

AT&T Inc. Financial Review 2010



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Selected Financial and Operating Data

Dollars in millions except per share amounts

At December 31 or for the year ended:	2010	2009 ¹	2008 ¹	2007 ¹	2006 ^{1,2}
As Adjusted					
Financial Data					
Operating revenues	\$124,280	\$122,513	\$123,443	\$118,322	\$ 62,518
Operating expenses	\$104,707	\$101,513	\$125,133	\$ 89,181	\$ 44,521
Operating income (loss)	\$ 19,573	\$ 21,000	\$ (1,690)	\$ 29,141	\$ 17,997
Interest expense	\$ 2,994	\$ 3,368	\$ 3,369	\$ 3,460	\$ 1,800
Equity in net income of affiliates	\$ 762	\$ 734	\$ 819	\$ 692	\$ 2,043
Other income (expense) – net	\$ 897	\$ 152	\$ (332)	\$ 814	\$ 398
Income tax expense (benefit)	\$ (1,162)	\$ 6,091	\$ (2,210)	\$ 9,917	\$ 6,088
Net Income (Loss)	\$ 20,179	\$ 12,447	\$ (2,364)	\$ 17,228	\$ 12,547
Less: Net Income Attributable to Noncontrolling Interest	\$ (315)	\$ (309)	\$ (261)	\$ (196)	\$ (5)
Net Income (Loss) Attributable to AT&T	\$ 19,864	\$ 12,138	\$ (2,625)	\$ 17,032	\$ 12,542
Earnings (Loss) Per Common Share:					
Net Income (Loss) Attributable to AT&T	\$ 3.36	\$ 2.06	\$ (0.44)	\$ 2.78	\$ 3.23
Earnings (Loss) Per Common Share – Assuming Dilution:					
Net Income (Loss) Attributable to AT&T	\$ 3.35	\$ 2.05	\$ (0.44)	\$ 2.76	\$ 3.22
Total assets	\$268,488	\$268,312	\$264,700	\$274,951	\$270,118
Long-term debt	\$ 58,971	\$ 64,720	\$ 60,872	\$ 57,253	\$ 50,062
Total debt	\$ 66,167	\$ 72,081	\$ 74,990	\$ 64,112	\$ 59,795
Construction and capital expenditures	\$ 20,302	\$ 17,294	\$ 20,290	\$ 17,831	\$ 8,337
Dividends declared per common share	\$ 1.69	\$ 1.65	\$ 1.61	\$ 1.47	\$ 1.35
Book value per common share	\$ 18.94	\$ 17.28	\$ 16.35	\$ 19.07	\$ 18.52
Ratio of earnings to fixed charges ⁶	4.52	4.42	—	6.95	8.67
Debt ratio	37.1%	41.4%	43.8%	35.7%	34.1%
Weighted average common shares outstanding (000,000)	5,913	5,900	5,927	6,127	3,882
Weighted average common shares outstanding with dilution (000,000)	5,938	5,924	5,958	6,170	3,902
End of period common shares outstanding (000,000)	5,911	5,902	5,893	6,044	6,239
Operating Data					
Wireless connections (000) ³	95,536	85,120	77,009	70,052	60,962
In-region network access lines in service (000)	43,678	49,392	55,610	61,582	66,469
Broadband connections (000) ^{4,5}	17,755	17,254	16,265	14,802	12,170
Number of employees	266,590	282,720	302,660	309,050	304,180

¹Financial data for 2006 – 2009 has been adjusted to reflect our voluntary change in accounting for pension and postretirement benefits. See Note 1 to consolidated financial statements.

²Our 2006 income statement amounts reflect results from BellSouth Corporation (BellSouth) and AT&T Mobility LLC (AT&T Mobility), formerly Cingular Wireless LLC, for the two days following the December 29, 2006 acquisition. Our 2006 balance sheet and end-of-year metrics include 100% of BellSouth and AT&T Mobility. Prior to the December 29, 2006 BellSouth acquisition, AT&T Mobility was a joint venture in which we owned 60% and was accounted for under the equity method.

³The number presented represents 100% of AT&T Mobility cellular/PCS customers.

⁴Broadband connections include in-region DSL lines, in-region U-verse High Speed Internet access, satellite broadband and 3G LaptopConnect cards.

⁵Prior-period amounts restated to conform to current period reporting methodology.

⁶Earnings were not sufficient to cover fixed charges in 2008. The deficit was \$943.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions except per share amounts

For ease of reading, AT&T Inc. is referred to as "we," "us," "AT&T" or the "Company" throughout this document, and the names of the particular subsidiaries and affiliates providing the services generally have been omitted. AT&T is a holding company whose subsidiaries and affiliates operate in the communications services industry both in the United States and internationally, providing wireless and wireline telecommunications services and equipment as well as directory advertising and publishing services. You should read this discussion in conjunction with the consolidated financial statements and accompanying notes. A reference to a "Note" in this section refers to the accompanying Notes to Consolidated Financial Statements. In the tables throughout this section, percentage increases and decreases that equal or exceed 100% are not considered meaningful and are denoted with a dash.

RESULTS OF OPERATIONS

Consolidated Results Our financial results are summarized in the table below. We then discuss factors affecting our overall results for the past three years. These factors are discussed in more detail in our "Segment Results" section. We also discuss our expected revenue and expense trends for 2011 in the "Operating Environment and Trends of the Business" section.

	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Operating Revenues	\$124,280	\$122,513	\$123,443	1.4%	(0.8)%
Operating expenses					
Cost of services and sales	52,263	50,571	56,688	3.3	(10.8)
Selling, general and administrative	33,065	31,427	48,772	5.2	(35.6)
Depreciation and amortization	19,379	19,515	19,673	(0.7)	(0.8)
Total Operating Expenses	104,707	101,513	125,133	3.1	(18.9)
Operating Income (Loss)	19,573	21,000	(1,690)	(6.8)	—
Interest expense	2,994	3,368	3,369	(11.1)	—
Equity in net income of affiliates	762	734	819	3.8	(10.4)
Other income (expense) – net	897	152	(332)	—	—
Income (loss) from continuing operations before income taxes	18,238	18,518	(4,572)	(1.5)	—
Income (loss) from continuing operations	19,400	12,427	(2,362)	56.1	—
Net Income (Loss) Attributable to AT&T	\$ 19,864	\$ 12,138	\$ (2,625)	63.7%	—

OVERVIEW

Operating income decreased \$1,427, or 6.8%, in 2010 and increased \$22,690 in 2009. Our operating income margin was 15.7% in 2010, down from 17.1% in 2009 and up from (1.4%) in 2008. Operating income includes actuarial losses related to pension and postretirement benefit plans, which were non-cash losses of \$2,521 in 2010, \$215 in 2009 and \$25,150 in 2008 (see Note 11). Excluding the impacts of these actuarial losses, operating income in 2010 reflected growth in wireless service revenue, driven mostly by our subscriber growth and growth in wireless data revenue, along with an increase in wireline data revenue resulting from growth in Internet Protocol (IP) data revenue, partially offset by the continuing decline in voice and print directory advertising revenue. Excluding the variance in actuarial losses in 2009 as compared to 2008, operating income in 2009 decreased primarily due to the decline in voice revenues and directory print advertising and the higher cost of equipment sales.

In January 2011, we announced a change in our method of recognizing actuarial gains and losses for pension and other postretirement benefits for all benefit plans. As part of this change, we have elected to immediately recognize the non-cash actuarial gains and losses in our operating results

in the year in which the gains and losses occur. The most significant factors contributing to actuarial gains and losses are actual returns on plan assets, the interest rate used to discount our benefit obligations and actual healthcare cost experience. We have applied this change retrospectively, adjusting all prior periods. See "Significant Accounting Policies and Estimates" and Note 1 for further discussion of the change and the impact to our operating results.

Operating revenues increased \$1,767, or 1.4%, in 2010 and decreased \$930, or 0.8%, in 2009. Revenues in 2010 reflect the continued growth in wireless service revenue, driven mostly by our increase in average subscribers along with a significant increase in wireless data revenue, stemming from higher integrated device sales and customer usage. Adding to the increase, we had higher wireline data revenue largely due to growth in IP-related services, driven by AT&T U-verseSM (U-verse) subscriber growth. These increases were partially offset by the continuing decline in voice revenues, due to decreasing access lines, and a decline in print directory advertising revenue. The decline in 2009 reflects decreases in voice and directory revenue, partially offset by growth in wireless service revenue along with an increase in wireline data revenue.

The declines in our voice and advertising revenues reflect continuing economic pressures on our customers as well as increasing competition. Total switched access lines decreased 11.6% in 2010 and 11.2% in 2009. Customers disconnecting access lines switched to wireless, Voice over Internet Protocol (VoIP) and cable offerings or terminated service permanently as businesses closed or consumers left residences. While we lose wireline voice revenues, we have the opportunity to increase wireless service or wireline data revenues should these customers choose us as their wireless or VoIP provider. We also continue to expand our VoIP service for customers who have access to our U-verse video service.

Cost of services and sales expenses increased \$1,692, or 3.3%, in 2010 and decreased \$6,117, or 10.8%, in 2009. Excluding the increase of more than \$700 in expense related to the previously discussed actuarial loss, expenses increased in 2010 primarily due to higher wireless integrated device costs, higher interconnect and network system costs, and higher Universal Service Fund (USF) costs. Partially offsetting these increases were lower service- and financing-related costs associated with our pension and postretirement benefits (referred to as "pension/OPEB expenses"), a decrease in other employee-related costs and lower traffic compensation. Excluding the decrease of almost \$8,000 in expense related to the actuarial loss, expense increases in 2009 were primarily due to higher equipment costs related to advanced integrated devices and increased pension/OPEB expenses.

Selling, general and administrative expenses increased \$1,638, or 5.2%, in 2010 and decreased \$17,345, or 35.6%, in 2009. Excluding an increase of almost \$1,600 in expense related to the actuarial loss, expenses were higher in 2010 primarily due to increases in advertising and various support expenses. These increases were mostly offset by lower bad debt expense along with lower pension/OPEB expenses and other employee-related costs. Excluding the decrease of almost \$17,000 in expense related to the actuarial loss, the decrease in 2009 was primarily due to declines in employee-related costs resulting from workforce reductions, decreases in materials and supplies expense along with wireless advertising and promotional expenses. These decreases were partially offset by increased pension/OPEB expenses, and higher commissions, customer service costs and IT/interconnect costs resulting from wireless subscriber growth along with increased support for data services and integrated devices.

Depreciation and amortization expenses decreased \$136, or 0.7%, in 2010 and \$158, or 0.8%, in 2009. The decreases in 2010 and 2009 were primarily due to lower amortization of intangibles related to customer relationships associated with acquisitions, partially offset by higher depreciation related to capital spending for network upgrades and expansion.

Interest expense decreased \$374, or 11.1%, in 2010 and \$1 in 2009. The decline in interest expense for 2010 was primarily due to a decrease in our average debt balances, along with a decrease in our weighted average interest rate.

Equity in net income of affiliates increased \$28, or 3.8%, in 2010 and decreased \$85, or 10.4%, in 2009. The 2010 increase was primarily due to improved results at América Móvil, S.A. de C.V. (América Móvil). The 2009 decrease was primarily due to foreign currency translation losses at América Móvil, Teléfonos de México, S.A. de C.V. (Telmex), and Telmex Internacional, S.A.B. de C.V. (TI), partially offset by improved results at América Móvil.

Other income (expense) – net We had other income of \$897 in 2010 and \$152 in 2009, and other expense of \$332 in 2008. Results for 2010 included a \$658 gain on the exchange of TI shares for América Móvil shares, \$197 gain on the sale of investments and \$110 of interest and leveraged lease income, partially offset by \$98 of investment impairments.

Other income for 2009 included a \$112 gain on the sale of investments, \$100 of interest and leveraged lease income, and \$42 of gains on the sale of a professional services business, partially offset by \$102 of investment impairments. Other expense for 2008 included losses of \$467 related to investment impairments, partially offset by \$156 of interest and leveraged lease income.

Income tax expense decreased \$7,253 in 2010 and increased \$8,301 in 2009. The decrease in income tax in 2010 resulted primarily from a settlement with the Internal Revenue Service (IRS) related to a 2008 restructuring of our wireless operations, which decreased our income taxes by \$8,300. This income tax benefit was partially offset by a \$995 charge recorded during the first quarter of 2010 to reflect the deferred tax impact of enacted U.S. healthcare legislation (see Note 10). Our 2009 income tax expense increased as a result of an increase in our Income from Continuing Operations Before Income Taxes, primarily due to a decrease in actuarial losses on our pension and postretirement benefit plans. This increase was partially offset by the recognition of income tax benefits related to audit issues and judicial developments. Our effective tax rate (benefit) in 2010 was (6.4)%, compared to 32.9% in 2009 and 48.3% in 2008.

Income (loss) from discontinued operations, net of tax increased \$759 in 2010 and \$22 in 2009. The increase in 2010 was primarily attributable to the gain of \$769 on our third-quarter 2010 sale of our subsidiary Sterling Commerce Inc. (Sterling).

Segment Results

Our segments are strategic business units that offer different products and services over various technology platforms and are managed accordingly. Our operating segment results presented in Note 4 and discussed below for each segment follow our internal management reporting. We analyze our various operating segments based on segment income before income taxes. We make our capital allocations decisions primarily based on the network (wireless or wireline) providing services. Actuarial gains and losses from pension and other postretirement benefits, interest expense and other income (expense) – net, are managed only on a total company basis and are, accordingly, reflected only in consolidated results. Each segment's percentage of total segment operating revenue and income calculations is derived from our segment results table in Note 4. We have four reportable segments: (1) Wireless, (2) Wireline, (3) Advertising Solutions and (4) Other.

The **Wireless segment** accounted for approximately 47% of our 2010 total segment operating revenues as compared to 44% in 2009 and 67% of our 2010 total segment income as compared to 63% in 2009. This segment uses our nationwide network to provide consumer and business customers with wireless voice and advanced data communications services.

The **Wireline segment** accounted for approximately 49% of our 2010 total segment operating revenues as compared to 52% in 2009 and 34% of our 2010 total segment income as compared to 38% in 2009. This segment uses our regional, national and global network to provide consumer and business customers with landline voice and data communications services, AT&T U-verse TV, high-speed broadband and voice services and managed networking to business customers. Additionally, we receive commissions on sales of satellite television services offered through our agency arrangements.

The **Advertising Solutions segment** accounted for approximately 3% of our 2010 total segment operating revenues as compared to 4% in 2009 and 4% of our 2010 total segment income as compared to 6% in 2009. This segment includes our directory operations, which publish Yellow and White Pages directories and sell directory advertising, Internet-based advertising and local search.

The **Other segment** accounted for approximately 1% of our 2010 and 2009 total segment operating revenues. Since segment operating expenses exceeded revenue in both years, a segment loss was incurred in both 2010 and 2009. This segment includes results from customer information services, our portion of the results from our international equity investments and all corporate and other operations. Also included in the Other segment are impacts of corporate-wide

decisions for which the individual operating segments are not being evaluated, including interest cost and expected return on pension and postretirement benefits assets. In May 2010, we announced the sale of Sterling, which we closed in August 2010. The Other segment results for all periods shown have been restated to exclude the results of Sterling, which are now reflected in discontinued operations (see Note 2).

In January 2011, we announced a change in our method of recognizing actuarial gains and losses for pension and other postretirement benefits as well as the attribution of those benefit costs to our segments (see Note 1). Historically, the total benefit costs were attributed to each segment. As part of the benefit accounting change, the service cost and the amortization of prior service costs, which represent the benefits earned by active employees during the period, will continue to be attributed to the segment in which the employee is employed, while interest cost and expected return on assets will now be recorded in the Other segment as those financing activities are managed on a corporate level. Actuarial gains and losses resulting from the remeasurement of our pension and postretirement benefit plans, which generally only occurs in the fourth quarter, will be reflected in AT&T's consolidated results only. We have adjusted prior-period segment information to conform to the current period's presentation.

Historically, intersegment activity had been reported as revenue in the billing segment and operating expense in the purchasing segment. Upon consolidation, the intersegment revenue and expense were eliminated with the consolidated results reflecting the cash operating and depreciation expense of providing the intersegment service. As part of AT&T's ongoing initiatives to manage its business from an external customer perspective, we no longer report intersegment revenue and report the cash operating and depreciation expense related to intersegment activity in the purchasing segment, which provided services to the external customer. While this change did not affect AT&T's total consolidated results, the impact to each operating segment varied. In particular, the Wireless segment, as a purchaser of network, IT and other services from the Wireline segment, experienced a reduction in cash operating expense partially offset by increased depreciation expense, with the net result being increased operating margins. This change was effective with the reporting of operating results for the quarter ended March 31, 2010. We have applied this change retrospectively, adjusting prior-period segment information.

The following sections discuss our operating results by segment. We discuss capital expenditures for each segment in "Liquidity and Capital Resources."

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

Wireless Segment Results

	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Segment operating revenues					
Service	\$53,510	\$48,563	\$44,249	10.2%	9.7%
Equipment	4,990	4,941	4,925	1.0	0.3
Total Segment Operating Revenues	58,500	53,504	49,174	9.3	8.8
Segment operating expenses					
Operations and support	36,746	33,631	31,530	9.3	6.7
Depreciation and amortization	6,497	6,043	6,025	7.5	0.3
Total Segment Operating Expenses	43,243	39,674	37,555	9.0	5.6
Segment Operating Income	15,257	13,830	11,619	10.3	19.0
Equity in Net Income of Affiliates	9	9	6	—	50.0
Segment Income	\$15,266	\$13,839	\$11,625	10.3%	19.0%

The following table highlights other key measures of performance for the Wireless segment:

	2010	2009	2008	2010 vs. 2009	2009 vs. 2008
Wireless Customers (000)	95,536	85,120	77,009	12.2%	10.5%
Net Customer Additions (000) ¹	8,853	7,278	6,699	21.6%	8.6%
Total Churn	1.31%	1.47%	1.70%	(16) BP	(23) BP
Postpaid Customers (000)	68,041	64,627	59,653	5.3%	8.3%
Net Postpaid Customer Additions (000) ¹	2,153	4,199	4,523	(48.7)%	(7.2)%
Postpaid Churn	1.09%	1.13%	1.18%	(4) BP	(5) BP
Prepaid Customers (000)	6,524	5,350	6,106	21.9%	(12.4)%
Net Prepaid Customer Additions (000) ¹	952	(801)	71	—	—
Reseller Customers (000)	11,645	10,439	8,589	11.6%	21.5%
Net Reseller Customer Additions (000) ¹	1,140	1,803	1,102	(36.8)%	63.3%
Connected Device Customers (000)	9,326	4,704	2,661	98.3%	76.8%
Net Connected Device Customer Additions (000)	4,608	2,077	1,003	—	—

¹Excludes merger and acquisition-related additions during the period.

Wireless Metrics

Customer Additions As of December 31, 2010, we served 95.5 million wireless customers. Higher net customer additions (net additions) in 2010 and 2009 were primarily attributable to higher net connected devices additions and additions in our reseller customer business. Connected devices, such as eReaders, security systems, fleet management and global positioning systems, as well as tablets (predominantly reflected in our prepaid customer category) are data-centric devices, with customers typically on lower-priced data-only plans compared with customers on our postpaid plans. During 2010, we also continued to see an increase in gross and net additions related to the sale of integrated devices (handsets which allow Internet access as well as voice). Lower net postpaid additions in 2010 and 2009 reflected slowing growth in the industry subscriber base and lower postpaid churn throughout the industry. We expect revenue growth to continue to shift from voice toward data revenues with increasing penetration rates for integrated devices and additional sales of data-centric devices.

Average service revenue per user (ARPU) declined 1.8% in 2010, reflecting strong growth in connected devices and tablet subscribers, who typically have a lower ARPU compared to ARPU generated by our other customers. ARPU growth was flat in 2009, due to increased data services ARPU growth offsetting declining voice and other service ARPU. Data services ARPU increased 14.7% in 2010 and 22.0% in 2009. We expect continued revenue growth from data services, as more customers purchase integrated devices and data-centric devices, and as we continue to expand our network. Voice and other service ARPU declined 8.6% and 6.5% in 2010 and 2009.

ARPU from postpaid customers increased 2.9% in 2010 and 2.8% in 2009, reflecting usage of more advanced integrated devices by these customers, evidenced by an increase in postpaid data services ARPU of 19.3% in 2010 and 23.7% in 2009. Of our total postpaid customers, 61.0% now use integrated devices, up from 46.8% a year earlier. The growth in postpaid data services ARPU in 2010 and 2009 was partially offset by a 4.1% decrease in 2010 and a 4.0% decrease in 2009 in postpaid voice and other service ARPU.

Postpaid voice and other service ARPU declined due to lower access and airtime charges, roaming revenues, and long-distance usage. Continued growth in our family plans (FamilyTalk® Plans) customer base, which has lower ARPU than traditional postpaid customers, has also contributed to these declines. We expect continued pressure on voice and other service ARPU.

Churn The effective management of customer churn (churn rate) is critical to our ability to maximize revenue growth and to maintain and improve margins. Churn rate is calculated by dividing the aggregate number of wireless customers who cancel service during a period by the total number of wireless customers at the beginning of that period. The churn rate for an annual period is equal to the average of the churn rate for each month of that period. Ongoing improvement in our total and postpaid churn rates contributed to our net additions in 2010 and 2009. These churn rate declines reflect network enhancements and broader coverage, more affordable rate plans and exclusive devices, continued growth in FamilyTalk® Plans, and free mobile-to-mobile calling among our wireless customers. Data-centric device customers, who generally have the lowest churn rate among our wireless customers, also contributed to overall churn improvement due to their increased share of net additions for 2010 and 2009.

Wireless Customer Relationships

The wireless industry continues to mature. Accordingly, we believe that future wireless growth will increasingly depend on our ability to offer innovative services and devices. To attract and retain customers, we offer a wide variety of service plans in addition to offering a broad handset line. Our postpaid customers typically sign a two-year contract, which includes discounted handsets and early termination fees. We also offer data plans at different price levels, beginning as low as fifteen dollars per month, to attract a wide variety of customers and to differentiate us from our competitors. Many of our customers are on FamilyTalk® Plans or business plans, which provide for service on multiple handsets at discounted rates, and such subscribers tend to have higher retention and lower churn rates. As of December 31, 2010, more than 80% of our postpaid subscribers are on FamilyTalk® Plans or business discount plans. Such offerings are intended to encourage existing customers to upgrade their current services and/or add connected devices, attract customers from other providers, and minimize customer churn. In fact, for 2010, over 65% of our smartphone handsets were purchased by existing AT&T customers.

We offer a large variety of handsets, including at least 18 smartphones (including Apple iPhones, our most popular models) with advanced operating systems from eight manufacturers. As technology evolves, rapid changes are occurring in the handset and device industry, with the continual introduction of new models or significant revisions of existing models. We believe offering a wide variety of handsets reduces dependence on any single product as these products evolve. From time to time, we offer and have offered attractive handsets on an exclusive basis. As these exclusivity arrangements end, we expect to continue to offer such handsets (based on historical industry practice), and we believe our service plan offerings will help to retain our customers by providing incentives not to move to a new carrier. As noted above, more than 80% of our postpaid subscribers are on FamilyTalk® Plans or business discount plans that would involve moving the whole group to a new carrier. Moreover, the vast majority of postpaid subscribers (including FamilyTalk® Plan users) are allowed to accumulate unused minutes (known as rollover minutes), a feature that is currently not offered by other major postpaid carriers in the United States, and users would lose these minutes if they switched carriers. As is common in the industry, most of our phones are designed to work only with our wireless technology, requiring customers who desire to move to a new carrier with a different technology to purchase a new device. In addition, many of our handsets would not work or would lose some functionality if they were used on another carrier's network that also used Global System for Mobile Communications (GSM) technology, requiring the customer to acquire another handset. Although exclusivity arrangements are important to us, such arrangements may not provide a competitive advantage over time, as the industry continues to introduce new devices and services. Also, while the expiration of any of our current exclusivity arrangements could increase churn and reduce postpaid customer additions, we do not expect any such termination to have a material impact on our Wireless segment income, consolidated operating margin or our cash from operations.

Wireless Operating Results

Our Wireless segment operating income margin was 26.1% in 2010, compared to 25.8% in 2009 after increasing from 23.6% in 2008. The margin growth in 2010 and 2009 was primarily due to higher data revenues generated by our customers during those years, partially offset by the higher selling costs associated with integrated device activations. The rate of margin growth flattened in 2010 due to a significant number of customers upgrading their handsets during the second half of the year. While we subsidize the sales prices of various integrated devices, we expect to recover that cost over time from increased usage of the devices (especially data usage by the customer).

Service revenues are comprised of local voice and data services, roaming, long-distance and other revenue. Service revenues increased \$4,947, or 10.2%, in 2010 and \$4,314, or 9.7%, in 2009. The increases for these periods consisted of the following:

- Data service revenues increased \$4,052, or 28.7%, in 2010 and \$3,539, or 33.4%, in 2009. The increases were primarily due to the increased number of subscribers and heavier text and multimedia messaging and Internet access by subscribers using integrated devices and other data-centric devices, such as eReaders, tablets, and mobile navigation devices. Data service revenues represented 34.0% of our Wireless segment service revenues in 2010, an increase from 29.1% in 2009, and 23.9% in 2008.
- Voice and other service revenues increased \$895, or 2.6%, in 2010 and \$775, or 2.3%, in 2009. The increases were due to an 11.1% increase in the average number of wireless customers in 2010 and a 9.4% increase in 2009, partially offset by declining ARPU for these services in both periods.

Equipment revenues increased \$49, or 1.0%, in 2010 and \$16, or 0.3%, in 2009. In both periods, higher sales and upgrades of postpaid integrated devices exceeded lower traditional handset devices in connection with promotions.

Operations and support expenses increased \$3,115, or 9.3%, in 2010 and \$2,101, or 6.7%, in 2009. The increase in 2010 was primarily due to the following:

- Equipment costs increased \$1,340 and commission expenses increased \$132 driven by record integrated device sales and upgrades.
- Interconnect, USF and network system costs increased \$1,103 due to higher network traffic, network enhancement efforts, revenue growth and a USF rate increase.
- Selling expenses (other than commissions) increased \$554, primarily due to increased advertising.
- Administrative expenses increased \$432 due in part to higher leasing, legal, and benefits costs.

These increases were partially offset by bad debt expense and customer service cost decreases, totaling \$353, and reseller service costs and long-distance cost decreases, totaling \$93, due to lower usage.

The increase in 2009 was primarily due to the following:

- Equipment costs increased \$1,246 and commission expenses increased \$112 driven by the higher cost of acquiring and selling more advanced integrated devices compared to prior years.
- Interconnect, USF and network system costs increased \$435 due to higher network traffic, network enhancement efforts, revenue growth, and a USF rate increase.
- Administrative expenses increased \$291 due in part to higher information technology and finance costs.
- Bad debt expense and customer service costs increased \$274 due to customer growth.

These increases were partially offset by selling expense (other than commissions) decreases totaling \$139, attributable to lower traditional handset sales exceeding the impact of the sale of advanced integrated devices, and long-distance and reseller services cost decreases totaling \$134 due to usage and rate declines.

Depreciation and amortization increased \$454, or 7.5%, in 2010 and \$18, or 0.3%, in 2009. Depreciation expense increased \$751, or 17.0%, in 2010 primarily due to increased capital spending for network upgrades and expansion and depreciation for assets acquired with our acquisition of Centennial Communications Corp. (Centennial), partially offset by certain network assets becoming fully depreciated. Amortization expense decreased \$297, or 18.4%, in 2010 primarily due to lower amortization of intangibles for customer lists related to acquisitions, partially offset by an increase in customer lists amortization related to the Centennial acquisition.

Depreciation expense increased \$468, or 11.8%, in 2009 due to ongoing capital spending for network upgrades and expansion, partially offset by certain network assets becoming fully depreciated. Amortization expense decreased \$450, or 21.8%, in 2009 due to lower amortization of intangibles attributable to our acquisition of BellSouth Corporation (BellSouth), partially offset by amortization of intangible assets attributable to subscribers added in the November 2009 acquisition of Centennial and the 2007 acquisition of Dobson Communications Corporation.

Wireline Segment Results

	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Segment operating revenues					
Voice	\$28,315	\$32,324	\$37,322	(12.4)%	(13.4)%
Data	27,479	25,561	24,416	7.5	4.7
Other	5,408	5,629	6,152	(3.9)	(8.5)
Total Segment Operating Revenues	61,202	63,514	67,890	(3.6)	(6.4)
Segment operating expenses					
Operations and support	41,008	42,352	44,817	(3.2)	(5.5)
Depreciation and amortization	12,371	12,743	12,786	(2.9)	(0.3)
Total Segment Operating Expenses	53,379	55,095	57,603	(3.1)	(4.4)
Segment Operating Income	7,823	8,419	10,287	(7.1)	(18.2)
Equity in Net Income of Affiliates	11	17	19	(35.3)	(10.5)
Segment Income	\$ 7,834	\$ 8,436	\$10,306	(7.1)%	(18.1)%

Operating Margin Trends

Our Wireline segment operating income margin was 12.8% in 2010, compared to 13.3% in 2009 and 15.2% in 2008. Results for 2010 and 2009 reflect revenue declines that exceeded expense declines. Our Wireline segment operating income decreased \$596, or 7.1%, in 2010 and decreased \$1,868, or 18.2%, in 2009. Our operating income continued to be pressured by access line declines due to economic pressures on our consumer and business wireline customers and increased competition, as customers either reduced usage or disconnected traditional landline services and switched to alternative technologies, such as wireless and VoIP. Our strategy is to offset these line losses by increasing non-access-line-related revenues from customer connections for data, video and voice. Additionally, we have the opportunity to increase Wireless segment revenues if customers choose AT&T Mobility as an alternative provider. The wireline operating margins are declining primarily due to reduced voice revenue, partially offset by continued growth in data revenue.

Decreases in wireline operating expenses reflect reduced pension/OPEB and other employee-related costs and savings from our continuing cost-control initiatives and workforce reductions.

Voice revenues decreased \$4,009, or 12.4%, in 2010 and \$4,998, or 13.4%, in 2009 primarily due to economic pressures and declining demand for traditional voice services by our consumer and business customers. Included in voice revenues are revenues from local voice, long-distance (including international) and local wholesale services. Voice revenues do not include VoIP revenues, which are included in data revenues.

- Local voice revenues decreased \$2,280, or 11.5%, in 2010 and \$2,737, or 12.2%, in 2009. The decrease in 2010 was driven primarily by an 11.6% decline in switched access lines and a decrease in average local voice revenue per user. The decrease in 2009 was driven primarily by an 11.2% decline in switched access lines and a decrease in average local voice revenue per user. We expect our local voice revenue to continue to be negatively affected by increased competition from alternative technologies, the disconnection of additional lines and economic pressures.
- Long-distance revenues decreased \$1,562, or 13.9%, in 2010 and \$2,036, or 15.3%, in 2009 primarily due to a net decrease in demand for long-distance service, due to slower demand from business and consumer customers, which decreased revenues \$1,239 in 2010 and \$1,491 in 2009. Additionally, expected declines in the number of national mass-market customers decreased revenues \$331 in 2010 and \$546 in 2009.

Data revenues increased \$1,918, or 7.5%, in 2010 and \$1,145, or 4.7%, in 2009. Data revenues accounted for approximately 45% of wireline operating revenues in 2010, 40% in 2009 and 36% in 2008. Data revenues include transport, IP and packet-switched data services.

- IP data revenues increased \$2,494, or 19.1%, in 2010 and \$1,986, or 17.9%, in 2009 primarily driven by AT&T U-verse expansion, broadband additions and growth in IP-based strategic business services, which include Ethernet and application services. U-verse video revenues increased \$1,227 in 2010 and \$1,039 in 2009, strategic business services increased \$648 in 2010 and \$582 in 2009 and broadband high-speed Internet access revenue increased \$446 in 2010 and \$311 in 2009. The increase in IP data revenues in 2010 and 2009 reflects continued growth in the customer base and migration from other traditional circuit-based services.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

- Traditional packet-switched data services, which include frame relay and asynchronous transfer mode services, decreased \$431, or 21.6%, in 2010 and \$521, or 20.7%, in 2009. This decrease is primarily due to lower demand as customers continue to shift to IP-based technology such as Virtual Private Networks (VPN), DSL and managed Internet services, and the continuing weak economic conditions. We expect these traditional, circuit-based services to continue to decline as a percentage of our overall data revenues.

Other operating revenues decreased \$221, or 3.9%, in 2010 and \$523, or 8.5%, in 2009. Major items included in other operating revenues are integration services and customer premises equipment, government-related services and outsourcing, which account for more than 60% of total other revenue for all periods.

Operations and support expenses decreased \$1,344, or 3.2%, in 2010 and \$2,465, or 5.5%, in 2009. Operations and support expenses consist of costs incurred to provide our products and services, including costs of operating and maintaining our networks and personnel costs, such as salary, wage and bonus accruals. Costs in this category include our repair technicians and repair services, certain network planning and engineering expenses, information technology and property taxes. Operations and support expenses also include bad debt expense; advertising costs; sales and marketing functions, including customer service centers; real estate costs, including maintenance and utilities on all buildings; credit and collection functions; and corporate support costs, such as finance, legal, human resources and external affairs. Pension/OPEB expenses, net of amounts capitalized as part of construction labor, are also included to the extent that they are associated with these employees.

The 2010 decrease was primarily due to the following:

- Pension/OPEB service cost and other employee-related expense of \$734. This decrease was primarily related to reduction in workforce and changes in future retiree benefits.
- Traffic compensation of \$452.
- Contract services of \$314.
- Bad debt expense of \$178 due to lower business revenue and improvements in cash collections.

The decreases were partially offset by increased cost of sales, primarily related to U-verse related expenses of \$369.

The 2009 decrease was primarily due to the following:

- Employee-related costs of \$1,182, primarily related to workforce reductions.
- Traffic compensation, including portal fees, of \$655.
- Nonemployee-related expenses, such as bad debt expense, materials and supplies costs of \$441.
- Contract services of \$134.

Depreciation and amortization expenses decreased \$372, or 2.9%, in 2010 and \$43, or 0.3%, in 2009. Both decreases were primarily related to lower amortization of intangibles for customer lists associated with acquisitions.

Supplemental Information

Telephone, Wired Broadband and Video Connections Summary Our switched access lines and other services provided by our local exchange telephone subsidiaries at December 31, 2010, 2009 and 2008, are shown below and trends are addressed throughout this segment discussion.

(in 000s)	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Switched Access Lines¹					
Retail consumer	22,515	26,378	30,614	(14.6)%	(13.8)%
Retail business ²	18,733	20,247	21,954	(7.5)	(7.8)
Retail Subtotal²	41,248	46,625	52,568	(11.5)	(11.3)
Wholesale Subtotal²	2,367	2,685	2,924	(11.8)	(8.2)
Total Switched Access Lines^{3,7}	43,678	49,392	55,610	(11.6)	(11.2)
Total Retail Consumer Voice Connections⁶	24,195	27,332	30,838	(11.5)	(11.4)
Total Wireline Broadband Connections⁴	16,310	15,789	15,077	3.3	4.7
Satellite service ⁵	1,930	2,174	2,190	(11.2)	(0.7)
U-verse video	2,987	2,065	1,045	44.6	97.6
Video Connections	4,917	4,239	3,235	16.0%	31.0%

¹Represents access lines served by AT&T's Incumbent Local Exchange Carriers (ILECs) and affiliates.

²Prior-period amounts restated to conform to current period reporting methodology.

³Total switched access lines includes payphone access lines of 63 at December 31, 2010, 82 at December 31, 2009 and 118 at December 31, 2008.

⁴Total wireline broadband connections include DSL, U-verse High Speed Internet and satellite broadband.

⁵Satellite service includes connections under our agency and resale agreements.

⁶Includes consumer U-verse VoIP connections of 1,680 at December 31, 2010, 954 at December 31, 2009 and 224 at December 31, 2008.

⁷Total switched access lines that are used solely by AT&T or our subsidiaries include 1,699 retail business and 95 wholesale lines at December 31, 2010, 1,750 retail business and 106 wholesale lines at December 31, 2009, and 1,879 retail business and 125 wholesale lines at December 31, 2008.

Advertising Solutions

Segment Results

	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Total Segment Operating Revenues	\$3,935	\$4,724	\$5,416	(16.7)%	(12.8)%
Segment operating expenses					
Operations and support	2,583	2,743	2,900	(5.8)	(5.4)
Depreciation and amortization	497	650	789	(23.5)	(17.6)
Total Segment Operating Expenses	3,080	3,393	3,689	(9.2)	(8.0)
Segment Income	\$ 855	\$1,331	\$1,727	(35.8)%	(22.9)%

Operating Results

Our Advertising Solutions segment operating income margin was 21.7% in 2010, 28.2% in 2009 and 31.9% in 2008.

The decrease in the segment operating income margin in both 2010 and 2009 was primarily the result of decreased operating revenues.

Operating revenues decreased \$789, or 16.7%, in 2010 and \$692, or 12.8%, in 2009. The decrease in 2010 was largely driven by continuing declines in print revenue of \$858, as customers reduced or eliminated print ad purchases due to the slow economy, partially offset by increased interactive revenue of \$77, as customers purchased more electronic advertising. The decrease in 2009 was primarily due to declines in print revenue of \$774 and lower sales agency

revenues of \$34, partially offset by interactive advertising revenue growth of \$132. The current weak economy has reduced demand for advertising, and customers have continued to shift to Internet-based search services.

Operating expenses decreased \$313, or 9.2%, in 2010 and \$296, or 8.0%, in 2009. The 2010 decrease was largely driven by decreases in depreciation and amortization expense of \$136 resulting from use of an accelerated method of amortization for customer lists, employee-related costs of \$99, and bad debt expense of \$34. The 2009 decrease was due to decreased depreciation and amortization expenses of \$139, product-related costs of \$92, advertising costs of \$44 and professional contracted expenses of \$17.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

Other Segment Results

	2010	2009	2008	Percent Change	
				2010 vs. 2009	2009 vs. 2008
Total Segment Operating Revenues	\$ 643	\$ 771	\$ 963	(16.6)%	(19.9)%
Total Segment Operating Expenses	2,484	3,136	1,136	(20.8)	—
Segment Operating Loss	(1,841)	(2,365)	(173)	22.2	—
Equity in Net Income of Affiliates	742	708	794	4.8	(10.7)
Segment Income (Loss)	<u>\$1,099</u>	<u>\$(1,657)</u>	<u>\$ 621</u>	<u>33.7%</u>	—

The Other segment includes results from customer information services, our portion of the results from our international equity investments and all corporate and other operations. Also included in the Other segment are impacts of corporate-wide decisions for which the individual operating segments are not being evaluated, including the interest cost and expected return on pension and other postretirement benefit plan assets.

Operating revenues decreased \$128, or 16.6%, in 2010 and \$192, or 19.9%, in 2009. The decrease in 2010 and 2009 is primarily due to reduced revenues from our operator services.

Operating expenses decreased \$652, or 20.8%, in 2010 and increased \$2,000 in 2009. The 2010 change was primarily due to lower interest costs on our pension and postretirement benefit obligation and a decrease in operator services operating expense. The increase in 2009 expense was primarily due to higher pension and postretirement benefit plan cost of approximately \$2,600 due to a lower-than-expected return on plan assets caused by investment losses in 2008, partially offset by workforce reductions in 2008.

Our Other segment also includes our equity investments in international companies, the income from which we report as equity in net income of affiliates. Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. Our equity in net income of affiliates by major investment is listed below:

	2010	2009	2008
América Móvil	\$560	\$505	\$469
Telmex	150	133	252
Telmex Internacional ¹	34	72	72
Other	(2)	(2)	1
Other Segment Equity in Net Income of Affiliates	\$742	\$708	\$794

¹Acquired by América Móvil in 2010.

Equity in net income of affiliates increased \$34 in 2010, primarily due to improved results at América Móvil. Equity in net income of affiliates decreased \$86 in 2009, primarily due to foreign currency translation losses at América Móvil, Telmex, and TI, partially offset by improved results at América Móvil. In June 2010, as part of a tender offer from América Móvil, we exchanged all our shares in TI for América Móvil L shares at the offered exchange rate of 0.373. The exchange was accounted for at fair value. In addition, we paid \$202 to purchase additional shares of América Móvil L stock to maintain our ownership percentage at a pretransaction level.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

2011 Revenue Trends We expect our operating environment in 2011 to remain challenging as weak economic conditions continue and competition remains strong. Despite these challenges, we expect our operating revenues in 2011 to grow, reflecting continuing growth in our wireless data and IP-related wireline data services including U-verse and business services. We expect our primary driver of growth to be wireless, especially in sales of and increases in data usage on advanced handsets and emerging devices (such as tablets, eReaders and mobile navigation devices). We expect that all our major customer categories will continue to increase their use of Internet-based broadband/data services. We expect continuing declines in traditional access lines and in print directory advertising. Where available, our U-verse services have proved effective in stemming access line losses, and we expect to continue to expand our U-verse service offerings in 2011.

2011 Expense Trends We will continue to focus sharply on cost-control measures, including areas such as simplifying product offerings. We will continue our ongoing initiatives to improve customer service and billing so we can realize our strategy of bundling services and providing a simple customer experience. We expect our 2011 operating income margin to improve, as our revenues improve. Expenses related to growth areas of our business, especially in the wireless, U-verse and strategic business services areas, will apply some pressure to our operating income margin. In addition, as we complete readying our Long-Term Evolution (LTE) technology for its intended use, we will no longer capitalize interest on this spectrum.

Market Conditions During 2010, the securities and fixed income markets and the banking system in general continued to stabilize, although bank lending and the housing industry remained weak. The ongoing weakness in the general economy has also affected our customer and supplier bases. We saw lower demand from our residential customers as well as our business customers at all organizational sizes. Some of our suppliers continue to experience increased financial and operating costs. These negative economic trends were offset by continued growth in our wireless data and IP-related services. While the economy appears to have stabilized, we do not expect a quick return to growth during 2011. Should the economy instead deteriorate further, we likely will experience further pressure on pricing and margins as we compete for both wireline and wireless customers who have less discretionary income. We also may experience difficulty purchasing equipment in a timely manner or maintaining and replacing warranted equipment from our suppliers.

Included on our consolidated balance sheets are assets held by benefit plans for the payment of future benefits. We are not required to make significant funding contributions to our pension plans in 2011. However, because our pension plans are subject to funding requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA), a continued weakness in the equity, fixed income and real asset markets could require us to make contributions to the pension plans in order to maintain minimum funding requirements as established by ERISA in future periods. Investment returns on these assets depend largely on trends in the U.S. securities markets and the U.S. economy. In addition, our policy of recognizing actuarial gains and losses related to our pension and other postretirement plans in the period in which they arise, subjects us to earnings volatility caused by changes in market conditions. Changes in our discount rate, which are tied to changes in the bond market and in the performance of equity markets, may have significant impacts on the fair value of pension and other postretirement plans at the end of 2011 (see "Significant Accounting Policies and Estimates").

OPERATING ENVIRONMENT OVERVIEW

AT&T subsidiaries operating within the U.S. are subject to federal and state regulatory authorities. AT&T subsidiaries operating outside the U.S. are subject to the jurisdiction of national and supranational regulatory authorities in the markets where service is provided, and regulation is generally limited to operational licensing authority for the provision of services to enterprise customers.

In the Telecommunications Act of 1996 (Telecom Act), Congress established a national policy framework intended to bring the benefits of competition and investment in advanced telecommunications facilities and services to all Americans by opening all telecommunications markets to competition and reducing or eliminating regulatory burdens that harm consumer welfare. However, since the Telecom Act was passed, the Federal Communications Commission (FCC) and some state regulatory commissions have maintained certain regulatory requirements that were imposed decades ago on our traditional wireline subsidiaries when they operated as legal monopolies. Where appropriate, we are pursuing additional legislative and regulatory measures to reduce regulatory burdens that inhibit our ability to compete more effectively and offer services wanted and needed by our customers. With the advent of the Obama Administration, the composition of the FCC has changed, and the new Commission appears to be more open than the prior Commission to maintaining or expanding regulatory requirements on entities subject to its jurisdiction. In addition, Congress, the President and the FCC all have declared a national policy objective of ensuring that all Americans have access to broadband technologies and services. To that end, the FCC delivered a National Broadband Plan to Congress in 2010. The FCC has issued dozens of notices seeking comment on whether and how it should modify its rules and policies on a host of issues, which would affect all segments of the communications industry, to achieve universal access to broadband. These issues include rules and policies relating to universal service support, intercarrier compensation and regulation of special access services, as well as a variety of others that could have an impact on AT&T's operations and revenues. However, at this stage, it is too early to assess what, if any, impact such changes could have on us.

In addition, states representing a majority of our local service access lines have adopted legislation that enables new video entrants to acquire a single statewide or state-approved franchise (as opposed to the need to acquire hundreds or even thousands of municipal-approved franchises) to offer competitive video services. We also are supporting efforts to update and improve regulatory treatment for retail services. Passage of legislation is uncertain and depends on many factors.

Our wireless operations operate in robust competitive markets but are likewise subject to substantial governmental regulation. Wireless communications providers must be licensed by the FCC to provide communications services at specified spectrum frequencies within specified geographic areas and must comply with the rules and policies governing the use of the spectrum as adopted by the FCC. The FCC has recognized the importance of providing carriers with access to adequate spectrum to permit continued wireless growth and has begun investigating how to develop policies to promote that goal. While wireless communications providers' prices and service offerings are generally not subject to state regulation, an increasing number of states are attempting to regulate or legislate various aspects of wireless services, such as in the area of consumer protection.

Expected Growth Areas

We expect our wireless services and data wireline products to remain the most significant portion of our business and have also discussed trends affecting the segments in which we report results for these products (see "Wireless Segment Results" and "Wireline Segment Results"). Over the next few years, we expect an increasing percentage of our growth to come from: (1) our wireless service and (2) data/broadband, through existing and new services. We expect that our previous acquisitions will enable us to strengthen the reach and sophistication of our network facilities, increase our large-business customer base and enhance the opportunity to market wireless services to that customer base. Whether, or the extent to which, growth in these areas will offset declines in other areas of our business is not known.

Wireless Wireless is our fastest-growing revenue stream and we expect to deliver continued revenue growth in the coming years. We believe that we are in a growth period of wireless data usage and that there are substantial opportunities available for next-generation converged services that combine wireless, broadband, voice and video.

We cover most major metropolitan areas of the U.S. with our Universal Mobile Telecommunications System/High-Speed Downlink Packet Access (HSPA) and HSPA+ network technology, with HSPA+ providing 4G speeds when combined with our upgraded backhaul. Our network provides superior speeds for data and video services, as well as operating efficiencies using the same spectrum and infrastructure for voice and data on an IP-based platform. Our wireless network also relies on digital transmission technologies known as GSM, General Packet Radio Services and Enhanced Data Rates for GSM Evolution for data communications. As of December 31, 2010, we served 95.5 million customers. We have also begun transitioning our network to more advanced LTE technology. We continue to expand the number of locations, including airports and cafés, where customers can access broadband Internet connections using wireless fidelity (local radio frequency commonly referred to as Wi-Fi) wireless technology.

As the wireless industry continues to mature, we believe that future wireless growth will increasingly depend on our ability to offer innovative services that will encourage existing customers to upgrade their services, either by adding new types of services, such as data enhancements, or through increased use of existing services, such as through equipment upgrades. These innovative services should attract customers from other providers, as well as minimize customer churn. We intend to accomplish these goals by continuing to expand our network coverage, improve our network quality and offer a broad array of products and services, including free mobile-to-mobile calling among our wireless customers. Minimizing customer churn is critical to our ability to maximize revenue growth and to maintain and improve our operating margins.

U-verse Services We are continuing to expand our deployment of U-verse High Speed Internet and TV services. As of December 31, 2010, we have passed 27.3 million living units (constructed housing units as well as platted housing lots) and are marketing the services to 77% of those units. Our rate of expansion will be slowed if we cannot obtain all required local building permits in a timely fashion. We also continue to work with our vendors on improving, in a timely manner, the requisite hardware and software technology. Our deployment plans could be delayed if we do not receive required equipment and software on schedule.

We believe that our U-verse TV service is subject to federal oversight as a "video service" under the Federal Communications Act. However, some cable providers and municipalities have claimed that certain IP services should be treated as a traditional cable service and therefore subject to the applicable state and local cable regulation. Certain municipalities have delayed our request or have refused us permission to use our existing right-of-ways to deploy or activate our U-verse-related services and products, resulting in litigation. Pending negotiations and current or threatened litigation involving municipalities could delay our deployment plans in those areas. Petitions have been filed at the FCC alleging that the manner in which we provision "public, educational and governmental" (PEG) programming over our U-verse TV service conflicts with federal law, and a lawsuit has been filed in a California state superior court raising similar allegations under California law. If courts having jurisdiction where we have significant deployments of our U-verse services were to decide that federal, state and/or local cable regulation were applicable to our U-verse services, or if the FCC, state agencies or the courts were to rule that we must deliver PEG programming in a manner substantially different from the way we do today or in ways that are inconsistent with our current network architecture, it could have a material adverse effect on the cost, timing and extent of our deployment plans.

REGULATORY DEVELOPMENTS

Set forth below is a summary of the most significant developments in our regulatory environment during 2010. While these issues may apply only to certain subsidiaries, the words "we," "AT&T" and "our" are used to simplify the discussion. The following discussions are intended as a condensed summary of the issues rather than as a precise legal description of all of these specific issues.

International Regulation Our subsidiaries operating outside the U.S. are subject to the jurisdiction of regulatory authorities in the market where service is provided. Our licensing, compliance and advocacy initiatives in foreign countries primarily enable the provision of enterprise (i.e., large-business) services. AT&T is engaged in multiple efforts with foreign regulators to open markets to competition, reduce network costs and increase our scope of fully authorized network services and products.

Federal Regulation A summary of significant 2010 federal regulatory developments follows.

Net Neutrality On December 23, 2010, the FCC released an order adopting "net neutrality" rules. These rules apply to mass-market retail broadband Internet access services, such as DSL, cable modem service, mobile wireless broadband Internet access services and similar retail services that are offered by AT&T and our competitors. The rules do not apply to "enterprise" broadband Internet access services sold to large businesses, nor do they apply to other broadband IP-based services that do not offer connectivity to all end points on the Internet, such as Internet Protocol television services like AT&T's U-verse video service; VoIP; VPN; smart utility meters, wireless medical monitoring devices and other similar devices. In addition, the FCC's rules do not prohibit broadband Internet access providers from adopting tiered or usage-sensitive pricing for their Internet access services.

Under the FCC's rules, broadband Internet access providers have the following duties: (i) *transparency* – all providers of broadband Internet access service (fixed and mobile) must disclose information in plain language about their commercial terms, performance characteristics, and network management; (ii) *no blocking* – providers of fixed broadband Internet access services may not block lawful content, applications, services or non-harmful devices, and providers of mobile broadband Internet access services may not block access to lawful Internet websites or lawful applications that compete with the provider's voice or video telephony services; and (iii) *no unreasonable discrimination* – providers of fixed broadband Internet access service may not unreasonably discriminate in the transmission of lawful Internet traffic over a consumer's wireline broadband Internet access services. Notwithstanding these duties, a broadband Internet access provider may engage in reasonable network

management in order to address network congestion, prevent harm to the network or users, or take other reasonable steps to manage their network.

COMPETITION

Competition continues to increase for telecommunications and information services. Technological advances have expanded the types and uses of services and products available. In addition, lack of or a reduced level of regulation of comparable alternatives (e.g., cable, wireless and VoIP providers) has lowered costs for these alternative communications service providers. As a result, we face heightened competition as well as some new opportunities in significant portions of our business.

Wireless

We face substantial and increasing competition in all aspects of our wireless business. Under current FCC rules, six or more PCS licensees, two cellular licensees and one or more enhanced specialized mobile radio licensees may operate in each of our service areas, which results in the potential presence of multiple competitors. Our competitors are multiple national companies, such as Verizon Wireless, Sprint Nextel Corp., T-Mobile, Metro PCS and Cricket, and a larger number of regional providers of cellular, PCS and other wireless communications services. More than 95% of the U.S. population lives in areas with three mobile telephone operators, and more than half the population lives in areas with at least five competing carriers.

We may experience significant competition from companies that provide similar services using other communications technologies and services. While some of these technologies and services are now operational, others are being developed or may be developed. We compete for customers based principally on service offerings, call quality, coverage area, price and customer service.

Wireline

Our wireline subsidiaries expect continued competitive pressure in 2011 from multiple providers, including wireless, cable and other VoIP providers, interexchange carriers and resellers. In addition, economic pressures are forcing customers to terminate their traditional local wireline service and substitute wireless and Internet-based services, intensifying a pre-existing trend toward wireless and Internet use. At this time, we are unable to quantify the effect of competition on the industry as a whole or financially on this segment. However, we expect both losses of revenue share in local service and gains resulting from business initiatives, especially in the area of bundling of products and services, including wireless and video, large-business data services and broadband. In most markets, we compete with large cable companies, such as Comcast Corporation,

Cox Communications Inc. and Time Warner Cable Inc., for local, high-speed Internet and video services customers and other smaller telecommunications companies for both long-distance and local services customers.

Our wireline subsidiaries generally remain subject to regulation by state regulatory commissions for intrastate services and by the FCC for interstate services. In contrast, our competitors are often subject to less or no regulation in providing comparable voice and data services or the extent of regulation is in dispute. Under the Telecom Act, companies seeking to interconnect to our wireline subsidiaries' networks and exchange local calls enter into interconnection agreements with us. Any unresolved issues in negotiating those agreements are subject to arbitration before the appropriate state commission. These agreements (whether fully agreed-upon or arbitrated) are then subject to review and approval by the appropriate state commission.

Our wireline subsidiaries (excluding rural carrier affiliates) operate under state-specific elective alternative forms of regulation for retail services (also referred to as "alternative regulation") that was either legislatively enacted or authorized by the appropriate state regulatory commission. Under alternative regulation, the state regulatory agency or the legislature may deregulate the competitive services; impose price caps for some services where the prices for these services are not tied to the cost of providing the services or to rate-of-return requirements; or adopt a regulatory framework that incorporates deregulation and price caps. Some states may impose minimum customer service standards with required payments if we fail to meet the standards.

We continue to lose access lines due to competitors (e.g., wireless, cable and VoIP providers) who can provide comparable services at lower prices because they are not subject to traditional telephone industry regulation (or the extent of regulation is in dispute), utilize different technologies, or promote a different business model (such as advertising based) and consequently have lower cost structures. In response to these competitive pressures, for several years we have utilized a bundling strategy that rewards customers who consolidate their services (e.g., local and long-distance telephone, high-speed Internet, wireless and video) with us. We continue to focus on bundling wireline and wireless services, including combined packages of minutes and video service through our U-verse service and our relationships with satellite television providers. We will continue to develop innovative products that capitalize on our expanding fiber network.

Additionally, we provide local, domestic intrastate and interstate, international wholesale networking capacity, and switched services to other service providers, primarily large Internet Service Providers using the largest class

of nationwide Internet networks (Internet backbone), wireless carriers, Competitive Local Exchange Carriers, regional phone ILECs, cable companies and systems integrators. These services are subject to additional competitive pressures from the development of new technologies and the increased availability of domestic and international transmission capacity. The introduction of new products and service offerings and increasing satellite, wireless, fiber-optic and cable transmission capacity for services similar to those provided by us continues to provide competitive pressures. We face a number of international competitors, including Orange Business Service, British Telecom, SingTel and Verizon Communications Inc., as well as competition from a number of large systems integrators, such as HP Enterprise Services.

Advertising Solutions

Our Advertising Solutions subsidiaries face competition from approximately 100 publishers of printed directories in their operating areas. Competition also exists from other advertising media, including newspapers, radio, television and direct-mail providers, as well as many forms of Internet-based and mobile advertising. Through our wholly-owned subsidiary, YELLOWPAGES.COM LLC, we compete with other providers of Internet-based advertising and local search.

ACCOUNTING POLICIES AND STANDARDS

Critical Accounting Policies and Estimates Because of the size of the financial statement line items they relate to, some of our accounting policies and estimates have a more significant impact on our financial statements than others. The following policies are presented in the order in which the topics appear in our consolidated statements of income.

Allowance for Doubtful Accounts We maintain an allowance for doubtful accounts for estimated losses that result from the failure of our customers to make required payments. When determining the allowance, we consider the probability of recoverability based on past experience, taking into account current collection trends as well as general economic factors, including bankruptcy rates. Credit risks are assessed based on historical write-offs, net of recoveries, and an analysis of the aged accounts receivable balances with reserves generally increasing as the receivable ages. Accounts receivable may be fully reserved for when specific collection issues are known to exist, such as pending bankruptcy or catastrophes. The analysis of receivables is performed monthly, and the allowances for doubtful accounts are adjusted accordingly. A 10% change in the amounts estimated to be uncollectible would result in a change in the provision for uncollectible accounts of approximately \$100.

Pension and Other Postretirement Benefits In January 2011, we announced a change in our method of recognizing actuarial gains and losses for pension and other postretirement benefits for all benefit plans. Historically, we have recognized the actuarial gains and losses as a component of Stockholders' Equity on our consolidated balance sheets on an annual basis and have amortized them into our operating results over the average future service period of the active employees of these plans, to the extent such gains and losses were outside of a corridor. We have elected to immediately recognize actuarial gains and losses in our operating results, noting that it is generally preferable to accelerate the recognition of deferred gains and losses into income rather than to delay such recognition. This change will improve transparency in our operating results by more quickly recognizing the effects of economic and interest rate conditions on plan obligations, investments and assumptions. These gains and losses are generally only measured annually as of December 31 and accordingly will be recorded during the fourth quarter. Additionally, for purposes of calculating the expected return on plan assets, we will no longer use a permitted averaging technique for the market-related value of assets but instead will use actual fair value of plan assets. We have applied this change retrospectively, adjusting all prior periods. See Note 1 for a presentation of our operating results before and after the application of this accounting change.

Our actuarial estimates of retiree benefit expense and the associated significant weighted-average assumptions are discussed in Note 11. Our assumed discount rate of 5.80% at December 31, 2010, reflects the hypothetical rate at which the projected benefit obligations could be effectively settled or paid out to participants. We determined our discount rate based on a range of factors, including a yield curve comprised of the rates of return on several hundred high-quality, fixed-income corporate bonds available at the measurement date and the related expected duration for the obligations. These bonds were all rated at least Aa3 or AA- by one of the nationally recognized statistical rating organizations, denominated in U.S. dollars, and neither convertible nor index linked. For the year ended December 31, 2010, we decreased our discount rate by 0.70%, resulting in an increase in our pension plan benefit obligation of \$3,238 and an increase in our postretirement benefit obligation of \$2,817. For the year ended December 31, 2009, we decreased our discount rate by 0.50%, resulting in an increase in our pension plan benefit obligation of \$2,065 and an increase in our postretirement benefit obligation of \$1,847.

Our return on assets assumption was 8.5% for the year ended December 31, 2010. In 2010, we experienced actual returns on investments somewhat higher than expected; however, in 2011 we will be decreasing our expected return on assets to 8.25%, based on expectations on future market and the asset mix of the plans' investments. If all other factors were to remain unchanged, we expect that a 1.0% decrease in the actual long-term rate of return would cause 2011 combined pension and postretirement cost to increase \$575.

Note 11 also discusses the effects of certain changes in assumptions related to medical trend rates on retiree healthcare costs. Should actual experience differ from actuarial assumptions, the projected pension benefit obligation and net pension cost and accumulated postretirement benefit obligation and postretirement benefit cost would be affected in future years.

Depreciation Our depreciation of assets, including use of composite group depreciation and estimates of useful lives, is described in Notes 1 and 5. We assign useful lives based on periodic studies of actual asset lives. Changes in those lives with significant impact on the financial statements must be disclosed, but no such changes have occurred in the three years ended December 31, 2010. However, if all other factors were to remain unchanged, we expect that a one-year increase in the useful lives of the largest categories of our plant in service (which accounts for more than 75% of our total plant in service) would result in a decrease of approximately \$2,275 in our 2011 depreciation expense and that a one-year decrease would result in an increase of approximately \$3,341 in our 2011 depreciation expense.

Asset Valuations and Impairments We account for acquisitions completed after 2008 using the acquisition method. We allocate the purchase price to the assets acquired and liabilities assumed based on their estimated fair values. The estimated fair values of intangible assets acquired are based on the expected discounted cash flows of the identified customer relationships, patents, trade names and FCC licenses. In determining the future cash flows, we consider demand, competition and other economic factors.

Customer relationships, which are finite-lived intangible assets, are primarily amortized using the sum-of-the-months-digits method of amortization over the period in which those relationships are expected to contribute to our future cash flows. The sum-of-the-months-digits method is a process of allocation, and reflects our belief that we expect greater revenue generation from these customer relationships during the earlier years of their lives.

Alternatively, we could have chosen to amortize customer relationships using the straight-line method, which would allocate the cost equally over the amortization period. Amortization of other intangibles, including patents and certain trade names, is determined using the straight-line method of amortization over the expected remaining useful lives.

Goodwill and wireless FCC licenses are not amortized but tested annually for impairment. We conduct our impairment tests as of October 1. We test goodwill on a reporting unit basis, and our reporting units coincide with our segments, except for certain operations in our Other segment. The goodwill impairment test is a two-step process. The first step involves determining the fair value of the reporting unit and comparing that measurement to the book value. If the fair value exceeds the book value, then no further testing is required. If the fair value is less than the book value (i.e., an impairment exists), then we perform a second step.

In the second step, we determine the fair values of all of the assets and liabilities of the reporting unit, including those that may not be currently recorded. The difference between the sum of all of those fair values and the overall reporting unit's fair value is a new implied goodwill amount, which we compare to the recorded goodwill. If implied goodwill is less than the recorded goodwill, then we record an impairment of the recorded goodwill. The amount of this impairment may be more or less than the difference between the overall fair value and book value of the reporting unit. It may even be zero if the fair values of other assets are less than their book values. Goodwill is the only asset that may be impaired when performing the goodwill impairment test.

As shown in Note 6, more than 99% of our goodwill resides in the Wireless, Wireline, and Advertising Solutions segments. For each of those segments, we assess their fair value using a market multiple approach and a discounted cash flow approach. Our primary valuation technique is to determine enterprise value as a multiple of a company's Operating Income Before Depreciation and Amortization (OIBDA). We determined the multiples of the publicly traded companies whose services are comparable to those offered by the segment and then calculate a weighted average of those multiples. Using those weighted averages, we then calculated fair values for each of those segments. We also perform a discounted cash flow analysis as a secondary test of fair value to corroborate our primary market multiple test. The calculated fair value exceeded book value in all circumstances and no additional testing was necessary. In the event of a 10% drop in the fair values of the reporting units, the fair values would have still exceeded the book values of the reporting units and additional testing would still have not been necessary.

Wireless FCC licenses are tested for impairment on an aggregate basis, consistent with the management of the business on a national scope. As in prior years, we performed our test of the fair values of FCC licenses using a discounted cash flow model (the Greenfield Approach). The Greenfield Approach assumes a company initially owns only the wireless FCC licenses, and then makes investments required to build an operation comparable to the one that currently utilizes the licenses. We utilized a 17-year discrete period to isolate cash flows attributable to the licenses, including modeling the hypothetical build-out. The projected cash flows are based on certain financial factors, including revenue growth rates, OIBDA margins, and churn rates. We expect wireless revenue growth to trend down from our 2010 growth rate of 9.3% to a long-term growth rate that reflects expected long-term inflation trends. We expect our churn rates to continue to decline from 1.31% in 2010, in line with expected trends in the industry but at a rate comparable with industry-leading churn. OIBDA margins should continue to trend above 40.0%.

This model then incorporates cash flow assumptions regarding investment in the network, development of distribution channels and the subscriber base, and other inputs for making the business operational. We based the assumptions, which underlie the development of the network, subscriber base and other critical inputs of the discounted cash flow model on a combination of average marketplace participant data and our historical results, trends and business plans. We also used operating metrics such as capital investment per subscriber, acquisition costs per subscriber, minutes of use per subscriber, etc., to develop the projected cash flows. Since we included the cash flows associated with these other inputs in the annual cash flow projections, the present value of the unlevered free cash flows of the segment, after investment in the network, subscribers, etc., is attributable to the wireless FCC licenses. The terminal value of the segment, which incorporates an assumed sustainable growth rate, is also discounted and is likewise attributed to the licenses. We used a discount rate of 9.0%, based on the optimal long-term capital structure of a market participant and its associated cost of debt and equity, to calculate the present value of the projected cash flows. This discount rate is also consistent with rates we use to calculate the present value of the projected cash flows of licenses acquired from third parties.

If either the projected rate of long-term growth of cash flows or revenues declined by 1%, or if the discount rate increased by 1%, the fair values of the wireless FCC licenses, while less than currently projected, would still be higher than the book value of the licenses. The fair value of the licenses exceeded the book value by more than 25%.

We review customer relationships and other long-lived assets for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable over the remaining life of the asset or asset group. To determine that the asset is recoverable, we verify that the expected undiscounted future cash flows directly related to that asset exceed its book value.

We evaluate our investments to determine whether market declines are temporary and accordingly reflected in accumulated other comprehensive income, or other-than-temporary and recorded as an expense in other income (expense) in the consolidated income statements. This evaluation is based on the length of time and the severity of decline in the investment's value. In 2010, we identified an other-than-temporary decline in the value of one of our equity method investments and various cost investments. At the end of the first quarter of 2009 and at the end of 2008, we concluded the severity of decline had led to an other-than-temporary decline in the value of assets contained in an independently managed trust for certain BellSouth employee benefits.

Income Taxes Our estimates of income taxes and the significant items giving rise to the deferred assets and liabilities are shown in Note 10 and reflect our assessment of actual future taxes to be paid on items reflected in the financial statements, giving consideration to both timing and probability of these estimates. Actual income taxes could vary from these estimates due to future changes in income tax law or the final review of our tax returns by federal, state or foreign tax authorities.

We use our judgment to determine whether it is more likely than not that we will sustain positions that we have taken on tax returns and, if so, the amount of benefit to initially recognize within our financial statements. We regularly review our uncertain tax positions and adjust our unrecognized tax benefits (UTBs) in light of changes in facts and circumstances, such as changes in tax law, interactions with taxing authorities and developments in case law. These adjustments to our UTBs may affect our income tax expense. Settlement of uncertain tax positions may require use of our cash.

New Accounting Standards

Revenue Arrangements with Multiple Deliverables In October 2009, the Financial Accounting Standards Board (FASB) issued "Multiple-Deliverable Revenue Arrangements" (ASU 2009-13), which addresses how revenues should be allocated among all products and services included in our bundled sales arrangements. It establishes a selling price hierarchy for determining the selling price of each product or service, with vendor-specific objective evidence at the highest level, third-party evidence at the intermediate level, and a best estimate at the lowest level. It eliminates the residual method as an acceptable allocation method, and

requires the use of the relative selling price method as the basis for allocation. It also significantly expands the disclosure requirements for such arrangements, including, potentially, certain qualitative disclosures. We adopted ASU 2009-13 for sales entered into or materially modified in the year beginning January 1, 2011. ASU 2009-13 had no material effect on our financial statements or existing revenue recognition policies.

See Note 1 for a discussion of other recently issued or adopted accounting standards.

OTHER BUSINESS MATTERS

Retiree Phone Concession Litigation In May 2005, we were served with a purported class action in U.S. District Court, Western District of Texas (Stoffels v. SBC Communications Inc.), in which the plaintiffs, who are retirees of Pacific Bell Telephone Company, Southwestern Bell and Ameritech, contend that the cash reimbursement formerly paid to retirees living outside their company's local service area, for telephone service they purchased from another provider, is a "defined benefit plan" within the meaning of ERISA. In October 2006, the Court certified two classes. The issue of whether the concession is an ERISA pension plan was tried before the judge in November 2007. In May 2008, the court ruled that the concession was an ERISA pension plan. We asked the court to certify this ruling for interlocutory appeal, and in August 2008, the court denied our request. In May 2009, we filed a motion for reconsideration with the trial court. That motion was granted on January 14, 2011, and a final judgment has been entered in our favor. Plaintiffs have appealed the judgment to the Fifth Circuit Court of Appeals. We believe that an adverse outcome having a material effect on our financial statements in this case is unlikely, but we will continue to evaluate the potential impact of this suit on our financial results as it progresses.

NSA Litigation Twenty-four lawsuits were filed alleging that we and other telecommunications carriers unlawfully provided assistance to the National Security Agency in connection with intelligence activities that were initiated following the events of September 11, 2001. In the first filed case, Hepting et al v. AT&T Corp., AT&T Inc. and Does 1-20, a purported class action filed in U.S. District Court in the Northern District of California, plaintiffs alleged that the defendants disclosed and are currently disclosing to the U.S. Government content and call records concerning communications to which Plaintiffs were a party. Plaintiffs sought damages, a declaratory judgment and injunctive relief for violations of the First and Fourth Amendments to the United States Constitution, the Foreign Intelligence Surveillance Act (FISA), the Electronic Communications Privacy Act and other federal and California statutes. We filed a motion to dismiss the complaint. The United States asserted the "state secrets privilege" and related statutory privileges and also filed a motion asking the court to dismiss the complaint. The Court denied the motions, and we and the

United States appealed. In August 2008, the U.S. Court of Appeals for the Ninth Circuit remanded the case to the district court without deciding the issue in light of the passage of the FISA Amendments Act, a provision of which addresses the allegations in these pending lawsuits (immunity provision). The immunity provision requires the pending lawsuits to be dismissed if the Attorney General certifies to the court either that the alleged assistance was undertaken by court order, certification, directive or written request or that the telecom entity did not provide the alleged assistance. In September 2008, the Attorney General filed his certification and asked the district court to dismiss all of the lawsuits pending against the AT&T Inc. telecommunications companies. The court granted the Government's motion to dismiss and entered final judgments in July 2009. In addition, a lawsuit seeking to enjoin the immunity provision's application on grounds that it is unconstitutional was filed. In March 2009, we and the Government filed motions to dismiss this lawsuit. The court granted the motion to dismiss and entered final judgment in July 2009. All cases brought against the AT&T entities have been dismissed. In August 2009, plaintiffs in all cases filed an appeal with the Ninth Circuit Court of Appeals, and this appeal remains pending. Management believes this appeal is without merit and intends to continue to defend these matters vigorously.

Universal Service Fees Litigation In October 2010, our wireless subsidiary was served with a purported class action in Circuit Court, Cole County, Missouri (MBA Surety Agency, Inc. v. AT&T Mobility, LLC), in which the plaintiffs contend that we violated the FCC's rules by collecting universal service fees on certain services not subject to such fees, including Internet access service provided over wireless handsets commonly called "smartphones" and wireless data cards, as well as collecting certain other state and local fees. Plaintiffs define the class as all persons who from April 1, 2003, until the present had a contractual relationship with us for Internet access through a smartphone or a wireless data card. Plaintiffs seek an unspecified amount of damages as well as injunctive relief. We believe that an adverse outcome having a material effect on our financial statements in this case is unlikely.

National Healthcare Law In 2010, we paid \$5,312 for a variety of health and welfare benefits provided to certain active and retired employees and their dependents under various plans. Of those benefits, \$4,463 related to medical and prescription drug benefits. In March 2010, the President signed into law the comprehensive healthcare reform legislation. The legislation changed the tax treatment of the Medicare Part D subsidy, provided Medicare payment reforms, and enacted an excise tax on "Cadillac" plans as well as mandates for providing coverage and other requirements for delivery of health care to employees and retirees. We recorded a non-cash charge of \$995 in the first quarter of 2010 to reflect the impact of this change. In 2011, we received a reimbursement

of \$92 relating to coverage provided to our early retirees as provided by the new legislation. We continue to evaluate the effects of the new law and its related regulations on the level of healthcare benefits we currently provide to active employees and retirees.

Wireless Transactions In June 2010, we acquired certain wireless properties, including FCC licenses and network assets from Verizon Wireless for \$2,376 in cash and increased goodwill by \$937. The assets primarily represented former Alltel Wireless assets and served approximately 1.6 million subscribers in 79 service areas across 18 states. Since the properties we acquired use a different network technology than our GSM technology, we expect to incur additional costs to convert that network and subscriber handsets to our GSM technology.

As a condition of our acquisition of Centennial, in August 2010, we sold eight service areas in Louisiana and Mississippi for \$273.

In December 2010, we agreed to purchase spectrum licenses in the Lower 700 MHz frequency band from Qualcomm Incorporated (Qualcomm) for approximately \$1,925 in cash. The spectrum covers more than 300 million people total nationwide, including 12 MHz of Lower 700 MHz D and E block spectrum covering more than 70 million people in five of the top 15 metropolitan areas and 6 MHz of Lower 700 MHz D block spectrum covering more than 230 million people across the rest of the U.S. We plan to deploy this spectrum as supplemental downlink capacity, using carrier aggregation technology once compatible handsets and network equipment are developed. The transaction is subject to regulatory approvals and other customary closing conditions. In February 2011, the waiting period under the Hart-Scott-Rodino Act expired without the Department of Justice requesting additional information. AT&T and Qualcomm anticipate closing the purchase in the second half of 2011.

Labor Contracts In February 2010, the Company and the Communications Workers of America (CWA) announced a tentative agreement covering approximately 30,000 core wireline employees in the nine-state former BellSouth region, subject to ratification by those covered employees. This agreement was ratified in March 2010. In September, approximately 4,000 core wireline employees in the Company's east region also ratified a tentative agreement previously announced by the Company and the CWA. All core wireline employees are now covered by agreements reached since prior labor agreements expired during 2009.

Environmental We are subject from time to time to judicial and administrative proceedings brought by various governmental authorities under federal, state or local environmental laws. Although we are required to reference in our Forms 10-Q and 10-K any of these proceedings that could result in monetary sanctions (exclusive of interest and costs) of one hundred thousand dollars or more, we do not believe that any of them currently pending will have a material adverse effect on our results of operations.

LIQUIDITY AND CAPITAL RESOURCES

We had \$1,437 in cash and cash equivalents available at December 31, 2010. Cash and cash equivalents included cash of \$332 and money market funds and other cash equivalents of \$1,105. Cash and cash equivalents decreased \$2,304 since December 31, 2009. During 2010, cash inflows were primarily provided by cash receipts from operations, the issuance of debt and the disposition of non-strategic assets. These inflows were more than offset by cash used to meet the needs of the business including, but not limited to, payment of operating expenses, funding capital expenditures, dividends to stockholders, repayment of debt, payment of interest on debt, and acquisitions. We discuss many of these factors in detail below.

Cash Provided by or Used in Operating Activities

During 2010, cash provided by operating activities was \$34,993 compared to \$34,405 in 2009. Our higher operating cash flow reflects decreased tax payments of \$933.

During 2010, our payments for current income taxes were lower than 2009 due to lower audit-related payments net of refunds. The timing of cash payments for income taxes is governed by the IRS and other taxing authorities and differs from the timing of recording tax expense.

In September 2010, we reached a settlement with the IRS on the calculation of the tax basis of certain assets relating to a restructuring of our wireless operations. The allowed amortization deductions on these settlement-related assets are expected to cover a 15-year period, which began in 2008. As a result of this settlement, we paid \$300 to the IRS during the fourth quarter of 2010, representing the tax effect of disallowed deductions taken on our federal income tax returns in 2008 and 2009. We also decreased our net tax liabilities approximately \$8,300 and expect to recognize the cash flow impacts of the settlement over a 15-year period, which began in 2008. The effect of the change to our net tax liabilities was recognized through our income statement in the third quarter of 2010 as a reduction in income tax expense.

During 2009, cash provided by operating activities was \$34,405 compared to \$33,610 in 2008. Our higher operating cash flow reflected decreased tax payments of \$836, partially offset by increased interest payments of \$157. During 2009, our payments for income taxes were lower than 2008 due primarily to changes in law impacting the timing of payments, partially offset by an increase in audit-related payments net of refunds.

Cash Used in or Provided by Investing Activities

During 2010, cash used in investing activities consisted of:

- \$19,530 in capital expenditures, excluding interest during construction.
- \$772 in interest during construction.
- \$2,376, net of cash acquired, related to the acquisition of various assets from Verizon.
- \$265 related to wireless spectrum and licenses acquired.
- \$265 related to other acquisitions.
- \$100 from the purchase of securities, net of investments.

During 2010, cash provided by investing activities consisted of:

- \$1,830 from dispositions of non-strategic assets.
- \$29 related to other activities.

Our capital expenditures are primarily for our wireless and wireline subsidiaries' networks, our U-verse services, and support systems for our communications services. Total capital spending in 2010 was \$19,530, which was a \$2,976 increase from 2009. Capital spending in our Wireless segment, excluding interest during construction, represented 43% of our total spending and increased over 50% from 2009. Wireless expenditures were used for network capacity expansion, integration and upgrades to our HSPA network and the initial deployment of LTE (4G) equipment for trials. Capital expenditures in our Wireline segment, which represented 56% of our capital expenditures excluding interest during construction, decreased 1% for 2010, reflecting decreased spending on U-verse services, less spending on wireline voice services, and lower DSL and High Capacity volumes. The Other segment capital expenditures were less than 1% of total capital expenditures for 2010. We expect to fund any Advertising Solutions segment capital expenditures using cash from operations. We expect total 2011 capital investment to be in the low- to mid-\$19,000 range. We anticipate using approximately \$1,925 of cash in 2011 to purchase wireless spectrum from Qualcomm.

Cash Used in or Provided by Financing Activities

We paid dividends of \$9,916 in 2010, \$9,670 in 2009, and \$9,507 in 2008, reflecting dividend rate increases. In December 2010, our Board of Directors approved a 2.4% increase in the quarterly dividend from \$0.42 to \$0.43 per share. This follows a 2.4% dividend increase approved by AT&T's Board in December 2009. Dividends declared by our Board of Directors totaled \$1.69 per share in 2010, \$1.65 per share in 2009 and \$1.61 per share in 2008. Our dividend policy considers both the expectations and requirements of stockholders, internal requirements of AT&T and long-term growth opportunities. It is our intent to provide the financial flexibility to allow our Board of Directors to consider dividend growth and to recommend an increase in dividends to be paid in future periods. All dividends remain subject to approval by our Board of Directors.

During 2010, we received net proceeds of \$2,235 from the issuance of \$2,250 of 2.50% global notes due in 2015. Debt proceeds were used for general corporate purposes. We also received proceeds of \$1,620 from the net issuance of commercial paper and other short-term bank borrowings.

During 2010, debt repayments totaled \$9,294 and consisted of:

- \$5,668 in repayments of long-term debt with a weighted-average interest rate of 2.86%.
- \$3,000 in the early redemption of the New Cingular Wireless Services, Inc. 7.875% notes originally due on March 1, 2011.
- \$594 related to the private exchange we completed on September 2, 2010, whereby holders exchanged \$1,362 of New Cingular Wireless Services, Inc. 8.75% senior notes due 2031 and \$1,537 of AT&T Corp. (ATTC) 8.00% senior notes due 2031 for \$3,500 of new 5.35% AT&T Inc. global notes due 2040 plus a cash payment.
- \$32 in repayments of capitalized leases.

At December 31, 2010, we had \$7,196 of debt maturing within one year, which included \$5,544 of long-term debt maturities, \$1,625 of commercial paper and \$27 of other borrowings. Debt maturing within one year includes \$1,000 of annual put reset securities issued by BellSouth that may be put each April until maturity in 2021.

During 2010, the following other financing activities occurred:

- We paid out \$278 related to derivative collateral; \$197 was our returning collateral to counterparties, which were funds they had posted to us in 2009 (see Note 9).
- We paid \$266 to minority interest holders.
- We received proceeds of \$50 from the issuance of treasury shares related to the settlement of share-based awards.

In December 2010, our Board of Directors approved a program to repurchase up to 300 million shares (approximately 5%) of our common stock; the program does not have an expiration date.

We plan to fund our 2011 financing activities through a combination of cash from operations and debt issuances. The timing and mix of debt issuance will be guided by credit market conditions and interest rate trends. The emphasis of our financing activities will be the payment of dividends, subject to approval by our Board of Directors, the repayment of debt, and potential share repurchases.

Credit Facilities In December 2010, we replaced our five-year, \$9,465 revolving credit facility with two new revolving credit facilities with a syndicate of banks – a four-year, \$5,000 agreement and a \$3,000, 364-day agreement. In the event advances are made under either agreement, those advances would be used for general corporate purposes, which could include repayment of maturing commercial paper. Advances are not conditioned on the absence of a material adverse change. All advances must be repaid no later than the date on which lenders are no longer obligated to make any advances under each agreement. Under each agreement, we can terminate, in whole or in part, amounts committed by the lenders in excess of any outstanding advances; however, we cannot reinstate any such terminated commitments. At December 31, 2010, we had no advances outstanding under either agreement and were in compliance with all covenants under each agreement.

The Four-Year Agreement

We can request the lenders to further increase their commitments (i.e., raise the available credit) up to an additional \$2,000 provided no event of default has occurred. The obligations of the lenders to provide advances will terminate on December 20, 2014, unless prior to that date either: (i) we reduce to \$0 the commitments of the lenders, or (ii) certain events of default occur. We and lenders representing more than 50% of the facility amount may agree to extend their commitments for an additional one year beyond the December 20, 2014, termination date (with a potential one-year further renewal), under certain circumstances.

Advances would bear interest, at our option, either:

- at an annual rate equal to (1) the highest of (a) the base (or prime) rate of a designated bank, (b) 0.50% per annum above the Federal funds rate, and (c) the British Bankers Association Interest Settlement Rate applicable to Dollars for a period of one month plus 1.00%, plus (2) a rate based on AT&T's credit default swap mid-rate spread and subject to a floor or cap as set forth in the Agreement (Applicable Margin) minus 1.00% provided such total exceeds zero; or

- at a rate equal to: (i) the London InterBank Offered Rate (LIBOR) (adjusted upwards to reflect any bank reserve costs) for a period of one, two, three or six months, as applicable, plus (ii) the Applicable Margin.

If we pledge assets or otherwise have liens on our properties, then advances will be ratably secured, subject to specified exceptions. We also must maintain a debt-to-EBITDA (earnings before interest, income taxes, depreciation and amortization, and other modifications described in the agreement) ratio of not more than three-to-one, as of the last day of each fiscal quarter, for the four quarters then ended.

Defaults under the agreement, which would permit the lenders to accelerate required repayment and which would increase the Applicable Margin by 2.00% per annum, include:

- We fail to pay principal or interest, or other amounts under the agreement beyond any grace period,
- We fail to pay when due other debt of \$400 or more that results in acceleration of that debt (commonly referred to as "cross-acceleration") or a creditor commences enforcement proceedings within a specified period after a money judgment of \$400 or more has become final,
- A person acquires beneficial ownership of more than 50% of AT&T common shares or more than a majority of AT&T's directors changes in any 24-month period other than as elected by the remaining directors (commonly referred to as a "change in control"),
- Material breaches of representations or warranties in the agreement,
- We fail to comply with the negative pledge or debt-to-EBITDA ratio covenants described above,
- We fail to comply with other covenants under the Agreement for a specified period after notice,
- We fail to make certain minimum funding payments under ERISA, and
- Our bankruptcy or insolvency.

364-day Agreement

The obligations of the lenders to provide advances will terminate on December 19, 2011, unless prior to that date either: (i) we reduce to \$0 the commitments of the lenders, or (ii) certain events of default occur. We and lenders representing more than 50% of the facility amount may agree to extend their commitments for an additional 364-day period beyond the December 19, 2011 termination date, under certain circumstances. We also can convert all or part of outstanding advances under the 364-day Agreement into term loan(s) maturing no later than the first anniversary of the termination date, under certain circumstances.

Advances would bear interest, at our option, either:

- at a variable annual rate equal to (1) the highest of (a) the base (or prime) rate of a designated bank, (b) 0.50% per annum above the Federal funds rate, and (c) the British Bankers Association Interest Settlement Rate applicable to Dollars for a period of one month plus 1.00%, plus (2) a rate based on AT&T's credit default swap mid-rate spread and subject to a floor or cap as set forth in such Agreement (Applicable Margin) minus 1.00% provided such total exceeds zero; or
- at a rate equal to: (i) LIBOR (adjusted upwards to reflect any bank reserve costs) for a period of one, two, three or six months, as applicable, plus (ii) the Applicable Margin.

The 364-day Agreement contains a negative pledge covenant that is identical to the negative pledge described above. In the event we elect to convert any outstanding advances to term loan(s), the debt-to-EBITDA financial ratio covenant described above also would apply while such term loan(s) were outstanding. The events of default described above also apply to the 364-day Agreement.

Other

Our total capital consists of debt (long-term debt and debt maturing within one year) and stockholders' equity. Our capital structure does not include debt issued by our international equity investees. Our debt ratio was 37.1%, 41.4% and 43.8% at December 31, 2010, 2009 and 2008. The debt ratio is affected by the same factors that affect total capital. Total capital increased \$4,046 in 2010 compared to an increase of \$2,716 in 2009. The 2010 total capital increase was primarily due to a \$9,848 increase in retained earnings, partially offset by a \$5,914 decrease in debt, both factors which lowered the debt ratio in 2010.

CONTRACTUAL OBLIGATIONS, COMMITMENTS AND CONTINGENCIES

Current accounting standards require us to disclose our material obligations and commitments to making future payments under contracts, such as debt and lease agreements, and under contingent commitments, such as debt guarantees. We occasionally enter into third-party debt guarantees, but they are not, nor are they reasonably likely to become, material. We disclose our contractual long-term debt repayment obligations in Note 8 and our operating lease payments in Note 5. Our contractual obligations do not include expected pension and postretirement payments as we maintain pension funds and Voluntary Employee Beneficiary Association trusts to fully or partially fund these benefits (see Note 11). In the ordinary course of business, we routinely enter into commercial commitments for various aspects of our operations, such as plant additions and office supplies. However, we do not believe that the commitments will have a material effect on our financial condition, results of operations or cash flows.

Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

Our contractual obligations as of December 31, 2010 are in the following table. The purchase obligations that follow are those for which we have guaranteed funds and will be funded with cash provided by operations or through incremental borrowings. The minimum commitment for certain obligations is based on termination penalties that could be paid to exit the contract. Since termination penalties would not be paid every year, such penalties are excluded from the table. Other long-term liabilities were included in the table based on the year of required payment or an estimate of the year of payment. Such estimate of payment is based on a review of past trends for these items, as well as a forecast of future activities. Certain items were excluded from the following table, as the year of payment is unknown and could not be reliably estimated since past trends were not deemed to be an indicator of future payment.

Substantially all of our purchase obligations are in our Wireline and Wireless segments. The table does not include the fair value of our interest rate swaps. Our capital lease

obligations and bank borrowings have been excluded from the table due to the immaterial amounts of such obligations at December 31, 2010. Many of our other noncurrent liabilities have been excluded from the following table due to the uncertainty of the timing of payments, combined with the absence of historical trending to be used as a predictor of such payments. Additionally, certain other long-term liabilities have been excluded since settlement of such liabilities will not require the use of cash. However, we have included in the following table obligations that primarily relate to benefit funding and severance due to the certainty of the timing of these future payments. Our other long-term liabilities are: deferred income taxes (see Note 10) of \$22,361; postemployment benefit obligations of \$28,803; and other noncurrent liabilities of \$12,743, which included deferred lease revenue from our agreement with American Tower Corp. of \$480 (see Note 5).

Contractual Obligations

	Payments Due By Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt obligations ¹	\$ 64,156	\$ 5,535	\$11,277	\$ 9,302	\$ 38,042
Interest payments on long-term debt	62,693	3,781	6,542	5,476	46,894
Operating lease obligations	24,804	2,590	4,711	4,156	13,347
Unrecognized tax benefits ²	3,141	—	—	—	3,141
Purchase obligations ³	10,603	3,158	4,904	1,934	607
Total Contractual Obligations	\$165,397	\$15,064	\$27,434	\$20,868	\$102,031

¹Represents principal or payoff amounts of notes and debentures at maturity or, for putable debt, the next put opportunity.

²The noncurrent portion of the unrecognized tax benefits is included in the "More than 5 Years" column, as we cannot reasonably estimate the timing or amounts of additional cash payments, if any, at this time. See Note 10 for additional information.

³We calculated the minimum obligation for certain agreements to purchase goods or services based on termination fees that can be paid to exit the contract. If we elect to exit these contracts, termination fees for all such contracts in the year of termination could be approximately \$863 in 2011, \$668 in the aggregate for 2012 and 2013, \$38 in the aggregate for 2014 and 2015, and \$5 in the aggregate, thereafter. Certain termination fees are excluded from the above table, as the fees would not be paid every year and the timing of such payments, if any, is uncertain.

MARKET RISK

We are exposed to market risks primarily from changes in interest rates and foreign currency exchange rates. These risks, along with other business risks, impact our cost of capital. It is our policy to manage our debt structure and foreign exchange exposure in order to manage capital costs, control financial risks and maintain financial flexibility over the long term. In managing market risks, we employ derivatives according to documented policies and procedures, including interest rate swaps, interest rate locks, foreign currency exchange contracts and combined interest rate foreign currency contracts (cross-currency swaps). We do not use derivatives for trading or speculative purposes. We do not foresee significant changes in the strategies we use to manage market risk in the near future.

Interest Rate Risk

The majority of our financial instruments are medium- and long-term fixed-rate notes and debentures. Changes in interest rates can lead to significant fluctuations in the fair value of these instruments. The principal amounts by expected maturity, average interest rate and fair value of our liabilities that are exposed to interest rate risk are described in Notes 8 and 9. In managing interest expense, we control our mix of fixed and floating rate debt, principally through the use of interest rate swaps. We have established interest rate risk limits that we closely monitor by measuring interest rate sensitivities in our debt and interest rate derivatives portfolios.

All our foreign-denominated debt has been swapped from fixed-rate foreign currencies to fixed-rate U.S. dollars at issuance through cross-currency swaps, removing interest rate risk and foreign currency exchange risk associated with the underlying interest and principal payments. Likewise, periodically we enter into interest rate locks to partially hedge the risk of increases in the benchmark interest rate during the period leading up to the probable issuance of fixed-rate debt. We expect gains or losses in our cross-currency swaps and interest rate locks to offset the losses and gains in the financial instruments they hedge.

Following are our interest rate derivatives subject to material interest rate risk as of December 31, 2010. The interest rates illustrated below refer to the average rates we expect to pay based on current and implied forward rates and the average rates we expect to receive based on derivative contracts. The notional amount is the principal amount of the debt subject to the interest rate swap contracts. The fair value asset (liability) represents the amount we would receive (pay) if we had exited the contracts as of December 31, 2010.

	Maturity						Fair Value Total 12/31/10	
	2011	2012	2013	2014	2015	Thereafter		
Interest Rate Derivatives								
Interest Rate Swaps:								
Receive Fixed/Pay Variable Notional								
Amount Maturing	\$3,000	\$3,050	\$3,000	\$1,000	—	\$1,000	\$11,050	
Weighted-Average Variable Rate Payable ¹	2.8%	3.4%	5.0%	4.8%	5.4%	5.9%		
Weighted-Average Fixed Rate Receivable	5.7%	5.5%	5.7%	5.6%	5.6%	5.6%		

¹Interest payable based on current and implied forward rates for One, Three or Six Month LIBOR plus a spread ranging between approximately 36 and 576 basis points.

Foreign Exchange Risk

We are exposed to foreign currency exchange risk through our foreign affiliates and equity investments in foreign companies. We do not hedge foreign currency translation risk in the net assets and income we report from these sources. However, we do hedge a large portion of the exchange risk involved in anticipation of highly probable foreign currency-denominated transactions and cash flow streams, such as those related to issuing foreign-denominated debt, receiving dividends from foreign investments, and other receipts and disbursements.

Through cross-currency swaps, all our foreign-denominated debt has been swapped from fixed-rate foreign currencies to fixed-rate U.S. dollars at issuance, removing interest rate risk and foreign currency exchange risk associated with the underlying interest and principal payments. We expect gains or losses in our cross-currency swaps to offset the losses and gains in the financial instruments they hedge.

In anticipation of other foreign currency-denominated transactions, we often enter into foreign exchange forward contracts to provide currency at a fixed rate. Our policy is to measure the risk of adverse currency fluctuations by calculating the potential dollar losses resulting from changes in exchange rates that have a reasonable probability of occurring. We cover the exposure that results from changes that exceed acceptable amounts.

For the purpose of assessing specific risks, we use a sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our financial instruments and results of operations. To perform the sensitivity analysis, we assess the risk of loss in fair values from the effect of a hypothetical 10% depreciation of the U.S. dollar against foreign currencies from the prevailing foreign currency exchange rates, assuming no change in interest rates. For foreign exchange forward contracts outstanding at December 31, 2010, the change in fair value was immaterial. Furthermore, because our foreign exchange contracts are entered into for hedging purposes, we believe that these losses would be largely offset by gains on the underlying transactions.

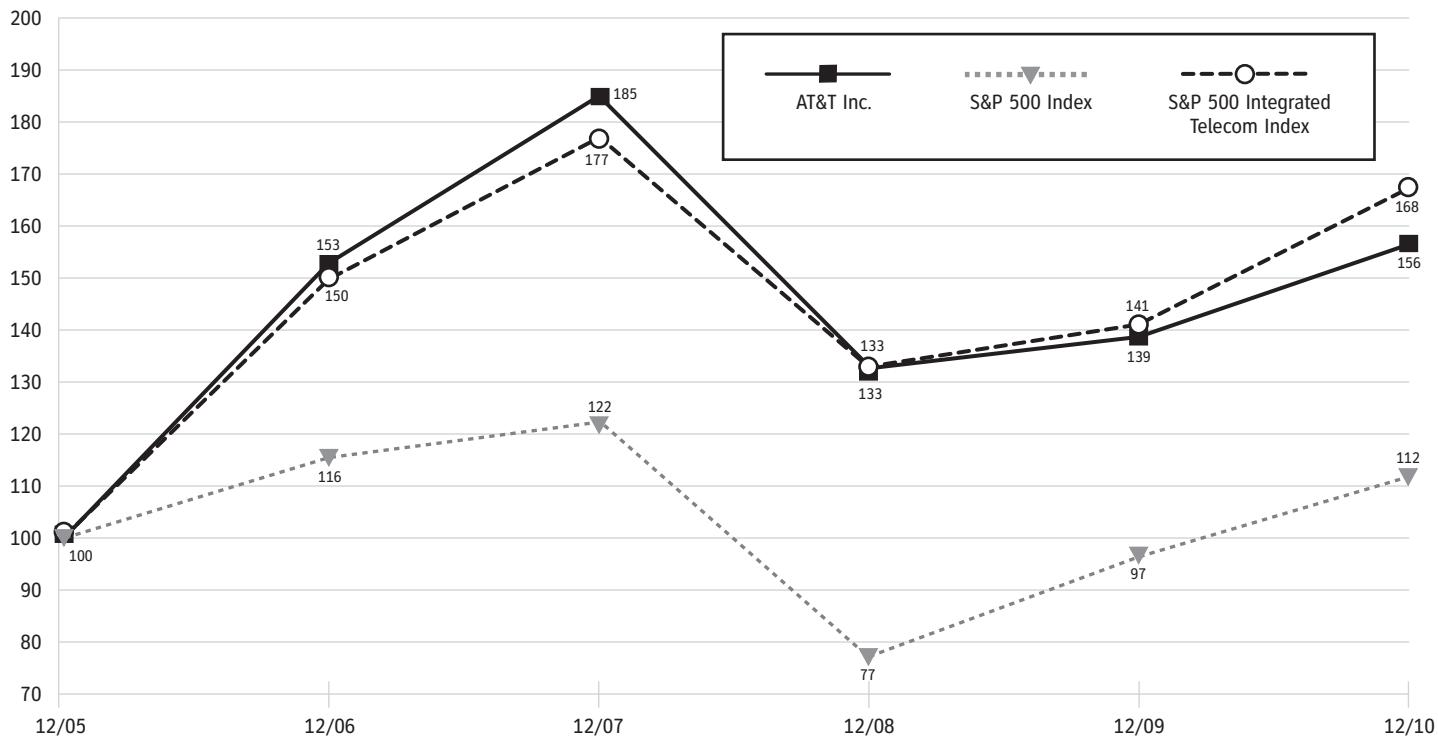
Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

STOCK PERFORMANCE GRAPH

Comparison of Five Year Cumulative Total Return

AT&T Inc., S&P 500 Index, and S&P 500 Integrated Telecom Index



The comparison above assumes \$100 invested on December 31, 2005, in AT&T common stock, Standard & Poor's 500 Index (S&P 500), and Standard & Poor's 500 Integrated Telecom Index (S&P 500 Integrated Telecom). Total return equals stock price appreciation plus reinvestment of dividends.

RISK FACTORS

In addition to the other information set forth in this document, including the matters contained under the caption "Cautionary Language Concerning Forward-Looking Statements," you should carefully read the matters described below. We believe that each of these matters could materially affect our business. We recognize that most of these factors are beyond our ability to control and therefore we cannot predict an outcome. Accordingly, we have organized them by first addressing general factors, then industry factors and, finally, items specifically applicable to us.

A worsening U.S. economy would magnify our customers' and suppliers' current financial difficulties and could materially adversely affect our business.

We provide services and products to consumers and large and small businesses in the United States and to larger businesses throughout the world. Current economic conditions in the U.S. have adversely affected our customers' demand for and ability to pay for existing services, especially local landline service, and their interest in purchasing new services. Our suppliers are also facing higher financing and operating costs. Should these current economic conditions worsen, we likely would experience both a decrease in revenues and an increase in certain expenses, including expenses relating to bad debt and equipment and software maintenance. We also may incur difficulties locating financially stable equipment and other suppliers, thereby affecting our ability to offer attractive new services. We are also likely to experience greater pressure on pricing and margins as we continue to compete for customers who would have even less discretionary income. While our largest business customers have been less affected by these adverse changes in the U.S. economy, if the continued adverse economic conditions in the U.S., Europe and other foreign markets persist or worsen, those customers would likely be affected in a similar manner.

Adverse changes in medical costs and the U.S. securities markets and interest rates could materially increase our benefit plan costs.

Our annual pension and postretirement costs are subject to increases, primarily due to continuing increases in medical and prescription drug costs, and can be affected by lower returns on funds held by our pension and other benefit plans, which are reflected in our financial statements for that year. Investment returns on these funds depend largely on trends in the U.S. securities markets and the U.S. economy. It is also unclear how many provisions of the new national healthcare law will apply to us since many regulations implementing the law have not been finalized. In addition, there have been third-party challenges to the constitutionality of the new national healthcare law that, if sustained, could have an impact on our accounting for related costs. In calculating the annual costs included on our financial statements of providing benefits under our plans, we have made certain assumptions regarding future investment returns, medical costs and

interest rates. If actual investment returns, medical costs and interest rates are worse than those previously assumed, our annual costs will increase.

The FASB requires companies to recognize the funded status of defined benefit pension and postretirement plans as an asset or liability in our statement of financial position and to recognize changes in that funded status in the year in which the changes occur. We have elected to reflect the annual adjustments to the funded status in our consolidated statement of income. Therefore, an increase in our costs or adverse market conditions will have a negative effect on our operating results.

The ongoing uncertainty in global financial markets could materially adversely affect our ability and our larger customers' ability to access capital needed to fund business operations.

The continuing instability in the global financial markets has resulted in periodic volatility in the credit, currency, equity and fixed income markets. Volatility has limited, in some cases severely, companies' access to the credit markets, leading to higher borrowing costs for companies or, in some cases, the inability of these companies to fund their ongoing operations. As a result, our larger customers, who tend to be heavy users of our data and wireless services, may be forced to delay or reduce or be unable to finance purchases of our products and services and may delay payment or default on outstanding bills to us. In addition, we contract with large financial institutions to support our own treasury operations, including contracts to hedge our exposure on interest rates and foreign exchange and the funding of credit lines and other short-term debt obligations, including commercial paper. These financial institutions also face new capital-related and other regulations in the U.S. and Europe, as well as ongoing legal and financial issues concerning their loan portfolios, which may hamper their ability to provide credit or raise the cost of providing such credit. While we have been successful in continuing to access the credit and fixed income markets when needed, a financial crisis could render us unable to access these markets, severely affecting our business operations.

Changes in available technology could increase competition and our capital costs.

The telecommunications industry has experienced rapid changes in the last several years. The development of wireless, cable and IP technologies has significantly increased the commercial viability of alternatives to traditional wireline telephone service and enhanced the capabilities of wireless networks. In order to remain competitive, we are deploying a more sophisticated wireline network and continue to deploy a more sophisticated wireless network, as well as research other new technologies. If the new technologies we have adopted or on which we have focused our research efforts fail to be cost-effective and accepted by customers, our ability to remain competitive could be materially adversely affected.

Changes to federal, state and foreign government regulations and decisions in regulatory proceedings could materially adversely affect us.

Our wireline subsidiaries are subject to significant federal and state regulation while many of our competitors are not. In addition, our subsidiaries and affiliates operating outside the U.S. are also subject to the jurisdiction of national and supranational regulatory authorities in the market where service is provided. Our wireless subsidiaries are regulated to varying degrees by the FCC and some state and local agencies. Adverse rulings by the FCC relating to broadband issues could impede our ability to manage our networks and recover costs and lessen incentives to invest in our networks. The development of new technologies, such as IP-based services, also has created or potentially could create conflicting regulation between the FCC and various state and local authorities, which may involve lengthy litigation to resolve and may result in outcomes unfavorable to us. In addition, increased public focus on potential global climate changes has led to proposals at state, federal and foreign government levels to increase regulation on various types of emissions, including those generated by vehicles and by facilities consuming large amounts of electricity.

Increasing competition in the wireless industry could adversely affect our operating results.

We have multiple wireless competitors in each of our service areas and compete for customers based principally on price, service/device offerings, call quality, coverage area and customer service. In addition, we are likely to experience growing competition from providers offering services using alternative wireless technologies and IP-based networks as well as traditional wireline networks. We expect market saturation to continue to cause the wireless industry's customer growth rate to moderate in comparison with historical growth rates, leading to increased competition for customers. We expect that the availability of additional 700 MHz spectrum could increase competition and the effectiveness of existing competition. This competition will continue to put pressure on pricing and margins as companies compete for potential customers. Our ability to respond will depend, among other things, on continued improvement in network quality and customer service and effective marketing of attractive products and services, and cost management. These efforts will involve significant expenses and require strategic management decisions on, and timely implementation of, equipment choices and deployment, and service offerings.

Increasing competition in our wireline markets could adversely affect wireline operating margins.

We expect competition in the telecommunications industry to continue to intensify. We expect this competition will continue to put pressure on pricing, margins and customer retention. A number of our competitors that rely on alternative technologies (e.g., wireless, cable and VoIP) and business models (e.g., advertising-supported) are typically subject to less (or no) regulation than our wireline and ATTC subsidiaries and therefore are able to operate with lower costs. These competitors also have cost advantages compared to us, due in part to a nonunionized workforce, lower employee benefits and fewer retirees (as most of the competitors are relatively new companies). We believe such advantages can be offset by continuing to increase the efficiency of our operating systems and by improving employee training and productivity; however, there can be no guarantee that our efforts in these areas will be successful.

Continuing growth in our wireless services will depend on continuing access to adequate spectrum, deployment of new technology and offering attractive services to customers.

The wireless industry is undergoing rapid and significant technological changes and a dramatic increase in usage, in particular demand for and usage of data and other non-voice services. We must continually invest in our wireless network in order to continually improve our wireless service to meet this increasing demand and remain competitive. Improvements in our service depend on many factors, including continued access to and deployment of adequate spectrum. We must maintain and expand our network capacity and coverage as well as the associated wireline network needed to transport voice and data between cell sites. Network service enhancements and product launches may not occur as scheduled or at the cost expected due to many factors, including delays in determining equipment and handset operating standards, supplier delays, increases in network equipment and handset component costs, regulatory permitting delays for tower sites or enhancements or labor-related delays. Deployment of new technology also may adversely affect the performance of the network for existing services. If the FCC does not allocate sufficient spectrum to allow the wireless industry in general, and the company in particular, to increase its capacity or if we cannot deploy the services customers desire on a timely basis or at adequate cost while maintaining network quality levels, then our ability to attract and retain customers, and therefore maintain and improve our operating margins, could be materially adversely affected.

Equipment failures, natural disasters and terrorist attacks may materially adversely affect our operations.

Major equipment failures or natural disasters, including severe weather, terrorist acts or other breaches of network or IT security that affect our wireline and wireless networks, including telephone switching offices, microwave links, third-party owned local and long-distance networks on which we rely, our cell sites or other equipment, could have a material adverse effect on our operations. While we have insurance coverage for some of these events, our inability to operate our wireline or wireless systems, even for a limited time period, may result in significant expenses, a loss of customers or impair our ability to attract new customers, which could have a material adverse effect on our business, results of operations and financial condition.

The continued success of our U-verse services initiative will depend on the timing, extent and cost of deployment; the development of attractive and profitable service offerings; the extent to which regulatory, franchise fees and build-out requirements apply to this initiative; and the availability and reliability of the various technologies required to provide such offerings.

The trend in telecommunications technology is to shift from the traditional circuit- and wire-based technology to IP-based technology. IP-based technology can transport voice and data, as well as video, from both wired and wireless networks. IP-based networks also potentially cost less to operate than traditional networks. Our competitors, many of which are newer companies, are deploying this IP-based technology. In order to continue to offer attractive and competitively priced services, we are deploying a new broadband network to offer IP-based voice, data and video services. Using a new and sophisticated technology on a very large scale entails

risks but also presents opportunities to expand service offerings to customers. Should deployment of our network be delayed or costs exceed expected amounts, our margins would be adversely affected and such effects could be material. Should regulatory requirements be different than we anticipated, our deployment could be delayed, perhaps significantly, or limited to only those geographical areas where regulation is not burdensome. In addition, should the delivery of services expected to be deployed on our network be delayed due to technological or regulatory constraints, performance of suppliers, or other reasons, or the cost of providing such services becomes higher than expected, customers may decide to purchase services from our competitors, which would adversely affect our revenues and margins, and such effects could be material.

Unfavorable litigation or governmental investigation results could require us to pay significant amounts or lead to onerous operating procedures.

We are subject to a number of lawsuits both in the U.S. and in foreign countries, including, at any particular time, claims relating to antitrust, patent infringement, wage and hour, personal injury, and our advertising, sales and billing and collection practices. We also spend substantial resources complying with various government standards, which may entail related investigations. As we deploy newer technologies, especially in the wireless area, we also face current and potential litigation relating to alleged adverse health effects on customers or employees who use such technologies including, for example, wireless handsets. We may incur significant expenses defending such suits or government charges and may be required to pay amounts or otherwise change our operations in ways that could materially adversely affect our operations or financial results.

**CAUTIONARY LANGUAGE CONCERNING
FORWARD-LOOKING STATEMENTS**

Information set forth in this report contains forward-looking statements that are subject to risks and uncertainties, and actual results could differ materially. Many of these factors are discussed in more detail in the "Risk Factors" section. We claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

The following factors could cause our future results to differ materially from those expressed in the forward-looking statements:

- Adverse economic and/or capital access changes in the markets served by us or in countries in which we have significant investments, including the impact on customer demand and our ability and our suppliers' ability to access financial markets.
- Changes in available technology and the effects of such changes, including product substitutions and deployment costs.
- Increases in our benefit plans' costs, including increases due to adverse changes in the U.S. and foreign securities markets, resulting in worse-than-assumed investment returns and discount rates and adverse medical cost trends and unfavorable healthcare legislation and regulations.
- The final outcome of Federal Communications Commission and other federal agency proceedings and reopenings of such proceedings and judicial review, if any, of such proceedings, including issues relating to access charges, broadband deployment, E911 services, competition, net neutrality, unbundled loop and transport elements, wireless license awards and renewals and wireless services.
- The final outcome of regulatory proceedings in the states in which we operate and reopenings of such proceedings and judicial review, if any, of such proceedings, including proceedings relating to Interconnection terms, access charges, universal service, unbundled network elements and resale and wholesale rates, broadband deployment including our U-verse services, net neutrality, performance measurement plans, service standards and traffic compensation.
- Enactment of additional state, federal and/or foreign regulatory and tax laws and regulations pertaining to our subsidiaries and foreign investments, including laws and regulations that reduce our incentive to invest in our networks, resulting in lower revenue growth and/or higher operating costs.
- Our ability to absorb revenue losses caused by increasing competition, including offerings that use alternative technologies (e.g., cable, wireless and VoIP) and our ability to maintain capital expenditures.
- The extent of competition and the resulting pressure on customer and access line totals and wireline and wireless operating margins.

- Our ability to develop attractive and profitable product/service offerings to offset increasing competition in our wireless and wireline markets.
- The ability of our competitors to offer product/service offerings at lower prices due to lower cost structures and regulatory and legislative actions adverse to us, including state regulatory proceedings relating to unbundled network elements and nonregulation of comparable alternative technologies (e.g., VoIP).
- The timing, extent and cost of deployment of our U-verse services; the development of attractive and profitable service offerings; the extent to which regulatory, franchise fees and build-out requirements apply to this initiative; and the availability, cost and/or reliability of the various technologies and/or content required to provide such offerings.
- Our continued ability to attract and offer a diverse portfolio of devices, some on an exclusive basis.
- The availability and cost of additional wireless spectrum and regulations relating to licensing and technical standards and deployment and usage, including network management rules.
- Our ability to manage growth in wireless data services, including network quality.
- The outcome of pending or threatened litigation, including patent and product safety claims by or against third parties.
- The impact on our networks and business from major equipment failures, our inability to obtain handsets, equipment/software or have handsets, equipment/software serviced in a timely and cost-effective manner from suppliers, severe weather conditions, natural disasters, pandemics, energy shortages, wars or terrorist attacks.
- The issuance by the Financial Accounting Standards Board or other accounting oversight bodies of new accounting standards or changes to existing standards.
- The issuance by the Internal Revenue Service and/or state tax authorities of new tax regulations or changes to existing standards and actions by federal, state or local tax agencies and judicial authorities with respect to applying applicable tax laws and regulations and the resolution of disputes with any taxing jurisdictions.
- Our ability to adequately fund our wireless operations, including payment for additional spectrum; network upgrades and technological advancements.
- Changes in our corporate strategies, such as changing network requirements or acquisitions and dispositions, which may require significant amounts of cash or stock, to respond to competition and regulatory, legislative and technological developments.

Readers are cautioned that other factors discussed in this report, although not enumerated here, also could materially affect our future earnings.