

**Translation – the German version is authoritative**

**TELES AG Aktiengesellschaft Informationstechnologien  
Berlin**

**Consolidated Financial Statements as of December 31, 2005  
and Management Report for TELES Group 2005**

**Auditor's Report**

**This is a translation of the German Report.  
The German version is authoritative**

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Group Management Report for the Financial Year 2005

Consolidated Financial Statements for the Financial Year 2005

Auditor's Report

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**Group Management Report**  
**of TELES AG Informationstechnologien for the Financial Year 2005**

## **A. General Economic Situation/ Industry Development**

The economy continued to grow throughout the world, including Europe and Germany, in 2005. The Western European and German information and telecommunications industry also maintained its expansion course.

In the market segment for broadband Internet services served by TELES the number of households with a high-speed Internet connection once again increased significantly throughout Europe in the period under review. In Germany alone the number of households with broadband Internet rose from 17% to 27%. This corresponds to growth of over 50%. It is expected that this growth trend will also continue in the years to come.

To date, however, growth in this market segment has mainly been driven by the conventional broadband technologies. In contrast, wireless broadband Internet still plays a negligible role.

The market segment for telecommunications systems served by TELES was mainly influenced by two factors in the period under review. Firstly, the market for the conventional TDM switching technology can be considered largely saturated. In addition, the telephone companies are focussing increasingly on the use of VoIP (Voice over Internet Protocol) technology for cheap telephony via the Internet.

## **B. Group Economic Situation**

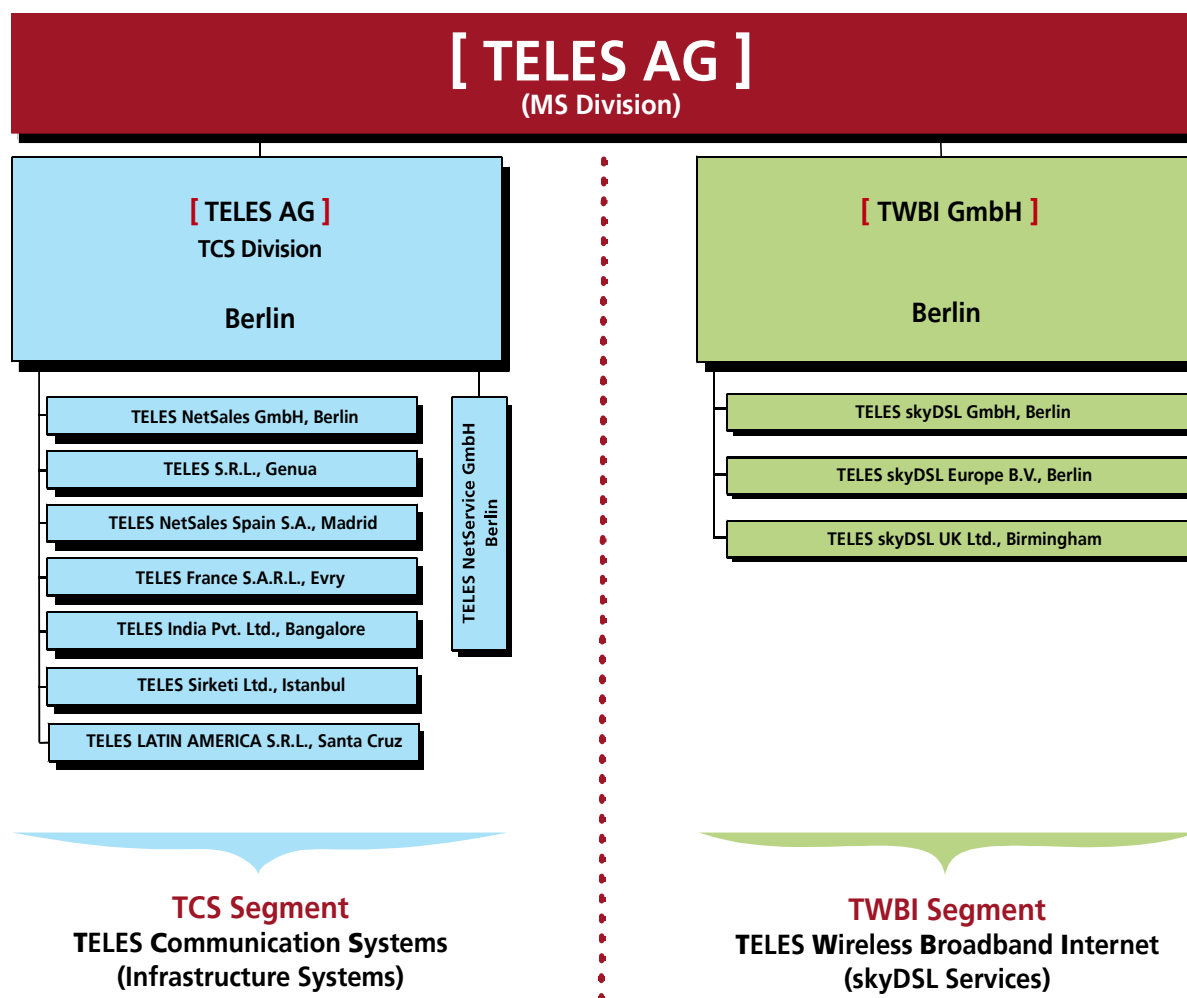
When looking at the Group's economic situation, attention should first be drawn to the fact that the Group structure was streamlined in the year 2005, bringing about a further significant improvement in its already solid financial footing.

The sale of the WebHosting business division to freenet.de AG (freenet) resulted at the beginning of the period under review not only in an 80 Mio€ cash payment and 3.1 million freenet shares, but also in Income from Discontinued Operations, net of tax, amounting to almost 124 Mio€. The Group has thus already pocketed a greater profit than could have been achieved over the next ten years from the WebHosting business. In addition, freenet has committed itself in a strategic cooperation agreement to buy TCS systems with an order volume of 10 Mio€ (further information is available at [teles.de](http://teles.de)). We also parted with the unprofitable WebLearning business (TEIA AG) to enable us to focus better on those business divisions which promise the greatest dynamic growth in future. This sale was concluded on 1 July 2005 for the symbolic price of 1 €. The amounts which can be allocated to expenses for deconsolidation are explained in the Group Financial Statements under Discontinued Operations. TELES will, however, participate in the future success of TEIA on the basis of an agreement regarding subsequent payments.

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With the sale of the two aforementioned divisions, TELES is now divided into two segments for IFRS purposes, as is illustrated in the diagram below:

- The **TCS Segment** (TELES Communication Systems, i.e. infrastructure systems),
- The **TWBI Segment** (TELES Wireless Broadband Internet, i.e. skyDSL services),



TELES' solid financial footing allowed the company to pay out a total of over 40 Mio€ or almost 2 € per share to its shareholders in connection with capital reductions in the course of and immediately after the reporting period. Above all, however, this strong financial background means that the company has more than sufficient reserves to bear the preproduction costs necessary to expected growth in continuing operations.

The following charts and explanations are based on the development of continuing operations at TELES in the reporting period of 2005. Future growth expectations for these business divisions are discussed in Section G.

## Group Revenues and Earnings in 2004 (according to IFRS)

### Group Operating Revenues and Earnings

in Mio€	2004	2005	Variation <sup>1</sup> 2004 vs. 2005
<b>Sales Revenues</b>	<b>24.6</b>	<b>25.4</b>	<b>3%</b>
Cost of Sales	10.5	15.6	49%
<i>of which: Depreciation and Amortization</i>	<i>0.3</i>	<i>0.2</i>	<i>-12%</i>
<b>Gross Profit</b>	<b>14.1</b>	<b>9.8</b>	<b>-31%</b>
Gross Profit Margin	57%	39%	-19%
Research and Development Expenses	4.4	5.2	19%
Sales and Marketing Expenses	8.1	12.0	49%
General and Administrative Expenses	4.9	4.8	-8%
Expenses related to Employee Stock Option Plans	0.2	0.3	54%
Other Income	0.1	0.2	n.a.
Other Expenses	0.1	0.1	n.a.
<b>EBITDA</b> <b>(Earnings before interest, tax, depreciation, amortization)</b>	<b>-3.2</b>	<b>-12.2</b>	<b>n.a.</b>
Operational Depreciation and Amortization	0.4	0.5	14%
<b>EBIT</b>	<b>-3.9</b>	<b>-12.9</b>	<b>n.a.</b>
<b>EBIT without</b> Expenses related to Employee Stock Option Plans	<b>-3.7</b>	<b>-12.6</b>	<b>n.a.</b>
Financial Income and Expenses	0.6	2.0	273%
<b>EBT</b>	<b>-3.3</b>	<b>-10.9</b>	<b>n.a.</b>

### Further Group Business Ratios

in Mio€ (except share-related information)	2004	2005
<b>Net Income</b>	<b>2.2</b>	<b>110.4</b>
<b>Income from Reduction of Share Capital</b>	<b>22.9</b>	<b>18.3</b>
<b>Earnings per Share, total</b>		
Undiluted	<b>0.10</b>	<b>5.27</b>
Diluted	<b>0.10</b>	<b>5.22</b>
<b>Per share amounts including reduction of share capital</b>		
Undiluted	<b>1.21</b>	<b>6.15</b>
Diluted	<b>1.18</b>	<b>6.09</b>

<sup>1</sup> Percentage variations are based on Euro amounts not subject to rounding.

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### Notes on the above Group figures:

- **Group Revenues** increased 3% in 2005 compared to 2004, and are therefore lower than forecast in our revised earnings expectations. This is due to missed revenues in both business divisions, as discussed in more detail elsewhere in this report.
- **Group Gross Profit** for continuing operations fell by 31% to 9.8 Mio€ in 2005 as a result of preproduction costs for the TWBI business division, despite an increase in revenues.
- Accordingly, the **Group Gross Profit Margin** dropped to 39% (prior year: 57%).
- **Group EBITDA** fell from -3.2 Mio€ in the prior year to -12.2 Mio€ in 2005. This is due to the aforementioned reduction in the gross profit and to operating preproduction costs for the business divisions TCS and TWBI.
- The fall in **Group EBIT** to -12.9 Mio€ in 2005 is in line with EBITDA development.
- **Group EBT** amounted to -10.9 Mio€ in 2005 and is below original forecasts, although – as already discussed in the Quarterly Report as at 30 September 2005 – still within the scope of Group planning.

The net result for the full year 2005 amounted to 110.4 Mio€. The corresponding Earnings per Share (EPS) amounted to 5.27 € (undiluted) or 5.22 € (diluted). This result is mainly due to Income from Discontinued Operations from the sale of the WebHosting business to freenet.de AG with a value of 124 Mio€ net of tax.

The 3.1 million freenet shares transferred to TELES as part of the sales price were entered as assets available for sale and share price increases since receipt of the shares in Q1/2005 have therefore not been included in the Income Statement; Capital Gains are recorded directly in Equity and amounted to 11 Mio€ (net of effects from deferred taxes) in the period from first-time recognition of the freenet shares until the end of 2005.

Per share amounts including the reduction of share capital resulting from the resolution of the Annual General Meeting on 3 June 2005 amounted to 6.15 € (undiluted) or 6.09 € (diluted) per share.

## Revenues and Earnings by Segment in 2005 (according to IFRS)

The company is controlled by the Management Service Division (MSD), which was set up in addition to the two operating segments. The following chart shows the allocation of revenues and earnings to the individual TCS (TELES Communication Systems) and TWBI (TELES Wireless Broadband Internet) Segments, with separate entries for MSD. The Company reports its MSD figures separately to enhance the transparency of its cost structure by showing that corporate services cause one-off impacts and recurring costs as well as showing the extent to which these costs can justifiably be allocated to the individual segments.

Revenues & Earnings by Segment in Mio€	2004	2005	Variation <sup>1</sup> 2004 vs. 2005
<b>MS Division</b>			
<b>Revenues</b>	<b>1.1</b>	<b>1.1</b>	<b>0%</b>
<b>Gross Profit</b>	<b>1.1</b>	<b>1.1</b>	<b>0%</b>
Gross Profit Margin	100%	100%	n.a.
Administration Expenses	3.3	3.3	1%
Stock Issued to Employees	0.2	0.3	54%
Other Income	0.1	0.0	n.a.
Other Expenses	0.1	0.1	n.a.
<b>EBITDA (Earnings Before Interest, Tax, Depreciation, Amortization)</b>	<b>-2.4</b>	<b>-2.6</b>	<b>-n.a.</b>
Operational D&A	0.1	0.0	n.a.
<b>EBIT</b>	<b>-2.5</b>	<b>-2.6</b>	<b>n.a.</b>
Financial Income and Expenses	0.5	2.0	310%
<b>Earnings before Tax and Minority Interests</b>	<b>-2.0</b>	<b>-0.6</b>	<b>n.a.</b>
<b>TCS Segment</b>			
<b>Revenues</b>	<b>20.0</b>	<b>19.3</b>	<b>-4%</b>
Cost of Sales	6.2	6.7	7%
<i>of which: Depreciation and Amortization</i>	<i>0.1</i>	<i>0.0</i>	<i>n.a.</i>
<b>Gross Profit</b>	<b>13.8</b>	<b>12.6</b>	<b>-9%</b>
Gross Profit Margin	69%	65%	-4%
Research and Development Expenses	3.8	4.3	14%
Sales and Marketing Expenses	4.3	5.3	24%
Administration Expenses	2.0	1.9	-9%
Other Income	0.0	0.2	n.a.
Other Expenses	0.0	0.0	n.a.
<b>EBITDA (Earnings Before Interest, Tax, Depreciation, Amortization)</b>	<b>3.8</b>	<b>1.3</b>	<b>-65%</b>
Operational D&A	0.3	0.4	16%
<b>EBIT</b>	<b>3.4</b>	<b>0.9</b>	<b>-74%</b>
Financial Income and Expenses	0.1	0.0	-61%
<b>Earnings before Tax and Minority Interests</b>	<b>3.5</b>	<b>0.9</b>	<b>-74%</b>
<b>TWBI Segment</b>			
<b>Revenues</b>	<b>4.6</b>	<b>6.1</b>	<b>35%</b>
Cost of Sales	4.3	8.9	111%
<i>of which: Depreciation and Amortization</i>	<i>0.2</i>	<i>0.2</i>	<i>n.a.</i>
<b>Gross Profit</b>	<b>0.3</b>	<b>-2.8</b>	<b>n.a.</b>
Gross Profit Margin	8%	-45%	n.a.
Research and Development Expenses	0.6	0.9	48%
Sales and Marketing Expenses	3.8	6.7	77%
Administration Expenses	0.7	0.7	11%
<b>EBITDA (Earnings Before Interest, Tax, Depreciation, Amortization)</b>	<b>-4.6</b>	<b>-10.9</b>	<b>n.a.</b>
Operational D&A	0.0	0.1	n.a.
<b>EBIT</b>	<b>-4.8</b>	<b>-11.2</b>	<b>n.a.</b>
Financial Income and Expenses	0.0	0.0	n.a.
<b>Earnings before Tax and Minority Interests</b>	<b>-4.8</b>	<b>-11.2</b>	<b>n.a.</b>

<sup>1</sup> Percentage variations are based on Euro amounts not subject to rounding.

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### Notes on the MS Division:

- **Revenues** in the **MS Division** represent cost allocations to the operating segments TCS and TWBI and do not include any amounts generated with third parties.
- **MSD Administration Expenses** were virtually unaltered compared to the prior year. They correspond in particular to capital market costs (including annual audit, Investor Relations and Annual General Meeting) and costs related to the patent department. TELES' intellectual property rights safeguard the sustainable, profitable growth of TELES and related costs increased significantly in 2005 due to legal disputes regarding the Intra-Star patents (VoIP patents). In addition, there was a charge of 0.3 Mio€ in MSD Operating Costs for the first time in 2005. This relates to expenses from the Employee Stock Option Programme (according to IFRS 2) and does not affect liquidity.
- The increase in **MSD Financial Income and Expenses** to 2 Mio€ resulted from a significant increase in liquidity as a result of the sale of the WebHosting business. The amount also includes almost 0.3 Mio€ from dividend payments on some of the freenet shares held by TELES.
- **MSD EBT** reflects the cost of capital procurement and amounted to approx. 0.4% p.a. on shareholders' equity.

### Notes on the TCS Segment:

- **Revenues in the TCS Segment** fell in 2005 by 4% compared to the prior year. After a continual increase in quarterly revenues over the first three quarters 2005, revenues fell in the fourth quarter, mainly as a result of weaker iGATE sales. On the product side, these are offset by the first signs of momentum from the sale of VoIP GATEs and Media GATEs. Further regional momentum was provided by expansion into other markets. Business with Asian mobile phone providers, for example, is developing in a promising fashion. Overall, 90% of TCS revenues are generated abroad, increasingly in non-European markets. Further details are given in Section G.
- The **TCS Gross Profit Margin** continued to be excellent at 65%. Partial pricing pressure was largely compensated for by optimized purchasing conditions, and as a result the TCS Gross Profit Margin was only 4% lower than in the prior year. Seen against a background of revenue development, however, the absolute Gross Profit fell by 9%. TELES is confident that the gross profit margin can be maintained at the same level in the medium term and that the absolute Gross Profit will therefore develop in accordance with the expected significant revenue increase.



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- The absolute increase in **TCS Operating Expenses** in 2005 amounted to 14% as against the prior year. The higher costs are related to growth expectations for the years to come (see Section G) and were caused by a diversification of the product portfolio and by the cost of distribution related to new, non-European sales markets.
- In 2005 **TCS EBITDA/EBIT** fell by 65% and 74% respectively compared to 2004 as a result of the decrease in earnings and increase in operating costs discussed above.
- The **TCS EBIT Margin 2005** amounted to almost 5%.

### Notes on the TWBI Segment:

- In 2005 **Revenues in the TWBI Segment** were 35% higher than in 2004. After adjustment for set-up fees, which have not been charged in direct marketing since January for competition reasons, the revenues for the year rose by 63% as against the prior year.

The number of skyDSL customers rose from 13,000 at the end of 2004 to a good 28,200 (+116%), whereby customer acquisition increased in momentum in the second half of the year. In this period foreign business contributed 30% of all new customers, particularly as a result of direct marketing measures in France, Italy and Spain.

In Germany TELES holds approx. 50% of the market against competitive providers of alternative broadband Internet services (i.e. not including the conventional telephone-based or cable-based broadband access).

TELES expects the trend in customer acquisition at least to continue in 2006, as a result of which three-figure percentage revenue increases should be achieved. More details are provided in Section G.

- The additional transponder capacities rented at the end of 2004 and corresponding preproduction costs resulted in a negative **TWBI Gross Profit** and **TWBI Gross Profit Margin** in 2005.
- **TWBI Operating Costs** increased by 65% in 2005 as a result of preproduction measures, particularly sales and marketing.
- **TWBI EBITDA** and **EBIT** decreased in 2005 to -10.9 Mio€ and -11.2 Mio€ respectively due to preproduction costs (prior year: -4.6 Mio€ and -4.8 Mio€). Growth perspectives for the segment are discussed in Section G.

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The following **segmental reporting of TELES does not show separate figures for the MS Division**. Instead, MSD expenses were allocated to the two TELES-segments TCS and VAIS in accordance with IFRS:

Revenues & Earnings by Segment in Mio€	2004	2005	Variation <sup>1</sup> 2004 vs. 2005
<b>TCS Segment</b>			
<b>Revenues</b>	<b>20.0</b>	<b>19.3</b>	<b>-4%</b>
Cost of Sales	6.2	6.7	7%
<i>of which: Depreciation and Amortization</i>	<i>0.1</i>	<i>0.0</i>	<i>n.a.</i>
<b>Gross Profit</b>	<b>13.8</b>	<b>12.6</b>	<b>-9%</b>
Gross Profit Margin	69%	65%	-4%
Research and Development Expenses	3.8	4.3	14%
Sales and Marketing Expenses	4.3	5.3	24%
Administration Expenses	3.3	3.1	-9%
Stock issued to Employees	0.2	0.3	
Other Income	0.1	0.2	n.a.
Other Expenses	0.1	0.1	n.a.
<b>EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization)</b>	<b>2.3</b>	<b>-0.3</b>	<b>-65%</b>
Operational D&A	0.4	0.4	16%
<b>EBIT</b>	<b>1.8</b>	<b>-0.7</b>	<b>-74%</b>
Financial Income and Expenses	0.6	2.0	-61%
<b>Earnings before Tax and Minority Interests</b>	<b>2.4</b>	<b>1.3</b>	<b>-74%</b>
<b>TWBI Segment</b>			
<b>Revenues</b>	<b>4.6</b>	<b>6.1</b>	<b>35%</b>
Cost of Sales	4.3	8.9	111%
<i>of which: Depreciation and Amortization</i>	<i>0.2</i>	<i>0.2</i>	<i>n.a.</i>
<b>Gross Profit</b>	<b>0.3</b>	<b>-2.8</b>	<b>n.a.</b>
Gross Profit Margin	8%	-45%	n.a.
Research and Development Expenses	0.6	0.9	48%
Sales and Marketing Expenses	3.8	6.7	77%
Administration Expenses	1.6	1.7	11%
<b>EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization)</b>	<b>-5.5</b>	<b>-11.9</b>	<b>n.a.</b>
Operational D&A	0.0	0.1	n.a.
<b>EBIT</b>	<b>-5.7</b>	<b>-12.2</b>	<b>n.a.</b>
Financial Income and Expenses	0.0	0.0	n.a.
<b>Earnings before Tax and Minority Interests</b>	<b>-5.7</b>	<b>-12.2</b>	<b>n.a.</b>

<sup>1</sup> Percentage variations are based on Euro amounts not subject to rounding.

## B.1 Cash Flow

The following chart compares the 2004 and 2005 cash flows.

Cash Flow	2004 Mio€	2005 Mio€
Operating Activities	15.3	-15.5
Investing Activities	-10.0	62.2
Financing Activities	-5.7	-22.4
Net Increase/ Decrease in Cash and Cash Equivalents	-0.4	24.3
Cash and Cash Equivalents at end of year	50.0	74.3

The **cash outflow from operating activities in 2005** amounted to -15.5 Mio€, mainly as a result of the negative EBITDA (-12.2 Mio€), prepayments of -1.1 Mio€, particularly for transponder capacities, and variations in working capital for the WebHosting segment and continuing operations.

The **cash inflow from investing activities in 2005** of 62.2 Mio€ relates mainly to the balance of cash inflows and outflows as a result of the sale of the WebHosting business.

The **cash outflow from financing activities in 2005** mainly relates to the distribution of almost 23 Mio€ to the shareholders in July 2005 as a result of the capital reduction decided on by resolution of the Shareholders in December 2004, and to inflows from the exercise of stock options by employees.

**Cash and Cash Equivalents at the end of 2005** increased as a result of these inflows and outflows to 74.3 Mio€. On 2 January 2006 this amount was reduced by a second payment to the shareholders of over 18 Mio€ as a result of the capital reduction agreed by shareholder resolution on 3 June 2005. In addition to its Cash and Cash Equivalents TELES also holds assets available for sale in the form of the 3.1 million freenet shares, which may be sold at short notice whenever so desired. TELES' cash position will therefore continue to be extremely comfortable in future.

## B.2 Asset and Capital Structure

The asset and capital structure was as follows:

<b>Asset and Capital Structure</b>	<b>31.12.2004 Mio€</b>	<b>31.12.2005 Mio€</b>
Cash and cash equivalents	50.0	74.3
Trade Receivables	6.2	4.5
Inventories	4.7	4.6
Fixed and Intangible Assets	15.3	1.6
Other Assets	13.6	76.2
Liabilities	60.2	27.2
Shareholders' Equity	29.6	134.0
In % of Balance Sheet Total	33%	83%
Balance Sheet Total	89.8	161.2
Investments in Fixed and Intangible Assets	10.6	1.6

In 2005 the **return on investment before taxes**

- was still 20% in the TCS Segment despite the fall in EBIT in 2005
- was necessarily still negative in the TWBI Segment as a result of start-up costs

Group **Trade Receivables** were reduced in 2005 by a total of 1.7 Mio€ as follows:

- A reduction of 1.1 Mio€ due to the sale of the WebHosting and WebLearning businesses.
- A reduction in the TCS segment by 1.0 Mio€ or 20%. Receivables are outstanding by an average of 74 days in this segment, due mainly to business procedures and payment terms common to the industry – including instruments securing payments such as letters of credit and payment guarantees. This period is 15 days lower than in the prior year.
- An increase of 0.4 Mio€ due to a significant upturn in skyDSL business. In the TWBI Segment the theoretical time to payment is 30 days due to the use of direct debiting customary in the mass market industry.

**Inventories** remained virtually unchanged in 2005 as against the prior year, and only play a secondary role in the TWBI Segment.

## Translation – the German version is authoritative

**Fixed and Intangible Assets** fell significantly to 1.6 Mio€ in 2005 due to the sale of the WebHosting business. Very little capital expenditure is required for continuing operations.

**Other Assets** are mainly related to the 3.1 million freenet shares received as part of the sale and purchase price for the WebHosting business.

**Liabilities** fell significantly in 2005 due to the sale of the WebHosting Segment. Independent of this, the item includes shareholder liabilities in the amount of over 18 Mio€ as a result of the capital reduction resolved by the shareholders on 3 June 2005. These were disbursed on 2 January 2006.

Despite the two reductions in capital of almost 23 Mio€ and over 18 Mio€, **Shareholders' Equity** increased significantly in 2005 to 134 Mio€ due to one-off income from the sale of the WebHosting business. There was a corresponding rise in the **Equity Ratio** to a very comfortable **83%**.

The **financial condition** of TELES thus continues to be sound and more than sufficient for the future business development of the company.

The following chart shows the geographical segments in a prior year comparison:

in Mio€	Revenues		Segment Assets		Investment in Tangible and Intangible Assets	
	2004	2005	31.12.2004	31.12.2005	2004	2005
<b>Germany</b>	7.5	6.8	77.3	81.6	10.4	1.3
<b>Rest of Europe</b>	14.8	16.1	5.5	5.4	0.2	0.1
<b>Rest of World</b>	2.3	2.5	0.1	0.4	0.0	0.2
<b>Not Allocated</b>			6.9	73.8		
<b>Total</b>	24.6	25.4	89.8	161.2	10.6	1.6

The value of the freenet shares as at 31 December 2005 is mainly responsible for the value of non-allocated segmental assets in 2005.

### **B.3 Employees**

The total number of employees at TELES was 281 on 31 December 2005. This represents an increase of 71 in continuing operations compared to the end of the prior year, 35 of which were employed in the TCS Segment and the majority of the rest in the TWBI division.

Employee stock options remain an important means of gaining and retaining highly qualified employees and managers. To this end TELES issued stock options under the scope of an Employee Stock Option Programme in 2005. More details of this can be found in the Notes to the Financial Statements.

### **C. Risks with Material Influence on the Company's Financial and Profit Situation**

In 2002 TELES initiated joint proceedings against Deutsche Telekom AG (DTAG) and SES ASTRAnet S.A. for the infringement of several patent rights with their "TDSL via Satellite" service. The company bases its case on the German and European patents protecting the skyDSL technology developed by TELES and on a corresponding German utility model. In two similar lawsuits regarding patent infringement the companies sued by TELES finally reached agreement with the Company – after a first-instance verdict – and withdrew from this field of business. In the patent infringement proceedings against DTAG and SES, which were resumed in respect of the German patent and utility model in the year under review after an interim suspension, a first-instance ruling was made on 27 January 2006. As forecast, the verdict was in favour of TELES. TELES expects the losing parties to lodge an appeal against this ruling. In the same connection, the aforementioned intellectual property rights were challenged before the German and European Patent Offices in 2003. In 2005, following confirmation of the German core skyDSL patent by the Federal Patents Court at the end of 2004, the Patent Office also ruled in favour of TELES' utility model in the first instance in a case with similar scope initiated by DTAG/SES. DTAG/SES have lodged an appeal with the Federal Patents Court against the Patent Office ruling. Finally, the European skyDSL patent was confirmed by the European Patent Office with only marginal qualifications on 26 January 2006. Here, too, TELES expects DTAG/SES to lodge an appeal. The company is confident that it will also win those cases which have not yet been finally decided. Both TELES and its legal advisors expect no risks to the Company to result from these facts and circumstances.

## **Translation – the German version is authoritative**

One of STRATO Medien AG's competitors took exception to advertisements for skyDSL in 2003 and applied for an injunction. On 17 February 2005 the Regional Court of Cologne ruled that STRATO must desist from advertising its satellite-based Internet access with what the court considered the misleading term "DSL", either on its own, or in the name "skyDSL". On 6 April 2005 STRATO Medien AG appealed the decision at the Higher Regional Court of Cologne. The outcome of the proceedings is uncertain. STRATO Medien AG, and following its withdrawal from the TELES Group the new skyDSL distribution company TELES skyDSL GmbH ("TSD"), reacted to the first-instance ruling by using the term "skyDSL" in advertisements only with a clarifying footnote. Depending on the outcome of the appeal, an identical follow-on case may be brought against the new sales company TSD.

In June 2003 TELES acquired 33.3% of the shares in a start-up company which operates as telecommunications service provider. Business activities at this company, which is registered in England, have now been discontinued. It originally provided services to carriers in Germany requiring low cost connections from fixed-line networks to mobile networks, until the mobile SIM cards were deactivated by the mobile network operator. The Company was unable to assert its temporary injunction for reactivation of the cards against the mobile network operators concerned, but is hoping for final clarification in the principal case after a mobile network operator initiated action for payment and damages at the end of 2004. TELES has also entered a claim for damages resulting from the deactivation of the mobile cards in the principal case. After an about-turn in jurisdiction regarding the legality of the deactivation of the SIM cards used in GSM gateways, it is uncertain whether the second-instance case will succeed before the Higher Regional Court of Düsseldorf. No high financial risks are involved, however.

In 2005, the same mobile network operator also applied for an injunction against the provision and sale of GSM gateways for carrier networks by TELES AG and TELES NetSales GmbH. In view of the aforementioned shift in jurisdiction regarding one aspect of the legal action (the legality of the use of GSM gateways in Germany), TELES' chances of success have fallen. It is also unclear what effect a negative ruling would have on international sales. TELES and its legal advisors consider both the risk of a general ban on exports and – in view of the minor significance of Germany as a market for GSM gateways – the economic risks for TELES to be low.

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It was agreed under the sale of the WebHosting business that STRATO Medien AG would continue to represent TELES in the lawsuit initiated by the bankruptcy administrator of KPNQwest Germany GmbH i.In., with any and all opportunities and threats related to this lawsuit remaining with TELES. As reported in prior years, the Company withheld payments to its technical supplier, KPNQwest, during 2001 and 2002, and claimed a reduction in payables for insufficient quality of services. After KPNQwest had filed for bankruptcy, the bankruptcy administrator instituted legal proceedings against STRATO in 2002 for payment of outstanding receivables. The closing amount of trade accounts payable for STRATO as at 31 December 2004 included 5.4 Mio€, an amount which includes a discount of 3.2 Mio€ for the reductions claimed, a claim the Company considers more than justified. In addition, STRATO has asserted counterclaims for damages of 8 Mio€. At the balance sheet date, the lawsuit was still in process. The Company has set up sufficient provisions for lawyers' fees and court costs. TELES and its legal advisors perceive no further threats to the Company from these facts and circumstances.

Since the previous Management Report the proceedings initiated by TELES in June and July 2004 against Quintum Inc. and its German distribution partners for alleged infringement of the TELES IntraStar patents have been decided at first instance in favour of TELES. The case against AVM GmbH and its distribution partners, however, was dismissed at the first instance. Appeals have been lodged against all of these rulings. In the patent infringement proceedings against CISCO Systems Inc., which are also pending, a verbal hearing has now been set for 31 March 2006. The cases submitted by CISCO for nullification of the German and European IntraStar patents have also been set for the first half of 2006, the first date being 5 April 2006 for the German IntraStar patent. TELES is, however, confident that these patents, like the German skyDSL patent, which was confirmed by the Federal Patents Court back in December 2004, will also be confirmed. Double-digit patent infringement suits against primarily non-European companies can be expected from TELES in the future, as their hybrid Internet telephony products (or VoIP products) may currently infringe the IntraStar patents (see the German-language VoIP Patent Infringement Forum at [teles.de](http://teles.de) for more information). TELES and its legal advisors see no threats to the company from these cases.

In October 2005 the IntraSTAR patent was granted to TELES for the United States of America, since when CISCO has also instituted legal proceedings for nullification of this US IntraStar patent and to ensure its non-infringement by CISCO products. TELES is currently examining the options and financial risks of defending its patent before the U.S. courts. Generally speaking, however, no claims can be made under U.S. law by the opponents for reimbursement of legal fees, even from an opposing party who has lost his case. As such, TELES and its legal advisers currently perceive no greater risks – apart from the defence costs – in these proceedings.



## D. Research and Development Activities

The TELES Group considers its highly qualified, experienced and very ambitious development team to be one of its most important assets, together with its highly competitive sales and marketing team. It is on these teams that TELES' growth in the years to come is based.

Major research and development activities were commenced or continued in both business segments in the year under review as follows.

### TCS:

The following activities are worthy of note in the TCS Segment :

- The development of intelligent media gateways with analogue and digital ports for use in small and medium-sized enterprises.
- The development of a high-performance media gateway controller (MGC) with excellent scaling capabilities for larger networks.
- The development of MobileNT, a new product for application in the growth wireless access sector. The product currently supports the mobile technologies GSM and CDMA and will also support UMTS in future. MobileNT is a further addition to the already very successful fixed wireless product portfolio.
- The introduction of a PrePaid CallingCard application, the first product in a new network applications and services product line.
- The development of a new generation of technology for gateway hardware with doubled transmission capacities and redundancy.

### TWBI:

- An increase of the maximum bandwidth in skyDSL technology to 24 mbps. Utilization of DVB-S2 cards, which are currently being developed by the suppliers, should make bandwidths of over 50 mbps possible in future.
- The development of a "skyDSL Setup Box" is being considered for the year 2006. This would save the user having to install the skyDSL software on his PC or laptop, and an Ethernet interface would make multiple use of the skyDSL service possible.
- TELES has also investigated the possibilities of an alternative, simple and more versatile receiving aerial and commenced development thereof.
- The great importance of the skyDSL patents already discussed elsewhere in this report for TELES' competitive position in the broadband Internet market should also be emphasized.

## **E. Events after the Balance Sheet Date**

On 2 January 2006 TELES paid approx. 18.3 Mio€ to the shareholders, or 0.868 € per share, as a result of the capital reduction resolved in the Annual General Meeting of 3 June 2005. This amount is generally exempt of tax for the shareholders<sup>1</sup>

The rulings in respect of the European skyDSL patent and the patent infringement proceedings against Deutsche Telekom AG (DTAG) and SES ASTRAnet S.A made subsequent to the business year are discussed in Section C.

On 15 February 2006 TELES filed a lawsuit at the Regional Court of Mannheim against Nokia GmbH and the Finnish Nokia Corporation for infringement of its German and European VoIP patents.

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<sup>1</sup> From the point of view of the Company this payment, as repayment of capital according to the preliminary tax assessment of the Company, would generally not be liable to any taxation. The Company assumes no liability for this evaluation. Fiscal effects of the payment for the shareholder should be verified by the shareholder's tax adviser.

## F. Threats to the Company's Future Development

The development and utilization of economic opportunities and potential offered by the market entails inevitable risk. It is of critical importance for the success of a company that risks are recognized at an early stage and active efforts taken to counteract these.

In view of this, section 91 subsection 2 of German Stock Corporation Law (AktG) binds the management to "take suitable measures, and particularly to set up a monitoring system, to ensure that developments which endanger the future of the company are recognized at an early stage."

For this reason the TELES Group has established a risk management system which is integrated into the operating processes of the Company, whereby the subsidiaries are responsible for the scope, form and content of their own risk management systems. Group management is responsible for monitoring and coordinating risk management for the Group. The risk reports from the subsidiaries to Group management include the regular and systematic identification, quantification and assessment of the relevant risks and back-up systems. Reporting is carried out on a monthly basis, with extraordinary reports as and when necessary according to certain indicators. The risk assessment is based on the cost of potential damage and the probability of such damage occurring.

It is in principle true that the competitive pressure on all markets addressed by the TELES Group may increase, with an adverse effect on gross profits. TELES aims to counter such risks by developing and acquiring innovative new products for these markets.

TELES' products are also exposed to the risk of hostile attacks on its telecommunications networks and servers. To a certain extent, this is inevitable. We are counteracting such threats by continuous improvements to the security of our systems.

In addition to the risks described under Section C, attention is drawn to the following risks for future business development:

### TCS

- It should first be noted that the impact of individual customers on the segment is low. The largest single customer generated less than 10% of TCS revenues in 2005. There are therefore no "cluster risks" in the receivables. The customary disclosure reports are always used to verify the creditworthiness of a new customer, and that of existing customers is also verified on a regular basis. In addition, advance payments are requested where possible and appropriate. In international sales – and particularly non-European transactions – letters of credit or payment guarantees are agreed. As billing has been carried out to date almost exclusively in EURO (the only exception being US Dollar), currency exposure is very low. If the proportion of revenues invoiced in US Dollar should increase in future, the currency exposure will be eliminated by corresponding hedging activities.

The development of the TCS Segment will continue to depend on the speed at which the telecommunications markets are liberalized and the extent to which this takes place, both within Europe and in regions such as the Middle East or Asia. A

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significant increase in the speed and the extent of liberalization is largely beyond the control of TELES.

Development will also be highly dependent upon the competitive position of TELES as a network supplier for the emerging VoIP telephony and networks of the future (NGN, or Next Generation Networks and IMS, or IP Multimedia Subsystems), and this will be influenced significantly by the company's R&D competence. With

- its comprehensive R&D activities and 35 patent families
- its expertise and patents in the field of VoIP
- the large number of TCS employees working in R&D
- its cooperation with external research institutions
- its many years of experience and expertise in the field of established telecommunications technologies, i.e. signalling protocols and telecommunications network infrastructure, and
- its large portfolio of product features for use in a very wide range of applications

TELES considers itself well equipped for the competitive arena.

### TWBI

- In the field of **satellite-based Internet access** there is always a risk that the products will not be as widely accepted by the market as expected. In contrast to the more conventional terrestrial broadband, however, TELES' highly competitive skyDSL services are available everywhere in Germany and in almost all of Europe. For a considerable percentage of all households this often makes the skyDSL services the only viable alternative to terrestrial broadband.

Although alternative technologies to skyDSL – such as WIMAX – are conceivable, it is unlikely that a low-priced broadband service based on these technologies and which is available everywhere will be able to establish itself on the market in the near future, particularly since considerable investments in infrastructure would be necessary. Given the unpredictability of the market, the skyDSL service should be able to look forward to successful development over the next few years.

For the sake of completeness, reference should be made here to two minor details:

The risk of possible payment losses is low in international skyDSL sales, as TELES requires advance payment from its distribution partners. Only credit card payments are accepted from customers in international direct marketing, and with the exception of the few customers in Great Britain who are invoiced in Pounds Sterling there is no currency exposure. Should one of the distribution partners discontinue its business activities, TELES can now use TELES skyDSL Europe B.V. to take over the active customers without the customer suffering disruption of service.

There is also always a possibility that defects or meteorite impact may cause a satellite to break down. But experiences in the past have shown that this risk is extremely low when a satellite is in orbit.

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A universal problem is posed by the finite life-span of satellites. TELES therefore focuses on positions which are guaranteed in the long term by the satellite operators, making it possible for the skyDSL service to be provided without notable difficulty by the successor satellite in the same orbital position at the end of a satellite's life-span.

### Miscellaneous

Finally, mention should be made of the price risk associated with the 3.1 million freenet shares which TELES received from freenet under the sale and purchase of the WebHosting business. The price risk inherent in shares which are traded on the stock exchange is offset by the chances of price improvement. In the period between conclusion of the Sale and Purchase Contract for the WebHosting business and the balance sheet date the value of the freenet shares rose from 50 Mio€ to 65 Mio€. Further upside potential is expected for the future, as underlined by analyst reports. Despite this, TELES also monitors share price movement on an ongoing basis to ensure that reaction is prompt should counteractive measures become necessary.

## **G. Growth Expectations for TELES to 2009**

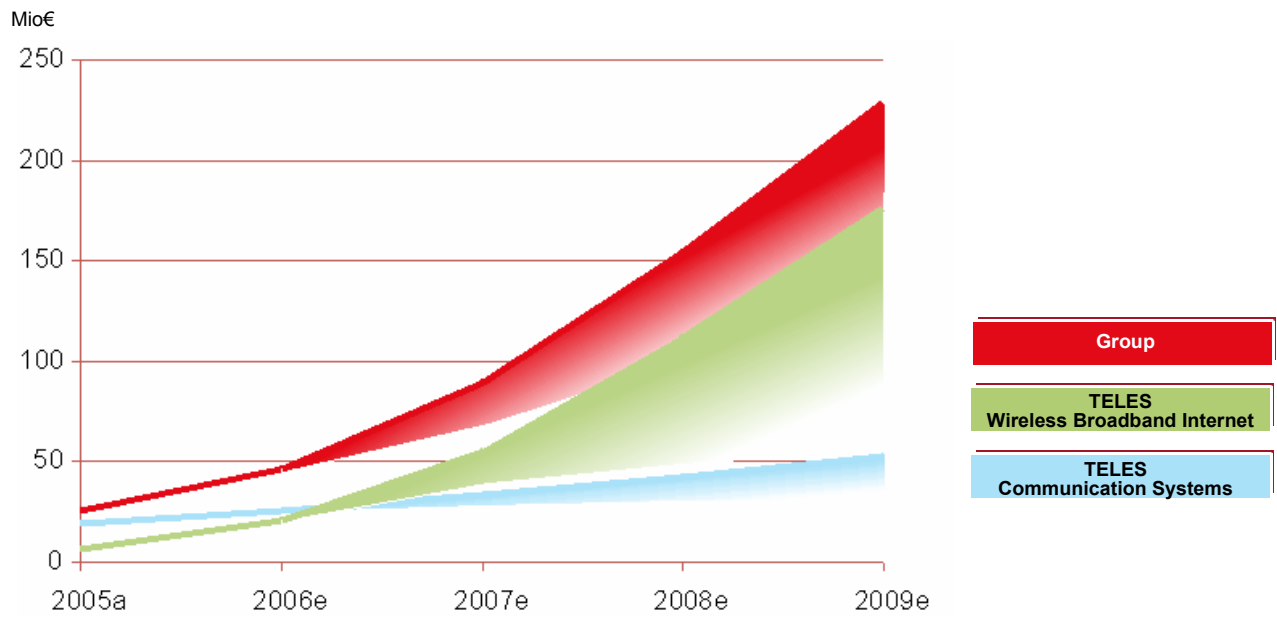
This section draws on the group structure displayed in Section B.

The following charts show revenues and earnings expectations for TELES' two business segments to the end of 2009. An annual increase in revenues of at least 20 percent is forecast for the Group until 2009, while earnings growth should gain momentum from 2007, and increase much faster than revenues. As a result of the preproduction expenses the Group result is unlikely to show positive figures again until 2007, despite a positive contribution to earnings from the long-established TCS Segment.

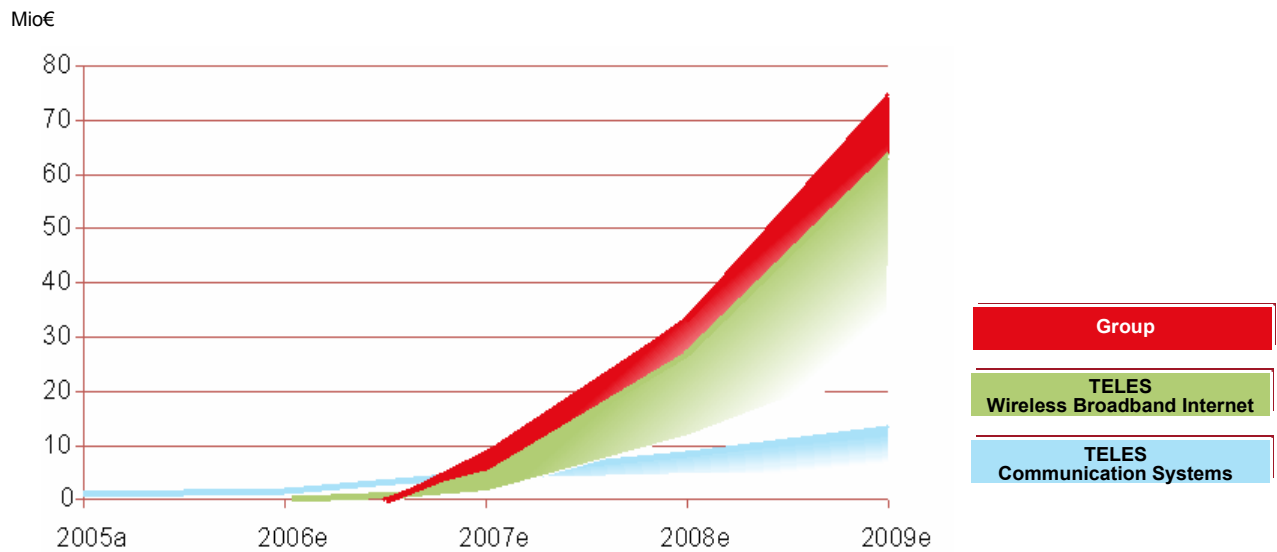
**We would like to draw attention once again to the fact that the very nature of growth forecasts means that we can make no representation or warranty in respect of their accuracy. Information on the risks pertaining to present and future developments can be found in Sections C and F.**

## G.1: TELES Growth Forecasts to 2009

### Group Revenue Forecast



### Group EBIT Forecast



The growth projections for the Group are based on the following principles and assumptions.

## G.2: Principles and Assumptions for the Projections

### Telecommunications Infrastructure and Systems Components (TCS Segment)

The telephone network is currently experiencing tumultuous development. Triggered by the booming Internet technologies, a transition is currently taking place from the conventional wired switching technology to packet switching (VoIP, or Voice over IP). At the same time, this heralds a further development towards the networks of the future (NGN, or Next Generation Networks, and IMS, or IP Multimedia Subsystems).

Regionally, market attention is drawn to the growth potential inherent in the Asian wireless market.

It is particularly in these markets that TELES should be able to stand firm against the regionally very diverse competition from small new or large established companies, thanks to its many years of experience and expertise in the field of telecommunications, its know-how and patents in the VoIP sector, its great flexibility and innovative capacity, which finds expression in 35 patent families, and thanks to its three-figure customer base in over 25 countries.

TELES has already taken the first, important steps on its way to the new growth markets, as is shown by the following overview:



The acquisition of tier 2 carriers – including freenet, which agreed to purchase telecommunications infrastructure systems from TELES under the sale of the Company's WebHosting business – should also benefit business development in the TCS Segment in the years to come.

**Value-added Internet Services: Broadband Internet Services (TWBI Segment)**

Success in this segment continues to be expected from the global trend towards high-speed Internet, as a result of which the demand for broadband Internet access is rising all over Europe. Current market research expects more than 40% of households in Germany alone to have broadband Internet access by the year 2007 (this figure was 27% at the end of 2005). The picture is similar in the rest of Europe. It can generally be expected that narrow-band connections to the Internet will to a great extent have been replaced by broadband over the next 10 years. There are currently 180 million households in the 25 member states of the EU. The demand for broadband Internet is also increasing dramatically in the non-European markets. This is particularly true of the Middle Eastern, African and Asian markets.

The physical and economic conditions are such that even in Germany a significant number of potential customers cannot be provided with broadband Internet using telephone cables. And in many of the countries in Europe and beyond the infrastructure for terrestrial broadband is even worse.

Unlike conventional terrestrial broadband Internet access, the competitive satellite-based skyDSL services provided by TELES are available almost everywhere in Europe in the footprint of the corresponding satellite. As a result, skyDSL services are the only way of profiting from broadband Internet anywhere where terrestrial broadband is not available. But even where it is available the competitively priced skyDSL services, with their download speeds of up to 24,000 Kbps, are a viable alternative to the terrestrial services.

We are now able to reach more than 300 million people with the skyDSL satellite transponders leased to date. These transponders will also speed up international sales.

This background and the Company's forward-looking and comprehensively patented technologies are the basis for the dynamic growth projections for this segment until 2009.

Summarizing this section of the Management Report 2005, the following can be concluded: The management of TELES is convinced that the technical and business orientation of the Group, together with its outstanding human and capital resources, provide an excellent foundation with which to translate the opportunities described in this report into business success in the years to come.

Berlin, 27 February 2006

The Management Board of TELES AG



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**CONSOLIDATED FINANCIAL STATEMENTS**

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**CONSOLIDATED BALANCE SHEET**

		31 December	
(in T€, except number of shares)	Note	2004	2005
<b>ASSETS</b>			
<b>Non-current assets</b>			
Property, plant and equipment	5	13,805	1,382
Intangible assets	6	1,518	181
Other financial assets	7	69	65,789
Deferred tax assets	20	4,540	3,755
Other non-current assets	8	3,272	686
		<b>23,204</b>	<b>71,793</b>
<b>Current assets</b>			
Inventories	9	4,680	4,564
Trade accounts receivable	10	6,228	4,504
Income tax receivable	20	1,523	3,470
Other current assets	11, 29	4,167	2,528
Cash and cash equivalents	27	49,955	74,311
		<b>66,553</b>	<b>89,377</b>
<b>Total assets</b>		<b>89,757</b>	<b>161,170</b>
<b>EQUITY AND LIABILITIES</b>			
<b>Equity</b>			
Share capital:		22,929	23,305
Issued: 22,928,570 and 23,304,676 respectively			
Outstanding: 20,754,077 and 21,130,183 respectively			
Additional paid-in capital		23,131	6,151
Other comprehensive income		0	10,487
Unappropriated retained earnings		5,272	115,713
Treasury stock (2,174,493 and 2,174,493 respectively)		-21,702	-21,702
Other changes in equity		3	-3
<b>Equity attributable to shareholders of the parent company</b>		<b>29,633</b>	<b>133,951</b>
<b>Minority interests</b>		<b>0</b>	<b>7</b>
<b>Total equity</b>	12, 25	<b>29,633</b>	<b>133,958</b>
<b>Non-current liabilities</b>			
Convertible debt	13	899	892
Deferred tax liabilities	20	597	1,635
Asset retirement obligations	14	604	0
Other non-current liabilities	15, 29	2,265	318
		<b>4,365</b>	<b>2,845</b>
<b>Current liabilities</b>			
Trade accounts payable	16	11,219	1,890
Accrual for income taxes	17, 20	1,478	1,160
Other accrued liabilities	17	781	454
Deferred revenues	18	15,095	54
Other current liabilities	19, 29	27,186	20,809
		<b>55,759</b>	<b>24,367</b>
<b>Total liabilities</b>		<b>60,124</b>	<b>27,212</b>
		<b>89,757</b>	<b>161,170</b>

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**CONSOLIDATED STATEMENT OF INCOME**

		01 January – 31 December	
(in T€, except per share information)	Note	2004	2005
<b>Sales revenues</b>	30, 31	<b>24,590</b>	<b>25,377</b>
<b>Cost of Sales</b>	30, 31	<b>10,490</b>	<b>15,596</b>
<b>Gross profit</b>	31	<b>14,100</b>	<b>9,781</b>
Research and development expenses		4,531	5,460
Sales and marketing expenses		8,193	12,186
General and administrative expenses		5,087	4,947
Expenses related to employee stock option plans	25	182	281
Other income	21	57	202
Other expenses	21	49	50
<b>Operating income</b>		<b>-3,885</b>	<b>-12,941</b>
Financial income	22	622	2,145
Financial expenses	22	72	93
<b>Earnings before taxes</b>		<b>-3,335</b>	<b>-10,889</b>
Income tax expense	20	-2,237	351
<b>Income/ loss from continuing operations</b>		<b>-1,098</b>	<b>-11,240</b>
Income/ loss from discontinued operations, net of tax	24	3,271	121,688
<b>Net income</b>		<b>2,173</b>	<b>110,448</b>
Thereof attributable to:			
Shareholders of the parent company		2,175	110,441
Minority interests		-2 <sup>1</sup>	7
Earnings per share from continuing operations			
Undiluted		-0.05	-0.54
Diluted		-0.05	-0.53
Total earnings per share	26		
Undiluted		0.10	5.27
Diluted		0.10	5.22
Number of shares			
Undiluted		20,806,030	20,952,051
Diluted		21,255,641	21,153,579
Additional information (non-audited):			
EBIT <sup>2</sup>		-3,885	-12,941
EBITDA <sup>3</sup>		-3,152	-12,166
Income from reduction of share capital		22,927	18,343
Amounts payable to shareholders from reduction of share capital		22,927	18,343
Per share amounts including reduction of share capital			
Undiluted		1.21	6.15
Diluted		1.18	6.09

<sup>1</sup> Netted against minority interests recorded during the year; net closing amount T€ 0

<sup>2</sup> Earnings before financial income/ expenses and taxes

<sup>3</sup> Earnings before depreciation and amortization, financial income/ expenses and taxes

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**STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**

(in T€, except number of shares)	Number of shares	Par value	Add. paid-in capital	Other comprehensive income	Unappropriated retained earnings	Treasury stock	Other changes in equity	Minority interests	Total
<b>31 December 2003</b>	<b>22,662,660</b>	<b>45,325</b>	<b>22,808</b>	<b>0</b>	<b>3,097</b>	<b>-15,725</b>	<b>3</b>	<b>0</b>	<b>55,508</b>
Net income attributable to shareholders of the parent company					2,175				2,175
Employee stock options	265,910	531	1						532
Purchase of treasury stock						-5,977			-5,977
Reduction of share capital		-22,927							-22,927
Stock issued to employees			322						322
<b>31 December 2004</b>	<b>22,928,570</b>	<b>22,929</b>	<b>23,131</b>	<b>0</b>	<b>5,272</b>	<b>-21,702</b>	<b>3</b>	<b>0</b>	<b>29,633</b>
Net income attributable to shareholders of the parent company and minority interests respectively					110,441			7	110,448
Currency translation							-6		-6
Employee stock options	376,106	376	558						934
Capital increase from the company's own resources		18,343	-18,343						0
Reduction of share capital		-18,343							-18,343
Stock issued to employees			805						805
Fair value measurement of assets available-for-sale, net of tax				10,487					10,487
<b>31 December 2005</b>	<b>23,304,676</b>	<b>23,305</b>	<b>6,151</b>	<b>10,487</b>	<b>115,713</b>	<b>-21,702</b>	<b>-3</b>	<b>7</b>	<b>133,958</b>

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**CONSOLIDATED STATEMENT OF CASH FLOWS**

01 January – 31 December

(in T€)	Note	2004	2005
Cash flow from operating activities:			
Net income		2,173	110,448
Reconciliation of net income to cash flow from operations:			
Income/ loss from deconsolidation	4	0	-126,965
Dividends received	22	0	-263
Net interest income		-646	-2,045
Taxes	20	2,785	4,072
Stock issued to employees	25	322	805
Amortization and depreciation of fixed assets	5	4,844	1,068
Amortization of intangible assets	6	2,587	539
Income from government grants		-350	-31
Currency translation		-1	-5
Allowance for doubtful accounts		-1,283	716
Loss on disposal of non-current assets		93	93
Change in other balance sheet items (net of effects from business combinations):			
Trade accounts receivable		3,188	-1,766
Inventories		-61	-342
Other current assets, accruals and deferrals		-2,791	-1,817
Current liabilities		2,184	594
Provisions and other liabilities		3,503	801
Interest received		966	1,912
Interest paid		-45	-62
Incomes taxes received		464	0
Income taxes paid		-2,604	-3,274
<b>Cash outflow (previous year cash inflow) from operating activities</b>		<b><u>15,328</u></b>	<b><u>-15,522</u></b>
Cash flow from investing activities:			
Repayments on loans issued to employees	8	92	125
Proceeds from sale of fixed assets		61	58
Purchase of fixed assets	5	-9,850	-1,846
Purchase of intangible assets	6	-354	-240
Dividends received	22	0	263
Disposal of subsidiaries, net of cash disposed	4	0	63,856
<b>Cash inflow (previous year cash outflow) from investing activities</b>		<b><u>-10,051</u></b>	<b><u>62,216</u></b>
Cash flow from financing activities:			
Payment to shareholders from reduction of share capital	19	0	-22,468
Withholding tax payment resulting from reduction of share capital		0	-826
Payments made on convertible debt issued to employees	13	0	-7
Proceeds from issue of shares to employees	25	220	934
Purchase of treasury stock	12	-5,977	0
Other financing activities		0	29
<b>Cash outflow from financing activities</b>		<b><u>-5,757</u></b>	<b><u>-22,338</u></b>
Change in cash and cash equivalents		-480	24,356
Cash and cash equivalents, beginning of the year	27	50,435	49,955
<b>Cash and cash equivalents, end of year</b>	27	<b><u>49,955</u></b>	<b><u>74,311</u></b>
Cash and cash equivalents include money-market funds		520	0

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1: GENERAL INFORMATION**

TELES Aktiengesellschaft Informationstechnologien (“TELES AG”) and its subsidiaries (“TELES” or the “Company”) are engaged in two areas of business: TELES develops, manufactures and sells innovative, integrated high-performance network and least cost routing systems for telecommunications and data networks; furthermore, the Company offers high-speed Internet access services via skyDSL/cableDSL .

TELES AG has its registered headquarters in Berlin, Germany. Its shares are listed in the Prime Standard and are traded on all German stock markets.

The average total staff amounted to 257 as compared to 503 in the previous year.

**NOTE 2: ACCOUNTING POLICIES**

***Basis of Presentation***

In compliance with section 315a HGB, TELES’ consolidated financial statements as at 31 December 2005 were prepared in accordance with the accounting principles of the International Accounting Standard Board (IASB), London. All international accounting standards (IAS/IFRS) and relating interpretations of the International Financial Reporting Interpretations Committee (IFRIC), binding at 31 December 2005 in the EU, have been applied.

Changes in previously applied accounting principles result from the first-time adoption of IFRS 2 (Share-based Payment, see note 25) and IFRS 5 (Non-current Assets Held for Sale and Discontinued Operations, see note 24); furthermore, classification and designations of balance sheet and income statement items have been adjusted in accordance with IAS 1 revised.

In March 2004, the IASB released IFRS 3 and thus new provisions for business combinations; in this connection the previously effective IAS 22 was repealed. Furthermore, IAS 36 “Impairment of Assets” and IAS 38 “Intangible Assets” were revised. The main change in goodwill accounting relates to the prohibition of goodwill amortization. Instead, a recognized goodwill must be tested annually for impairment. The new standard and the amended standards respectively have to be applied to business combinations for which the agreement date is on or after 31 March 2004. These mentioned standards have no material effects on the consolidated financial statements of the Company for the year 2005.

In December 2003, the IASB released several revised IAS also effective for the first time from 1 January 2005. Purpose of the revision (“Improvement Project”) was the further enhancement of quality and consistency of the existing IAS. The following standards were subject to amendments: IAS 1, IAS 2, IAS 8, IAS 10, IAS 16, IAS 17, IAS 21, IAS 24, IAS 27, IAS 28, IAS 31, IAS 33 and IAS 40. These amendments mainly affected the consolidated

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financial statements 2005 with respect to balance sheet and income statement presentation. In accordance with IAS 1 revised and IAS 27, minority interests were recognized in equity separated from the equity attributable to shareholders of TELES. Net profit or loss for the period attributable to minority interests and shareholders of TELES respectively was disclosed as a thereof remark on the face of the income statement.

Following is a description of standards and interpretations adopted by the EU by 31 December 2005 but effective from 1 January 2006, which have certain relevance to the Company.

The revised IAS 39 must be applied for annual periods beginning on or after 1 January 2006. Among other things, the possibility to measure financial assets and liabilities at fair value was restricted to a certain degree. As a result, however, the securities of the Company at the balance sheet date still meet the criteria for fair value measurement.

According to IFRIC 4, applicable for annual periods beginning on or after 1 January 2006, contractual relationships must be reviewed with regard to whether specific assets, legally owned by the contracting party, are physically and economically controlled by the reporting company so that for example third parties are excluded from the use of these assets and do not receive a significant share of the produced volume generated by them. With respect to the use of those assets, the classification of the embedded leasing agreement and corresponding effects on accounting have to be determined in accordance with IAS 17. However, due to the situation at the balance sheet date no material effects on profitability and the financial situation of the Company are expected from the adoption of IFRIC 4.

According to IAS 1 revised, applicable for annual periods beginning on or after 1 January 2006, disclosure regarding the composition and management of the so called economic capital is required. This comprises for example external capital requirements and capital restrictions. Based on the situation at the balance sheet date, the amendment of this standard will not be relevant to the Company.

Furthermore, the Company will not be affected substantially by the provisions of IFRS 6 as well as IFRIC 5 both effective for annual periods beginning on or after 1 January 2006.

There were no early adoptions of IFRS standards and interpretations that become effective in 2006.

***Discontinued Operations***

The Company presents continuing and discontinued operations separately in the income statement, disclosing a summarized income from discontinued operations. A breakdown of the income and the amounts attributable to discontinued operations in the balance sheet and statement of cash flows are disclosed in note 24.

The previous year figures for continuing operations have been adjusted with respect to the disposal of the WebLearning business.



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***Use of Estimates***

The preparation of financial statements and related disclosures to conform with accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Estimates are used for, but not limited to, the accounting for inventory allowances, allowance for doubtful accounts, depreciation and amortization, accruals, warranty costs, sales returns, impairment of assets, taxes and contingencies. Actual results may differ from these estimates. Estimation uncertainties, that have a significant risk of requiring a material adjustment to the carrying amounts of assets and liabilities within the next financial year, relate to the taxation on income. This domain requires key assumptions to calculate national and international accrued taxes. For certain business transactions final taxation cannot be definitely determined during the ordinary course of business. The Company determines the amount of accruals for expected tax audits on the basis of estimates considering the extent that additional taxes might become due. If final taxation of certain business transactions varies from initial expectations, this will have an effect on actual and deferred taxes in the period in which the taxes are finally determined. Furthermore, the recognition of deferred tax assets on tax loss carried forward depends on future expectations for the development of income. Reference is made to the balance sheet and note 20 for detailed information on income taxes in the consolidated financial statements.

***Companies included in Consolidation***

The consolidated financial statements for financial year 2005 include the parent company TELES AG and seven German as well as 12 foreign subsidiaries. Compared to the previous year the number of subsidiaries decreased by six having been sold and at the same time increased by three as a result of new foundations.

TELES AG holds a 19.9% investment in GRAVIS AG. Furthermore TELES AG has been granted an option to acquire the majority of the shares in GRAVIS AG which become exercisable after 1 January 2006. Due to the absence of control by the Company, GRAVIS AG was not included in consolidation.

There are no investments in associated companies.

Refer to note 34 for a list of the companies included in consolidation.

***Consolidation Methods***

All companies are included in these consolidated financial statements TELES AG is directly or indirectly able to govern the financial and operating policies in order to obtain the benefits from their activities. Uniform accounting principles are applied. The first time inclusion of these companies occurs upon TELES AG gaining control over the subsidiary. Amounts attributable to minority interests are shown separately.

Consolidation of shareholders' equity is based on the purchase method, unless the Company opted for the exemptions relating to business combinations as set forth in IFRS 1 at the time of adopting IFRS on 1 January 2002. Under the purchase method, the historical cost of the

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investment is offset against the group's share in the relevant shareholders' equity. Assets acquired and liabilities assumed, including those not accounted for in previous statutory accounts, are stated at their fair values at the time of acquisition. Minority shares in the assets and liabilities are also stated at their fair values and included in minority interests at the time of acquisition. Any remaining positive balance was capitalized as goodwill and amortized straight-line until 31 December 2004. In connection with the disposal of companies the residual book value was unrecognized.

Intercompany transactions are eliminated. Intercompany receivables and liabilities are offset. Intercompany profits are eliminated and intercompany income and expenses are offset.

Minority interests in the net income of a consolidated subsidiary are separately shown in the income statement. Negative amounts reduce the balance sheet item "Minority Interests" until it is completely depleted.

Upon disposal of a subsidiary, its residual value of assets and liabilities including goodwill are offset against the proceeds from the transaction.

***Property, Plant and Equipment***

Property, plant and equipment are stated at cost less accumulated depreciation and write-downs. No revaluations have been made. Depreciation is provided using the straight-line method over the estimated useful lives of:

Computer hardware:	3 years
Office equipment:	5 years
Leasehold improvements:	10 years
Other:	10 years

Repair and maintenance expenses are shown as incurred.

***Intangible Assets***

Intangible assets acquired are capitalized if it is probable that their use will result in future economic benefits. They are carried at cost less amortization and write-downs, if applicable. Amortization is provided using the straight-line method over the estimated useful lives of:

Software:	3-5 years
Customer relations:	7 years
Internet learning platform:	3 years
Content for web learning courses:	4 years
Other:	3-5 years

***Financial Assets***

The shares in freenet.de AG owned by the Company are classified as assets available-for-sale. The shares are carried as "Other Financial Assets" and measured at their fair values. The fair value is determined by the stock price at the end of the period under review.

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Changes in value after first-time recognition are recognized directly within the equity (“Other Comprehensive Income”).

The Company holds a minority interest in GRAVIS AG. The investment is carried at cost less historical write-downs due to the absence of a fair value being determinable with a reasonable degree of assurance.

TELES holds a recovery right (“Besserungsrecht”) from the remission of debt in respect of this investment. Under the terms of the recovery right, the Company participates in any increase in the fair value of GRAVIS in terms of profit sharing or in the event of resale of the above mentioned shares.

Furthermore, the Company holds three recovery rights as well as call and put options on the shares of a subsidiary and a call option on the shares of another subsidiary. The recovery rights and options were not recognized as the Company did not assign a value to them as of the balance sheet date.

Trade accounts receivable as well as other receivables are stated at nominal value. Receivables with a term of more than one year are discounted using the prevailing interest rate. Credit risk is accounted for by grouping the receivables in respect of their due dates; subsequently allowances for bad debt are made based on their ageing. Specific allowances are made, if required.

Purchases and sales of financial assets are accounted for at the settlement date.

***Inventories***

Inventories are stated at the lower of average cost or market value. Allowances are recorded for existing slow-moving and obsolete inventory.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments with a maturity of ninety days or less at the time of acquisition to be cash equivalents.

***Treasury Stock***

The Company’s purchase of common stock is recorded as “Treasury Stock” and results in a reduction of shareholder’s equity. When treasury shares are reissued, the Company uses a first-in, first-out (FIFO) method with the difference between cost and re-issuance price treated as a reduction or increase of retained earnings.

***Financial Liabilities***

The Company has financial liabilities resulting from the issue of convertible debt as part of the ESOP. The liabilities issued bear an historic market interest rate of 6%. The Company holds loans receivable granted as part of the ESOP in an amount almost equal to the financial liabilities. Both items are considered as held to maturity and accounted at cost.

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The convertible debt is classified as liability since the conversion right depends on uncertain events which are beyond the control of the Company. Further, there was no equity attributable to it as of the date when the convertible debt was issued.

***Provisions***

Provisions are made for legal and constructive obligations resulting from past events if it seems probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount required can be made.

Asset retirement obligations are provided for if an outflow of resources is expected. The present value of those obligations is accounted for as an increase in fixed assets. At each balance sheet date, the present value of the obligation is increased affecting net income.

The Company generally warrants its telecommunication products over a period of 12 months. In some cases the period is extended up to 24 months. Estimated warranty costs are accrued when the related revenue is recognized. The amounts are based on historic experiences and the assessment of future circumstances.

***Deferred Income Taxes***

The accounting for deferred income taxes is based on the liability method. They are recorded on all significant temporary differences between the tax base and carrying value of assets and liabilities as well as on tax loss carry forward. Deferred taxes are calculated using the tax rate set forth by tax laws in effect at the balance sheet date. Provisions are made if it seems probable that some or all of the deferred tax assets may not be used. Deferred income taxes are classified as non-current assets and liabilities in the balance sheet.

***Impairment***

Impairment tests are made if there is a triggering event indicating that the carried value of the asset may exceed its net realizable value.

***Research and Development Expenses***

Research expenses are shown as incurred. Costs incurred for the development of software for telecommunications devices or Internet services available for sale were not capitalized since the requirements of IAS 38, particularly with regard to the identifying of costs, the technological feasibility and the probability of related future economic benefits were not met. Costs incurred for the development of internally used software were also not capitalized.

***Leases***

If the Company is not classified economic owner of the asset, the lease is accounted for as operating. Lease payments are charged to income straight-line over the term of the lease.

If the Company is classified economic owner of the asset, the lease is accounted for as financing. The leased asset is capitalized and depreciated over the shorter of the useful life or the term of the lease. The liability assumed is accounted for at its present value and reduced by the principal payments made.

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***Foreign Currency Translation***

The local currency has been designated as the functional currency. Accordingly, all assets and liabilities have been calculated at the current exchange rate as of the balance sheet date. Income and expenses have been calculated at the average monthly exchange rates prevailing during the year. Gains and losses resulting from the calculation of the subsidiary's financial statements are included in "Other Changes in Equity". Foreign currency calculation gains and losses are included in the net income for the period.

***Employee Stock Option Plans***

Since 1 January 2005, the requirements of IFRS 2 Share-based Payments have to be met. According to IFRS 2, the effects of share-based payments should be recognized in income and the financial and assets position of the company; this includes expenses resulting from stock options granted to employees. Consequently the fair value of the employee services received in exchange for the stock options granted has to be recognized as an expense and increase in equity. Since it is not possible to estimate reliably the fair value of the employees' services, the fair value must be measured by reference to the fair value of the stock options at the grant date.

In accordance with the transition provisions, IFRS 2 has to be applied to all grants after 7<sup>th</sup> November 2002 that were unvested as of 1 January 2005. The comparative figures have to be adjusted accordingly.

Payments received on the exercise of stock options are recorded as capital increase resulting in neither profit nor loss.

***Revenue Recognition***

Products

The Company generally recognizes product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, no significant customer obligations remain and collectibility is probable. The Company accrues all potential costs relating to product returns, warranty costs and other allowances based on its experience.

Services

The Company recognizes revenue from sales of services when the services are substantially complete and chargeable.

Reimbursement of Transportation and Shipping Costs

The Company records the reimbursement of shipping costs as revenue and the related costs as cost of sales.

***Cost of Sales***

Cost of sales relating to the sale of products comprise direct material and manufacturing costs, indirect costs including depreciation of fixed assets used in production and amortization of other intangibles as well as allowances for inventories.

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***Earnings per Common Share***

Basic net income per common share is computed using the weighted-average number of common shares outstanding during the period. Treasury stock reduces the number of shares outstanding. Diluted net income per common share is computed using the weighted-average number of common and diluted common equivalent shares outstanding during the period. Diluted common equivalent shares consist of stock options only.

***Segment Reporting***

Segment reporting includes information on the revenue and risks associated with the different kinds of products and services as well as the different geographical markets in which the Company operates. Based on the origin of revenues and risks, the Company defines business segments as its primary segments and geographical regions as secondary segments.

***Government Grants***

Government grants received for investments in fixed assets are accounted for as “Other Non-current Liabilities” and released over the useful life of the related assets affecting net income. In so far as the related assets have been partially or fully depreciated at the time the government grants are received, the grants are immediately recorded as income.

***Dividend Income***

Dividend Income is recognized at the time of acquiring the right to receive the payment.

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**NOTE 3: MAJOR ITEMS INCLUDED IN INCOME FROM OPERATIONS<sup>4</sup>**

	01 January – 31 December	
(in T€)	2004	2005
<b>Amortization and Depreciation</b> (included in cost of sales and operating expenses)	734	775
<i>thereof:</i> depreciation of fixed assets	590	667
<i>thereof:</i> amortization of intangibles	144	108
<b>Inventories</b> Cost of inventories charged to expense therein included: write-downs of inventories (included in cost of sales)	8,004 250	12,790 278
<b>Income relating to prior periods</b> (included in operating expenses and other income)	0	332
<b>Allowances for doubtful accounts</b> (included in sales and marketing expenses) <i>thereof:</i> increase in allowances <i>thereof:</i> reversal of allowances	542 764 -222	842 1,169 -327
<b>Staff costs (excluding expenses related to employee stock option plans)</b> (included in cost of sales and operating expenses) <i>thereof:</i> employer's share to statutory pension scheme <i>thereof:</i> employer's share to defined contribution plans	10,634 636 27	12,177 748 34
<b>Government grants („Investitionszulage“)</b> relating to prior periods (included in other income)	0	24

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<sup>4</sup> Continuing Operations

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**NOTE 4: CHANGES IN THE COMPANIES INCLUDED IN CONSOLIDATION**

In December 2005, TELES Latin America S.R.L. was founded with TELES holding 100% of shares. The nature of the business is the distribution of TCS-products. Common stock of the company and proportional acquisition costs amount to T€ 32 (300,000 Bolivian Boliviano).

In September 2005, TELES Communication Systems Commerce and Industry Ltd. Sirketi was founded with TELES holding 100% of shares. The nature of the business is the distribution of TCS-products. Common stock of the company and proportional acquisition costs amount to T€ 31 (50,000 New Turkish Lira).

In July 2005, TELES skyDSL UK Ltd. was founded with TELES holding 100% of shares. The nature of the business is the distribution of skyDSL-products. Common stock of the company and proportional acquisition costs amount to € 17.39 (12.00 British Pounds).

TELES sold its WebLearning business under the terms of a contract dated 22 June 2005. The transaction was concluded by transfer of all of the shares held in TEIA – TELES European Internet Academy AG to the buyer. As a consequence, all of the shares held in TEIA – SPC Lehrbuchverlag GmbH by TEIA AG were also transferred to the buyer. The contract came into effect on 1 July 2005.

The purchase price of 1.00 € was symbolic only. However, TELES can participate in future profits of the company when additional contributions are agreed upon.

In detail the following assets and liabilities were sold:

(in T€)

Cash and cash equivalents	50
Receivables	67
Inventories	201
Fixed and intangible assets	17
Other assets	3
Current Liabilities	181

The investing cash flow was affected by the disposal as follows:

(in T€)

Cash component of sale and purchase price	0
Less outflow of cash and cash equivalents	<u>-50</u>
<b>Outflow of cash and cash equivalents</b>	<b>-50</b>

Reference regarding the transaction's effect on profit and loss is made in note 24.

The comparative figures of the income statement for the financial year 2004 were adjusted retrospectively with reference to the disposal of the business.



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TELES sold its WebHosting business to freenet.de AG under the terms of a contract dated 12 December 2004. The transaction was closed by transfer of all of the shares held in TECT-TELES eCommerce Track AG (including its subsidiaries STRATO Medien AG and Cronon AG) and STRATO Rechenzentrum AG to freenet.de AG. The contract came into effect on 27 January 2005.

The sale and purchase price is comprised of:

(in T€)

Cash component	80,000
Shares of freenet.de AG	<u>55,025<sup>5</sup></u>
<b>Total sales price</b>	<b>135,025</b>

In detail the following assets and liabilities were sold:

(in T€)

Cash and cash equivalents <sup>6</sup>	16,783
Receivables	2,550
Inventories	76
Fixed and intangible assets	13,550
Other assets	6,534
Current liabilities <sup>7</sup>	28,138
Non-current liabilities	2,580

The dividend of T€ 873 included in net assets at the time of sale has been paid to TELES AG in the meantime.

The investing cash flow was affected by the disposal as follows:

(in T€)

Cash component of sale and purchase price	80,000
Less outflow of cash and cash equivalents <sup>6</sup>	<u>-16,783</u>
<b>Inflow of cash and cash equivalents</b>	<b>63,217</b>

Reference regarding the transaction's effect on profit and loss is made in note 24.

In May 2005, EuroSkyNet B.V. was renamed TELES skyDSL Europe B.V.

In February 2005, TELES NetOperations GmbH was renamed TELES skyDSL GmbH.

In February 2005, cyPOS AG was renamed DirectSat AG.

<sup>5</sup> The shares of freenet.de AG were measured at fair value at the trade date.

<sup>6</sup> Adjusted for the payment to TELES AG in February 2005 due to the profit transfer of 2004.

<sup>7</sup> Adjusted for the liability towards TELES AG due to the profit transfer of 2004.

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**NOTE 5: PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment developed as follows in the financial years 2004 and 2005:

(in T€)	31 December 2003	Additions	Asset costs		Acquisition of Companies	31 December 2004
			Disposals			
Computer hardware	12,435	8,407	22		27	20,847
Capital leases	2,092	284	34		0	2,342
Furniture and fixtures	1,308	59	297		0	1,070
Leasehold improvements	3,766	910	76		0	4,600
Assets leased to customers	323	0	0		0	323
Other	<u>944</u>	<u>567</u>	<u>570</u>		<u>3</u>	<u>944</u>
<b>Total</b>	<b>20,868</b>	<b>10,227</b>	<b>999</b>		<b>30</b>	<b>30,126</b>

(in T€)	31 December 2003	Additions	Accumulated depreciation		Acquisition of Companies	31 December 2004
			Disposals			
Computer hardware	7,694	3,896	52		4	11,542
Capital leases	1,437	31	20		0	1,448
Furniture and fixtures	1,180	60	295		0	945
Leasehold improvements	1,011	415	46		0	1,380
Assets leased to customers	323	0	0		0	323
Other	<u>643</u>	<u>438</u>	<u>398</u>		<u>0</u>	<u>683</u>
<b>Total</b>	<b>12,288</b>	<b>4,840</b>	<b>811</b>		<b>4</b>	<b>16,321</b>

(in T€)	Net closing amounts	
	31 December 2003	31 December 2004
Computer hardware	4,741	9,305
Capital leases	655	894
Furniture and fixtures	128	125
Leasehold improvements	2,755	3,220
Assets leased to customers	0	0
Other	<u>301</u>	<u>261</u>
<b>Total</b>	<b>8,580</b>	<b>13,805</b>

(in T€)	31 December 2004	Additions	Asset costs		Sale of Companies	31 December 2005
			Disposals			
Computer hardware	20,847	842	395		15,723	5,571
Capital leases	2,342	0	0		925	1,417
Furniture and fixtures	1,070	100	89		320	761
Leasehold improvements	4,600	11	1		4,086	524
Assets leased to customers	323	0	323		0	0
Other	<u>944</u>	<u>393</u>	<u>162</u>		<u>691</u>	<u>484</u>
<b>Total</b>	<b>30,126</b>	<b>1,346</b>	<b>970</b>		<b>21,745</b>	<b>8,757</b>

(in T€)	31 December 2004	Additions	Accumulated depreciation		Sale of Companies	31 December 2005
			Disposals			
Computer hardware	11,542	851	388		7,334	4,671
Capital leases	1,448	0	0		31	1,417
Furniture and fixtures	945	39	41		286	657
Leasehold improvements	1,380	48	1		917	510
Assets leased to customers	323	0	323		0	0
Other	<u>683</u>	<u>130</u>	<u>116</u>		<u>577</u>	<u>120</u>
<b>Total</b>	<b>16,321</b>	<b>1,068</b>	<b>869</b>		<b>9,145</b>	<b>7,375</b>

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(in T€)	Net closing amounts	
	31 December 2004	31 December 2005
Computer hardware	9,305	900
Capital leases	894	0
Furniture and fixtures	125	104
Leasehold improvements	3,220	14
Assets leased to customers	0	0
Other	<u>261</u>	<u>364</u>
<b>Total</b>	<b>13,805</b>	<b>1,382</b>

Capital leases as at 31 December 2004 (net book amount T€ 894) relate to technical leasehold improvements acquired in 2003. The technical leasehold improvements are attributable to the WebHosting business disposed of in 2005.

**NOTE 6: INTANGIBLE ASSETS**

Intangible assets developed as follows in the financial years 2004 and 2005:

(in T€)	31 December 2003	Additions	Asset costs		Acquisition of Companies	31 December 2004
			Disposals			
Software	7,742	279	84	0	0	7,937
Customer relations	6,916	0	0	0	0	6,916
Goodwill	4,806	0	0	0	0	4,806
Learning management system	1,560	0	0	0	0	1,560
Content for Internet courses	1,296	74	68	0	0	1,302
Other	<u>321</u>	<u>1</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>322</u>
<b>Total</b>	<b>22,641</b>	<b>354</b>	<b>152</b>	<b>0</b>	<b>0</b>	<b>22,843</b>

(in T€)	31 December 2003	Additions	Accumulated amortization		Acquisition of Companies	31 December 2004
			Disposals			
Software	6,559	929	82	0	0	7,406
Customer relations	6,730	58	0	0	0	6,788
Goodwill	4,191	194	0	0	0	4,385
Learning management system	338	994	0	0	0	1,332
Content for Internet courses	772	386	64	0	0	1,094
Other	<u>294</u>	<u>26</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>320</u>
<b>Total</b>	<b>18,884</b>	<b>2,587</b>	<b>146</b>	<b>0</b>	<b>0</b>	<b>21,325</b>

(in T€)	Net closing amounts	
	31 December 2003	31 December 2004
Software	1,183	531
Customer relations	186	128
Goodwill	615	421
Learning management system	1,222	228
Content for Internet courses	524	208
Other	<u>27</u>	<u>2</u>
<b>Total</b>	<b>3,757</b>	<b>1,518</b>

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(in T€)	31 December 2004	Additions	Asset costs		31 December 2005
			Disposals	Sale of Companies	
Software	7,937	240	1	3,857	4,319
Customer relations	6,916	0	0	409	6,507
Goodwill	4,806	0	0	4,806	0
Learning management system	1,560	0	0	1,560	0
Content for Internet courses	1,302	10	0	1,312	0
Other	<u>322</u>	<u>10</u>	<u>0</u>	<u>213</u>	<u>119</u>
<b>Total</b>	<b>22,843</b>	<b>260</b>	<b>1</b>	<b>12,157</b>	<b>10,945</b>

(in T€)	31 December 2004	Additions	Accumulated amortization		31 December 2005
			Disposals	Sale of Companies	
Software	7,406	178	0	3,436	4,148
Customer relations	6,788	5	0	286	6,507
Goodwill	4,385	0	0	4,385	0
Learning management system	1,332	130	0	1,462	0
Content for Internet courses	1,094	226	0	1,320	0
Other	<u>320</u>	<u>0</u>	<u>0</u>	<u>211</u>	<u>109</u>
<b>Total</b>	<b>21,325</b>	<b>539</b>	<b>0</b>	<b>11,100</b>	<b>10,764</b>

(in T€)	Net closing amounts	
	31 December 2004	31 December 2005
Software	531	171
Customer relations	128	0
Goodwill	421	0
Learning management system	228	0
Content for Internet courses	208	0
Other	<u>2</u>	<u>10</u>
<b>Total</b>	<b>1,518</b>	<b>181</b>

All intangible assets have a definite useful life.

The remaining depreciable life of the major part of the software licenses is approx. two years.

**NOTE 7: OTHER FINANCIAL ASSETS**

Other financial assets include:

(in T€)	31 December 2004	31 December 2005
Listed securities: freenet.de AG	0	65,720
Unlisted securities: GRAVIS AG	<u>69</u>	<u>69</u>
	<b>69</b>	<b>65,789</b>

Other financial assets developed as follows:

(in T€)	2004	2005
1 January	69	69
Additions	0	55,025
Fair value measurement	<u>0</u>	<u>10,695</u>
<b>31 December</b>	<b>69</b>	<b>65,789</b>

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TELES' 19.9%-investment in GRAVIS was initially measured at cost (T€ 438) and is carried at cost less historical write-downs (T€ 369) at the balance sheet date. In the absence of information on the company's futures profits, the investment was not accounted for at its fair value since it was not determinable with a reasonable degree of assurance. Furthermore, the Company holds a recovery right from the remission of debt. Under the terms of the recovery right, the Company participates in any future increases in the fair value of GRAVIS in the event of resale of the shares until 30 June 2007 and in an amount of up to T€ 2,103.

Furthermore, TELES holds a call option on the majority of the voting rights in GRAVIS which become exercisable after 1 January 2006.

In the course of the sale of TEIA AG and its subsidiary TEIA - SPC Lehrbuchverlag GmbH in 2005 (q.v. note 4) a recovery right was granted under which TELES receives revenue and profit related additional contributions. Furthermore, in the event of a sale of these companies, TELES obtains 50% of profits as measured by the price at which the companies were sold less additional contributions already received. The recovery right is valid from 1 July 2005 till 30 June 2009.

In the course of the sale of SPC and SuXess GmbH a recovery right was granted under which TELES participates in any future increases in the fair value of these companies in the event of a sale occurring until 31 December 2005. TELES will receive 50% of the positive difference between the sales price and the price at which the companies were sold by TELES. Furthermore the Company receives 30% of the companies' net income in the years 2003 to 2005. The aforementioned recovery right did not result in any income.

TELES also holds two call as well as one put options on all of the shares in call media service Ltd. The exercise price is £ 1.00 per share. The options have an unlimited term.

Furthermore, TELES holds a put option on all of its shares in TELES Computer Systems India Private Limited. The option has an unlimited term.

As in the previous year these financial instruments were not recognized at the balance sheet date since the Company currently does not assign any value to them.

**NOTE 8: OTHER NON-CURRENT ASSETS**

Other non-current assets include loans granted to employees as part of the ESOP (T€ 686, T€ 812 in the previous year). Like the corresponding convertible debt, the loans bear an interest rate of 6%. The fair value of these loans is equal to their net book value.

Furthermore, an interest-bearing security was recorded as of 31 December 2004 relating to DENIC (T€ 2,460) and attributable to the WebHosting business disposed of in 2005.

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**NOTE 9: INVENTORIES**

Inventories include:

(in T€)	<b>31 December 2004</b>	<b>31 December 2005</b>
Finished goods	739	471
Merchandise	626	566
Raw material and supplies	<u>3,315</u>	<u>3,527</u>
	<b>4,680</b>	<b>4,564</b>
Thereof items:		
Reported at net realizable values	273	213
Range > 12 months	400	519

**NOTE 10: TRADE ACCOUNTS RECEIVABLE**

Trade accounts receivable are comprised of:

(in T€)	<b>31 December 2004</b>	<b>31 December 2005</b>
Trade accounts receivable	9,505	6,649
Other	<u>28</u>	<u>442</u>
	9,533	7,091
Less allowance for doubtful accounts	<u>3,305</u>	<u>2,586</u>
	<b>6,228</b>	<b>4,505</b>

Securities received such as bank guarantees and letters of credit amount to T€ 330 as of 31 December 2005.

**NOTE 11: OTHER CURRENT ASSETS**

Other current assets include:

(in T€)	<b>31 December 2004</b>	<b>31 December 2005</b>
Prepaid expenses	1,805	1,134
Receivables from government grants	1,393	224
Receivables from fiscal authorities	0	367
Other	<u>969</u>	<u>803</u>
	<b>4,167</b>	<b>2,528</b>

Receivables from government grants as at 31 December 2004 are mainly attributable to the WebHosting business (T€ 1,193) disposed of in 2005.

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**NOTE 12: SHAREHOLDERS' EQUITY**

Common stock is made up of 23,304,676 non-par value shares. The imputed value per share amounts to € 1.00. The total number of shares includes 376,106 new shares issued to employees who had exercised their stock options in 2005.

Following a resolution by the shareholders' meeting at 13 December 2004, the share capital was reduced by € 22,927,070 for repayment to TELES' shareholders. The resolution was entered in the trade register. The amount was paid to the shareholders after the lock-up period of six months following promulgation of that entry on 7 July 2005. This procedure is designed to protect the creditors of companies in Germany.

Furthermore, due to the resolution by the shareholders' meeting at 3 June 2005, the share capital was increased by € 18,342,856 out of capital reserves and subsequently reduced by the same amount for distribution to TELES' shareholders. Reference regarding the payment is made in note 32.

Both reductions in share capital mentioned above do not impact on earnings of TELES being a corporate entity and thus are not taxable.

**Authorized Capital**

The authorized capital (authorized capital I) as at 31 December 2005 amounts to T€ 19,000.

The authorized capital I is based on the resolution by the shareholders' meeting on 2 April 2004. The authorized capital I gives authorization to the Management Board to increase the Company's share capital upon approval of the Supervisory Board for the period until 31 March 2009. Contributions of up to T€ 19,000 may be made in cash or other assets as part of a single transaction or a series of transactions.

**Restricted Capital**

The restricted capital as at 31 December 2005 amounts to T€ 1,916, equaling 1,915,840 non-par value shares, and is made up as follows:

Restricted capital I:	T€ 1,532, equaling 1,531,964 non-par value shares
Restricted capital III:	T€ 384, equaling 383,876 non-par value shares

The restricted capital I, created for the first time at the shareholders' meeting in 1998, amounted to T€ 1,527 as at the previous balance sheet date and was to be utilized for the potential issuing of up to 1,527,104 non-par value shares as part of the Company's stock incentive plan. Based on the resolution by the shareholders' meeting of 3 June 2005, the restricted capital I shall be used to issue potential shares to employees following exercise of conversion rights and stock options which had been granted on the grounds of previous shareholders' resolutions. It shall furthermore be used to issue potential shares to employees as part of the ESOP approved under item 7 of the agenda of the same shareholders' meeting. For that purpose, it was increased by T€ 120 equaling 120,000 non-par value

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shares. The restricted capital I will only be used if conversion rights or stock options are exercised as part of the ESOP. In the reporting period, the restricted capital I was utilized to issue a total of 115,140 shares to employees. Hence, the restricted capital I was adjusted to T€ 1,532 equaling 1,531,964 non-par value shares.

At the shareholders' meeting of 11 July 2000, the Company's shareholders also approved creation of the restricted capital III amounting to T€ 1,300. In accordance with the shareholders' resolution dated 31 August 2001, it will only be utilized as far as stock options granted to the Management Board and employees are exercised in the period until 30 August 2006. The restricted capital III amounted to T€ 645 as of the prior balance sheet date and was to be utilized for the potential issuing of up to 644,842 non-par value shares as part of the ESOP. Following the issuing of 260,966 shares due to the exercise of stock options in the reporting period, the restricted capital III amounts to T€ 384 equaling 383,876 non-par value shares.

***Treasury Stock***

At 25 May 1999, the Company's shareholders approved the Management Board's right to repurchase up to 10% of the Company's shares within the following 18 months for purposes other than trading. At the shareholders' meetings for the business years 2000, 2001, 2002, 2003, 2004 and finally at 3 June 2005 the authorizations were cancelled and new authorizations were granted to extend the right to repurchase shares for a period of up to 18 months.

Furthermore, the Management Board was authorized to resell the treasury stock upon prior approval by the Supervisory Board. Treasury stock may also be transferred to third parties in a merger or in exchange for the acquisition of shares in companies which are to be wholly or partly owned. Shares may only be transferred at the prevailing market price. Treasury stock may also be re-issued in so far as conversion rights by employees are exercised. Furthermore, the Management Board was authorized to redeem treasury shares upon prior approval by the Supervisory Board without requiring authorization by the shareholders' meeting. The authorization to redeem shares may be exercised partially or in full. In financial 2005, no treasury shares were acquired on the basis of the authorization by the shareholders' meeting.

Treasury stock developed as follows:

(in T€)	Number of shares	Cost
<b>31 December 2004</b>	2,174,493	21,702
<b>Additions</b>	0	0
<b>31 December 2005</b>	2,174,493	21,702

***Additional Paid-In Capital***

Additional paid-in capital includes surpluses paid by shareholders. It was reduced by the effects of the pooling-of-interests accounting for business combinations under U.S. GAAP.



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The additional paid-in capital as at 31 December 2005 increased by T€ 1,131 due to the first-time adoption of IFRS 2 regarding the accounting of employee stock option plans. It includes prior period adjustments in the amount of T€ 326.

***Other Comprehensive Income***

Changes in value after first-time recognition of assets available-for-sale are recognized in other comprehensive income (T€ 10,487 as at 31 December 2005) and reduced by related deferred taxes.

***Profit Transfer***

TELES AG finalised control and profit/loss transfer agreements with three of its subsidiaries. The agreements have a five-year term and create fiscal entities for trade and corporate tax purposes. The agreements with RVS GmbH and TECT AG were cancelled following the discontinuation of the activities of RVS and the sale of TECT AG to freenet.de AG, respectively.

**NOTE 13: CONVERTIBLE DEBT**

Amounts recognized in the balance sheet:

(in T€)	31 December 2004	31 December 2005
6% convertible debt (maturity June 2008)	683	676
6% convertible debt (maturity August 2009)	<u>216</u>	<u>216</u>
	<b>899</b>	<b>892</b>

On 24 June 1998, the Supervisory Board of the Company authorized the grant of convertible bonds as part of the employee stock option plan. The Company received proceeds of T€ 1,569 from the issuing of 61,393 convertible bonds at a nominal value of € 25.56 each. The bonds mature on 24 June 2008, if not previously converted.

On 16 August 1999, the Supervisory Board of the Company authorized the grant of further convertible bonds as part of the employee stock option plan. The Company has a long-term loan receivable from employees, who were granted a loan to pay for the convertible bonds. A total of 198,210 bonds were issued with a nominal value of € 2.00 each. The bonds mature on 16 August 2009, if not previously converted.

The bonds bear an interest of 6%, payable at 31 December of each year. The final interest payments are due on 24 June 2008 and 16 August 2009, respectively. The corresponding loans receivable from employees have the same terms. The fair value of the convertible bonds is equal to their carried amount. Please refer to note 25 for the conversion terms.

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**NOTE 14: ASSET RETIREMENT OBLIGATIONS**

Provisions for asset retirement obligations amounted to T€ 604 as at 31 December 2004 and represent the net present value of expected outflows to be incurred by STRATO Rechenzentrum AG being part of the WebHosting business.

**NOTE 15: OTHER NON-CURRENT LIABILITIES**

Other non-current liabilities include:

(in T€)	31 December 2004	31 December 2005
Deferred income from government grants	1,059	0
Finance lease liabilities	917	0
Payables to related parties	190	190
Other	<u>99</u>	<u>128</u>
	<b>2,265</b>	<b>318</b>

Government grants developed as follows:

(in T€)	2004	Additions	31 December Release	Sale of Companies	2005
„Investitionszulagen“	836	0	27	809	0
„Investitionszuschüsse“	<u>223</u>	<u>0</u>	<u>7</u>	<u>216</u>	<u>0</u>
<b>Total</b>	<b>1,059</b>	<b>0</b>	<b>34</b>	<b>1,025</b>	<b>0</b>

Finance lease liabilities as at 31 December 2004 represent the present value of contractual minimum lease payments including extension rights of the Company.

The aforementioned liabilities are completely attributable to the WebHosting business disposed of in 2005.

Reference regarding the related party transactions is made in note 29.

**NOTE 16: TRADE ACCOUNTS PAYABLE**

Reference is made in note 28 regarding the contractual claim against a technical supplier reported in the previous year.

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**NOTE 17: PROVISIONS**

Provisions developed as follows:

(in T€)	2004	Utilization	Release	31 December			2005
				Additions	Reclas- sification	Sale of Companies	
Litigation	443	52	28	0	0	85	278
Other	338	172	8	242	-25	199	176
<b>Total</b>	<b>781</b>	<b>224</b>	<b>36</b>	<b>242</b>	<b>-25</b>	<b>284</b>	<b>454</b>
<b>Income taxes</b>	<b>1,478</b>	<b>277</b>	<b>92</b>	<b>1,118</b>	<b>14</b>	<b>1,081</b>	<b>1,160</b>

The litigation risk assessment is based on estimates made by the Company's attorneys. In order not to weaken the Company's negotiating position, both in-court and out-of-court, no further details are disclosed.

The outflow of resources is primarily expected to occur within the next financial year.

**NOTE 18: DEFERRED REVENUES**

Deferred Revenues as at 31 December 2004 amounting to T€ 15,011 represent prepayments for Internet services of the WebHosting business disposed of in 2005.

**NOTE 19: OTHER CURRENT LIABILITIES**

Other current liabilities include:

(in T€)	31 December 2004	31 December 2005
Amounts payable to shareholders from reduction of share capital	22,468	18,343
Withholding tax liability	459	0
Payables to related parties	796	362
Other	<u>3,463</u>	<u>2,104</u>
	<b>27,186</b>	<b>20,809</b>

Reference regarding the related party transactions is made in note 29.

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**NOTE 20: TAXATION ON INCOME**

Earnings before taxes were allocated as follows:

(in T€)	Years ending 31 December	
	2004	2005
<b>Germany</b>	<b>5,459</b>	<b>116,749</b>
thereof: continuing operations	-2,834	-8,660
thereof: discontinued operations	8,293	125,409
<b>Foreign countries</b>	<b><u>-501</u></b>	<b><u>-2,229</u></b>
<b>Income before taxes</b>	<b>4,958</b>	<b>114,520</b>

Income tax expense is made up of:

(in T€)	Years ending 31 December	
	2004	2005
<b>Current taxes</b>		
Germany	2,198	2,908
thereof: continuing operations	1,280	190
thereof: discontinued operations	918	2,718
Foreign countries	<u>260</u>	<u>248</u>
<b>Total:</b>	<b>2,458</b>	<b>3,156</b>
<b>Deferred taxes</b>		
Germany	603	666
thereof: continuing operations	-3,501	-337
thereof: discontinued operations	4,104	1,003
Foreign countries	<u>-276</u>	<u>250</u>
<b>Total:</b>	<b>327</b>	<b>916</b>
<b>Tax expense:</b>	<b>2,785</b>	<b>4,072</b>

The income of a corporation is subject to a federal corporation tax of 25.0% plus a solidarity surcharge of 5.5%. After taking the solidarity surcharge into account, the effective federal corporation tax rate amounts to approximately 26.4%. Including the additional effective trade tax rate, the total tax rate amounts to approximately 38.9%.

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The following table summarizes the significant differences between the Company's effective tax rate and the German rate of approximately 38.9%:

(in T€)	Fiscal years ending 31 December	
	2004	2005
Income before taxes	4,958	114,520
Tax expense at statutory rate	1,928	44,537
Tax rate-differentials	30	4
Non-taxable items	0	-47,292
Non-deductible items	121	103
Change in valuation allowances	-537	1,147
Non recognition of deferred tax assets	779	4,378
Employee stock option plans	125	313
Other items, net	<u>339</u>	<u>882</u>
<b>Effective tax expense</b>	<b>2,785</b>	<b>4,072</b>

Deferred taxes relating to assets available-for-sale were recognized directly in equity (T€ 208, previous year: T€ 0).

The approximate tax effects of temporary differences which give rise to deferred taxes are:

(in T€)	Fiscal years ending 31 December	
	2004	2005
Deferred tax assets:		
Intercompany transactions	135	79
Allowance for doubtful accounts	65	133
Operating tax loss carry forwards	8,171	6,727
Other	33	33
Valuation allowance	<u>-609</u>	<u>-603</u>
Total deferred tax assets	7,795	6,369
Offsetting against deferred tax liabilities	-3,255	-2,614
Net closing amount of deferred tax assets	<u>4,540</u>	<u>3,755</u>
Deferred tax liabilities:		
Costs of assets available-for-sale	0	850
Assets available-for-sale	0	208
Intercompany transactions	3,054	3,062
Intangibles acquired in business combinations	27	0
Refund of web-hosting fees	731	0
Other	<u>40</u>	<u>129</u>
Total deferred tax liabilities	3,852	4,249
Offsetting against deferred tax assets	-3,255	-2,614
Net closing amount of deferred tax liabilities	<u>597</u>	<u>1,635</u>
<b>Deferred tax assets, net</b>	<b>3,943</b>	<b>2,120</b>

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Deferred tax liabilities relating to temporary differences of T€ 97 due to undistributed earnings of subsidiaries have not been recognized since distribution is not intended in the near future.

Deferred tax assets in the amount of T€ 2,753 have been recognized by subsidiaries with a history of operating losses.

Deferred tax assets on tax losses carried forward are recognized based on future expectations concerning the results of the respective companies.

Unrecognized tax losses carried forward in companies with active businesses relate to German corporate tax (T€ 11,192) and trade tax (T€ 10,170) as well as foreign taxes on income (T€ 2,820), as they cannot be utilized.

Further, no deferred tax assets on tax losses carried forward totaling approx. € 17 million in companies without active businesses were recognized as they cannot be utilized by these companies. However, the major part of the losses was utilized by write-downs recorded in the tax accounts of the holding company.

When calculating a certain tax component of a company in a particular tax jurisdiction area, current deferred tax assets and liabilities were offset against one another. Deferred tax assets and liabilities may be presented as follows:

(in T€)	<b>31 December 2004</b>		<b>31 December 2005</b>	
	To be settled in less than 12 months	To be settled in more than 12 months	To be settled in less than 12 months	To be settled in more than 12 months
Deferred tax assets	1,318	3,222	241	3,514
Deferred tax liabilities	<u>597</u>	<u>0</u>	<u>0</u>	<u>1,635</u>
<b>Net deferred taxes</b>	<b>721</b>	<b>3,222</b>	<b>241</b>	<b>1,879</b>

With respect to the deferred tax assets on tax losses carried forward reported in the interim financial periods of the financial year 2005, the estimates concerning the expected future utilization of tax losses carried forward have been revised. Hence, the amount of deferred tax assets on tax losses carried forward has been reduced by T€ 2,340.

**NOTE 21: OTHER INCOME AND EXPENSES**

Other Income for the financial year 2005 mainly includes an amount of T€ 140 from the successful settlement of litigation as well as T€ 24 government grants (2004: T€ 0), T€ 17 income from the disposal of fixed assets (2004: T€ 31) and T€ 21 currency exchange gains (2004: T€ 10).

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Other expenses for the financial year 2005 mainly include an amount of T€ 8 from the disposal of fixed assets (2004: T€ 0), T€ 13 donations (2004: T€ 6), T€ 6 value-added tax adjustments (2004: 15T€) as well as T€ 16 currency exchange losses (2004: T€ 9).

**NOTE 22: FINANCIAL INCOME AND EXPENSES**

The items include:

	Financial years ending 31 December	
(in T€)	2004	2005
<b>Financial income</b>		
Interest	622	1,882
Dividends	<u>0</u>	<u>263</u>
Total	622	2,145
<b>Financial expenses</b>		
Convertible debt	61	55
Other	<u>11</u>	<u>38</u>
Total	72	93

**NOTE 23: FINANCIAL RISKS**

**1. Foreign Currency Risks**

Trade receivables are denominated in Euro. In 2005, payments due to trade liabilities denominated in U.S. dollar amounted to approximately TUSD 1,165. At the time being, the Company does not hedge against foreign currency risks. However, it closely monitors the developments in the exchange rate.

**2. Credit Risks**

There are no credit risks arising from the sale of goods and services beyond the ordinary risks covered by valuation allowances against outstanding receivables.

Securities and cash are mainly placed with two major financial institutions. There is no credit risk.

**3. Liquidity Risks**

The Company has a substantial amount of free cash. Nonetheless, there are instruments for monitoring and disposing of cash in the group, most important of which is the weekly cash report.

**4. Interest Rate Risk**

Financial assets in the form of cash are held as sight deposits at the prevailing short-term interest rate. There are no significant interest rate risks from financial liabilities. The development of interest rates has continuously been monitored throughout the financial

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period so that interest rate risks could be hedged against, if necessary. However, at the balance sheet date there were no such financial instruments held by the Company.

**5. Price Risks**

The Company holds shares classified as assets available-for-sale and is thus exposed to the price risk naturally inherent in shares traded at the stock market. This price risk is offset by the prospect of increasing share prices. Nevertheless, TELES permanently monitors the development of the share price to take timely countermeasures, if necessary.

**NOTE 24: DISCONTINUED OPERATIONS**

***Operations discontinued in the current Financial Period***

In the interests of a further concentration of its business activities, the Company sold its debt-ridden WebLearning business on 1 July 2005. Reference to this is also made in note 4.

The WebLearning business, i.e. the TEIA Segment, was part of the Value-Added Internet Services Segment (VAIS) in the financial year 2004.

***Operations discontinued in previous Financial Periods***

Under the terms of a contract dated 12 December 2004, TELES sold its WebHosting business which was part of the Value-Added Internet Services Segment (VAIS) to freenet.de AG. The contract came into effect on 27 January 2005. Reference to this is also made in note 4.

The transaction was closed by transfer of all of the shares held in TECT-TELES eCommerce Track AG (including its subsidiaries STRATO Medien AG and Cronon AG) and STRATO Rechenzentrum AG to freenet.de AG. However, the skyDSL/cableDSL-business of Strato Medien AG was not part of the transaction and remained with TELES. We refer to note 28 for the risks and opportunities of pending litigation to be completed by TELES.

Operating expenses amounting to T€ 348, incurred in the previous year and associated with the disposal of the WebHosting business, and the corresponding tax effect were reclassified from continuing to discontinued operations; the previous years figures were adjusted accordingly.

In March 2002, the Company decided to dispose of the business activities of developing and marketing software systems for ISDN components (RVS). RVS was part of the TCS Segment.

In July 2001, the Company began liquidating its computer hardware and software wholesale business (more!). Additionally, in August 2001, the Company announced its decision to sell its computer hardware and software retail business (GRAVIS). Together these two businesses formed the Sales & Post Sales Services Segment of the Company, which was entirely disposed of in 2001. The income from discontinued operations includes revenues amounting to T€ 107 (previous year T€ 0) from the recovery right agreed upon with GRAVIS.



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The table below shows income from discontinued operations:

(in T€, except per share information)	Financial years ending 31 December	
	2004	2005
<i>Operating result from discontinued operations</i>		
<b>Sales revenues</b>	<b>54,892</b>	<b>5,042</b>
thereof: WebHosting	53,784	4,894
thereof: WebLearning	1,108	148
<b>Operating expenses</b>	<b>46,636</b>	<b>5,156</b>
thereof: WebHosting	43,059	3,965
thereof: WebLearning	3,577	1,191
<b>Other income</b>	<b>14</b>	<b>9</b>
thereof: WebHosting	11	0
thereof: WebLearning	3	9
<b>Other expenses</b>	<b>273</b>	<b>33</b>
thereof: WebHosting	42	1
thereof: WebLearning	231	32
<b>Financial income</b>	<b>95</b>	<b>135</b>
thereof: WebHosting	95	135
thereof: WebLearning	0	0
<b>Earnings before taxes</b>	<b>8,092</b>	<b>-3</b>
thereof: WebHosting	10,789	1,063
thereof: WebLearning	-2,697	-1,066
<b>Income tax expenses</b>	<b>4,917</b>	<b>381</b>
thereof: WebHosting	4,429	352
thereof: WebLearning	488	29
<b>Operating result from discontinued operations, net of tax</b>	<b>3,175</b>	<b>-384</b>
thereof: WebHosting	6,360	711
thereof: WebLearning	-3,185	-1,095

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<b>Income from discontinued operations</b>	<b>201</b>	<b>125,412</b>
thereof: WebHosting	0	125,653
thereof: WebLearning	0	-356
thereof: Other operations discontinued in prior periods	201	115
<b>Income tax expenses</b>	<b>105</b>	<b>3,340</b>
thereof: WebHosting	0	1,849
thereof: WebLearning	0	583
thereof: Other operations discontinued in prior periods	105	908
<b>Income from discontinued operations, net of tax</b>	<b>96</b>	<b>122,072</b>
thereof: WebHosting	0	123,804
thereof: WebLearning	0	-939
thereof: Other operations discontinued in prior periods	96	-793
<b>Total income / loss from discontinued operations, net of tax</b>	<b>3,271</b>	<b>121,688</b>
thereof: WebHosting	6,360	124,515
thereof: WebLearning	-3,185	-2,034
thereof: Other operations discontinued in prior periods	96	-793
Weighted average number of common shares used to compute basic earnings (loss) per share		
Undiluted	20,806,030	20,952,051
Diluted	21,255,641	21,153,579
Earnings per share from discontinued operations		
Undiluted	0.15	5.81
Diluted	0.15	5.75

Assets and liabilities relating to operations discontinued in prior financial periods were as follows:

(in T€)	31 December 2004		31 December 2005	
	RVS	more!	RVS	more!
Current assets	27	189	37	193
Non-current assets	0	0	0	0
Current liabilities	3	234	869	203
Non-current liabilities	0	99	0	109
Net assets of discontinued operations	24	-144	-832	-119

There were no assets or liabilities relating to terminal systems.

The following Cash Flow was generated by the discontinued operations:

(in T€)	Financial years ending 31 December	
	2004	2005
Cash flow from operating activities	14,799	-1,125
Cash flow from investing activities	-9,231	-1,122
Cash flow from financing activities	-6,009	-6,414
Net changes in cash	-441	-8,661

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**NOTE 25: EMPLOYEE STOCK OPTION PLANS**

In 1998 and 1999 as well as in 2001, 2002, 2004 and 2005 TELES AG adopted employee stock option plans in which the Company grants equity instruments; the consideration for those exercised comprises likewise equity instruments. Any equity instruments granted as part of these plans may only be exercised if a defined performance hurdle is taken: The average performance of the TELES stock during the reference period needs to outperform the benchmark by at least ten percentage points.

Under the terms of the stock options plans 1998, 1999, 2001 and 2002, 70% of the options granted to each employee are exercisable if the performance hurdle is taken without any further conditions. The remaining 30% only become exercisable if the employee had not sold any of the shares received under the plan by the end of the term ("bonus amount"). The 2004 and 2005 stock incentive plans do not include bonus amounts.

The option rights expire 8 to 10 years after their issue date.

Following the reduction of share capital which was approved by the extraordinary shareholders' meeting in 2004, the imputed value of the share options granted by the end of 2004 was reduced from € 2.00 to € 1.00.

Following is a description of the individual terms of the plans:

**The 1998 and 1999 Stock Option Plans**

In 1998 and 1999 the Company issued convertible bonds to employees and members of the Management Board. The bonds have a 10-year term. The conditions of the original plans were modified in 2001. Refer to the details given below.

**The 2001 and 2002 Stock Option Plans**

**a) The 2001 Plan**

On 31 August 2001, the Management Board and the Supervisory Board of TELES AG were authorized to grant up to 650,000 further stock options with a total nominal value of € 1,300,000.00 to employees and members of the Management Board until 30 August 2006 based on a stock option plan approved by the Management Board and the Supervisory Board.

On 31 August 2001, the Management Board and the Supervisory Board of TELES AG were also authorized to grant up to 1,593,581 stock options to the participants of the 1998 and 1999 stock option plans until 31 December 2001. Under the terms of release agreements issued ("Erlassverträge"), the employees and the Management Board of the Company were granted the right to waive their exchange rights on shares from stock option plans adopted in previous years. In return they would be granted stock options under the new plan. The release agreements are valid for a period of two years after completion under the following conditions: If the average price of the TELES shares exceeds a value of € 20.00 during any period of ten days and all remaining conditions originally agreed are fulfilled, then, the entitled individuals may enact the exchange of convertible bonds in accordance with the

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conditions detailed in the 1998 and 1999 stock option plans within a specified period of time. A total of 709,079 stock options were exchanged.

Each option grants the right to acquire one share with an imputed value of € 1.00 per share at an exercise price of € 2.00 per share. The option rights can be exercised in installments. At the earliest, the exercise of options rights can be started two years after the issuance and can be completed after six years.

The option rights expire on 9 October 2009 and 2011 respectively.

Although conversion rights were exchanged for stock options, the related convertible debts were not settled. Instead, they have to be retained until the end of the term or the exit of the employee, whichever occurs first.

***b) The 2002 Plan***

On 17 December 2002, a total of 417,640 stock options were issued by the Company to employees based on the authorization of the shareholders' meeting of 31 August 2001.

Each option grants the right to buy one share with an imputed value of € 1.00 per share at an exercise price of € 3.40 per share. The stock options cannot be exercised earlier than two years after their date of issue.

The option rights expire on 16 December 2012.

The stock options granted as part of the 2001 and 2002 stock option plans may only be exercised if a defined performance hurdle is taken: The average performance of the TELES stock during the reference period needs to outperform the benchmark by at least ten percentage points. The benchmark period starts at the day following the grant date and ends whenever the employee decides to exercise his options. The average performance of the stock is based on the average closing prices as determined by the XETRA trading system during a period of ten days before the stock options are granted and the period of ten days before the exercise of the option. The average performance of the benchmark is calculated accordingly. The relevant benchmark will either be the TecDAX (and NEMAX 50 respectively) or the DAX, whichever performs better. If an option right becomes exercisable only upon a defined performance hurdle being taken, the performance hurdle must only be taken once during the term of the options.

***The 2004 Plan***

Based on the authorization by the annual shareholders' meetings dated 31 August 2001 and 22 August 2003, a total of 581,572 employee stock options were granted on 17 August 2004. Based on the resolutions of the shareholders' meeting in 2004, the restricted capital I as well as the remaining amount of the restricted capital III after deduction of previous ESOP expenses shall be used if new shares are issued due to the granted stock options. Some of the stock options were granted to employees who had once exited the Company and later returned. These employees first had to waive any conversion rights historically granted.

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Each option grants the right to acquire one share with an imputed value of € 1.00 per share at an exercise price of € 6.19 per share. The option rights can be exercised in installments. At the earliest, the exercise of options rights can be started two years after the issue date and can be completed after six years.

The option rights expire on 16 August 2010 as far as the converted options are concerned. The remaining rights expire on 16 August 2014.

The performance hurdle and the related conditions respectively correspond with those of the 2001 and 2002 stock option plans.

If extraordinary or unforeseeable events occur, exercise of the options may be further restricted.

***The 2005 Plan***

Based on the authorization by the annual shareholders' meeting of 2 April 2004, a total of 295,290 employee stock options were granted on 22 November 2005. According to the resolutions of the aforementioned shareholders' meeting, the restricted capital I shall be used if new shares are issued due to the granted stock options.

Each option grants the right to acquire one share with an imputed value of € 1.00 per share at an exercise price of € 6.98 per share. The option rights can be exercised in installments. At the earliest, the exercise of options rights can be started two years after the issue date and can be completed after six years.

The option rights expire on 21 November 2015.

The performance hurdle and the related conditions respectively correspond with those of the 2001 and 2002 stock option plans.

If extraordinary or unforeseeable events occur, exercise of the options may be further restricted.

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**Development of the Number of Stock Options granted**

Taking the exchange of conversion rights for stock options into account, the total number of stock options and conversion rights granted developed as follows:

**Employee stock option plan**

	1998 & 1999	2001	2002	2004	2005	Total
	Conversion rights	Stock options	Stock options	Stock options	Stock options	
<b>Outstanding at 31 December 2003</b>	<b>468,276</b>	<b>587,995</b>	<b>409,740</b>	<b>0</b>	<b>0</b>	<b>1,466,011</b>
Granted	0	0	0	581,572	0	581,572
Exercised	0	-109,916	0	0	0	-109,916
Forfeited	-69,192	-942	-34,536	0	0	-104,670
<b>Outstanding at 31 December 2004</b>	<b>399,084</b>	<b>477,137</b>	<b>375,204</b>	<b>581,572</b>	<b>0</b>	<b>1,832,997</b>
Granted	0	0	0	0	295,290	295,290
Exercised	0	-246,236	-129,870	0	0	-376,106
Forfeited	0	-33,752	-11,768	-28,450	0	-73,970
<b>Outstanding at 31 December 2005</b>	<b>399,084</b>	<b>197,149</b>	<b>233,566</b>	<b>553,122</b>	<b>295,290</b>	<b>1,678,211</b>
<b>Number of vested options at 31 December 2005</b>	<b>399,084</b>	<b>189,841</b>	<b>98,935</b>	<b>204,909</b>	<b>0</b>	<b>892,769</b>

The exercise of stock options occurred in the period between 9 June and 14 December 2005. The exercise price was € 2.00 and € 3.40 respectively per option. The weighted average share price during the reporting period for stock options exercised in 2005 was € 8.65. The options outstanding on 31 December 2005 had a weighted average remaining contractual life of 6.5 years.

**Expenses from Equity Instruments granted to Employees**

Expenses have been calculated for the 2002, 2004 and 2005 employee stock option plans.

Since it is not possible to estimate reliably the fair value of the employees' services received in exchange for the equity instruments granted, the fair value must be measured indirectly by reference to the fair value of the equity instruments at the grant date.

The value of the subscription rights was determined using a Monte Carlo Simulation, taking the performance hurdle into account, and is costed proportionately rateably over the vesting period. Non-market vesting conditions are included in assumptions about the number of options that are expected to become exercisable. The estimates regarding non-market vesting conditions are revised on each balance sheet date and resultant changes are recognized in the income statement with a corresponding adjustment to equity.

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The following parameters were used to determine the value of the subscription rights:

**Employee stock option plan**

	<b>2002</b>	<b>2004</b>	<b>2005</b>
Valuation date	17 December 2002	17 August 2004	22 November 2005
Exercise price TELES	3.40 €	6.19 €	6.98 €
Basis DAX	3,185.74	3,735.19	5,080.48
Basis TecDAX	421.47	462.39	580.17
Valuation rate TELES	3.10 €	6.31 €	6.90 €
Valuation rate DAX	3,139.97	3,705.73	5,174.72
Valuation rate TecDAX	395.10	465.24	587.44
Interest rate	4.39%	4.10%	3.49%
Volatility TELES	91.70%	65.60%	57.68%
Volatility DAX	31.65%	33.24%	27.46%
Volatility TecDAX	51.79%	37.43%	29.32%
Correlation TELES / DAX	0.21	0.27	0.24
Correlation TELES / TecDAX	0.27	0.29	0.27
Correlation DAX / TecDAX	0.72	0.78	0.77
<b>Fair value of the option</b>	<b>2.57 €</b>	<b>2.42 €</b>	<b>2.12 €</b>

Based on corresponding studies, a stock price threshold of 200% of the exercise price was determined for the early exercise of options.

For the purpose of an objective approach, volatilities and correlations are determined historically and calculated on the basis of the daily XETRA closing prices of the TELES stock and the indices DAX and TecDAX (and NEMAX 50 respectively).

The development of the TELES' stock price in the period from its first listing in 1998 to 2000 was mainly influenced by the New Economy Boom at the Neuer Markt (New Market). The period from July 1998 to December 1999 was characterized by the strongest fluctuations of the TELES' stock price. During this phase, the stock price increased from approx. € 23.18 at the time of TELES' first listing to more than € 90 and subsequently decreased to about € 27 by December 1999. Due to the one-time character of these developments and the related extreme daily stock price fluctuations, the time slot for determining the historical volatilities and correlations has been limited to a period of three years prior to the grant date of stock options for the 2002 and 2004 plans and to a period of four years for the 2005 plan.

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The following expenses from equity instruments granted to employees have been recognized in income for the period under review:

(in T€)	<b>Employee stock option plan</b>			
	<b>2002</b>	<b>2004</b>	<b>2005</b>	<b>Total</b>
<b>Financial year ending 31 December</b>				
<b>2005</b>	<b>293</b>	<b>423</b>	<b>89</b>	<b>805</b>
thereof: continuing operations	47	145	89	281
thereof: discontinued operations	246	278	0	524

The comparative figures were adjusted by the following amounts with respect to the expenses from equity instruments granted to employees:

(in T€)	<b>Employee stock option plan</b>			
	<b>2002</b>	<b>2004</b>	<b>2005</b>	<b>Total</b>
<b>Financial year ending 31 December</b>				
<b>2004</b>	<b>121</b>	<b>201</b>	<b>0</b>	<b>322</b>
thereof: continuing operations	37	145	0	182
thereof: discontinued operations	84	56	0	140

The opening balance sheet 2004 (unappropriated retained earnings) was adjusted by T€ 4.

**NOTE 26: EARNINGS PER SHARE**

The following table illustrates the computation of diluted and undiluted earnings per common share attributable to shareholders of the parent company:

(in T€, except per share information)	<b>Financial years ending 31 December</b>	
	<b>2004</b>	<b>2005</b>
Net income for the year attributable to shareholders of the parent company	2,175	110,441
Weighted average number of common shares used to compute earnings per share		
Undiluted	20,806,030	20,952,051
Diluted	21,255,641	21,153,579
Earnings per share		
Undiluted	0.10	5.27
Diluted	0.10	5.22



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	Financial years ending 31 December	
(in T€, except per share information)	2004	2005
Net income for the year attributable to shareholders of the parent company including amounts resulting from the reduction of share capital	25,102	128,784
Weighted average number of common shares used to compute earnings per share		
Undiluted	20,806,030	20,952,051
Diluted	21,255,641	21,153,579
Amount per share after capital reduction		
Undiluted	1.21	6.15
Diluted	1.18	6.09

Stock options granted to employees are the only category of potential dilutive shares.

The outstanding convertible bonds (see note 25) could be potentially dilutive in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the periods presented.

**NOTE 27: RESTRICTED CASH, OTHER FINANCIAL COMMITMENTS AND CONTINGENT LIABILITIES**

***Restricted Cash***

As of the balance sheet date, cash in the amount of T€ 118 (previous year: T€ 74) was restricted.

***Operating Leases***

The Company has rented satellite capacities, buildings, vehicles, warehouses and certain office equipment under non-cancelable lease contracts without purchase options. Leases of office buildings have a maximum term until 30 April 2007. Some of them include extension rights for the Company. Operating lease expenses amounted to T€ 6,507 and T€ 4,291 for the financial years ending 31 December 2005 and 2004, respectively.

Future minimum lease payments under non-cancelable lease contracts with a term of one year or longer were approximately as follows:

	31 December 2005
(in T€)	
Less than one year	2,848
Between one and five years	461
Later than five years	0
<b>Total</b>	<b>3,309</b>

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**Other Financial Commitments**

Future minimum payments under legally binding agreements are:

	31 December	
	2004	2005
(in T€)		
Purchase commitments		
Software	138	3
Fixed assets	1,323	73
Advertising	737	0
Other services	0	275
Inventories	249	0
Maintenance	<u>138</u>	<u>32</u>
<b>Total</b>	<b>2,585</b>	<b>383</b>

Within the scope of the TWBI business (see also note 31), the direct debit is done by a renowned financial service provider. In this regard it was agreed that an amount of T€ 31 is deposited for contingent direct debit liabilities.

**NOTE 28: LITIGATION**

The Company is involved in legal proceedings and litigation arising from the ordinary course of business. It is the Company's policy to accrue for amounts related to these matters if it is probable that a liability has been incurred and an amount can be reasonably estimated.

In 2002 TELES initiated joint proceedings against Deutsche Telekom AG (DTAG) and SES ASTRAnet S.A. for the infringement of several patent rights with their "T-DSL via Satellite" service. In two similar lawsuits regarding patent infringement the companies sued by TELES finally reached agreement with the Company – after a first-instance verdict – and withdrew from this field of business. In connection with the aforementioned patent infringement suits, a German and a European patent as well as a German utility model protecting the skyDSL technology developed by TELES, were challenged by DTAG/SES before the German and European Patent Offices in 2003 with applications for deregistration of two utility models and two patent appeals. In the ongoing patent infringement proceeding against DTAG and SES, which was resumed after an interim postponement in the last year, a further important success has been achieved by TELES in 2005: Following confirmation of the German core skyDSL patent by the Federal Patents Court at the end of 2004, the Patent Office also ruled in favour of TELES in the first instance in a case with similar scope initiated by DTAG/SES to have the TELES utility model cancelled. DTAG has lodged an appeal against the Patent Office ruling based on formal aspects. The verdict regarding the patent infringement suit is expected at the beginning of 2006. TELES is confident that it will also win these cases. Both TELES and its legal advisors expect no risks to the Company to result from these facts and circumstances.

One of STRATO Medien AG's competitors took exception to advertisements for skyDSL in 2003 and applied for an injunction. On 17 February 2005 the Regional Court of Colgone

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ruled that STRATO must desist from advertising its satellite-based Internet access with what the court considered the misleading term “DSL”, either on its own, or in the name “skyDSL”. On 6 April 2005 STRATO Medien AG appealed the decision at the Higher Regional Court of Cologne. A hearing before the Higher Regional Court of Cologne is scheduled for 13 January 2006. The outcome of the proceedings is uncertain. STRATO Medien AG, and following its withdrawal from the TELES Group the new skyDSL distribution company TELES skyDSL GmbH (“TSD”), reacted to the first-instance ruling by using the term “skyDSL” in advertisements only with a clarifying footnote. Depending on the outcome of the appeal, an identical follow-on case may be brought against the new sales company TSD.

In June 2003 TELES acquired 33.3% of the shares in a start-up company which operates as telecommunications service provider. Business activities of this company, which is registered in England, have now been discontinued. It originally provided telecommunications services to carriers in Germany requiring low cost connections from fixed-line networks to mobile networks, until the mobile SIM cards were deactivated by the mobile network operators. The Company was unable to assert its temporary injunction for reactivation of the cards against the mobile network operators concerned, but is hoping for final clarification in the principal case after a mobile network operator initiated action for payment and damages at the end of 2004. TELES has also entered a claim for damages resulting from the deactivation of the mobile cards in the principal case. After an about-turn in jurisdiction regarding the legality of the deactivation of the SIM cards used in GSM gateways, it is uncertain whether the second-instance case will succeed before the Higher Regional Court of Düsseldorf. No high financial risks are involved, however.

In 2005, the same mobile network operator also applied for an injunction against the provision and sale of GSM gateways for carrier networks by TELES AG and TELES NetSales GmbH. In view of the aforementioned shift in jurisdiction regarding one aspect of the legal action (the legality of the use of GSM gateways in Germany), TELES’ chances of success have fallen. It is also unclear what effect a negative ruling would have on international sales. TELES and its legal advisors consider both the risk of a general ban on exports and – in view of the minor significance of Germany as a market for GSM gateways – the economic risks for TELES to be low.

It was agreed under the sale of the WebHosting business that STRATO Medien AG would continue to represent TELES in the lawsuit initiated by the bankruptcy administrator of KPNQwest Germany GmbH i.In., with any and all opportunities and threats related to this lawsuit remaining with TELES. As reported in previous years, the Company withheld payments to its technical supplier, KPNQwest, during 2001 and 2002, and claimed a reduction in payables for insufficient quality of services. After KPNQwest had filed for bankruptcy, the bankruptcy administrator instituted legal proceedings against STRATO in 2002 for payment of outstanding receivables. The closing amount of trade accounts payable for STRATO as at 31 December 2004 included € 5.4 million, an amount which includes a discount of € 3.2 million for the reductions claimed, a claim the Company considers more than justified. In addition, STRATO has asserted counterclaims for damages of € 8 million. On the balance sheet date, the lawsuit was still in process. The Company has set up

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sufficient provisions for lawyers' fees and court costs. TELES and its legal advisors perceive no further threats to the Company from these facts and circumstances.

The proceedings initiated by TELES in June and July 2004 before the Regional Court of Mannheim against Quintum Inc. and its German distribution partners for infringement of the TELES IntraStar patents have been decided at first instance in favour of TELES. The first case against AVM GmbH and its distribution partners, however, was dismissed at the first instance. Appeals have been lodged against all of these rulings. Furthermore TELES has filed another lawsuit against AVM GmbH due to modifications of the originally affected product. In the patent infringement proceeding against CISCO Systems Inc., which is also pending, a verbal hearing has now been set for 31 March 2006. The cases submitted by CISCO to the Federal Patents Court for nullification of the German and European IntraStar patents have also been set for the first half of 2006, the first date being 5 April 2006 for the German IntraStar patent. TELES is, however, confident that these patents, like the German skyDSL patent, which was confirmed by the Federal Patents Court back in December 2004, will also be confirmed. Altogether a two digit number of patent infringement suits by TELES against primarily non-European companies can be still expected in the future, as their hybrid Internet telephone products (or VoIP products) may currently infringe the IntraStar patents (see the German-language [VoIP Patent Infringement Forum](#) at [www.teles.de](http://www.teles.de) for more information). TELES and its legal advisors see no threats to the company from these cases.

In October 2005 the IntraSTAR patent was granted to TELES for the United States of America, since when CISCO has also instituted legal proceedings for nullification of this US IntraStar patent and to ensure its non-infringement by CISCO products. TELES is currently examining the options and financial risks of defending its patent before the U.S. courts. Generally speaking, however, no claims can be made under U.S. law by the opponents for reimbursement of legal fees, even from an opposing party who has lost his case. As such, TELES and its legal advisers currently perceive no greater risks – apart from the defence costs – in these proceedings.

Although the ultimate outcome of legal proceedings cannot be predicted with certainty, it is the opinion of the Company's management that the outcome of any claim which is pending, either individually or on a combined basis, will not have a materially adverse effect on the consolidated financial condition of TELES but could materially affect consolidated results of operations in a given year.

**NOTE 29: RELATED PARTY TRANSACTIONS**

The following transactions between the Company and related parties occurred in the reporting periods:

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**Purchase of Services:**

(in T€)	Financial years ending 31 December	
	2004	2005
Mock-Rechtsanwälte <sup>8</sup>	167	83
Rechtsanwälte Feser & Spliedt	<u>172</u>	<u>92</u>
<b>Total</b>	<b>339</b>	<b>175</b>

The aforementioned services were received from professional associations which the members of the TELES' Supervisory Board have a financial interest in.

**Receivables from Related Parties:**

Receivables from related parties amounted to T€ 3 as of the balance sheet date.

**Payables to Related Parties:**

(in T€)	Financial years ending 31 December	
	2004	2005
Convertible debt held by Management Board members	190	190
Bonuses payable to Management Board members	305	177
Payables to members of the Supervisory Board	<u>491</u>	<u>185</u>
<b>Total</b>	<b>986</b>	<b>552</b>

**Remuneration of the Members of the Management Board:**

(in T€)	Financial years ending 31 December			
	2004		2005	
	Fix	Variable	Fix	Variable
Jan Bastian	149	50	149	100
Andreas Krüger	150	80	150	100
Olaf Schulz	159	100	159	100
Joachim Schwarzer	162	100	14	0
Rochus Wegener	<u>174</u>	<u>600</u>	<u>12</u>	<u>0</u>
	<b>794</b>	<b>930</b>	<b>484</b>	<b>300</b>

The amounts stated for the variable remuneration were accrued based on original targets. The ultimate determination for financial 2005 is still pending. In 2005 Mr. Bastian, Mr. Krüger and Mr. Schulz received advance payments on their potential bonuses of T€ 40 each.

An amount of T€ 561 of the variable remuneration stated above for the financial year 2004 was only recognized in the income statement in 2005 due to the final settlement.

In 2005, no further stock options were granted to members of the Management Board.

<sup>8</sup> Until 30 September 2004: Linklaters Oppenhoff & Rädler

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Mr. Prof. Dr.-Ing. Schindler received T€ 24 (previous year: T€ 24) benefits from the use of a free company car.

	<b>Stock options</b>	<b>Shares</b>
Herr Prof. Dr. - Ing. Sigram Schindler	39,600	11,403,055
Herr Jan Bastian	83,310	4,484
Herr Andreas Krüger	60,000	73,164
Herr Olaf Schulz	66,648	0
	<b>249,558</b>	<b>11,480,703</b>

At 31 December 2005, Prof. Dr.-Ing. Sigram Schindler held 48.93% of the shares in TELES AG.

During 2005, an aggregate of 22,562 shares mainly resulting from the exercise of stock options were sold by members of the Management Board at the stock market. Refer to note 25 for the terms of the employee stock option plan.

***Remuneration of the Members of the Supervisory Board:***

Total remuneration of the members of the Supervisory Board amounted to T€ 45 in each of the financial years reported.

(in T€)	<b>2004</b>	<b>2005</b>
Dr. Walter Rust	20	20
Dr. Jürgen D. Spliedt	15	15
Prof. Dr. Dr. Thomas Schildhauer	<u>10</u>	<u>10</u>
	<b>45</b>	<b>45</b>

***Other:***

One shareholder of the Company held 9.0% of the shares in TELES European Internet Academy ("TEIA"), formerly known as SPC Computer Training GmbH ("SPC"), up to the disposal of TEIA AG (see Note 4 and 24).

**NOTE 30: COMPOSITION OF SALES REVENUES AND COST OF SALES**

(in T€)	<b>2004</b>	<b>2005</b>
<b>Sales revenues</b>	24,590	25,377
Products	18,845	18,880
Services	5,745	6,497
 <b>Cost of Sales</b>	 10,490	 15,596
Products	5,968	7,359
Services	4,522	8,237

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**NOTE 31: SEGMENT REPORTING**

**Description of the reported Segments**

After the sale of the WebHosting business, the Company dismantled its previously reported VAIS Segment from 1 January 2005 in favor of a separate reporting for the two business segments WebLearning and broadband Internet services therein contained. In 2005, the WebLearning business was sold. Reference is made to note 24 for detailed information concerning the two sold business divisions.

TELES is now divided into the two main segments telecommunications systems (TCS) and broadband Internet services (TWBI). The segment for telecommunications systems includes the development, manufacture and sale of telecommunications equipment to carriers. Activities of the TWBI segment are focused on wireless broadband Internet services which are internationally available. The Company evaluates segment performance based mainly on operating income.

The previous years figures have been adjusted according to the current structure.

**Measurement of Segment Income/Loss**

The underlying accounting principles are basically the same as the ones set forth in the section "accounting policies".

The operating income of the segments includes allocations of corporate overhead to TCS of T€ 1,649 (previous year T€ 1,573) and to TWBI of T€ 932 (previous year T€ 961). Refer to the section "Management Services Division" in the Management Report for the nature of these expenses.

The Gross Profit of the TWBI Segment includes expenses for transponder capacities of T€ 5,511 (previous year T€ 2,276).

Intersegmental transactions were immaterial.

(in T€)

**Financial year ending 31 December**

**2004**

	<b>TCS</b>	<b>TWBI</b>	<b>Other</b>	<b>TELES</b>
Sales revenues	20,045	4,545		24,590
Gross profit	13,759	341		14,100
Gross profit margin %	68.6	7.5		57.3
<b>Operating income</b>	<b>1,825</b>	<b>-5,710</b>		<b>-3,885</b>
Financial income and expenses				550
Income before taxes				3,335
Income tax expense				-2,237
<b>Income/ loss from continuing operations</b>				<b>-1,098</b>

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(in T€)	Financial year ending 31 December			
	<b>2004</b>			
Income/ loss from discontinued operations, net of tax (see also note 24)			3,271	3,271
<b>Net income</b>				<b>2,173</b>
Segment assets	33,813	1,743	47,257	82,813
Non-allocated assets				6,944
Consolidated assets				89,757
Segment liabilities	26,899	952	29,108	56,959
Non-allocated liabilities				3,165
Consolidated liabilities				60,124
Investments	617	483	9,511	10,611
Depreciation and amortization	526	208		734

(in T€)	Financial year ending 31 December			
	<b>2005</b>			
	<b>TCS</b>	<b>TWBI</b>	<b>Other</b>	<b>TELES</b>
Sales revenues	19,262	6,115		25,377
Gross profit	12,538	-2,757		9,781
Gross profit margin %	65.1	-45.1		38.5
<b>Operating income</b>	<b>-779</b>	<b>-12,162</b>		<b>-12,941</b>
Financial income and expenses				2,052
Income before taxes				-10,889
Income tax expense				351
<b>Income/ loss from continuing operations</b>				<b>-11,240</b>
Income/ loss from discontinued operations, net of tax (see also note 24)				121,688
<b>Net income</b>				<b>110,448</b>

(in T€)	Financial year ending 31 December			
	<b>2005</b>			
	<b>TCS</b>	<b>TWBI</b>	<b>Other</b>	<b>TELES</b>
Segment assets	85,151	2,042	193	87,386
Non-allocated assets				73,784
Consolidated assets				161,170
Segment liabilities	21,127	1,896	312	23,335
Non-allocated liabilities				3,877
Consolidated liabilities				27,212
Investments	882	304	420	1,606
Depreciation and amortization	534	241		775



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**Geographical Information**

Sales revenues per regions were as follows:

(in T€)	<b>Financial years ending 31 December</b>	
	<b>2004</b>	<b>2005</b>
Sales revenues:		
Germany	7,471	6,782
Europe, without Germany	14,822	16,123
Other	<u>2,297</u>	<u>2,472</u>
Total	<u>24,590</u>	<u>25,377</u>

Both reported segments generate sales revenues in Germany as well as in the remaining part of Europe and other parts of the world.

Segment assets per regions were:

(in T€)	<b>31 December</b>	<b>31 December</b>
	<b>2004</b>	<b>2005</b>
Segment assets:		
Germany	77,284	81,613
Europe, without Germany	5,476	5,359
Other	53	414
Non-allocatable	<u>6,944</u>	<u>73,784</u>
Total	<u>89,757</u>	<u>161,170</u>

Additions to fixed and intangible assets were:

(in T€)	<b>31 December</b>	<b>31 December</b>
	<b>2004</b>	<b>2005</b>
Germany	10,391	1,253
Europe, without Germany	190	130
Other	<u>30</u>	<u>223</u>
Total	10,611	1,606

**NOTE 32: SUBSEQUENT EVENTS**

On 2 January 2006, after expiration of the statutory lock-up period for protection of creditors, payment was made to TELES' shareholders due to the capital reduction resolved at the Annual General Meeting on 3 June 2005. Payment was made in the amount of € 0.8680 per circulating share on the payment date.

On 26 January 2006, the European skyDSL patent was confirmed by the European Patent Office with only marginal qualifications. Furthermore, TELES' claim – due to the infringement of its skyDSL patent and skyDSL utility model by the "TDSL via Satellite" service jointly

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provided by Deutsche Telekom and SES Astranet - was admitted in the first-instance on 27 January 2006.

On 15 February 2006, TELES filed a lawsuit at the Regional Court of Mannheim against Nokia GmbH and the Finnish Nokia Corporation for infringement of its German and European VoIP patents.

Additional reference regarding the three aforementioned facts is made to the notes as well as note 28.

**NOTE 33: OTHER INFORMATION**

***Changes compared to the Previous Year***

Other income and expenses as well as gains and losses from currency calculations, of continued operations, were disclosed in operating income, summarized in the positions "Other income" and "Other expenses"; see also note 21. The comparative figures were adjusted accordingly (other income T€ 57 and other expenses -T€ 49).

***Services of the Auditing Company***

In 2005, PricewaterhouseCoopers AG Wirtschaftsprüfungsgesellschaft rendered the following services to the Company: annual audit (T€ 120), tax consultancy (T€ 20) and other consulting services (T€ 65).

***Companies included in Consolidation***

The consolidated financial statements include the accounts of TELES AG and the following companies, all of which are wholly-owned subsidiaries of TELES AG unless otherwise stated:

<b>Subsidiary</b>	<b>Registered headquarters</b>
TELES skyDSL Europe B.V. (formerly known as EuroSkyNet B.V.)	Roelofarendsveen, Holland
TELES Communications Corp.	San Francisco, USA
TELES Computer Systems India Private Ltd. <sup>1</sup>	Bangalore, India
TELES France S.A.R.L. <sup>2</sup>	Evry, France
TELES S.R.L. <sup>3</sup>	Genua, Italy
RVS Datentechnik GmbH	Munich, Germany
TELES Wireless Broadband Internet GmbH (formerly known as TELES EuroService GmbH)	Berlin, Germany
TELES skyDSL GmbH (formerly known as TELES NetOperations GmbH)	Berlin, Germany
TCS Commerce & Industry Ltd. Sirketi <sup>4</sup>	Istanbul, Turkey
TELES Latin America S.R.L. <sup>5</sup>	Santa Cruz, Bolivia
TELES skyDSL UK <sup>6</sup>	Birmingham, England
TELES Ireland Ltd.	Shannon, Republic of Ireland

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Subsidiary	Registered headquarters
TELES EuroService Ltd.	Shannon, Republic of Ireland
TELES NetSales Spain S.A.	Madrid, Spain
TELES NetSales GmbH	Berlin, Germany
TELES NetService GmbH	Berlin, Germany
DirectSat AG (formerly known as cyPOS AG)	Berlin, Germany
call media services Ltd.	London, Great Britain
more! Computer AG	Berlin, Germany

<sup>1</sup> – 84.999% held by TELES NetSales GmbH / 0.001% held by TELES NetService GmbH

<sup>2</sup> – 0.01% held by TELES NetSales GmbH / 99.9% held by TELES AG

<sup>3</sup> – 3% held by TELES NetSales GmbH / 97% held by TELES AG

<sup>4</sup> – 1% held by TELES NetSales GmbH / 99% held by TELES AG

<sup>5</sup> – 1% held by TELES NetSales GmbH / 99% held by TELES AG

<sup>6</sup> – 100% held by TELES Wireless Broadband Internet GmbH

**Information on Companies not included in Consolidation**

(Refer to note 2)

Name of the company	Registered headquarters	Shares held by TELES AG (%)	Currency	Equity <sup>1</sup>	Net income 2005 <sup>1,2</sup>
GRAVIS Beteiligungs AG	Berlin, Germany	19.99	EUR	3,147	55
GRAVIS Computer-vertriebsgesellschaft mbH	Berlin, Germany	indirectly: 19.99	EUR	3,186	796
GRAVIS EDV- Service- und Entwicklungsgesellschaft	Berlin, Germany	indirectly: 19.99	EUR	37	-668
HSD Consult EDV-Beratungsgesellschaft mbH	Berlin, Germany	indirectly: 19.99	EUR	442	131

<sup>1</sup> – The figures stated for equity and net income are based on preliminary information at 31 October 2005

<sup>2</sup> – Based on national accounting regulations

**Corporate Governance Code**

The Management Board and Supervisory Board of TELES AG submitted a declaration of compliance with the German Corporate Governance Code pursuant to section 161 AktG. The declaration was published on the homepage of TELES AG.

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***Management Board***

The following individuals were members of the Management Board of TELES AG during the reporting period:

Prof. Dr.-Ing. Sigrum Schindler, Berlin, Chief Executive Officer,  
Dipl.-Volkswirt Joachim Schwarzer, Berlin, Broadband Internet Services Segment,  
until 31 January 2005,  
Dipl.-Inf. Rochus Wegener, Berlin, WebHosting Segment, until 1 February 2005,  
Dipl.-Inf. Jan Bastian, Berlin, Telecommunications Systems,  
Dipl.-Ing. Andreas Krüger, Berlin, Broadband Internet Services Segment,  
Dipl.-Betriebswirt Olaf Schulz, Berlin, Chief Financial Officer

***Supervisory Board***

The following individuals were members of the Supervisory Board of TELES AG during the reporting period:

Dr. Walter Rust, Berlin, attorney and notary (Chairman)  
Dr. Jürgen D. Spliedt, Berlin, attorney and certified accountant (Deputy Chairman)  
Prof. Dr. Dr. Thomas Schildhauer, Berlin, University Professor

The following individuals held seats on the Supervisory Board of other companies:

Dr. Walter Rust,  
SHF Communication Technologies AG, Berlin (Chairman)  
Linde Kältetechnik Verwaltungs GmbH, Köln (ordinary member until 31 December 2005)

Prof. Dr. Dr. Thomas Schildhauer,  
WG-DATA AG, Berlin (ordinary member)  
rbb Media GmbH, Berlin (ordinary member)  
JOBULO AG, Hamburg (ordinary member until August 2005)

Berlin, 27 February 2006

The Management Board

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***List of Abbreviations***

AG	Aktiengesellschaft (Stock Corporation)
AktG	Aktiengesetz (German Stock Corporation Act)
DENIC	Domain Verwaltungs- und Betriebsgesellschaft e.G.
DRS	Deutscher Rechnungslegungsstandard (German Accounting Principle)
DRSC	Deutsches Rechnungslegungsstandards Committee (German Accounting Principles Board)
ESOP	Employees Share Ownership Program
ESTG	Einkommensteuergesetz (German Income Tax Act)
FIFO	First-in, First-out
GmbH	Gesellschaft mit beschränkter Haftung (Limited Partnership)
HGB	Handelsgesetzbuch (German Commercial Code)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
KapErh	Kapitalerhöhung (Capital increase)
Ltd	Limited
Mio€	Euro millions
SIC	Standing Interpretations Committee
T€	Euro thousands
TUSD	US dollars thousands
US-GAAP	United States Generally Accepted Accounting Principles

## **Translation of the copy of PricewaterhouseCoopers Auditor's Report**

### **Auditor's report**

We have audited the consolidated financial statements prepared by TELES Aktiengesellschaft Informationstechnologien, Berlin, comprising the balance sheet, income statement, statement of changes in equity, cash flow statements and the notes to the consolidated financial statements, together with the group management report for the business year from 1<sup>st</sup> of January to 31<sup>st</sup> of December 2005. The preparation of the consolidated financial statements and the group management report in accordance with the IFRSs, as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB (Article 315a paragraph 1 German Commercial Code) are the responsibility of the parent Company's Board of Managing Directors. Our responsibility is to express an opinion on the consolidated financial statements and on the group management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany, IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the group management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the group management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of the entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the Company's Board of Managing Directors, as well as evaluating the overall presentation of the consolidated financial statements and the group management report. We believe that our audit provides a reasonable basis for our opinion. Our audit has not led to any reservations.

## **Translation of the copy of PricewaterhouseCoopers Auditor's Report**

In our opinion based on the findings of our audit the consolidated financial statements comply with the IFRSs as adopted by the EU, the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The group management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

(Berlin, February 28<sup>th</sup>, 2006)

**PricewaterhouseCoopers  
Aktiengesellschaft  
Wirtschaftsprüfungsgesellschaft**

(Hartman)  
Wirtschaftsprüfer  
(German Public Auditor)

(ppa. Boll)  
Wirtschaftsprüfer  
(German Public Auditor)