

**ECI Telecom Ltd.  
Interim Consolidated  
Financial Statements  
(Unaudited)  
As at September 30, 2003**

**Consolidated Financial Statements as at September 30, 2003**

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## The Board of Directors of ECI Telecom Ltd.

### Review of the unaudited interim consolidated financial statements for the nine and three month periods ended September 30, 2003

At your request, we have reviewed the interim consolidated balance sheet of ECI Telecom Ltd. and its subsidiaries as at September 30, 2003, and the related interim consolidated statements of income, the interim statements of comprehensive income, the interim statements of changes in shareholders' equity and the interim consolidated statements of cash flows for the nine and three month periods then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel and included, inter alia, reading the said financial statements, reading the minutes of Shareholders' Meetings and of the Board of Directors and its committees, as well as making inquiries of those responsible for financial and accounting matters.

We received review reports of other auditors, regarding the interim financial statements of certain consolidated subsidiaries, whose assets constitute approximately 6.3% of the total consolidated assets as at September 30, 2003 and whose revenues constitute approximately 6.35% and 8.45% of the consolidated revenues for the nine and three month periods then ended, respectively. Furthermore, the data included in the interim financial statements relating to the net asset value of the Company's investments in affiliation and its equity in their operating results, is based on the interim financial statements of such affiliates, for most of them, were reviewed by other auditors.

Since such a review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the said interim consolidated financial statements.

In the course of our review, including the review of reports of other auditors, nothing came to our attention which would indicate the necessity of making material changes in the said financial statements in order for them to be in conformity with generally accepted accounting principles (GAAP) in the United States, and in conformity with the U.S. Securities and Exchange Commission Regulation regarding Interim Financial Statements (regulation S-X: Item 210.10-01). Note 10 to the Interim Financial Statements describes the material differences between U.S. and Israeli GAAP as they relate to these financial statements.

Somekh Chaikin  
Certified Public Accountants (Isr.)

November 5, 2003



Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is a member of KPMG International, a Swiss cooperative.

## Consolidated Balance Sheets

	September 30 2003 <u>(Unaudited)</u> <u>\$ in thousands</u>	September 30 2002 <u>(Unaudited)</u> <u>\$ in thousands</u>	December 31 2002 <u>(Audited)</u> <u>\$ in thousands</u>
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents	173,307	326,195	356,649
Short-term investments	41,270	28,535	6,840
Receivables:			
Trade	158,882	225,769	207,315
Other	26,174	17,365	24,194
Prepaid expenses	4,370	5,151	4,349
Recoverable costs and estimated earnings, not yet billed	15,009	10,890	13,690
Inventories	122,152	167,730	149,747
Assets - discontinued operations	-	25,900	20,648
<b>Total current assets</b>	<b>541,164</b>	<b>807,535</b>	<b>783,432</b>
<b>Long-term receivables and related deposits, net</b>	<b>116,454</b>	<b>136,491</b>	<b>132,173</b>
<b>Long-term investments in deposits and marketable securities</b>	<b>35,220</b>	<b>-</b>	<b>-</b>
<b>Investments</b>	<b>38,387</b>	<b>17,587</b>	<b>42,985</b>
<b>Property, plant and equipment</b>			
Cost	285,328	281,245	278,159
Less – Accumulated depreciation	157,007	129,407	139,572
	<b>128,321</b>	<b>151,838</b>	<b>138,587</b>
<b>Software development costs, net</b>	<b>17,158</b>	<b>22,404</b>	<b>20,082</b>
<b>Goodwill and other intangible assets</b>	<b>13,257</b>	<b>21,607</b>	<b>21,045</b>
<b>Other assets</b>	<b>6,953</b>	<b>30,018</b>	<b>16,795</b>
<hr/> Doron Inbar President, Chief Executive Officer			
<hr/> Giora Bitan Executive Vice President, Chief Financial Officer Petah Tikva, November 5, 2003			
<b>Total assets</b>	<b>896,914</b>	<b>1,187,480</b>	<b>1,155,099</b>

	September 30 2003	September 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities</b>			
Short-term loans and current maturities of long-term debt	22,500	243,355	230,012
Trade payables	46,492	37,506	41,221
Other payables and accrued liabilities	120,747	141,639	133,826
Liabilities - discontinued operations	-	17,400	12,148
<b>Total current liabilities</b>	<b>189,739</b>	439,900	417,207
<b>Long-term liabilities</b>			
Banks loans	37,500	-	-
Other liabilities	6,125	10,842	8,379
Liability for employee severance benefits, net	27,846	26,589	26,357
<b>Total long-term liabilities</b>	<b>71,471</b>	37,431	34,736
<b>Total liabilities</b>	<b>261,210</b>	477,331	451,943
<b>Minority Interest</b>	<b>44,111</b>	55,813	56,756
<b>Shareholders' equity</b>			
Share capital	6,160	6,148	6,152
Capital surplus	661,508	*658,047	658,425
Accumulated other comprehensive loss	(2,280)	(529)	(1,832)
Retained deficit	(73,795)	*(9,330)	(16,345)
<b>Total shareholders' equity</b>	<b>591,593</b>	654,336	646,400
<b>Total liabilities and shareholders' equity</b>	<b>896,914</b>	1,187,480	1,155,099

(\*) Reclassified.

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Income**

	Nine months ended		Three months ended		Year ended
	September 30	September 30	September 30	September 30	December 31
	2003	2002	2003	2002	2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
Revenues	324,846	497,008	104,563	147,460	646,211
Cost of revenues	198,893	313,047	64,557	95,012	395,231
<b>Gross profit</b>	<b>125,953</b>	183,961	<b>40,006</b>	52,448	250,980
Research and development costs, net	57,944	69,515	20,503	20,017	93,097
Selling and marketing expenses	67,551	85,502	23,232	26,841	115,241
General and administrative expenses	44,738	77,431	12,980	47,124	92,056
Amortization of acquisition-related intangible assets	1,503	1,320	270	440	1,760
long-term receivables					
Impairment of assets	6,686	-	-	-	1,525
Restructuring expenses	6,532	-	2,091	-	-
<b>Operating loss</b>	<b>(59,001)</b>	(49,807)	<b>(19,070)</b>	(41,974)	(52,699)
Financial expenses	(6,066)	(16,038)	(1,146)	(5,484)	(18,375)
Financial income	5,349	21,217	1,728	6,596	24,564
Other income (expenses), net	(4,875)	(12,605)	126	(21,387)	(13,297)
<b>Loss from continuing operations before taxes on income</b>	<b>(64,593)</b>	(57,233)	<b>(18,362)</b>	(62,249)	(59,807)
Taxes on income	(1,516)	(8,659)	(427)	(1,997)	(8,812)
<b>Loss from continuing operations after taxes on income</b>	<b>(66,109)</b>	(65,892)	<b>(18,789)</b>	(64,246)	(68,619)
Company's equity in results of investee companies – net	(1,627)	(1,926)	(280)	(470)	(3,055)
Minority interest in results of subsidiaries – net	12,810	(5,204)	4,417	(1,852)	(6,045)
<b>Loss from continuing operations</b>	<b>(54,926)</b>	(73,022)	<b>(14,652)</b>	(66,568)	(77,719)
Cumulative effect of an accounting change, net	-	(550)	-	-	(550)
Loss on discontinued operations, net	(2,524)	(75,098)	-	(22,566)	(77,416)
<b>Loss for the period</b>	<b>(57,450)</b>	(148,670)	<b>(14,652)</b>	(89,134)	(155,685)

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Income (cont'd)**

	Nine months ended		Three months ended		Year ended
	September 30 2003	September 30 2002	September 30 2003	September 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
<b>Loss per share</b>					
Basic and diluted loss per share:					
Continuing operations	<b>(0.51)</b>	(0.70)	<b>(0.14)</b>	(0.62)	(0.74)
Cumulative effect of an accounting change, net	-	(0.01)	-	-	(0.01)
Discontinued operations	<b>(0.02)</b>	(0.71)	-	(0.21)	(0.73)
Net loss per share	<b>(0.53)</b>	(1.42)	<b>(0.14)</b>	(0.83)	(1.48)
Weighted average number of shares outstanding used to compute basic earnings per share – in thousands	<b>107,775</b>	104,892	<b>107,943</b>	107,145	105,512

The accompanying notes are an integral part of these interim financial statements.

### Consolidated Statements of Comprehensive Income

	Nine months ended		Three months ended		Year ended
	September 30	September 30	September 30	September 30	December 31
	2003	2002	2003	2002	2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
Loss for the period	<b>(57,450)</b>	(148,670)	<b>(14,652)</b>	(89,134)	(155,685)
Other comprehensive loss:					
Unrealized losses from changes in the fair value of financial instruments	<b>(448)</b>	(2,078)	<b>(2,104)</b>	(6)	(3,632)
Unrealized holding loss on available for sale securities arising during the period, net	-	(251)	-	(120)	-
Total other comprehensive loss	<b>(448)</b>	(2,329)	<b>(2,104)</b>	(126)	(3,632)
Comprehensive loss	<b>(57,898)</b>	(150,999)	<b>(16,756)</b>	(89,260)	(159,317)

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Changes in Shareholders' Equity**

	Number of shares	Share capital	Capital surplus	Accumulated other comprehensive income (loss)	Retained earnings (deficit)	Treasury stock	Total shareholders' equity
	\$ in thousands except share amounts						
<b>Balance at January 1, 2003 (audited)</b>	<b>107,512,612</b>	<b>6,152</b>	<b>658,425</b>	<b>(1,832)</b>	<b>(16,345)</b>	<b>-</b>	<b>646,400</b>
<u>Unaudited</u>							
Net loss for the nine months ended September 30, 2003	-	-	-	-	(57,450)	-	(57,450)
Share issuance to employees	424,633	8	647	-	-	-	655
Employee stock options exercised and paid, net	18,125	-	57	-	-	-	57
Amortization of deferred compensation expenses	-	-	2,379	-	-	-	2,379
Net unrealized gain on financial instruments	-	-	-	(448)	-	-	(448)
<b>Balance at September 30, 2003</b>	<b>107,955,370</b>	<b>6,160</b>	<b>661,508</b>	<b>(2,280)</b>	<b>(73,795)</b>	<b>-</b>	<b>591,593</b>
<b>Balance at January 1, 2002 (audited)</b>	<b>93,573,549</b>	<b>5,873</b>	<b>656,614</b>	<b>1,800</b>	<b>173,567</b>	<b>(82,998)</b>	<b>754,856</b>
<u>Unaudited</u>							
Net loss for the nine months ended September 30, 2002	-	-	-	-	(148,670)	-	(148,670)
Share issuance, net	13,160,000	263	*-	-	*(34,227)	82,998	49,034
Share issuance to employees	570,870	12	1,542	-	-	-	1,554
Net unrealized loss on available for sale securities	-	-	-	(251)	-	-	(251)
Amortization of deferred compensation expenses	-	-	(109)	-	-	-	(109)
Net unrealized loss on financial instruments	-	-	-	(2,078)	-	-	(2,078)
<b>Balance at September 30, 2002</b>	<b>107,304,419</b>	<b>6,148</b>	<b>658,047</b>	<b>(529)</b>	<b>(9,330)</b>	<b>-</b>	<b>654,336</b>

\* Reclassified

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Changes in Shareholders' Equity (cont'd)**

	Number of shares	Share Capital	Capital surplus	Accumulated other comprehensive income (loss)	Retained earnings (deficit)	Treasury stock	Total shareholders' equity
	\$ in thousands except share amounts						
<b>Balance at July 1, 2003 (unaudited)</b>	<b>107,937,245</b>	<b>6,160</b>	<b>660,261</b>	<b>(176)</b>	<b>(59,143)</b>	-	<b>607,102</b>
<u>Unaudited</u>							
Net loss for the three months ended September 30, 2003	-	-	-	-	<b>(14,652)</b>	-	<b>(14,652)</b>
Employee stock options exercised and paid, net	<b>18,125</b>	-	<b>57</b>	-	-	-	<b>57</b>
Amortization of deferred compensation expenses	-	-	<b>1,190</b>	-	-	-	<b>1,190</b>
Net unrealized loss on financial instruments	-	-	-	<b>(2,104)</b>	-	-	<b>(2,104)</b>
<b>Balance at September 30, 2003 (unaudited)</b>	<b>107,955,370</b>	<b>6,160</b>	<b>661,508</b>	<b>(2,280)</b>	<b>(73,795)</b>	-	<b>591,593</b>
<b>Balance at July 1, 2002 (unaudited)</b>	107,068,201	6,144	657,499	(403)	79,804	-	743,044
<u>Unaudited</u>							
Net loss for the three months ended September 30, 2002	-	-	-	-	<b>(89,134)</b>	-	<b>(89,134)</b>
Net unrealized loss on available for sale securities	-	-	-	<b>(120)</b>	-	-	<b>(120)</b>
Amortization of deferred compensation expenses	-	-	<b>56</b>	-	-	-	<b>56</b>
Share issuance to employees	236,218	4	492	-	-	-	496
Net unrealized loss on financial instruments	-	-	-	<b>(6)</b>	-	-	<b>(6)</b>
<b>Balance at September 30, 2002 (unaudited)</b>	<b>107,304,419</b>	<b>6,148</b>	<b>658,047</b>	<b>(529)</b>	<b>(9,330)</b>	-	<b>654,336</b>

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Changes in Shareholders' Equity (cont'd)**

\$ in thousands except share amounts

	Number of shares	Share capital	Capital surplus	Accumulated other comprehensive income	Retained earnings (deficit)	Treasury stock	Total shareholders' equity
<b>Balance at January 1, 2002</b>	93,573,549	5,873	656,614	1,800	173,567	(82,998)	754,856
<b>Changes during 2002</b>							
Net loss for the year ended December 31, 2002	-	-	-	-	(155,685)	-	(155,685)
Share issuance, net	13,160,000	263	-	-	(34,227)	82,998	49,034
Share issuance to employees and others	779,063	16	1,960	-	-	-	1,976
Amortization of deferred compensation expenses	-	-	(149)	-	-	-	(149)
Net unrealized loss on financial instruments	-	-	-	(3,632)	-	-	(3,632)
Balance at December 31, 2002	<u>107,512,612</u>	<u>6,152</u>	<u>658,425</u>	<u>(1,832)</u>	<u>(16,345)</u>	<u>-</u>	<u>646,400</u>

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Cash Flows**

	Nine months ended		Three months ended		Year ended
	September 30 2003 (Unaudited) \$ in thousands	September 30 2002 (Unaudited) \$ in thousands	September 30 2003 (Unaudited) \$ in thousands	September 30 2002 (Unaudited) \$ in thousands	December 31 2002 (Audited) \$ in thousands
<b>Cash flows for operating activities</b>					
Loss for the period	(57,450)	(148,670)	(14,652)	(89,134)	(155,685)
<b>Adjustments to reconcile net loss to cash provided by (used in) operating activities:</b>					
Depreciation and amortization	31,521	41,737	9,962	13,483	56,451
Cumulative effect of an accounting change, net	-	550	-	-	550
Amortization of deferred compensation (including subsidiaries)	2,378	364	1,189	190	81
Loss on sale of property and equipment	431	4,048	59	1,373	3,936
Impairment of assets	6,686	-	-	-	1,525
Capital loss, net	4,772	8,143	10	18,949	8,738
Other - net (mainly deferred taxes)	6,899	(1,355)	249	(489)	6,039
Company's equity in results of investee companies	1,627	1,926	280	470	3,055
Minority interest in net results of subsidiaries	(12,810)	5,204	(4,417)	1,852	6,045
Decrease (increase) in short-term investments	(334)	716	(282)	44	852
Decrease in trade receivables (including non-current maturities of bank deposits and trade receivables)	66,816	104,645	18,214	48,528	112,056
Decrease (increase) in other receivables	1,854	23,443	1,741	(2,982)	30,170
Decrease (increase) in prepaid expenses	(69)	4,466	774	2,245	4,501
Decrease (increase) in recoverable costs and estimated earnings - not yet billed	(1,319)	18,210	785	5,459	19,540
Decrease in inventories - including one-time write-off	25,322	99,378	13,422	42,697	113,056
Increase (decrease) in trade payables	4,220	(38,449)	4,916	(6,938)	(35,217)
Increase (decrease) in other payables and accrued liabilities	(16,849)	(27,265)	(7,707)	(8,947)	(38,461)
Increase (decrease) in liability for employee severance benefits, net	1,589	(1,809)	(1,051)	(1,002)	(2,081)
Decrease in other long-term liabilities	(2,254)	(731)	(2,118)	(121)	(3,194)
Cumulative effect of an accounting change of discontinued operations	-	36,646	-	-	36,646
Impairment of long-lived assets relating to discontinued operations	-	22,678	-	6,843	22,678
<b>Net cash provided by (used in) operating activities</b>	<b>63,030</b>	<b>153,875</b>	<b>21,374</b>	<b>32,520</b>	<b>191,281</b>

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Cash Flows (cont'd)**

	Nine months ended		Three months ended		Year ended
	September 30 2003	September 30 2002	September 30 2003	September 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
<b>Cash flows for investing activities</b>					
Decrease (increase) in short-term investments, net	(19,571)	(22,376)	(9,657)	22,594	(450)
Software development costs capitalized	(8,719)	(10,097)	(2,855)	(3,616)	(12,935)
Investment in property, plant and equipment	(7,025)	(9,281)	(3,505)	(3,099)	(11,759)
Proceeds from sale of property, plant and equipment	706	467	218	87	746
Purchase of technology	(869)	-	-	-	-
Acquisition of investee Companies	(203)	(2,534)	(113)	(560)	(2,584)
Long-term loan granted	-	(5,010)	-	(1,789)	(6,227)
Proceeds from realization of shares at consolidated subsidiary and operation	-	20,302	-	-	20,302
Acquisition of newly consolidated subsidiaries (see Note A)	-	-	-	-	513
Investment in marketable Securities	(49,809)	-	(43,442)	-	-
Proceeds from realization of a subsidiary and operation (see Note B)	9,100	-	-	-	(10,003)
<b>Net cash provided by (used in) investing activities</b>	<b>(76,390)</b>	<b>(28,529)</b>	<b>(59,354)</b>	<b>13,617</b>	<b>(22,397)</b>

The accompanying notes are an integral part of the financial statements.

**Consolidated Statements of Cash Flows (cont'd)**

	Nine months ended		Three months ended		Year ended
	September 30 2003	September 30 2002	September 30 2003	September 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
<b>Cash flows for financing activities</b>					
Repayment of loans from banks	(100,000)	(76,667)	-	(13,334)	(90,000)
Increase (decrease) in short-term credit, net	(70,012)	(8)	-	6	(18)
Proceeds from share issuance	-	49,680	-	-	49,680
Proceeds from share issuance to employees	712	1,554	57	496	1,976
Share issue expenses	-	(646)	-	-	(646)
<b>Net cash provided by (used in) financing activities</b>	<b>(169,300)</b>	<b>(26,087)</b>	<b>57</b>	<b>(12,832)</b>	<b>(39,008)</b>
Effect of change in exchange rate on cash	(682)	744	(198)	(401)	581
<b>Changes in cash and cash equivalents</b>	<b>(183,342)</b>	<b>100,003</b>	<b>(38,121)</b>	<b>32,904</b>	<b>130,457</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>356,649</b>	<b>226,192</b>	<b>211,428</b>	<b>293,291</b>	<b>226,192</b>
<b>Cash and cash equivalents at end of period</b>	<b>173,307</b>	<b>326,195</b>	<b>173,307</b>	<b>326,195</b>	<b>356,649</b>

The accompanying notes are an integral part of these interim financial statements.

**Consolidated Statements of Cash Flows (cont'd)****Appendices:**

	Nine months ended		Three months ended		Year ended
	September 30	September 30	September 30	September 30	December 31
	2003	2002	2003	2002	2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands	\$ in thousands
<b>A. Acquisition of newly subsidiaries</b>					
Current assets (other than cash)	-	-	-	-	(1,795)
Property, plant, equipment and other assets, net	-	-	-	-	(171)
Goodwill	-	-	-	-	(3)
Investment in investee company	-	-	-	-	2,482
	-	-	-	-	513
<b>B. Proceeds from realization of a subsidiary and operations</b>					
Current assets (other than cash)	(600)	-	-	-	9,600
Property, plant, equipment and other assets - net	843	-	-	-	6,742
Inventories	8,857	-	-	-	3,263
Investments in investee companies	-	-	-	-	(29,608)
	9,100	-	-	-	(10,003)
<b>C. Non-cash activities</b>					
Sale of fixed assets in return for shares in investee company	1,053	-	1,053	-	-

**Condensed Notes to the Interim Consolidated Financial Statements**

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**Note 1 - Financial Reporting Principles and Accounting Policies**

**A. General**

The interim financial statements are prepared in a condensed format, as at September 30, 2003 and for the nine and three-month periods then ended. The interim consolidated financial statements should be read in conjunction with Company's annual consolidated financial statements as at December 31, 2002 and the accompanying notes thereto.

During 2002, the Company's Board of Directors decided to focus the Company's activities on its two core businesses, which are as follows: Broadband Access Division (formerly- Inovia) and Optical Network Division (formerly - Lightscape and Enavis).

**Note 2 - Significant Accounting Policies**

- A.** The accounting policies applied in the preparation of these interim consolidated financial statements are not materially different than those applied in the preparation of the latest annual consolidated financial statements.
- B.** The interim consolidated financial statements are prepared in accordance with accounting principles for preparation of financial statements for interim periods.
- C.** Certain amounts in prior years' financial statements have been reclassified to conform to the current year's presentation. See also Note 8.

**Note 3 - Financial Statements Denominated in U.S. Dollars**

The interim consolidated financial statements have been prepared in accordance with U.S. GAAP on the basis of historical cost convention and denominated in U.S. dollars.

Note 10 include reconciliation from U.S. GAAP, on which the financial statements of the Company are based, to Israeli GAAP, on which the financial statements of the Company's major shareholders in Israel are based.

## Condensed Notes to the Interim Consolidated Financial Statements

### Note 4 - Shareholders' Equity

- A. In October 1995 the Financial Accounting Standards Board (FASB) issued SFAS 123 "Accounting for Stock-based Compensation" which establishes financial accounting and reporting standards for stock-based compensation plans. The statement defines a fair value based method of accounting for an employee stock option.

As required by SFAS 123, the Company has determined the weighted average fair value of stock-based arrangements grants during the reporting period to be \$ 1.7. The fair values of stock based compensation awards granted were estimated using the "Black - Scholes" option pricing model with the following assumptions.

	<u>Option term</u>	<u>Expected volatility</u>	<u>Risk free interest rate</u>
<u>Period of grant</u>	<u>term</u>	<u>volatility</u>	<u>interest rate</u>
Nine months ended September 30, 2003	5	70	1%
Nine months ended September 30, 2002	5	95	2%
Three months ended September 30, 2003	5	70	1%
Three months ended September 30, 2002	5	95	2%
Year ended December 31, 2002	5	105	1.5%

- B. Had the compensation expenses for stock options granted under the Company's stock option plans been determined based on fair value at the grant dates consistent with the method of SFAS 123, the Company's net loss and net loss per share would have been as follows:

	<u>Nine months ended</u>		<u>Three months ended</u>		<u>Year ended</u>
	<u>September 30</u>	<u>September 30</u>	<u>September 30</u>	<u>September 30</u>	<u>December 31</u>
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2002</u>
Net loss (\$ in thousands)					
as reported	<b>(57,450)</b>	(148,670)	<b>(14,652)</b>	(89,134)	(155,685)
Deduct: Total stock based employee compensation Expenses determined under fair value based method for all awards, net of related tax effects	<b>(23,029)</b>	(47,951)	<b>(4,593)</b>	(15,500)	(59,644)
Pro forma net loss	<b>(80,479)</b>	(196,621)	<b>(19,245)</b>	(104,634)	(215,329)
Basic and diluted loss per share (\$)					
as reported	<b>(0.53)</b>	(1.42)	<b>(0.14)</b>	(0.83)	(1.48)
Pro forma	<b>(0.75)</b>	(1.87)	<b>(0.18)</b>	(0.98)	(2.04)

**Condensed Notes to the Interim Consolidated Financial Statements**

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**Note 5 - Liens on Assets**

The existing and future liabilities of the Company towards Israeli banks are collateralized by certain pledges on assets (real estate in Israel), on certain rights (shares in companies held by the Company) and by an unlimited "negative pledge" on the Company's assets. As a condition to the continued granting of credit by the banks, and in accordance with the "negative pledge", the Company was obligated to maintain certain financial ratios, such as an equity ratio, capital to assets ratio, current ratio and a certain ratio of operating income. According to a facility agreement with the lending banks, the Company was to have maintained these ratios since the third quarter of 2001. Commencing from October 1, 2002 until the first quarter of 2003, the Company was not in compliance with some of the financial ratios and, therefore, the loans starting from the third quarter of 2002 until the first quarter of 2003 were classified as current loans.

During the reporting period, the Company signed a letter agreement which amended the aforementioned facility agreement. Under the letter agreement, the Company repaid an amount of approximately \$ 78 million in respect of the long-term loan and fully paid of \$45 million of the short-term loan. In addition, the Company is to maintain certain financial ratios, inter alia, tangible equity to total liabilities, current ratio and, starting 2004, certain ratios of operating income. Accordingly, the loan starting from the second quarter of 2003 is classified as long-term.

**Note 6 - Material Transactions in the Current Period****A. Shareholders' equity**

On February 11, 2003 the Company granted to its employees and managers 879,228 share options at an exercise price of \$1.75 per share. The options vest as follows: 12.5% after six months and 6.25% on the last day of each following quarter over a period of 14 quarters.

In February 2003 the Company granted 300,000 share options to a company of which one of its directors shares control at an exercise price of \$ 2.21 per share. Half of the options vested immediately and the balance will vest in February 2004.

In February 2003, the Company granted an aggregate 130,000 share options to two directors at an exercise price of \$ 1.99 per share. 30,000 of these options will be fully vested in August 2004, and one third of the remaining 100,000 options will be vested, respectively, in January 2004, January 2005 and January 2006.

On April 10, 2003, the Company granted to its employees and managers 746,831 share options at an exercise price of 1.78 per share, which constituted the market price of the share on the date the options were granted. The options will be vested as follows: 12.5% after half a year and 6.25% during 14 consecutive quarters thereafter. In addition, the Company granted to its employees and managers 3,095,600 share options at an exercise price of \$0 per share. The share option will be vested as follows: 68.75% after one year and 6.25% during five consecutive quarters thereafter.

**Condensed Notes to the Interim Consolidated Financial Statements**

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**Note 6 - Material Transactions in the Current Period (cont'd)****A. Shareholders' equity (cont'd)**

During the first quarter of 2003, the Company agreed to grant employees of certain segments the right to exchange their option warrants, convertible into shares in certain subsidiaries, for others, convertible into shares of the Company according to a certain ratio, on a date at least six months after conversion date. Accordingly, on September 10, 2003, the Company granted to its employees and managers 5,109,982 share options at an exercise price of \$ 3.24 per share. In most instances, these options were exercisable as to 50% from the date they were granted and as to additional 6.25% on the last day of each of the next eight consecutive quarters, beginning on September 30, 2003.

In addition, the Company granted certain persons who had agreed to the exchange but left the employ of the Company since the conversion date 132,413 share options at an exercise price of \$ 3.24 per share. The options vested immediately and are exercisable for one year thereafter.

None of the above share options (other than those granted at an exercise of \$0 per share) were granted at exercise prices below of the market price on the date of the grant.

During the reporting period, 18,125 options were exercised.

**B. Sale of long-term notes**

In the reported period, the Company sold long-term notes of customers in the amount of \$ 12,535 thousand to a bank.

**C. Restructuring expenses**

As part of the Company's Board of Directors' decision to focus on its two core activities, the Company recorded \$ 6.5 million in reorganization expenses associated largely with the integration of the Lightscape Optical Networks Division and Enavis into the Optical Networks Division, mainly termination benefit.

**D. Long-term customer debt**

During the reporting period, the Company included a provision for a doubtful debt in the amount of \$6.6 million with respect to a specific long-term customer debt. The provision reflects the expected outcome of advanced discussions with the customer. These discussions include revised and extended repayment terms.

Furthermore, an associated \$ 3.4 million charge recorded in other expenses for decline in the value of the Company's investment in convertible notes of the customer's parent company.

**E. Impairment of assets**

During the second quarter of 2003, the Company recorded \$6.7 million associated mainly with ECTel, a consolidated company, write-down of goodwill from its Net-Eye acquisition in October 2001.

## Condensed Notes to the Interim Consolidated Financial Statements

### Note 7 - Legal Proceedings

The Company is in dispute with a subcontractor regarding certain financial terms of a supply agreement as described in Note 11H4 of the annual financial statements as at December 31, 2002. The dispute was referred to an arbitrator in April 2003 and the subcontractor submitted a claim in the amount of \$ 25.1 million and VAT in the amount of \$ 4.5 million.

The Company rejected the allegations made against it and already filed its defense statement. The Company also filed a claim against the subcontractor in the amount of at least \$ 42.4 million and VAT in the amount of \$ 7.6 million.

In the opinion of Management, the arbitrator's decision will not have any negative material effect on the Company's financial position and/or the results of its operations.

### Note 8 - Discontinuance of InnoWave Segment Operation

During the third quarter of 2002, the Company's Board of Directors decided on a plan to sell the operations of the InnoWave segment, which specializes in development of solutions for broad and wireless access to communications networks. In April 2003, the Company signed an agreement with Alvarion and completed the sale of the InnoWave operations.

The total value of the transaction was approximately \$ 20 million, consisting of a cash consideration paid by Alvarion and the cash balances withdrawn by ECI at closing. In addition, Alvarion granted warrants to purchase 200,000 Alvarion shares over a period of five years at an exercise price of \$ 3 per share (of which, warrants to purchase 50,000 were to be transferred to certain key InnoWave employees being transferred to Alvarion).

The assets and liabilities which relate to the discontinued operations are presented in separate categories in the current assets and current liabilities sections, respectively. A loss from discontinued operations is presented in the statement of income after the loss from continuing operations.

Set forth below is detail of the assets and liabilities of the discontinued activities on September 30, 2003:

	Nine months ended September 30 2003 (Unaudited) US\$ in thousands	Nine months ended September 30 2002 (Unaudited) US\$ in thousands	Year ended December 31 2002 (Audited) US\$ in thousands
<u>Assets relating to discontinued operations</u>			
Trade and other receivables	-	12,554	8,883
Inventory	-	9,189	8,798
Long-term receivables	-	3,349	2,234
Property, plant and equipment	-	808	733
	-	25,900	20,648

**Condensed Notes to the Interim Consolidated Financial Statements****Note 8 - Discontinuance of InnoWave Segment Operation (cont'd)**

	Nine months ended September 30 2003 <u>(Unaudited)</u> <u>US\$ in thousands</u>	Nine months ended September 30 2002 <u>(Unaudited)</u> <u>US\$ in thousands</u>	Year ended December 31 2002 <u>(Audited)</u> <u>US\$ in thousands</u>
<u>Liabilities relating to discontinued operations</u>			
Trade payables	-	3,821	2,699
Other payables	-	13,579	9,449
	<u>-</u>	<u>17,400</u>	<u>12,148</u>

Set forth below are the results of operations of the discontinued segment

	<u>Nine months ended</u> <u>September 30</u>		<u>Three months ended</u> <u>September 30</u>		<u>Year ended</u> <u>December 31</u>
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2002</u>
	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Unaudited)</u>	<u>(Unaudited)</u>
	<u>US\$ thousands</u>	<u>US\$ thousands</u>	<u>US\$ thousands</u>	<u>US\$ thousands</u>	<u>US\$ thousands</u>
Segment revenues	3,441	39,849	-	6,379	46,637
Segment operating expenses	(5,965)	(78,301)	-	(28,945)	(87,407)
Cumulative effect of an accounting change, net	-	(36,646)	-	-	(36,646)
Results of segment activities	<u>(2,524)</u>	<u>(75,098)</u>	<u>-</u>	<u>(22,566)</u>	<u>(77,416)</u>

**Note 9 - Segment Reports****1. Segment activities disclosure:**

Segment information is presented in accordance with SFAS No. 131, "*Disclosures about Segments of an Enterprise and Related Information*". This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and internal financial reports to the management. The Company's internal financial reporting systems present various data for management to run the business, including profit and loss statements (P&L).

**Condensed Notes to the Interim Consolidated Financial Statements****Note 9 - Segment Reports (cont'd)****2. Operational segment disclosure:**

The following financial information is the information that management uses for analyzing the business results. The figures are presented as a consolidated basis and reflect its presentation to the management.

	<b>Nine months ended September 30, 2003</b>				
	<b>Optical Networks</b>	<b>Broadband Access</b>	<b>ECtel</b>	<b>Other</b>	<b>Consolidated</b>
	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>
Revenues	<b>129,066</b>	<b>135,690</b>	<b>35,338</b>	<b>24,752</b>	<b>324,846</b>
Operating profit (loss)	<b>(28,490)</b>	<b>12,065</b>	<b>(29,073)</b>	<b>(13,503)</b>	<b>(59,001)</b>

	<b>Nine months ended September 30, 2002</b>				
	<b>Optical Networks</b>	<b>Broadband Access</b>	<b>ECtel</b>	<b>Other</b>	<b>Consolidated</b>
	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>
Revenues	181,565	189,759	71,636	54,048	497,008
Operating profit (loss)	(20,941)	2,809	12,903	(44,578)	(49,807)

	<b>Three months ended September 30, 2003</b>				
	<b>Optical Networks</b>	<b>Broadband Access</b>	<b>ECtel</b>	<b>Other</b>	<b>Consolidated</b>
	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>	<b>\$ in thousands</b>
Revenues	47,015	40,307	10,034	7,207	104,563
Operating profit (loss)	(6,767)	2,301	(11,399)	(3,205)	(19,070)

**Condensed Notes to the Interim Consolidated Financial Statements****Note 9 - Segment Reports (cont'd)****2. Operational segment disclosure: (cont'd)**

	Three months ended September 30, 2002				
	Optical Networks \$ in thousands	Broadband Access \$ in thousands	ECtel \$ in thousands	Other \$ in thousands	Consolidated \$ in thousands
Revenues	57,457	49,616	24,312	16,075	147,460
Operating profit (loss)	(13,222)	636	4,597	(33,985)	(41,974)

  

	Year ended December 31, 2002				
	Optical Networks \$ in thousands	Broadband Access \$ in thousands	ECtel \$ in thousands	Other \$ in thousands	Consolidated \$ in thousands
Revenues	233,218	241,807	95,777	75,409	646,211
Operating profit (loss)	(29,536)	4,653	17,208	(45,024)	(52,699)

The segment information for earlier periods, including interim periods, is restated to reflect the change in the structure of the Company's internal organization.

**Note 10 – Material Differences Between U.S. and Israeli GAAP**

The material differences between measurements according to U.S. and Israeli GAAP, applicable to these financial statements, are as follows:

- A.** According to U.S. GAAP, marketable securities defined as available-for-sale securities are stated at market value. Any changes in their value is shown separately in shareholders' equity except in cases were there is a decrease in the value thereof, which is not of a temporary nature. According to Israeli GAAP, securities which meet the definition of 'current investments' are stated at market value and any changes in their value are shown in the income statement. Quoted securities which do not meet the definition, are shown at cost unless there is a decrease in the value thereof, which is not of a temporary nature.

**Condensed Notes to the Interim Consolidated Financial Statements**

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**Note 10 – Material Differences Between U.S. and Israeli GAAP (cont'd)**

**B.** According to U.S. GAAP, no deferred taxes are recorded on adjustments arising from the difference between the rate of change of the C.P.I. (the base on which income taxes are calculated) and the rate of change in the dollar - shekel exchange rate. According to Israeli GAAP, deferred taxes are recorded on such adjustments.

**C.** Commencing January 1, 2001, the Company has adopted Standard No. 133 – *"Accounting for derivative Instruments and Hedging Activities"*.

The Standard requires calculation and classification of all derivative financial instruments in the balance sheet as assets or liabilities and measurement thereof based on fair value. Changes in the fair value of derivative financial instruments are recorded in the statement of operations or the comprehensive income statement in accordance with the designation of the use of the instrument. Pursuant to the accounting principles in Israel, the results of derivative financial instruments, which are defined as "hedging" items, are recorded in correspondence with the recording of the hedged item in the financial statements based on the change in the currency rates of exchange during the reported period.

**D.** In July 2001, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 141 *"Business Combinations"* and No. 142 *"Goodwill and Other Intangible Assets"*. FAS No. 141 replaces APB 16 and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill.

Standard No. 142 cancels the periodic amortization of goodwill and provides that the value of goodwill should be examined at least once a year or when circumstances indicate that there has been a decline in its value. When the circumstances require the recording of an impairment in the value of the goodwill, the loss will be presented as a separate item in the statement of operations in the framework of operating earnings but upon the initial implementation of the standard the decline in the value of the goodwill will be presented as a change in accounting policy. Standard No. 141 was applied in the third quarter of 2001 and the Company applied Standard No. 142 in the first quarter of 2002.

**E.** In the fourth quarter of 2000, Staff Accounting Bulletin SAB No. 101, *"Revenue Recognition in Financial Statements"* (hereinafter - "SAB 101"), came into effect, which deals with revenue recognition policies in financial statements. The changes resulting from SAB 101 primarily affected the reporting of sales of products under agreements that contained customer acceptance criteria or payment terms that were linked to the timing of the installation of the product at the customer specified location. Since SAB 101 only took effect in the fourth quarter of 2000, after the publication of the interim financial statements of the first three quarters, its instructions should be applied retroactively as from the beginning of 2000 and the results for the first three quarters should be restated.

According to Israeli GAAP, the new guidelines may only be adopted from the beginning of the first period for which financial statements have not yet been drawn up and published - i.e. the fourth quarter of 2000, without amending or restating data previously published and if, in the opinion of management, the revenue recognition policies determined in SAB 101 are appropriate to the economic and business environment in which the Company operates.

## Condensed Notes to the Interim Consolidated Financial Statements

### Note 10 - Material Differences Between U.S. and Israeli GAAP (cont'd)

The effects on the financial statements are as follows:

#### A. Consolidated Statements of Income

	Nine months ended September 30, 2003			Nine months ended September 30, 2002			Year ended December 31, 2002		
	As reported	Adjustments	According to	As reported	Adjustments	According to	As reported	Adjustments	According to
	\$ thousands	\$ thousands	Israeli GAAP	\$ thousands	\$ thousands	Israeli GAAP	\$ thousands	\$ thousands	Israeli GAAP
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)	(Audited)	(Audited)
Revenues	324,846	(6,515)	318,331	497,008	(3,867)	493,141	646,211	(4,271)	641,940
Cost of revenues	198,893	(1,015)	197,878	313,047	(1,055)	311,992	395,231	(2,646)	392,585
Selling and marketing expenses	67,551	-	67,551	85,502	(77)	85,425	115,241	(77)	115,164
Amortization of acquisition valued intangible assets	1,503	1,211	2,714	1,320	1,361	2,681	1,760	1,809	3,569
Impairment of assets	6,686	(2,450)	4,236	-	533	533	1,525	533	2,058
Financial expenses	6,066	-	6,066	16,038	251	16,289	18,375	-	18,375
Financial income	(5,349)	448	(4,901)	(21,217)	2,078	(19,139)	(24,564)	3,632	(20,932)
Taxes on income	(1,516)	(257)	(1,773)	(8,659)	417	(8,242)	(8,812)	645	(8,167)
Cumulative effect of an accounting change, net	-	-	-	(550)	550	-	(550)	550	-
Discontinued operations	(2,524)	-	(2,524)	(75,098)	(570)	(75,668)	(77,416)	(570)	(77,986)
Net loss	(57,450)	(4,966)	(62,416)	(148,670)	(6,561)	(155,231)	(155,685)	(6,897)	(162,582)

**Condensed Notes to the Interim Consolidated Financial Statements**


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**Note 10 - Material Differences Between U.S. and Israeli GAAP (cont'd)**

The effects on the financial statements are as follows: (cont'd)

**A. Consolidated Statements of Income (cont'd)**

	Three months ended September 30, 2003			Three months ended September 30, 2002		
	As reported	Adjustment	According to	As reported	Adjustment	According to
	\$ thousands	\$ thousands	Israeli GAAP	\$ thousands	\$ thousands	Israeli GAAP
	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)	(Audited)	(Audited)
Revenues	104,563	(620)	103,943	147,460	(2,076)	145,384
Cost of revenues	64,557	(210)	64,347	95,012	(638)	94,374
Selling and marketing expenses	23,232	-	23,232	26,841	-	26,841
Amortization of acquisition valued intangible assets	270	347	617	440	448	888
Impairment of assets	-	-	-	-	-	-
Financial expenses	1,146	-	1,146	5,484	120	5,604
Financial (income) expenses	(1,728)	2,104	376	(6,596)	6	(6,590)
Taxes on income	(427)	(220)	(647)	(1,997)	(44)	(2,041)
Discontinued operations	-	-	-	(22,566)	-	(22,566)
Net loss	(14,652)	(3,081)	(17,733)	(89,134)	(2,056)	(91,190)

## Condensed Notes to the Interim Consolidated Financial Statements

### Note 10 - Material Differences Between U.S. and Israeli GAAP (cont'd)

The effects on the financial statements are as follows: (cont'd)

#### B. Consolidated items of Balance Sheets

	September 30, 2003			September 30, 2002			December 31, 2002		
	As reported	Adjustments	According to	As reported	Adjustments	According to	As reported	Adjustments	According to
	\$ thousands	\$ thousands	Israeli GAAP	\$ thousands	\$ thousands	Israeli GAAP	\$ thousands	\$ thousands	Israeli GAAP
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)	(Audited)	(Audited)
Trade receivables	158,882	615	159,497	225,769	7,534	233,303	207,315	7,130	214,445
Inventories	122,152	(212)	121,940	167,730	(2,818)	164,912	149,747	(1,227)	148,520
Other assets, goodwill and other intangible assets	20,210	1,675	21,885	(*)51,625	913	52,538	37,840	693	38,533
Accumulated other comprehensive loss	(2,280)	2,280	-	-	-	-	(1,832)	1,832	-
Shareholders' equity	591,593	2,078	593,671	654,336	5,629	659,965	646,400	6,596	652,996

(\*) Reclassified

