Responsibility

Management's report

The consolidated financial statements and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

The consolidated financial statements are prepared by the management of Island Telecom Inc., which is responsible for the integrity and objectivity of this information. The statements have been prepared using generally accepted accounting principles and methods appropriate to the Company including, where applicable, amounts based on management's best estimates. Financial information presented elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

The Company maintains a system of internal controls designed to provide reasonable assurance that transactions are recorded and executed in accordance with its authorizations practice, that assets are properly safeguarded and that reliable financial records are maintained. This system includes written policies and procedures, an organizational structure that segregates duties and a comprehensive program of periodic audits by the internal auditors.

The Board of Directors is responsible for ensuring that management fulfills its responsibility for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee.

The Audit Committee, comprised of Directors who are not officers or employees of the Company, meets periodically with management, the Company's internal auditors and the external auditors to discuss audit and financial matters. In addition, this committee reviews the quarterly and annual financial statements of the Company and submits its report to the Board of Directors. The financial statements are submitted to the Board for approval.

Ernst & Young LLP, Chartered Accountants, the external auditors recommended by the Board of Directors and appointed by the shareholder, are engaged to provide an independent audit of the financial statements in accordance with generally accepted auditing standards. Ernst & Young LLP has full and free access to the Audit Committee.

Gerhard H. Erl
Vice President Finance

Auditors' report

To the Shareholder of Island Telecom Inc.:

We have audited the consolidated balance sheets of Island Telecom Inc. as at December 31, 1999 and 1998 and the consolidated statements of income, retained earnings and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1999 and 1998 and the results of its operations and the changes in its cash flows for the years then ended in accordance with generally accepted accounting principles.

Ernst & Young LLP
Charlottetown, Prince Edward Island,
February 1, 2000

The numbers

Consolidated balance sheets

(Thousands of dollars) *As at December 31*	**1999**	1998
ASSETS		
Current assets		
Cash & equivalents	**$ 757**	$ 233
Accounts receivable	**15,606**	12,194
Income taxes receivable	**742**	—
Due from affiliated companies *(Note 12)*	**238**	—
Prepayments	**649**	381
Total current assets	**17,992**	12,808
Capital assets *(Note 5)*	**100,328**	108,923
Other assets		
Investments	**—**	88
Deferred income taxes	**1,793**	—
Deferred charges	**1,128**	1,240
Prepaid pension cost *(Note 9)*	**6,565**	5,191
Total other assets	**9,486**	6,519
Total assets	**$ 127,806**	$ 128,250

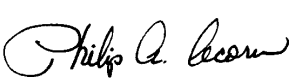
See accompanying notes to the consolidated financial statements

(Thousands of dollars) *As at December 31*	**1999**	1998
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	**$ 8,122**	$ 4,641
Due to affiliated companies *(Note 12)*	**3,910**	789
Income taxes payable	**—**	1,039
Interest accrued	**1,586**	1,529
Dividends payable	**—**	415
Other current liabilities	**1,863**	1,880
Debt due within one year *(Note 7)*	**4,097**	7,770
Total current liabilities	**19,578**	18,063
Long-term debt *(Note 8)*	**46,500**	41,417
Deferred income taxes	**—**	832
Deferred credits	**355**	290
Total liabilities	**66,433**	60,602
Shareholders' equity		
Preferred stock *(Note 2 and 10)*	**36,898**	—
Common stock *(Note 2 and 10)*	**3,901**	9,206
Contributed surplus *(Note 2)*	**—**	22,815
Retained earnings	**20,574**	35,627
Total shareholders' equity	**61,373**	67,648
Total liabilities and shareholders' equity	**$ 127,806**	$ 128,250

See accompanying notes to the consolidated financial statements

Signed on behalf of the board of directors:

Colin Latham
Director



Philip Acorn
Director

Consolidated statements of income

(Thousands of dollars) *For the years ended December 31*	**1999**	1998
Revenues		
Local service	**$ 49,544**	$ 45,298
Long-distance service	**22,543**	25,282
Wireless service	**11,467**	10,561
Other revenues *(Note 4)*	**4,350**	4,076
Total revenues	**$ 87,904**	$ 85,217
Expenses		
Cost of revenues	**9,790**	11,744
Depreciation and amortization	**17,796**	17,634
Other operating expenses *(Note 2)*	**37,550**	31,829
Total operating expenses	**$ 65,136**	$ 61,207
Operating income	**22,768**	24,010
Other (expense) income *(Note 2)*	**(2,705)**	292
Income before debt expenses and income taxes	**20,063**	24,302
Interest and other debt expenses *(Note 6)*	**4,826**	5,030
Income before income taxes	**$ 15,237**	$ 19,272
Income taxes *(Note 11)*	**7,234**	8,942
Net income	**$ 8,003**	$ 10,330

See accompanying notes to the consolidated financial statements

Consolidated statements of retained earnings

(Thousands of dollars) *For the years ended December 31*	**1999**	1998
Balance, beginning of year, as previously reported	**$ 36,774**	$ 31,129
Restatement *(Note 2)*	**$ (1,147)**	$ (587)
Balance, beginning of year, as restated	**$ 35,627**	$ 30,542
Net income	**8,003**	10,330
Dividends	**(12,531)**	(5,173)
Exchange and redemption of common stock *(Note 2)*	**(10,189)**	—
Other items *(Note 2)*	**(336)**	(72)
Balance, end of year	**$ 20,574**	$ 35,627

See accompanying notes to the consolidated financial statements

Consolidated statements of cash flows

(Thousands of dollars) *For the years ended December 31*	**1999**	1998
Cash from (used in) operations		
Net income	**$ 8,003**	$ 10,330
Add (deduct) non-cash items		
Depreciation & amortization	**17,796**	17,634
Prepaid pension costs	**(1,374)**	(1,609)
Deferred income taxes	**(2,625)**	(1,310)
Direct entries to retained earnings	**(336)**	(72)
	21,464	24,973
Change in non-cash working capital *(Note 15)*	**943**	(2,411)
	22,407	22,562
Cash from (used in) financing		
Issuance of common shares	**—**	93
Repayment of debt due within one year	**(3,673)**	(1,069)
Issuance (repayment) of long-term debt	**10,000**	(2,486)
Repayment of notes payable	**(4,917)**	—
Redemption of common shares	**(1,411)**	—
Dividends	**(12,946)**	(5,163)
	(12,947)	(8,625)
Cash from (used in) investing		
Net capital expenditures	**(11,793)**	(15,231)
Other capital related items	**2,592**	97
Decrease in deferred charges/credits	**177**	560
Decrease in investments	**88**	448
	(8,936)	(14,126)
Increase (decrease) in cash & equivalents	**524**	(189)
Cash & equivalents, beginning of year	**233**	422
Cash & equivalents, end of year	**$ 757**	$ 233
Supplemental cash flow disclosure		
Interest paid	**$ 4,769**	$ 4,901
Income taxes paid	**$ 11,916**	$ 9,484

See accompanying notes to the consolidated financial statements

Financial statement notes

1. Significant accounting policies

Island Telecom Inc. is incorporated by a private statute of the Province of Prince Edward Island. The term "Company" is used to mean Island Telecom Inc. and, where the context of the narrative text permits or requires, its subsidiaries.

The Company, a direct wholly-owned subsidiary of Aliant Telecom Inc. which is a wholly-owned subsidiary of Aliant Inc., operates in the telecommunications industry and is subject to regulation by the Canadian Radio – television and Telecommunications Commission ("CRTC").

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada and in conformity with prevailing practices in the Canadian telecommunications industry. Certain comparative figures in the consolidated financial statements have been reclassified to conform with the current-year presentation.

Consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Island Tel Advanced Solutions Inc.

Capital assets are recorded at cost. Depreciation is computed on a straight-line basis over the useful lives of the assets. Depreciation and amortization expense in 1999 was $17.8 million (1998 – $17.6 million). The average depreciation rate was 8.4% for 1999 (1998, 8.0%).

Pension costs and obligations – The Company provides retirement benefits for its employees under defined benefit or defined contribution pension plans. Costs of the defined contribution plan are charged to operations as contributions come due. Costs of the defined benefit plan are actuarially determined on the basis of best estimate assumptions using the projected benefit method prorated on years of service. Adjustments to pension cost and experience gains and losses are amortized to income on a straight-line basis over the expected average remaining service life of pension plan members. Market-related values of pension fund assets are calculated using a three-year moving average of year-end market values. The cumulative difference between the amount contributed to the pension plan and the amount charged to income, including the effects of curtailments and settlements, is recorded on the balance sheet as a prepaid pension cost.

Post-retirement benefits other than pensions – The Company provides health care and other benefits to its retirees. The costs of these post-retirement benefits are charged to income when the costs are incurred.

Deferred charges include debt issue costs and are amortized on a straight-line basis over the term of the related debt.

Income taxes are accounted for under the tax allocation method. Under this method, income taxes have been calculated on reported income rather than on earnings currently taxable.

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments of less than 90 days. The Company uses the indirect method to prepare its cash flow statement.

Interest during construction is capitalized using the Company's average cost of debt.

2. Business combination

Effective May 31, 1999 Island Telecom Inc., Bruncor Inc., Maritime Telegraph & Telephone Company, Limited, and NewTel Enterprises Limited combined their businesses to form Aliant Inc. through an exchange of shares.

As part of the combination, the Company's majority shareholder exchanged its 3,831,455 common shares for preferred shares. The effect of this transaction was to reduce common stock, contributed surplus and retained earnings by $4,789,000, $22,815,000 and $9,294,000 respectively and to increase preferred stock by $36,898,000. The Company also redeemed 412,351 common shares as part of a reorganization which reduced common stock and retained earnings by $516,000 and $895,000 respectively.

The Company also transferred certain investments to affiliates during the year. The transfer of these investments has been accounted for on the continuity of interests basis with results of operations of these investments being removed from the results of the Company for 1999 and 1998. The net effect of these transactions was to reduce net assets, 1998 opening retained earnings and 1998 net income by $4,417,000, $587,000 and $560,000 respectively.

As a result of the combination, the Company has charged $3.4 million to 1999 earnings for the costs associated with restructuring activities. This charge is included in other operating expenses and represents the Company's agreed share of the estimated costs for 1999 and 2000 to complete restructuring activities. A significant portion of these expenses are for voluntary early retirement programs for employees. In addition, the business restructuring includes other expenses related to merger integration activities.

During the year the Company standardized its accounting methods and estimates with the other subsidiaries of Aliant Inc. As a result, $2.7 million was recorded as an expense in other (expense) income.

Third party costs of $336,000 related to the combination were charged to retained earnings. These costs include financial advisor fees, regulatory filing fees, legal and accounting fees and printing and mailing costs.

3. Segment information

The Company has two reportable segments: Island Tel and Island Tel Mobility, each of which provides telecommunications products and services.

a) Measurement of segment income and segment assets

The Company evaluates performance based on earnings before interest, income taxes, depreciation and amortization (EBITDA). The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

b) Factors management used to identify the enterprise's reportable segments

The Company's reportable segments are business units that offer different products and services and are each managed separately. Island Tel provides local and long distance telecommunications services. Island Tel Mobility is the principal supplier of wireless communications in Prince Edward Island.

c) Segment information

(Thousands of dollars)

(Year ended December 31, 1999)	Island Tel	Island Tel Mobility	Totals
Revenues	**$ 73,845**	**$ 11,467**	**$ 85,312**
EBITDA	**33,426**	**4,975**	**38,401**

(Year ended December 31, 1998)	Island Tel	Island Tel Mobility	Totals
Revenues	$ 72,320	$ 10,561	$ 82,881
EBITDA	38,880	4,200	43,080

3. Segment information continued

Reconciliations

(Thousands of dollars)	**1999**	1998
Revenues		
Total external revenues for reportable segments	**$ 85,312**	$ 82,881
Other revenues	**2,592**	2,336
Total consolidated revenues	**$ 87,904**	$ 85,217
Income		
EBITDA for reportable segments	**$ 38,401**	$ 43,080
Other (expense) income	**$ (2,705)**	$ 292
Unallocated amounts	**(20,459)**	(24,100)
Total consolidated income before income taxes	**$ 15,237**	$ 19,272

4. Other revenues

(Thousands of dollars)	**1999**	1998
Internet and advanced solutions revenues	**2,382**	1,759
Equipment sales	**1,356**	1,421
Miscellaneous	**612**	896
	$ 4,350	$ 4,076

5. Capital assets

As at December 31

(Thousands of dollars)	**1999**			1998		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
Central office equipment	**$ 91,877**	**$ 56,392**	**$ 35,485**	$ 88,965	$ 49,433	$ 39,532
Outside plant	**85,697**	**44,352**	**41,345**	83,955	40,986	42,969
Station equipment	**24,292**	**17,498**	**6,794**	28,703	18,009	10,694
Application software	**5,015**	**2,343**	**2,672**	4,571	2,936	1,635
Buildings	**11,746**	**5,242**	**6,504**	11,770	4,860	6,910
Other equipment	**9,655**	**5,021**	**4,634**	7,785	3,890	3,895
Plant under construction	**1,394**	**—**	**1,394**	2,536	—	2,536
Land	**354**	**—**	**354**	354	—	354
Construction materials	**1,146**	**—**	**1,146**	398	—	398
	$ 231,176	**$ 130,848**	**$ 100,328**	$ 229,037	$ 120,114	$ 108,923

6. Interest and other debt expenses

(Thousands of dollars)		**1999**		1998
Interest on long-term debt	**$**	**4,511**	$	4,574
Interest on short-term debt	**$**	**387**	$	497
Interest on assets under construction	**$**	**(106)**	$	(76)
Other		**34**		35
	$	**4,826**	$	5,030

7. Debt due within one year

(Thousands of dollars)		**1999**		1998
Bank advances	**$**	**4,097**	$	7,770

Bank advances represent instruments with an average term to maturity of less than 90 days. The average interest rate was 5.6% in 1999 (1998, 5.1%).

8. Long-term debt

(Thousands of dollars)

	Fixed rate	Maturity		**1999**		1998
Bonds						
Q	11.25%	March 15, 2006	**$**	**4,000**	$	4,000
R	12.25%	October 15, 2007		**5,000**		5,000
S	11.45%	July 20, 2008		**7,500**		7,500
T	10.60%	July 14, 2009		**3,500**		3,500
U	11.15%	March 1, 2010		**6,500**		6,500
V	9.77%	March 1, 2018		**5,000**		5,000
W	8.76%	January 15, 2019		**5,000**		5,000
Y *(a)*	7.22%	October 15, 2004		**10,000**		—
				46,500		36,500
Note *(b)*	9.82%	January 31, 2000		**—**		4,917
			$	**46,500**	$	41,417

(a) This bond is payable to Aliant Telecom Inc.

(b) The note was repaid prior to maturity in 1999 for total consideration of $4,917,000 plus accrued interest. The note was issued under long-term floating rate facilities; however at December 31, 1998 the Company had in place agreements which effectively fixed the interest at the rate noted above for the indicated term.

8. Long-term debt continued

Annual repayments of long-term debt are as follows:

(Thousands of dollars)	
2000	$ —
2001	—
2002	—
2003	—
2004	10,000
Thereafter	36,500
	$ 46,500

The Bonds are redeemable at the option of the Company prior to maturity at the prices, times, and conditions specified in each series.

The Bonds are secured by a Deed of Trust and Mortgage and by supplemental deeds. These instruments contain a first fixed and specific mortgage, a pledge and charge upon all real and immovable property and equipment of the Company, and a floating charge on all other property of the Company, both present and future.

9. Pensions

The present value of accrued pension benefits and the assets available to provide for these benefits are as follows:

(Thousands of dollars)	**1999**	1998
Accrued pension benefits	**$ 46,236**	$ 41,132
Pension-fund assets, at market-related values	**$ 57,228**	$ 54,615

Due to the long-term nature of management estimates and assumptions, it is possible that changes in future conditions may require a material change in the present value of the accrued pension benefits.

Defined benefit pension costs are accrued and charged to earnings over the employees' average remaining working lives. The weighted average discount rate used in determining the accrued plan benefits was 9% for the years ended December 31, 1998 and 1999. The long-term salary escalation rate was assumed to be 3.0% for 1998 and 4.0% for 1999. Pension expense is calculated using a weighted average assumed long-term rate of return on plan assets of 9% for the years ended December 31, 1998 and 1999. Variances between such estimates and actual experience are amortized over the employees' average remaining working lives.

The components of the defined benefit pension expense (recovery) are as follows:

(Thousands of dollars)	**1999**	1998
Current service expense	**$ 1,173**	$ 902
Expected interest cost on accrued pension benefits	**3,720**	3,451
Expected return on pension-fund assets	**(5,039)**	(4,592)
Curtailments	**(117)**	(329)
Amortization of gains	**(744)**	(799)
	$ (1,007)	$ (1,367)

10. Capital stock

Authorized

Authorized capital stock at December 31, 1999 consists of 10,000,000 common shares at $1.25 par value and 6,000,000 preferred shares at $1.25 par value.

Issued

Common shares issued and outstanding, and changes therein during the year, are as follows:

(Thousands of dollars)	Number of shares		
January 1, 1998	3,678,510	$	9,196
Two-for-one stock split	3,678,510	$	—
Exercise of stock options	7,900	$	10
December 31, 1998	7,364,920	$	9,206
Exchanged and cancelled *(Note 2)*	(3,831,455)	$	(4,789)
Redeemed *(Note 2)*	(412,351)	$	(516)
December 31, 1999	3,121,114	$	3,901

Preferred shares issued and outstanding, and changes therein during the year, are as follows:

(Thousands of dollars)	Number of shares		
December 31, 1998	—	$	—
Exchanged *(Note 2)*	3,831,455	$	36,898
December 31, 1999	3,831,455	$	36,898

Common stock plans

Prior to May 31, 1999, the Company had a Common Shareholder Dividend Reinvestment Plan (DRP) and an Employees' Stock Savings Plan (ESSP) for which the Company had reserved 312,332 shares.

11. Income taxes

A reconciliation of the statutory income tax rate to the effective income tax rate is as follows:

	1999	1998
Combined basic federal and provincial income tax rate	**45.1 %**	45.1 %
Interest during construction, net of applicable depreciation adjustment	**0.8**	0.7
Other permanent differences	**1.6**	0.6
	47.5 %	46.4%

12. Related-party transactions

BCE Inc. beneficially owned and controlled 41.23% of the outstanding common shares of the Company as at December 31, 1999 (34.4% as at December 31, 1998).

In the normal course of business, the company had transactions with related parties as follows:

(Thousands of dollars)		**1999**	1998
Related party *(relationship)*	Nature of transactions		
Controlled investees of BCE Inc.	Purchase of telecommunications and other services	**$ 7,219**	$ 11,067
	Sales of telecommunications and other services	**$ 4,997**	$ 5,727

These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

The balances due to and due from affiliates are non-interest bearing, are under normal credit terms and have arisen from the sales of product and provision of services referred to above.

13. Commitments

The Company has provided a loan guarantee of $9,310,000 to third party lenders who have provided medium-term financing to Aliant Telecom Inc.

Operating leases

The future minimum lease payments under operating leases with initial non-cancellable lease terms in excess of one year at December 31, 1999 are as follows:

(Thousands of dollars)	
2000	$ 1,715
2001	1,888
2002	170
2003	$ 170

14. Financial instruments

The carrying values of the Company's financial instruments other than long-term debt approximate fair values because of their short-term maturity and normal credit terms.

The Company's accounts receivable do not represent significant concentration of credit risk because the accounts are owed by a large number of customers on normal credit terms.

The fair value of long-term debt has been estimated based on the present value of contractual cash flows at the rates available to the Company at December 31, 1999 and 1998 for debt with similar terms and remaining maturities. Based on this method, the fair value of the Company's long-term debt has been estimated to be $56,608,000 (1998, $55,799,000) with a carrying value of $46,500,000 (1998, $41,417,000). The Company generally holds long-term financial instruments to maturity and therefore does not anticipate that any difference between carrying value and fair value will be recorded in the accounts. Fair-value estimates were made based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

Derivative instruments

Derivative instruments are primarily used to fix interest rates on floating rate debt and are not undertaken for speculative purposes. The Company utilizes instruments such as interest rate swaps, future rate agreements and interest rate caps in this process.

At December 31, 1998, the Company held one interest rate swap, at a rate of 9.82%, to protect floating rate long-term debt of approximately $5,000,000. An additional interest rate swap, at a rate of 4.75%, was held to protect floating rate debt due within one year of $2,000,000. The maturity dates of the swaps, which range from one to two years, are the same as the debt instruments to which they relate. The Company intends to hold these instruments until maturity. The fair values of these derivative instruments at December 31, 1999 are not material.

The Company contracts derivative financial instruments through Canadian financial institutions that have a minimum rating of A on their senior securities and therefore does not anticipate non-performance by these institutions.

15. Changes in non-cash working capital

(Thousands of dollars)	**1999**	1998
Cash provided by (used in):		
Accounts receivable	**$ (3,412)**	$ (144)
Due to / from affiliated companies	**2,883**	445
Prepayments	**(268)**	(862)
Accounts payable	**3,481**	(2,032)
Income taxes	**(1,781)**	293
Interest and other current liabilities	**40**	(111)
	$ 943	$ (2,411)