.12.2002</u>	<u>1.1.-31.12.2001</u>
	(€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
<b>Cash and cash equivalents as at the end of the period</b>	<u><b>5,181</b></u>	<u><b>72,005</b></u>

Cash and cash equivalents correspond to the balance-sheet item Cash reserve and include cash on hand and balances held at central banks.

## **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.

**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.

**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.

**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 €6,619 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.

**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.

**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.

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.



**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**

	<u>2002</u>	<u>2001</u>
	(€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><u>63,896</u></b>	<b><u>74,083</u></b>

**(22) Provision for possible loan losses**

The provisions of the comdirect Group break down as follows:

	<u>2002</u>	<u>2001</u>
	(€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><u>(2,037)</u></b>	<b><u>(2,074)</u></b>

**(23) Net commission income**

	<u>2002</u>	<u>2001</u>
	(€thousand)	
Securities transactions	75,659	89,316
Payment transactions	1,406	3,335
Other commissions	77	367
<b>Total</b>	<b><u>77,142</u></b>	<b><u>93,018</u></b>

**(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.

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

	<b>2002</b>	<b>2001</b>
	(€ thousand)	
<b>Result of securities trading</b>	<b>(134)</b>	<b>(332)</b>
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
<b>Total</b>	<b><u>(285)</u></b>	<b><u>(29)</u></b>

**(25) Administrative expenses**

*Personnel costs*

	<b>2002</b>	<b>2001</b>
	(€ 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)
<b>Total</b>	<b><u>(38,721)</u></b>	<b><u>(51,432)</u></b>

*Breakdown of expenses for pensions and other employee benefits*

	<b>2002</b>	<b>2001</b>
	(€ thousand)	
Costs of company pension scheme	(900)	(535)
Contributions to Versicherungsverein des Bankengewerbes a.G (BVV)	(3)	(15)
<b>Total</b>	<b><u>(903)</u></b>	<b><u>(550)</u></b>

*Other administrative expenses*

	<b>2002</b>	<b>2001</b>
	(€ 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)
Sundry operating expenses	(18,402)	(30,769)
<b>Total</b>	<b><u>(76,157)</u></b>	<b><u>(144,179)</u></b>

\*) 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*

	<b>2002</b>	<b>2001</b>
	(€ thousand)	
Office furniture and equipment	(14,742)	(23,986)
Intangible assets	(8,518)	(4,720)
<b>Total</b>	<b><u>(23,260)</u></b>	<b><u>(28,706)</u></b>

**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.

	<u>2002</u>	<u>2001</u>
	(€ 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	<u>1,359</u>	<u>4,549</u>
<b>Total</b>	<b><u>2,917</u></b>	<b><u>6,659</u></b>

**(27) Extraordinary result and restructuring costs**

comdirect's extraordinary result and restructuring costs mainly comprise the following expenses and income:

	<u>2002</u>	<u>2001</u>
	(€ 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	<u>14,136</u>	<u>0</u>
<b>Total</b>	<b><u>(23,295)</u></b>	<b><u>(98,264)</u></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>

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

*Transitional presentation of taxes on income*

	<b>2002</b>
	<b>(€ thousand)</b>
<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
<b>Total</b>	<b>(8,836)</b>

**(29) Cash reserve**

Cash reserve breaks down as follows:

	<b>31.12.2002</b>	<b>31.12.2001</b>
	<b>(€ thousand)</b>	
Cash on hand	123	232
Balances held at central banks	5,058	71,773
<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 €8,257 thousand (2001: €44,756 thousand).

**(30) Claims on banks**

	<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>
	<b>(€ thousand)</b>					
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
<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 €5,746 thousand (2001: €39,310 thousand).

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>
	<b>(€ thousand)</b>					
<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 €63,185 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 €96 thousand (2001: €75 thousand).

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

**(32) Provision for possible loan losses**

	<u>Credit default risks</u>		<u>General provisions</u>		<u>Total</u>	
	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€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
<b>Provision for possible loan losses as of 31 December</b>	<b><u>(6,306)</u></b>	<b><u>(4,905)</u></b>	<b><u>(49)</u></b>	<b><u>(31)</u></b>	<b><u>(6,355)</u></b>	<b><u>(4,936)</u></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 €18 thousand (2001: €22 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:

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€thousand)	
German borrowers	(6,236)	(4,831)
Foreign borrowers	(70)	(74)
<b>Total</b>	<b><u>(6,306)</u></b>	<b><u>(4,905)</u></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.

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€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 derivative financial instruments</b>	<b>0</b>	<b>938</b>
Interest-rate derivatives	0	938
<b>Total</b>	<b><u>0</u></b>	<b><u>2,164</u></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.

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€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><u>1,057,701</u></b>	<b><u>861,212</u></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**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€thousand)	
Other intangible assets	<u>14,094</u>	<u>22,076</u>

Changes in intangible assets are shown in the schedule of assets (note 37).

**(36) Fixed assets**

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€thousand)	
Land and buildings	3,309	0
Office and furniture equipment	24,866	45,816
<b>Total</b>	<b><u>28,175</u></b>	<b><u>45,816</u></b>

Changes in fixed assets are shown in the schedule of assets (note 37).

**(37) Schedule of assets**

	<u>Land and buildings</u>	<u>Office furniture and equipment</u>	
		<u>Software</u>	<u>Other</u>
	(€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><u>3,309</u></b>	<b><u>3,548</u></b>	<b><u>21,318</u></b>

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

	<u>Intangible assets</u>	<u>Investments</u> (€ thousand)	<u>Holdings in subsidiaries</u>
<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><u>14,094</u></b>	<b><u>866</u></b>	<b><u>12,800</u></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:

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€ thousand)	
Claims on the tax authorities from income taxes	8,512	9,634
Deferred tax claims	3,189	0
<b>Total</b>	<b><u>11,701</u></b>	<b><u>9,634</u></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:

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€ 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
<b>Total</b>	<b><u>3,189</u></b>	<b><u>0</u></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
<b>Total</b>	<b><u>8,936</u></b>	<b><u>18,200</u></b>

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

Other assets breaks down as follows:

	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€thousand)	
Claims on Group companies	4,709	8,494
Claims on affiliated companies	9	0
Other	1,107	4,013
<b>Total</b>	<b><u>5,825</u></b>	<b><u>12,507</u></b>

**(40) Liabilities to banks**

	<u>Total</u>		<u>Due on demand</u>		<u>Other liabilities</u>	
	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€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><u>14,913</u></b>	<b><u>0</u></b>	<b><u>14,913</u></b>	<b><u>0</u></b>	<b><u>0</u></b>	<b><u>0</u></b>

**(41) Liabilities to customers**

	<u>Total</u>		<u>Due on demand</u>		<u>With agreed maturity or withdrawal period</u>	
	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2002</u>	<u>31.12.2001</u>
	(€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><u>1,948,680</u></b>	<b><u>2,289,327</u></b>	<b><u>1,873,432</u></b>	<b><u>2,242,546</u></b>	<b><u>75,248</u></b>	<b><u>46,781</u></b>

Foreign-currency amounts equal to €5,067 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><u>21,108</u></b>	<b><u>51,351</u></b>

The changes in provisions for pensions developed as follows:

	as of <u>1.1.2002</u>	Utilised/ change	Depreciation	Allocation	as of <u>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)



**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

Actuarial gains and losses are amortised over three years (2002: € thousand).

<u>Parameters</u>	<u>31.12.2002</u>	<u>31.12.2001</u>	<u>31.12.2000</u>
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:

	<u>as of</u> <u>1.1.2002</u>	<u>Utilised</u>	<u>Reversal</u>	<u>Allocation</u>	<u>as of</u> <u>31.12.2002</u>
			<b>(€ thousand)</b>		
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><u>49,576</u></b>	<b><u>38,706</u></b>	<b><u>7,958</u></b>	<b><u>15,726</u></b>	<b><u>18,638</u></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:

	<u>as of</u> <u>1.1.2002</u>	<u>Utilised</u>	<u>Reversal</u>	<u>Allocation</u>	<u>as of</u> <u>31.12.2002</u>
			<b>(€ thousand)</b>		
<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:

	<u>31.12.2002</u>	<u>31.12.2001</u>
		<b>(€ thousand)</b>
<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>
<b>Total</b>	<b><u>0</u></b>	<b><u>10,444</u></b>

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).

**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)
<b>Total</b>	<u><u>0</u></u>	<u><u>4,761</u></u>

**(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
<b>Total</b>	<u><u>16,617</u></u>	<u><u>16,617</u></u>

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</u> <u>€ thousand</u>	<u>Interest rate</u> <u>per 31.12.2002</u>	<u>Maturity</u> <u>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.

Terms of the profit-sharing certificates outstanding:

<u>Start of maturity</u>	<u>Amount</u> <u>€ thousand</u>	<u>Interest rate</u> <u>per 31.12.2002</u>	<u>Maturity</u> <u>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.

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

**(45) Maturities, by remaining lifetimes**

	<b>Remaining lifetimes as of 31.12.2002</b>					
	<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)					
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>

	<b>Remaining lifetimes as of 31.12.2001</b>					
	<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)					
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**

	<b>31.12.2002</b>	<b>31.12.2001</b>
	(€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**

	<b>Interest assets</b>		<b>Interest liabilities</b>		<b>Interest gap</b>	<b>Interest differential</b>
	<b>€million</b>	<b>interest in %</b>	<b>€million</b>	<b>interest in %</b>	<b>€million</b>	<b>% points</b>
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
	<b>GBP million</b>	<b>interest in %</b>	<b>GBP million</b>	<b>interest in %</b>	<b>GBP million</b>	<b>% points</b>
Up to one year	7	3.80	0	0.00	7	3.80

**COMDIRECT BANK GROUP**  
**NOTES (UNAUDITED) — (Continued)**

**(48) Number of employees at the end of the reporting period**

	<u>31.12.2002</u>	<u>31.12.2001</u>
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:

	<u>comdirect Germany</u>	<u>comdirect Europe, excluding Germany</u>	<u>Group management/ others/ consolidation</u>	<u>comdirect bank group total</u>
	(€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>
<b>Acquisition costs of segment assets</b>	<b>7,313</b>	<b>1,789</b>	<b>0</b>	<b>9,102</b>
<b>Depreciation on segment assets</b>	<b>20,991</b>	<b>2,269</b>	<b>0</b>	<b>23,260</b>
<b>Cost-income-ratio</b>	<b>0.8715</b>	<b>3.1753</b>	<b>—</b>	<b>0.9615</b>
<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.

**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

**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

**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:

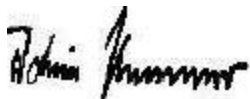
	<b>2002</b>	<b>2001</b>
	<b>(€thousand)</b>	
Board of Managing Directors	961	1,290
of which: non-variable	700	794
of which: variable	261	496
Supervisory Boards	23	87

Neither advance payments nor loans were extended. comdirect did not take on any contingent liabilities.

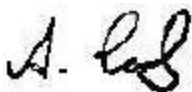
**Holdings**

<b>Name</b>	<b>Domicile</b>	<b>Share of capital held in %</b>	<b>Equity in thousand</b>
comdirect ltd.	London/United Kingdom	100.0	GBF 9,857
comdirect nominee ltd.	London/United Kingdom	100.0	GBF (1.00)
comdirect bank S.p.A. i.L.	Milan/Italy	100.0	EUR 12,800

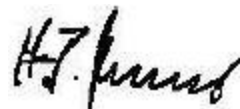
Quickborn, 14 February, 2003  
The Board of Managing Directors



Dr. Achim Kassow



Dr. Andre Carls



Hans-Joachim Nitschke





