

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation Throughout this document, AT&T Inc., formerly known as SBC Communications Inc. (SBC), is referred to as "AT&T," "we" or the "Company." On November 18, 2005, we acquired 100 percent of the outstanding common shares of AT&T Corp. (ATTC). In connection with the merger, we changed the name of the company from "SBC Communications Inc." to "AT&T Inc." ATTC is a wholly owned subsidiary of the Company and the results of ATTC's operations have been included in our consolidated financial statements after the November 18, 2005 acquisition date. For a detailed discussion of our acquisition, see Note 2.

The consolidated financial statements include the accounts of the Company and our majority-owned subsidiaries. Our subsidiaries and affiliates operate in the communications services industry both domestically and internationally providing wireline and wireless telecommunications services and equipment as well as directory advertising and publishing services.

All significant intercompany transactions are eliminated in the consolidation process. Investments in partnerships, joint ventures, including Cingular Wireless (Cingular), and less than majority-owned subsidiaries where we have significant influence are accounted for under the equity method. We account for our 60% economic interest in Cingular under the equity method since we share control equally (i.e., 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular. Earnings from certain foreign equity investments accounted for using the equity method are included for periods ended within up to three months of our year end (see Note 6).

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, including estimates of probable losses and expenses. Actual results could differ from those estimates.

Consolidation of Variable Interest Entities In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51" (FIN 46). FIN 46 provides guidance for determining whether an entity is a variable interest entity (VIE) and which equity investor of that VIE, if any, should include the VIE in its consolidated financial statements. In December 2003, the FASB staff revised FIN 46 (FIN 46(R)) to clarify some of the provisions. The revision delayed the effective date for application of FIN 46(R) by large public companies, such as us, until periods ending after March 15, 2004, for all types of VIEs other than special-purpose entities, including our investment in Cingular. In 2003, we recorded an extraordinary loss of \$7, net of taxes of \$4, related to consolidation of real estate leases under FIN 46.

In accordance with the provisions of FIN 46(R), we performed a quantitative study of potential cash flows of

Cingular, covering a wide range of scenarios that valued Cingular significantly above and below the estimated fair value of Cingular. The probability of these scenarios was assessed to establish the weighted-average amount that these scenarios were both above and below the average of all the scenarios. These are the "residual returns" and "expected losses" as defined by FIN 46(R). As Cingular's total capitalization has a high equity component, the "expected losses" of the FIN 46(R) calculations were significantly below not only the fair value of Cingular's equity, but also its book value. Therefore, we determined that Cingular did not qualify for consolidation by us under the provisions of FIN 46(R), and our accounting treatment of our investment in Cingular remained unchanged. Cingular's acquisition of AT&T Wireless Services Inc. (AT&T Wireless) was accomplished entirely through equity contributions to Cingular; Cingular's debt increased only by the amount of AT&T Wireless public debt assumed in connection with the acquisition. When we reassessed whether Cingular should be consolidated under FIN 46(R), primarily because of the large increase in the fair value of Cingular's equity as a result of the transaction, we concluded the acquisition of AT&T Wireless did not change our accounting for Cingular under FIN 46(R).

Stock-Based Compensation In September 2005, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (FAS 123(R)), which is a revision of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123). FAS 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and amends Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows."

We adopted FAS 123(R) using the "modified retrospective" method. The modified retrospective method requires that compensation cost be recognized beginning with the effective date (a) based on the requirements of FAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of FAS 123 for all awards granted to employees prior to the effective date of FAS 123(R) that remain unvested on the effective date. The modified retrospective method also allowed companies to restate based on the amounts previously recognized under FAS 123 for purposes of pro forma disclosures for all prior years for which FAS 123 was effective. See Note 12 for a detailed discussion of our stock-based compensation and our adoption of FAS 123(R).

Conditional Asset Retirement Obligations In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," (FIN 47) an interpretation of Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" (FAS 143) and is effective for fiscal years ended after December 15, 2005. FIN 47 clarifies that the term "conditional asset retirement obligation," as used in FAS 143 refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

even though uncertainty exists about the timing and/or method of settlement. FIN 47 requires a company to recognize the liability for the fair value of the conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any liability accrued is offset by an increase in the value of the asset. Adoption of FIN 47 did not have a material impact on our financial statements.

Reclassifications We have reclassified certain amounts in prior-period financial statements to conform to the current period's presentation, including those related to our discontinued operations (see Note 17). We have reclassified accounts receivable for our directory segment. Previously we netted accounts receivable from our directory customers against deferred revenue which is recognized ratably over the life of the directory. During 2005, we began reporting accounts receivable from our directory customers on a gross basis as the full amount is receivable from the customer at the time the directory is issued. As a result of this change, accounts receivable and accounts payable and accrued liabilities each increased by \$1,421 at December 31, 2004.

Income Taxes Deferred income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. To the extent allowed by GAAP, we provide valuation allowances against the deferred tax assets for amounts when the realization is uncertain. Management reviews these items regularly in light of changes in tax laws and court rulings at both federal and state levels.

Our income tax returns are regularly audited and reviewed by the Internal Revenue Service (IRS) and state taxing authorities. The IRS has completed field examinations for all tax years through 1999. The IRS has issued assessments challenging the timing and amounts of various deductions for the 1997-1999 period. We paid the taxes on these assessments and filed refund claims, which the IRS had denied. We reached a settlement with the IRS regarding almost all issues included in 1997-1999 claims in the fourth quarter of 2005. The 1997-1999 IRS settlement resulted in an income tax benefit that was recognized during 2005. Additionally, the IRS is expected to complete fieldwork for the 2000-2002 period during 2006. The completion of the 2000-2002 audit fieldwork is not expected to have an adverse impact on the financial statements.

The IRS has completed its audit of the ATTC Group for 1997 – 2001 and has referred the case to Joint Committee for review and approval which we expect during the first quarter of 2006. Additionally, the IRS is currently reviewing the ATTC Group for 2002 – 2005. Any adjustments required by either Joint Committee or the review of 2002 – 2005 will be subject to the rules under purchase accounting, and it is not expected that either will result in an adverse impact to the financial statements.

Investment tax credits earned prior to their repeal by the Tax Reform Act of 1986 are amortized as reductions in income tax expense over the lives of the assets which gave rise to the credits.

Cash Equivalents Cash and cash equivalents include all highly liquid investments with original maturities of three months or less and the carrying amounts approximate fair

value. At December 31, 2005, we held \$709 in cash, \$257 in money market funds and \$258 in other cash equivalents.

Investment Securities Investments in securities principally consist of held-to-maturity or available-for-sale instruments. Short-term and long-term investments in money market securities are carried as held-to-maturity securities. Available-for-sale securities consist of various debt and equity securities that are long term in nature. Unrealized gains and losses, net of tax, on available-for-sale securities are recorded in accumulated other comprehensive income. Our investment securities maturing within one year are recorded in "Other current assets" and instruments with maturities more than one year are recorded in "Other Assets" on the Consolidated Balance Sheets.

Revenue Recognition Revenues derived from local telephone, long-distance and data services are recognized when services are provided. This is based upon either usage (e.g. minutes of traffic processed), period of time (e.g. monthly service fees) or other established fee schedules. Service revenues also include billings to our customers for various regulatory fees imposed on us by governmental authorities. We record an estimated revenue reduction for future adjustments to customer accounts, other than a provision for doubtful accounts, at the time revenue is recognized based on historical experience. Cash incentives given to customers are recorded as a reduction of revenue. When required as part of providing service, revenues and associated expenses related to nonrefundable, upfront service activation and set-up fees are deferred and recognized over the associated service contract period. If no service contract exists, those fees are recognized over the average customer relationship period. Associated expenses are deferred only to the extent of such deferred revenue. For contracts that involve the bundling of services, revenue is allocated to the services based on their relative fair value. We record the sale of equipment to customers as gross revenue when we are the primary obligor in the arrangement, when title is passed and the products are accepted by customers. For agreements involving the resale of third-party services in which we are not considered the primary obligor of the arrangement, we record the revenue net of the associated costs incurred. For contracts where we provide customers with an indefeasible right to use network capacity, we recognize revenue ratably over the stated life of the agreement.

We recognize revenues and expenses related to publishing directories on the amortization method, which recognizes revenues and expenses ratably over the life of the directory title, typically 12 months. Prior to 2003, we recognized revenues and expenses related to publishing directories on the "issue basis" method of accounting, which recognizes the revenues and expenses at the time the initial delivery of the related directory is completed. See the discussion of our 2003 change in directory accounting in the "Cumulative Effect of Accounting Changes" section below.

Traffic Compensation Expense We use various estimates and assumptions to determine the amount of traffic compensation expenses recognized during any reporting period. Switched traffic compensation costs in our AT&T Corp. segment are accrued utilizing estimated rates by

product, formulated from historical data and adjusted for known rate changes and volume levels, which are estimated for certain products and known for other products. Such estimates are adjusted monthly to reflect newly available information, such as rate changes and new contractual agreements. Bills reflecting actual incurred information are generally not received until three to nine months subsequent to the end of the reporting period, at which point a final adjustment is made to the accrued switched traffic compensation expense. Dedicated traffic compensation costs are estimated based on the number of circuits and the average projected circuit costs, based on historical data adjusted for rate changes. These costs are adjusted to reflect actual expenses over the three months following the end of the reporting period as bills are received.

Allowance for Uncollectibles We maintain an allowance for doubtful accounts for estimated losses that result from the failure or inability of our customers to make required payments. When determining the allowance, we consider the probability of recoverability of accounts receivable based on past experience, taking into account current collection trends that are expected to continue, as well as general economic factors, including bankruptcy rates. Credit risks are assessed based on historical write-offs, net of recoveries, and future estimated net write-offs as well as 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 bad debt allowances adjusted accordingly.

Cumulative Effect of Accounting Changes

Directory accounting Effective January 1, 2003, we changed our method of recognizing revenues and expenses related to publishing directories from the "issue basis" method to the "amortization" method. The issue basis method recognizes revenues and expenses at the time the initial delivery of the related directory is completed. Consequently, quarterly income tends to vary with the number and size of directory titles published during a quarter. The amortization method recognizes revenues and expenses ratably over the life of the directory, which is typically 12 months. Consequently, quarterly income tends to be more consistent over the course of a year. We decided to change methods because the amortization method has now become the more prevalent method used among significant directory publishers. This change permits a more meaningful comparison between our directory segment and other publishing companies (or publishing segments of larger companies).

Our directory accounting change resulted in a noncash charge of \$1,136, net of an income tax benefit of \$714, recorded as a cumulative effect of accounting change on the Consolidated Statements of Income as of January 1, 2003. The effect of this change was to increase consolidated pretax income and our directory segment income for 2003 by \$80 (\$49 net of tax, or \$0.01 per diluted share).

Depreciation accounting On January 1, 2003, we adopted FAS 143. FAS 143 sets forth how companies must account for the costs of removal of long-lived assets when those assets are no longer used in a company's business, but only if a company is legally required to remove such assets. FAS 143 requires that companies record the fair value of the costs of removal in the period in which the obligations are incurred and capitalize that amount as part of the book value of the long-lived asset. To determine whether we have a legal obligation to remove our long-lived assets, we reviewed state and federal law and regulatory decisions applicable to our subsidiaries, primarily our wireline subsidiaries, which have long-lived assets. Based on this review, we concluded that we are not legally required to remove any of our long-lived assets, except in a few minor instances.

However, in November 2002, we were informed that the Securities and Exchange Commission (SEC) staff concluded that certain provisions of FAS 143 require that we exclude costs of removal from depreciation rates and accumulated depreciation balances in certain circumstances upon adoption, even where no legal removal obligations exist. In our case, this means that for plant accounts where our estimated costs of removal exceed the estimated salvage value, we are prohibited from accruing removal costs in those depreciation rates and accumulated depreciation balances in excess of the salvage value. For our other long-lived assets, where our estimated costs of removal are less than the estimated salvage value, we will continue to accrue the costs of removal in those depreciation rates and accumulated depreciation balances.

Therefore, in connection with the adoption of FAS 143 on January 1, 2003, we reversed all existing accrued costs of removal for those plant accounts where our estimated costs of removal exceeded the estimated salvage value. The noncash gain resulting from this reversal was \$3,684, net of deferred taxes of \$2,249, recorded as a cumulative effect of accounting change on the Consolidated Statements of Income as of January 1, 2003.

In addition, in 2003, TDC A/S (TDC), the Danish communications company in which we then held an investment accounted for on the equity method, recorded a loss upon adoption of FAS 143. Our share of that loss was \$7, which included no tax effect. This noncash charge of \$7 was also recorded as a cumulative effect of accounting change on the Consolidated Statements of Income as of January 1, 2003.

Beginning in 2003, for those plant accounts where our estimated costs of removal previously exceeded the estimated salvage value, we expense all costs of removal as we incur them (previously those costs had been recorded in our depreciation rates). As a result, our 2003 depreciation expense decreased and our operations and support expense increased as these assets were removed from service. The effect of this change was to increase consolidated pretax income and our wireline segment income for 2003 by \$280 (\$172 net of tax, or \$0.05 per diluted share). However, over the life of the assets, total operating expenses recognized under this new accounting method will be approximately the same as under the previous method (assuming the cost of removal would be the same under both methods).

Property, Plant and Equipment Property, plant and equipment is stated at cost, except for assets acquired using purchase accounting, which are recorded at fair value (see Note 2). The cost of additions and substantial improvements to property, plant and equipment is capitalized. The cost of maintenance and repairs of property, plant and equipment is charged to operating expenses. Property, plant and equipment are depreciated using straight-line methods over their estimated economic lives. Certain subsidiaries follow composite group depreciation methodology; accordingly, when a portion of their depreciable property, plant and equipment is retired in the ordinary course of business, the gross book value is reclassified to accumulated depreciation; no gain or loss is recognized on the disposition of this plant.

Property, plant and equipment is reviewed for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss shall be recognized only if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.

The fair value of a liability for an asset retirement obligation is recorded in the period in which it is incurred if a reasonable estimate of fair value can be made. In periods subsequent to initial measurement, period-to-period changes in the liability for an asset retirement obligation resulting from the passage of time and revisions to either the timing or the amount of the original estimate of undiscounted cash flows are recognized. The increase in the carrying value of the associated long-lived asset is depreciated over the corresponding estimated economic life.

Software Costs It is our policy to capitalize certain costs incurred in connection with developing or obtaining internal-use software. Capitalized software costs are included in "Property, Plant and Equipment" on our consolidated Balance Sheets and are amortized over three years. Software costs that do not meet capitalization criteria are expensed immediately.

Goodwill and Other Intangible Assets Goodwill represents the excess of consideration paid over the fair value of net assets acquired in business combinations. Goodwill and other indefinite-lived intangible assets are not amortized but are tested at least annually for impairment. We have completed our annual impairment testing for 2005 and determined that no impairment exists. During 2005, the carrying amount of our goodwill increased from our acquisition of ATTC and an acquisition by a subsidiary and decreased from the sale of our paging subsidiary.

Intangible assets that have finite useful lives are amortized over their useful lives, which range from 1.5 to 9 years. Customer relationships are amortized using the "sum of the months digits" method of amortization over the expected period in which those relationships are expected to contribute to our future cash flows, including consideration for demand, competition and other economic factors based in such a way as to allocate it as equitably as possible to periods during which we expect to benefit from those relationships.

Advertising Costs Advertising costs for advertising products and services or promoting our corporate image are expensed as incurred.

Foreign Currency Translation Our foreign investments and foreign subsidiaries generally report their earnings in their local currencies. We translate our share of their foreign assets and liabilities at exchange rates in effect at the balance sheet dates. We translate our share of their revenues and expenses using average rates during the year. The resulting foreign currency translation adjustments are recorded as a separate component of accumulated other comprehensive income in the accompanying Consolidated Balance Sheets. Gains and losses resulting from exchange-rate changes on transactions denominated in a currency other than the local currency are included in earnings as incurred.

We have also entered into foreign currency contracts to minimize our exposure to risk of adverse changes in currency exchange rates. We are subject to foreign exchange risk for foreign currency-denominated transactions, such as debt issued, recognized payables and receivables and forecasted transactions. At December 31, 2005, our foreign currency exposures were principally Euros, British pound sterling, Danish krone and Japanese Yen.

Derivative Financial Instruments We record derivatives on the balance sheet at fair value. We do not invest in derivatives for trading purposes. We use derivatives from time to time as part of our strategy to manage risks associated with our contractual commitments. These derivatives are designated as either a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), or a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). Our derivative financial instruments primarily include interest rate swap agreements and foreign currency exchange contracts. For example, we use interest rate swaps to manage our exposure to changes in interest rates on our debt obligations (see Note 8). We account for our interest rate swaps using mark-to-market accounting and include gains or losses from interest rate swaps when paid or received in interest expense on our Consolidated Statements of Income. Amounts paid or received on interest rate forward contracts are amortized over the period of the related interest payments.

All other derivatives are not formally designated for accounting purposes (undesignated). These derivatives, although undesignated for accounting purposes, are entered into to hedge economic risks.

We record changes in the fair value of fair value hedges, along with the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk. Gains or losses upon termination of our fair value hedges are amortized as interest expense over the term of the interest payments of the related debt issuances.

We record changes in the fair value of cash flow hedges, along with the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk, in "Accumulated other comprehensive income," which is a component of Stockholders' Equity. The settlement gains or costs on our cash flow hedges are amortized as interest

expense over the term of the interest payments of the related debt issuances.

Changes in the fair value of undesignated derivatives are recorded in other income (expense), net, along with the change in fair value of the underlying asset or liability, as applicable.

Cash flows associated with derivative instruments are presented in the same category on the Consolidated Statements of Cash Flows as the item being hedged.

When hedge accounting is discontinued, the derivative is adjusted for changes in fair value through other income (expense), net. For fair value hedges, the underlying asset or liability will no longer be adjusted for changes in fair value and any asset or liability recorded in connection with the hedging relationship (including firm commitments) will be removed from the balance sheet and recorded in current period earnings. For cash flow hedges, gains and losses that were accumulated in other comprehensive income as a component of Stockholders' Equity in connection with hedged assets or liabilities or forecasted transactions will be recognized in other income (expense), net, in the same period the hedged item affects earnings.

Employee Separations In accordance with Statement of Financial Accounting Standards No. 112, "Employers' Accounting for Postemployment Benefits," we establish obligations for expected termination benefits provided to former or inactive employees after employment but before retirement. These benefits include severance payments, workers' compensation, disability, medical continuation coverage and other benefits. At December 31, 2005, we had severance accruals for legacy SBC employees of approximately \$410, of which \$283 was established as merger-related severance accruals. In accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" (FAS 141), severance accruals recorded for ATTC employees were included in the purchase price allocation (see Note 2). At December 31, 2004, we had severance accruals of approximately \$147.

Pension and Postretirement Benefits See Note 10 for a comprehensive discussion of our pension and postretirement benefit expense, including a discussion of the actuarial assumptions.

NOTE 2. ACQUISITIONS AND DISPOSITIONS

Acquisitions

AT&T Corp. In November 2005, we acquired ATTC in a transaction accounted for under FAS 141. ATTC was one of the nation's largest business service communications providers, offering a variety of global communications services, including large domestic and multinational businesses, small and medium-sized businesses and government agencies. ATTC operated one of the largest telecommunications networks in the U.S. with enterprise networking services available in 127 countries at December 31, 2005. ATTC was also a provider of domestic and international long-distance and usage-based-communications services to consumer customers.

Under the merger agreement, each share of ATTC common stock was exchanged for 0.77942 of a share of our common stock. We issued approximately 632 million shares to ATTC shareholders, giving them an approximate 16 percent stake in the combined company, based on common shares outstanding. In addition, immediately prior to the closing of the transaction, ATTC paid each ATTC shareholder a special dividend of \$1.30 per share. Based on the \$24.17 per share closing price of our common stock on the New York Stock Exchange (NYSE) on November 17, 2005, the last trading day before the closing of the merger, combined with the special dividend, consideration received by ATTC shareholders was approximately \$16,300.

Based on the average closing price of our common stock on the NYSE for the two days prior to, including, and two days subsequent to the public announcement of the merger (January 31, 2005) of \$23.87 and capitalized merger-transaction costs, the transaction was valued, for accounting purposes, at approximately \$15,517. ATTC is now a wholly owned subsidiary of AT&T and the results of ATTC's operations have been included in our consolidated financial statements after the November 18, 2005 acquisition date.

We paid a premium (i.e., goodwill) over the fair value of the net tangible and identified intangible assets acquired for a number of reasons, including the following:

Strategic Fit

- Our company will benefit from ATTC's assets and capabilities, including: a state-of-the-art nationwide and global communications network; advanced technological capabilities in data and internet protocol (IP)-based services; sales and service expertise for complex communications services; and significant product and service development capabilities in AT&T Labs, a leading communications research organization.
- The merger will combine our broad consumer and small- and medium-business customer base with ATTC's enterprise and government customer bases.
- The combined company will have a strong, diversified set of products and service offerings.

Cost Savings and Revenue Synergies

- Combined network operations and IT expenses will decrease, as facilities and operations will be consolidated.
- Sales and support functions of the business services organizations will be combined.
- Duplicate corporate functions will be eliminated.

Technological Strength

- In acquiring ATTC's assets, which include an advanced product portfolio as well as a leading communications research organization (AT&T Labs), we will now have additional resources and skills to innovate and more quickly deliver to customers the next generation of advanced, integrated IP-based wireline and wireless communications services.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

The application of purchase accounting under FAS 141 requires that the total purchase price be allocated to the fair value of assets acquired and liabilities assumed based on their fair values at the acquisition date, with amounts exceeding the fair values being recorded as goodwill. The allocation process requires an analysis of acquired fixed assets, contracts, customer lists and relationships, contractual commitments, legal contingencies and brand value to identify and record the fair value of all assets acquired and liabilities assumed. In valuing acquired assets and assumed liabilities, fair values were based on, but not limited to: future expected discounted cash flows for trade names and customer relationships; current replacement cost for similar capacity and obsolescence for certain fixed assets; comparable market rates for contractual obligations and certain investments, real estate and liabilities, including pension and postretirement benefits; expected settlement amounts for litigation and contingencies, including the AT&T Wireless litigation, and; appropriate discount rates and growth rates.

Under the purchase method of accounting, the assets and liabilities of ATTC were recorded at their respective fair values as of the date of the acquisition, November 18, 2005, and we recorded goodwill of \$12,343. We have obtained preliminary third-party valuations of property, plant and equipment, intangible assets (including the AT&T trade name), debt and certain other assets and liabilities. Because of the proximity of this transaction to year end, the values of certain assets and liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Such additional information includes, but is not limited to: valuations and physical counts of property, plant and equipment, valuation of investments and the involuntary termination of employees. We will have 12 months from the closing of the acquisition to finalize our valuations. Changes to the valuation of property, plant and equipment may result in adjustments to the fair value of certain identifiable intangible assets acquired. When finalized, material adjustments to goodwill may result.

We have not identified any material unrecorded pre-acquisition contingencies where the related asset, liability or impairment is probable and the amount can be reasonably estimated. Prior to the end of the one-year purchase price allocation period, if information becomes available which would indicate it is probable that such events had occurred and the amounts can be reasonably estimated, such items will be included in the final purchase price allocation and may adjust goodwill.

The following table summarizes the preliminary estimated fair values of the ATTC assets acquired and liabilities assumed and related deferred income taxes as of acquisition date.

	ATTC
Assets acquired	
Current assets	\$ 6,295
Property, plant and equipment	10,921
Intangible assets not subject to amortization	
Trade name	4,900
Licenses	40
Intangible assets subject to amortization	
Customer lists and relationships	3,050
Patents	150
Brand licensing agreements	70
Investments in unconsolidated subsidiaries	160
Other assets	4,247
Goodwill	12,343
Total assets acquired	42,176
Liabilities assumed	
Current liabilities, excluding	
current portion of long-term debt	6,740
Long-term debt	8,293
Deferred income taxes	531
Postemployment benefit obligation	8,807
Other noncurrent liabilities	2,288
Total liabilities assumed	26,659
Net assets acquired	\$15,517

Goodwill of \$12,343, resulting from the acquisition of ATTC was assigned to the AT&T Corp. segment. However, as part of the final valuation of the acquisition we will determine to which entities and to what extent the benefit of the acquisition applies, and as required by GAAP record the appropriate goodwill to each entity. Goodwill includes a portion of value for assembled workforce which is not separately classified from goodwill in accordance with FAS 141. The purchased intangibles and goodwill are not deductible for tax purposes. However, purchase accounting allows for the establishment of deferred tax liabilities on purchased intangibles (other than goodwill) that will be reflected as a tax benefit on our future Consolidated Statements of Income in proportion to and over the amortization period of the related intangible asset.

Substantially all of the licenses acquired and the trade name of AT&T have an indefinite life, and accordingly, are not subject to amortization. The customer relationships intangible assets are being amortized over a weighted period of 1.5 to 9 years for business customers and 1.5 to 2.5 years for consumer customers, using the sum of the months digits method of amortization. This method best reflects the estimated pattern in which the economic benefits will be consumed. Patent intangible assets include protective and commercialized patents, which are amortized using the straight-line method over 2 to 18 years based on the remaining lives of the patents and have a weighted-average amortization period of 10 years.

ATTC maintained change-in-control provisions with its employees that allowed for enhanced severance and benefit payments. Included in the assets acquired and liabilities assumed above are severance accruals of approximately \$1,543, of which \$636 will be paid from ATTC's pension plans and \$37 from ATTC's postemployment benefit plans. These severance payments are expected to be paid over the next two years.

The following unaudited pro forma consolidated results of operations assume that the acquisition of ATTC was completed as of January 1 for each of the fiscal years shown below.

Year Ended December 31,	2005	2004 ¹
Revenues	\$66,061	\$69,367
Net Income (Loss)	6,167	(74)
Earnings Per Common Share	\$ 1.59	\$ (0.02)
Earnings Per Common Share – Assuming Dilution	\$ 1.59	\$ (0.02)

¹ATTC's 2004 results include an impairment charge on property, plant and equipment of \$11,400. Since the triggering event for assessing impairment of long-lived assets occurred in July 2004, it is not adjusted in the pro forma consolidated results.

Pro forma data may not be indicative of the results that would have been obtained had these events actually occurred at the beginning of the periods presented, nor does it intend to be a projection of future results.

Yantra Corporation In January 2005, our subsidiary Sterling Commerce, Inc. (Sterling), acquired Yantra Corporation (Yantra) for approximately \$169 in cash. We recorded goodwill in our wireline segment of approximately \$98 associated with this acquisition. Yantra is a provider of distributed order management and supply chain fulfillment services.

Dispositions

Net proceeds from the 2004 dispositions of our international investments were generally used to fund, in part, our share of the purchase price paid by Cingular to acquire AT&T Wireless. See Note 16 for additional information on the Cingular – AT&T Wireless transaction.

Directory advertising In September 2004, we sold our interest in the directory advertising business in Illinois and northwest Indiana to R.H. Donnelley Corporation (Donnelley) for net proceeds of approximately \$1,397. The sale included our interest in the DonTech II Partnership, a partnership between us and Donnelley that was the exclusive sales agent for Yellow Pages advertising in those two areas. This transaction closed in the third quarter of 2004 and we recorded a gain of approximately \$1,357 (\$827 net of tax) in our third-quarter 2004 financial results. During the third quarter of 2004, we changed our reporting for this portion of the directory business to discontinued operations (see Note 17).

TDC A/S During 2004, we sold our investment in Danish telecommunications provider TDC for approximately \$2,864 in cash. We reported a net loss of approximately \$138 (\$66 net of tax). The details of this disposition follow.

In June 2004, we sold approximately 69.4 million shares of TDC for approximately \$2,125 in cash. Approximately 51.3 million shares were sold to certain institutional investors located in Europe, the United States and elsewhere. TDC also repurchased 18.1 million shares. After this transaction, we owned approximately 20.6 million shares of TDC. We reported a loss of approximately \$191 (\$101 net of tax) in our second-quarter 2004 financial results due to this transaction.

As a result of this June transaction, directors designated by us resigned all of their board seats and we removed all of our employees from day-to-day operations at TDC. Accordingly, as we no longer exerted significant influence on TDC's operations, we were required to change from the equity method of accounting to the cost method of accounting for our remaining interest in TDC during June 2004. Therefore, we ceased recording proportionate results from TDC as equity income in our financial results from the date of this transaction.

We had previously agreed to not sell our remaining approximate 20.6 million shares of TDC until December 6, 2004, subject to various exceptions, including for sales made with the prior written consent of the investment banks that conducted the sale of a portion of our shares in TDC in June of 2004. However, we received approval by those banks on November 3, 2004, and sold our remaining approximate 20.6 million shares of TDC for approximately \$739 in cash. We reported a gain of approximately \$53 (\$35 net of tax) in our fourth-quarter 2004 financial results due to this transaction.

Telkom S.A. Limited During 2004, we also sold our investment in South African telecommunications provider Telkom S.A. Limited (Telkom) for approximately \$1,186 in cash. We reported a loss of approximately \$82 (\$55 net of tax). The details of this disposition follow.

In June 2004, we sold approximately 50% of our stake in Telkom for approximately \$543 in cash to South African and international institutional investors. We reported a loss of approximately \$68 (\$45 net of tax) in our second-quarter 2004 financial results due to this transaction. Because we retained significant representation on Telkom's Board of Directors and participation and influence on operations, we continued to use the equity method of accounting for our then-remaining interest in Telkom.

We had previously agreed to not sell any of our remaining interest prior to the date of the release of Telkom's interim financial results (which was scheduled for November 15, 2004), subject to various exceptions, including for sales made with the prior written consent of the investment banks that conducted the sale of a portion of our shares in Telkom in June of 2004. We received the written consent of those investment banks and in November 2004, we sold our remaining interest in Telkom for approximately \$643 in cash. We reported a loss of approximately \$14 (\$10 net of tax) in our fourth-quarter 2004 financial results due to this transaction.

Belgacom S.A. In March 2004, in connection with Belgacom S.A.'s (Belgacom) initial public offering (IPO), we

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

disposed of our entire investment in Belgacom. Both our investment and TDC's investment in Belgacom were held through Belgacom's minority stockholder, ADSB Telecommunications B.V. (ADSB). In a series of transactions culminating with the IPO, we reported a combined direct and indirect net gain of approximately \$1,067 (\$715 net of tax) in our 2004 financial results. Approximately \$235 of this pretax gain was reported as equity income, reflecting our indirect ownership through TDC (which also disposed of its interest). We received approximately \$2,063 in cash from the disposition of our direct interest.

NOTE 3. EARNINGS PER SHARE

A reconciliation of the numerators and denominators of basic earnings per share and diluted earnings per share for income from continuing operations for the years ended December 31, 2005, 2004 and 2003 are shown in the table below.

Year Ended December 31,	2005	2004	2003
Numerators			
Numerator for basic earnings per share:			
Income from continuing operations	\$4,786	\$4,979	\$5,859
Dilutive potential common shares:			
Other stock-based compensation	10	9	9
Numerator for diluted earnings per share	\$4,796	\$4,988	\$5,868
Denominators			
Denominator for basic earnings per share:			
Weighted-average number of common shares outstanding (000,000)	3,368	3,310	3,318
Dilutive potential common shares (000,000):			
Stock options	1	2	1
Other stock-based compensation	10	10	10
Denominator for diluted earnings per share	3,379	3,322	3,329
Basic earnings per share			
Income from continuing operations	\$ 1.42	\$ 1.50	\$ 1.77
Income from discontinued operations	—	0.28	0.03
Extraordinary item	—	—	—
Cumulative effect of accounting changes	—	—	0.76
Net income	\$ 1.42	\$ 1.78	\$ 2.56
Diluted earnings per share			
Income from continuing operations	\$ 1.42	\$ 1.50	\$ 1.76
Income from discontinued operations	—	0.27	0.04
Extraordinary item	—	—	—
Cumulative effect of accounting changes	—	—	0.76
Net income	\$ 1.42	\$ 1.77	\$ 2.56

At December 31, 2005, 2004 and 2003, we had issued and outstanding options to purchase approximately 277 million, 214 million and 231 million shares of AT&T common stock. The exercise prices of options to purchase a weighted average of 257 million, 191 million and 212 million shares in 2005, 2004 and 2003 exceeded the average market price of AT&T stock. Accordingly, we did not include these amounts in determining the dilutive potential common shares for the respective periods. At December 31, 2005, the exercise price of 20 million stock options was below market price. Of these options, 5 million will expire by the end of 2007.

NOTE 4. SEGMENT INFORMATION

Our segments are strategic business units that offer different products and services and are managed accordingly. Due to the proximity of our acquisition of ATTC to year end, we have reported those results in the AT&T Corp. segment even though there may be some overlap in the products and services provided by that segment and our wireline segment. Under GAAP segment reporting rules, we analyze our various operating segments based on segment income. Interest expense, interest income, other income (expense) – net and income tax expense are managed only on a total company basis and are, accordingly, reflected only in consolidated results. Therefore, these items are not included in the calculation of each segment's percentage of our consolidated results. We have six reportable segments that reflect the current management of our business: (1) wireline, (2) AT&T Corp., (3) Cingular, (4) directory, (5) international, and (6) other.

The wireline segment provides both retail and wholesale landline telecommunications services, including local and long-distance voice, switched access, data and messaging services and satellite television services through our agreement with EchoStar Communications Corp. (EchoStar).

The AT&T Corp. segment reflects the results of ATTC for the 43 days following the November 18, 2005 acquisition. ATTC operates as both a retail and wholesale seller of communications services, primarily providing long-distance and local voice, data and managed networking to business customers. ATTC also provides local and long-distance voice and data services to consumers.

The Cingular segment reflects 100% of the results reported by Cingular, our wireless joint venture. Although we analyze Cingular's revenues and expenses under the Cingular segment, we eliminate the Cingular segment in our consolidated financial statements. In our consolidated financial statements, we report our 60% proportionate share of Cingular's results as equity in net income of affiliates. For segment reporting, we report this equity in net income of affiliates in our other segment.

The directory segment includes our directory operations, including Yellow and White Pages advertising and electronic publishing. Results for this segment are shown under the amortization method, which means that revenues and direct expenses are recognized ratably over the life of the directory title, typically 12 months. Results reflect the September 2004 sale of our interest in the directory advertising business in Illinois and northwest Indiana to Donnelley (see Note 2).

Our international segment includes all investments with primarily international operations, excluding investments acquired as a result of the ATTC acquisition. The other segment includes results from all corporate and other operations as well as the Cingular equity income, as discussed above.

In the following tables, we show how our segment results are reconciled to our consolidated results reported in accordance with GAAP. The Wireline, AT&T Corp., Cingular, Directory, International and Other columns represent the segment results of each such operating segment. The Wireline column includes revenues from services sold to Cingular of \$815 in 2005, \$602 in 2004 and \$539 in 2003. The AT&T Corp. column includes revenues from services sold to Cingular of \$54 in 2005. Since we account for Cingular using the equity method of accounting,

these revenues are not eliminated upon consolidation and as such, remain in consolidated revenue. The Consolidation and Elimination column includes those line items that we manage on a consolidated basis only: interest expense, interest income and other income (expense) – net. This column also eliminates any intercompany transactions included in each segment's results. Since our 60% share of the results from Cingular is already included in the Other column, the Cingular Elimination column removes the results of Cingular shown in the Cingular segment. In the balance sheet section of the tables below, we included goodwill and other intangibles from the acquisition of ATTC in the "Segment assets" line item in the AT&T Corp. column and included our investment in Cingular in the "Investment in equity method investees" line item in the Other column (\$26,989 in 2005 and \$26,830 in 2004).

Segment results, including a reconciliation to AT&T consolidated results, for 2005, 2004 and 2003 are as follows:

At December 31, 2005 or for the year ended	Wireline	AT&T Corp.	Cingular	Directory	International	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from									
external customers ¹	\$37,219	\$ 2,880	\$34,433	\$3,625	\$ 10	\$ 253	\$ (125)	\$(34,433)	\$43,862
Intersegment revenues	226	7	—	89	—	—	(322)	—	—
Total segment operating revenues	37,445	2,887	34,433	3,714	10	253	(447)	(34,433)	43,862
Operations and support expenses	26,319	2,355	26,034	1,715	28	80	(446)	(26,034)	30,051
Depreciation and amortization expenses	7,121	414	6,575	5	—	103	—	(6,575)	7,643
Total segment operating expenses	33,440	2,769	32,609	1,720	28	183	(446)	(32,609)	37,694
Segment operating income	4,005	118	1,824	1,994	(18)	70	(1)	(1,824)	6,168
Interest expense	—	—	1,260	—	—	—	1,456	(1,260)	1,456
Interest income	—	—	49	—	—	—	383	(49)	383
Equity in net income of affiliates	—	2	5	(5)	395	217	—	(5)	609
Other income (expense) – net	—	—	(87)	—	—	—	14	87	14
Segment income before income taxes	4,005	120	531	1,989	377	287	(1,060)	(531)	5,718
Segment assets	65,363	42,252	79,319	4,041	13,685	120,195	(99,904)	(79,319)	145,632
Investment in equity method investees	—	135	7	64	1,797	27,024	—	(7)	29,020
Expenditures for additions to long-lived assets	5,296	167	7,475	2	—	111	—	(7,475)	5,576

¹The Consolidation and Elimination column includes revenues from external customers of \$(125) due to items classified differently for segment presentation than for consolidated presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

At December 31, 2004 or for the year ended	Wireline	AT&T Corp.	Cingular	Directory	International	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from									
external customers	\$36,857	\$ —	\$19,565	\$3,665	\$ 22	\$ 243	\$ —	\$(19,565)	\$ 40,787
Intersegment revenues	30	—	—	94	—	1	(125)	—	—
Total segment operating revenues	36,887	—	19,565	3,759	22	244	(125)	(19,565)	40,787
Operations and support expenses	25,809	—	14,960	1,644	31	(37)	(125)	(14,960)	27,322
Depreciation and amortization expenses	7,454	—	3,077	9	—	101	—	(3,077)	7,564
Total segment operating expenses	33,263	—	18,037	1,653	31	64	(125)	(18,037)	34,886
Segment operating income	3,624	—	1,528	2,106	(9)	180	—	(1,528)	5,901
Interest expense	—	—	900	—	—	—	1,023	(900)	1,023
Interest income	—	—	12	—	—	—	492	(12)	492
Equity in net income of affiliates	—	—	(415)	—	812	61	—	415	873
Other income (expense) – net	—	—	(82)	—	—	—	922	82	922
Segment income before income taxes	3,624	—	143	2,106	803	241	391	(143)	7,165
Segment assets	66,086	—	82,238	4,574	14,041	107,825	(82,261)	(82,238)	110,265
Investment in equity method investees	—	—	2,676	63	1,494	27,071	—	(2,676)	28,628
Expenditures for additions to long-lived assets	4,999	—	3,449	1	—	99	—	(3,449)	5,099
For the year ended December 31, 2003									
Revenues from									
external customers	\$36,508	\$ —	\$15,577	\$3,701	\$ 30	\$ 259	\$ —	\$(15,577)	\$ 40,498
Intersegment revenues	32	—	—	72	—	4	(108)	—	—
Total segment operating revenues	36,540	—	15,577	3,773	30	263	(108)	(15,577)	40,498
Operations and support expenses	24,735	—	11,234	1,637	47	33	(108)	(11,234)	26,344
Depreciation and amortization expenses	7,763	—	2,089	21	—	86	—	(2,089)	7,870
Total segment operating expenses	32,498	—	13,323	1,658	47	119	(108)	(13,323)	34,214
Segment operating income	4,042	—	2,254	2,115	(17)	144	—	(2,254)	6,284
Interest expense	—	—	856	—	—	—	1,191	(856)	1,191
Interest income	—	—	14	—	—	—	603	(14)	603
Equity in net income of affiliates	—	—	(333)	—	606	647	—	333	1,253
Other income (expense) – net	—	—	(74)	—	—	—	1,767	74	1,767
Segment income before income taxes	4,042	—	1,005	2,115	589	791	1,179	(1,005)	8,716

Geographic Information

Our investments outside of the United States are primarily accounted for under the equity method of accounting. Accordingly, we do not include in our operating revenues and expenses the revenues and expenses of these individual investees. Therefore, less than 1% of our total operating revenues for all years presented are from outside the United States.

Long-lived assets consist primarily of net property, plant and equipment; goodwill, and; the book value of our equity investments, which are shown in the table below:

December 31,	2005	2004
United States	\$ 99,547	\$78,806
Mexico	1,564	1,221
Other foreign countries	691	272
Total	\$101,802	\$80,299

Because of the proximity of the ATTC acquisition to year end, the values of certain ATTC assets are based on preliminary valuations and are subject to adjustment as additional information is obtained. (See Note 2)

We also had long-lived intangible assets which were not presented in the table shown above. At December 31, 2005, substantially all of our intangible assets consisted of \$4,900 from the value of the AT&T trade name and \$3,033 of customer lists. (See Note 14)

NOTE 5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is summarized as follows at December 31:

	Lives (years)	2005	2004
Land	—	\$ 1,169	\$ 643
Buildings	35-45	15,557	11,909
Central office equipment	3-10	57,254	55,703
Cable, wiring and conduit	10-50	55,858	52,860
Other equipment	5-15	12,111	9,749
Software	3	5,539	4,222
Under construction	—	1,750	1,091
		149,238	136,177
Accumulated depreciation and amortization		90,511	86,131
Property, plant and equipment - net		\$ 58,727	\$ 50,046

Our depreciation expense was \$7,372 in 2005, \$7,447 in 2004 and \$7,667 in 2003.

Certain facilities and equipment used in operations are leased under operating or capital leases. Rental expenses under operating leases were \$473 for 2005, \$479 for 2004 and \$420 for 2003. At December 31, 2005, the future minimum rental payments under noncancelable operating leases for the years 2006 through 2010 were \$632, \$514, \$412, \$312 and \$239 with \$517 due thereafter. Capital leases are not significant.

During 2005, we had impairments in our wireline segment of approximately \$349 on assets for which we do not believe we will recover their value due to the acquisition of ATTC. The impairments primarily consisted of \$237 due to the write-down of out-of-region assets to current market value and write-offs of \$45 of collocation assets and \$43 of software. The impairments are reflected as an operating expense in the "Selling, general and administrative" line on our Consolidated Statements of Income.

SpectraSite Agreement

In August 2000, we reached an agreement with SpectraSite, Inc. (SpectraSite) under which we granted SpectraSite the exclusive rights to lease space on a number of our communications towers. These operating leases were scheduled to close over a period ending in 2002 (subsequently extended to 2004). SpectraSite would sublease space on the towers to Cingular and also agreed to build or buy new towers for Cingular over the next five years. Cingular's sublease payments to SpectraSite reduce Cingular's net income and partially offset the rental income we receive from SpectraSite.

Under the terms of the original agreement, we received a combination of cash and stock as complete prepayment of rent with the closing of each leasing agreement.

The value of the prepayments were recorded as deferred revenue and recognized in income as revenue over the life of the leases. In November 2001, we received \$35 from SpectraSite in consideration for amending the agreement to reduce the maximum number of towers subject to its terms and to extend the schedule for tower closings until the first quarter of 2004. The balance of deferred revenue was \$598 in 2005, \$628 in 2004 and \$605 in 2003.

In late 2002, SpectraSite and certain of its senior debt holders agreed to restructure its debt. To effect the restructuring, SpectraSite filed a "prearranged" plan of reorganization under Chapter 11 of the United States Bankruptcy Code. We agreed with SpectraSite, subject to completion of its Chapter 11 reorganization, to decrease the number of towers to be leased to SpectraSite and to extend the schedule for tower closing until the third quarter of 2004. In addition, we exchanged all of our shares in SpectraSite for warrants to purchase shares representing less than 1% of the restructured company with no significant financial impact on us; we disposed of this interest in 2005. SpectraSite emerged from bankruptcy in 2003.

NOTE 6. EQUITY METHOD INVESTMENTS

We account for our nationwide wireless joint venture, Cingular, and our investments in equity affiliates under the equity method of accounting.

Cingular The following table is a reconciliation of our investments in and advances to Cingular as presented on our Consolidated Balance Sheets:

	2005	2004
Beginning of year	\$33,687	\$11,003
Contributions	—	21,688
Equity in net income	200	30
Other adjustments	(2,483)	966
End of year	\$31,404	\$33,687

Undistributed earnings from Cingular were \$2,711 and \$2,511 at December 31, 2005 and 2004. "Other adjustments" in 2005 included the net activity of \$2,442 under our revolving credit agreement with Cingular, consisting of a reduction of \$1,747 (reflecting Cingular's repayment of their shareholder loan during 2005) and a decrease of \$695 (reflecting Cingular's net repayment of their revolving credit balance during 2005) (see Note 15).

During 2004, we made an equity contribution to Cingular in connection with its acquisition of AT&T Wireless (see Note 16). "Other adjustments" in 2004 included the net activity of \$972 under our revolving credit agreement with Cingular, consisting of a reduction of \$30 (reflecting Cingular's repayment of advances during 2004) and an increase of \$1,002 (reflecting the December 31, 2004 balance of advances to Cingular under this revolving credit agreement).

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e., 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

The following table presents summarized financial information for Cingular at December 31, or for the year then ended:

	2005	2004	2003
Income Statements			
Operating revenues	\$34,433	\$19,565	\$15,577
Operating income	1,824	1,528	2,254
Net income	333	201	977
Balance Sheets			
Current assets	\$ 6,049	\$ 5,570	
Noncurrent assets	73,270	76,668	
Current liabilities	10,008	7,983	
Noncurrent liabilities	24,333	29,719	

We have made a subordinated loan to Cingular that totaled \$4,108 and \$5,855 at December 31, 2005 and 2004, which matures in June 2008. This loan bears interest at an annual rate of 6.0%. During 2005, Cingular repaid \$1,747 to reduce the balance of this loan in accordance with the terms of a revolving credit agreement. We earned interest income on this loan of \$311 during 2005, \$354 in 2004 and \$397 in 2003. This interest income does not have a material impact on our net income as it is mostly offset when we record our share of equity income in Cingular. (See Note 15)

Other Equity Method Investments Our investments in equity affiliates include primarily international investments. As of December 31, 2005, our investments in equity affiliates included an 8.2% interest in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company, and a 7.9% interest in América Móvil S.A. de C.V. (América Móvil), primarily a wireless provider in Mexico, with telecommunications investments in the United States and Latin America. We are a member of a consortium that holds all of the class AA shares of Telmex stock, representing voting control of the company. Another member of the consortium, Carso Global Telecom, S.A. de C.V., has the right to appoint a majority of the directors of Telmex. We also are a member of a consortium that holds all of the class AA shares of América Móvil stock, representing voting control of the company. Another member of the consortium, Americas Telecom S.A. de C. V., has the right to appoint a majority of the directors of América Móvil.

The following table is a reconciliation of our investments in equity affiliates as presented on our Consolidated Balance Sheets:

	2005	2004
Beginning of year	\$1,798	\$6,924
Additional investments	6	100
Equity in net income	409	843
Dividends received	(158)	(331)
Currency translation adjustments	66	(53)
Dispositions	(228)	(4,995)
Other adjustments	138	(690)
End of year	\$2,031	\$1,798

Undistributed earnings from equity affiliates were \$1,615 and \$1,377 at December 31, 2005 and 2004. The currency translation adjustment for 2005 primarily reflects the effect of exchange rate fluctuations on our investments in Telmex and América Móvil. Dispositions for 2005 primarily reflect

the dissolution of a wireless partnership. "Other adjustments" for 2005 include equity investment balances at December 31, 2005, acquired as part of our acquisition of ATTC totaling approximately \$135, which includes our 49% economic interest in Alestra S. de R.L. de C.V., a telecommunications company in Mexico.

The currency translation adjustment for 2004 primarily reflects the effect of exchange rate fluctuations on our investments in TDC, Telmex and Telkom. Dispositions for 2004 reflect the sale of TDC shares of \$2,619, Belgacom shares of \$1,190, Telkom shares of \$1,114 (see Note 2), Telmex L shares of \$63 and América Móvil L shares of \$9. "Other adjustments" for 2004 include an adjustment of \$686 resulting from our change from the equity method to the cost method of accounting for our investment in TDC (see Note 2).

During 2004, we sold our entire investment in Danish telecommunications provider TDC for approximately \$2,864 in cash. We reported a net loss of approximately \$138 (\$66 net of tax). We also sold our entire investment in South African telecommunications provider Telkom during 2004 for approximately \$1,186 in cash. We reported a net loss of approximately \$82 (\$55 net of tax). See Note 2 for details of these transactions.

Following our initial disposition of part of TDC, the remaining portion was reclassified to a cost investment, reflected in "Other adjustments" in the table above. As noted, that remaining investment was also sold during 2004.

In March 2004, in connection with Belgacom's IPO, we disposed of our entire investment in Belgacom. We received approximately \$2,063 in cash from the disposition of our direct interest and reported a combined direct and indirect net gain of approximately \$1,067 (\$715 net of tax). See Note 2 for details of this transaction.

In November 2004, a subsidiary in our directory segment entered into a joint venture agreement with BellSouth Corporation (BellSouth) and purchased the internet directory publisher YELLOWPAGES.COM (YPC) for approximately \$98, our portion of which was \$65.

The following table presents summarized financial information of our significant international investments accounted for using the equity method, taking into account all adjustments necessary to conform to GAAP but excluding our purchase adjustments, including goodwill, at December 31 or for the year then ended. As noted above, during 2004 we completely disposed of our investments in TDC, Belgacom and Telkom. Accordingly, those investments are not included in the 2005 or 2004 column in the table below.

	2005	2004	2003
Income Statements			
Operating revenues	\$30,521	\$22,800	\$34,747
Operating income	7,773	6,487	9,067
Net income	4,254	4,131	4,689
Balance Sheets			
Current assets	\$ 6,990	\$ 5,101	
Noncurrent assets	27,801	21,280	
Current liabilities	9,404	5,493	
Noncurrent liabilities	13,588	12,280	

At December 31, 2005, we had goodwill of approximately \$316 related to our significant international investments in equity affiliates.

The fair value of our investment in Telmex, based on the equivalent value of Telmex L shares at December 31, 2005, was approximately \$2,221. The fair value of our investment in América Móvil, based on the equivalent value of América Móvil L shares at December 31, 2005, was approximately \$4,198. Our weighted-average share of operating revenues shown above was approximately 8% in 2005 and 2004 and 17% in 2003.

NOTE 7. DEBT

Long-term debt of AT&T and its subsidiaries, including interest rates and maturities, is summarized as follows at December 31:

	2005	2004	
Notes and debentures ¹			
Interest Rates			
Maturities			
0.00% – 5.98%	2005 – 2054 ²	\$12,292	\$11,105
6.00% – 7.85%	2005 – 2043 ³	12,678	11,429
8.25% – 11.08%	2005 – 2031	4,418	141
	29,388	22,675	
Unamortized net premium (discount)	639	(142)	
Total notes and debentures	30,027	22,533	
Capitalized leases	115	35	
Total long-term debt, including current maturities	30,142	22,568	
Current maturities of long-term debt	(4,027)	(1,337)	
Total long-term debt	\$26,115	\$21,231	

¹The fair value of our variable rate interest rate swaps was reported with its corresponding debt (see Note 8).

²Includes \$1,000 of 4.18% Puttable Reset Securities (PURS) maturing in 2021 with a put option by holder in 2006. If the option by holder to elect repayment is exercised in 2006, we intend to refinance that amount with long-term debt.

³Includes \$125 of 6.35% debentures maturing in 2026 with a put option by holder in 2006. If the option by holder to elect repayment is exercised in 2006, we intend to refinance that amount with long-term debt.

On November 18, 2005, we assumed \$8,293 in long-term debt, including capital leases, related to our acquisition of ATTC. ATTC's debt included both fixed and floating-rate coupons with a weighted average rate of approximately 8.6% (ranging from 3.87% to 9.75%) and had maturities ranging from 2006 to 2054. Included in our "Total notes and debentures" balance in the table above was the face value of acquired debt from ATTC of \$6,910, which had a carrying amount of \$7,694 at December 31, 2005.

Included in the table above at December 31, 2005, was approximately \$784 representing the remaining excess of the fair value over the recorded value of debt in connection with the acquisition of ATTC, of which \$747 was included in our "Unamortized net premium (discount)" and \$37 was included in our "Current maturities of long-term debt." The excess is amortized over the remaining lives of the underlying debt obligations.

At December 31, 2005, the aggregate principal amounts of long-term debt and weighted-average interest rate scheduled for repayment for the years 2005 through 2009, excluding the effect of interest rate swaps and the remaining excess of the fair value over the recorded value of debt

of approximately \$37 mentioned above, were \$3,990 (6.2%), \$1,129 (6.6%), \$1,208 (5.6%), \$4,094 (5.0%) and \$1,148 (5.1%) with \$17,913 (6.8%) due thereafter. As of December 31, 2005, we were in compliance with all covenants and conditions of instruments governing our debt. Substantially all of our outstanding long-term debt is unsecured.

Financing Activities

Debt During 2005, we used a portion of our available excess cash from operations to repay our current and long-term debt. Debt repayments totaled \$6,801 and consisted of:

- \$4,077 related to commercial paper borrowings.
- \$1,077 related to debt maturities with interest rates ranging from 6.25% to 9.50%.
- \$1,347 related to our early redemption of debt, which included \$26 of call premiums.
- \$238 related to the exercise of a put option on our 5.95% notes originally maturing in 2038.
- \$42 related to net repayments on other short-term borrowings.
- \$20 related to scheduled principal payments on other debt.

In November 2005, we received net proceeds of \$1,973 from the issuance of \$2,000 of long-term debt consisting of \$500 of three-year floating rate notes, with an initial rate of 4.52%; \$1,000 of 5.30% five-year notes; and \$500 from the reopening of our 6.15% 30-year bonds maturing in 2034.

Debt maturing within one year consists of the following at December 31:

	2005	2004
Current maturities of long-term debt	\$4,027	\$1,337
Commercial paper	320	4,397
Bank borrowings ¹	108	—
Total	\$4,455	\$5,734

¹Primarily represents borrowings, the availability of which is contingent on the level of cash held by some of our foreign subsidiaries.

The weighted-average interest rate on commercial paper debt at December 31, 2005 and 2004 was 4.31% and 2.26%.

Credit Facility We have a three-year credit agreement totaling \$6,000 with a syndicate of banks, which expires on October 18, 2007. Advances under this agreement may be used for general corporate purposes, including support of commercial paper borrowings and other short-term borrowings. There is no material adverse change provision governing the drawdown of advances under this credit agreement. We are in compliance with all covenants under the agreement. We had no borrowings outstanding under committed lines of credit as of December 31, 2005 or 2004.

We are subject to a debt-to-EBITDA (a metric defined in the agreement and nominally representing earnings before interest, taxes, depreciation and amortization; although other adjustments are also included) covenant, and if advances are received, we are subject to a negative pledge covenant, both as defined in the agreement. Defaults under the agreement, which would permit the lenders to accelerate required payment, include nonpayment of principal or interest beyond any applicable grace period; failure

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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by AT&T or any subsidiary to pay when due other debt above a threshold amount that results in acceleration of that debt (commonly referred to as "cross-acceleration") or commencement by a creditor of enforcement proceedings within a specified period after a money judgment above a threshold amount has become final; acquisition by any person of beneficial ownership of more than 50% of AT&T common shares or a change of more than a majority of AT&T's directors in any 24-month period other than as elected by the remaining directors (commonly referred to as a "change of control"); material breaches of representations in the agreement; failure to comply with the negative pledge or debt-to-EBITDA ratio covenants described above; failure to comply with other covenants for a specified period after notice; failure by AT&T or certain affiliates to make certain minimum funding payments under the Employee Retirement Income Security Act of 1974, as amended (ERISA); and specified events of bankruptcy or insolvency.

NOTE 8. FINANCIAL INSTRUMENTS

The carrying amounts and estimated fair values of our long-term debt, including current maturities, and other financial instruments, are summarized as follows at December 31:

	2005		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Notes and debentures	\$30,027	\$30,735	\$22,533	\$23,628
Commercial paper	320	320	4,397	4,397
Bank borrowings	108	108	—	—
Cingular shareholder loan	4,108	4,108	5,855	5,855
Available-for-sale equity securities	648	648	732	732
EchoStar note receivable	465	447	453	453
Preferred stock of subsidiaries	43	43	393	393

The fair values of our notes and debentures were estimated based on quoted market prices, where available, or on the net present value method of expected future cash flows using current interest rates. The carrying value of debt with an original maturity of less than one year approximates market value. The carrying amount of commercial paper borrowings approximates fair value.

Our shareholder loan to Cingular is recorded at face value, and the carrying amounts approximate fair values. The fair value of our EchoStar note receivable was estimated based on a third-party valuation. The carrying amount of this note was based on the present value of cash and interest payments, which will be accreted on the note up to the face value of \$500 on a straight-line basis through August 2008.

Our available-for-sale equity securities are carried at fair value, and realized gains and losses on these equity securities were included in "Other income (expense) – net" on the Consolidated Statements of Income. The fair value of our available-for-sale equity securities was principally determined based on quoted market prices and the carrying amount of the remaining securities approximates fair value. Gross realized gains on our available-for-sale equity securities were \$110 in 2005, \$323 in 2004 and

\$1,775 in 2003. Gross realized losses on these securities were \$1 in 2005, \$191 in 2004 and \$0 in 2003. These gains and losses were determined using the specific identification method. Our proceeds from the sales of our available-for-sale equity securities were \$125 in 2005, \$3,188 in 2004 and \$2,975 in 2003.

Our short-term investments, other short-term and long-term held-to-maturity investments and customer deposits are recorded at amortized cost, and the carrying amounts approximate fair values. In addition, we held other short-term held-to-maturity securities of \$3 at December 31, 2005 compared to \$99 at December 31, 2004.

Preferred Stock Issuances In November 2005, we issued 768,391.4 shares of Perpetual Cumulative Preferred Stock (AT&T preferred stock), par value \$1 per share. The AT&T preferred stock was issued to replace each share of ATTC preferred stock that was issued and outstanding prior to the November 18, 2005 acquisition and is held by a subsidiary of ATTC. (See Note 2)

Preferred Stock Issuances by Subsidiaries In the fourth quarter of 2002, we restructured our holdings in certain investments, including Sterling. As part of this restructuring, a newly created subsidiary issued approximately \$43 of preferred stock, which was included in "Other noncurrent liabilities" on the Consolidated Balance Sheets. The preferred stock will accumulate dividends at an annual rate of 5.79% and can be converted, at the option of the holder, to common stock (but not a controlling interest) of the subsidiary at any time.

In June 1997 and December 1999, an AT&T subsidiary issued \$250 and \$100 of preferred stock in private placements. In December 2005, we redeemed these subsidiary-issued preferred stock private placements.

In November 2005, we repaid approximately \$378 of preferred securities previously issued by an AT&T subsidiary, which was related to an internal restructuring of our ownership in several investments.

Letters of Credit Letters of credit are guarantees we purchase, which ensure our performance or payment to third parties in accordance with specified terms and conditions. Management has determined that our letters of credit do not create additional risk to us. The notional amounts outstanding at December 31, 2005, were approximately \$623 and the fair values of the letters of credit, based on the fees paid to obtain the obligations, were approximately \$1.

Derivatives We use interest rate swaps, interest rate forward contracts and foreign currency exchange contracts to manage our market risk changes in interest rates and foreign exchange rates. We do not use financial instruments for trading or speculative purposes. Each swap matches the exact maturity dates of the underlying debt to which they are related, allowing for perfectly effective hedges. Each utilized forward contract matches the interest payments of the underlying debt to which they are related, allowing for perfectly effective hedges.

Interest Rate Swaps We had fair value interest rate swaps with a notional value of \$4,250 at December 31, 2005 and 2004, with a net carrying and fair value liability of approximately \$16 and a carrying and fair value asset of \$79, respectively. The net fair value liability of \$16 at

December 31, 2005, was comprised of a liability of \$33 and an asset of \$17.

Interest Rate Locks In November 2005, we entered into an interest rate forward contract with a notional amount of \$500 to partially hedge interest expense related to refinancing a portion of our debt maturities in 2006. In November 2005, we utilized the notional amount of this interest rate forward contract, and incurred settlement costs of approximately \$2. During 2004, we utilized a notional amount of \$1,500 of interest rate forward contracts, and incurred settlement costs of approximately \$302 (\$196 net of tax benefit). During 2006, we expect to reclassify into earnings between \$6 to \$7, net of tax, of the previously mentioned settlement expenses.

Interest Rate Foreign Currency Swaps We have combined interest rate foreign currency swap agreements for Euro-denominated debt, which hedge our risk to both interest rate and currency movements. At December 31, 2005, the notional amounts related to these contracts were \$636, which were not designated for accounting purposes. The carrying value of these swaps at December 31, 2005 was an asset of \$233. These swaps are valued using current market quotes, which were obtained from dealers.

Foreign Currency Forward Contracts We enter into foreign currency forward contracts to manage our exposure to changes in currency exchange rates related to foreign-currency-denominated transactions. At December 31, 2005, our foreign exchange contracts consisted principally of Euros, British pound sterling, Danish krone and Japanese Yen. At December 31, 2005, the notional amounts under contract were \$623, of which \$18 were designated as net investment hedges. The remaining contracts were not designated for accounting purposes. There was no ineffectiveness recognized in earnings for these contracts during 2005. These foreign exchange contracts had a net carrying and fair value liability of \$8, comprised of a liability of \$13 and an asset of \$5. These contracts were valued using current market quotes, which were obtained from independent sources.

NOTE 9. INCOME TAXES

Significant components of our deferred tax liabilities (assets) are as follows at December 31:

	2005	2004
Depreciation and amortization	\$13,921	\$13,725
Intangibles (nonamortizable)	1,874	—
Equity in foreign affiliates	727	706
Employee benefits	(4,897)	(2,197)
Currency translation adjustments	(272)	(300)
Allowance for uncollectibles	(351)	(320)
Unamortized investment tax credits	(79)	(73)
Other – net	2,146	3,358
Subtotal	13,069	14,899
Deferred tax assets valuation allowance	627	145
Net deferred tax liabilities	\$13,696	\$15,044
Net long-term deferred tax liabilities	\$15,713	\$15,621
Less: net current deferred tax assets	(2,011)	(566)
Less: other assets	(6)	(11)
Net deferred tax liabilities	\$13,696	\$15,044

At December 31, 2005 and 2004, net deferred tax liabilities include a deferred tax asset of \$542 and \$605 relating to compensation expense under FAS 123(R). Full realization of this deferred tax asset requires stock options to be exercised at a price equaling or exceeding the sum of the strike price plus the fair value of the option at the grant date. The provisions of FAS 123(R), however, do not allow a valuation allowance to be recorded unless the company's future taxable income is expected to be insufficient to recover the asset. Accordingly, there can be no assurance that the stock price of AT&T common shares will rise to levels sufficient to realize the entire tax benefit currently reflected in our balance sheet. See Note 12 for additional discussion of FAS 123(R).

The change in the valuation allowance for 2005 is primarily the result of the acquisition of ATTC. Other changes are the result of an evaluation of the uncertainty associated with the realization of certain deferred tax assets unrelated to FAS 123(R). Future adjustments to the valuation allowance attributable to the ATTC opening balance sheet items may be required to be allocated to goodwill and other purchased intangibles. The valuation allowance is maintained in deferred tax assets for certain federal and state loss carryforwards, expiring through 2025, that may not be realized.

The components of income tax expense are as follows:

	2005	2004	2003
Federal:			
Current	\$1,385	\$1,145	\$(528)
Deferred – net	(681)	843	3,046
Amortization of investment tax credits	(21)	(32)	(24)
	683	1,956	2,494
State, local and foreign:			
Current	226	427	(37)
Deferred – net	23	(197)	400
	249	230	363
Total	\$ 932	\$2,186	\$2,857

A reconciliation of income tax expense and the amount computed by applying the statutory federal income tax rate (35%) to income before income taxes, income from discontinued operations, extraordinary items and cumulative effect of accounting changes is as follows:

	2005	2004	2003
Taxes computed at federal statutory rate	\$2,001	\$2,508	\$3,051
Increases (decreases) in income taxes resulting from:			
State and local income taxes – net of federal income tax benefit	176	213	241
Effects of international operations	(70)	(222)	(230)
Medicare reimbursements	(95)	(89)	(8)
Tax settlements	(902)	(65)	(41)
Other – net	(178)	(159)	(156)
Total	\$ 932	\$2,186	\$2,857

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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In December 2005, we reached an agreement with the IRS to settle certain claims, principally related to the utilization of capital losses and tax credits for years 1997-1999. Included in the settlement was relief from previous assessments and agreement on multiple items challenged by the IRS in the course of routine audits. As we had previously paid the assessments in full and filed refund claims with the IRS, the settlement resulted in our recognition of approximately \$902 of reduced income tax expense in 2005 and a corresponding increase in net income.

Effects of international operations include items such as foreign tax credits, sales of foreign investments and the effects of undistributed earnings from international operations. Deferred taxes are not provided on the undistributed earnings of subsidiaries operating outside the United States that have been or are intended to be permanently reinvested.

NOTE 10. PENSION AND POSTRETIREMENT BENEFITS

We acquired ATTC on November 18, 2005. ATTC sponsored noncontributory defined benefit pension plans covering the majority of its U.S. employees. In accordance with Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" (FAS 87) and Statement of Financial Accounting Standards No. 106

"Employers' Accounting for Postretirement Benefits Other Than Pensions" (FAS 106), when an employer is acquired as part of a merger, any excess of projected benefit obligation over the plan assets is recognized as a liability and any excess of plan assets over the projected benefit obligation is recognized as a plan asset. The recognition of a new liability or a new asset by the acquirer, at the date of the merger, results in the elimination of any (a) previously existing unrecognized net gain or loss, (b) unrecognized prior service cost and (c) unrecognized net transition obligation. In addition, the accumulated postretirement benefit obligations are to be measured using actuarial assumptions and terms of the substantive plans, as determined by the purchaser. As such, and consistent with our practice, we did not account for the annual dollar value cap of labor contracts in the value of the accumulated postretirement benefit obligation for the ATTC postretirement benefit plans (i.e., we assumed the cap would be waived for all future contract periods). All other significant weighted-average assumptions used were determined based on our policies that are discussed below in "Assumptions."

The reconciliation of the December 31, 2004 funded status of ATTC's U.S. plans, excluding supplemental retirement plans, and status of those plans subsequent to the merger are as follows:

	Pension Benefits		Postretirement Benefits	
	Pre-merger	Post-merger	Pre-merger	Post-merger
Benefit obligations	\$(16,178)	\$(16,942)	\$(5,813)	\$(9,129)
Fair value of plan assets	18,510	18,917	2,313	2,429
Funded (unfunded) benefit obligation	2,332	1,975	(3,500)	(6,700)
Unrecognized net loss	949	—	1,298	—
Unrecognized prior service cost	356	—	53	—
Net amount recorded	\$ 3,637	\$ 1,975	\$(2,149)	\$(6,700)

In subsequent periods, net periodic pension cost for ATTC will exclude any amortization of either the unrecognized loss or the unrecognized prior service cost existing at the date of the merger. However, the funding of ATTC's plans is not directly affected by the merger. The basis of funding, over time, will reflect the past amendments and losses that underlie those amounts. As they are reflected in the funding process, contributions will, in some periods, exceed the net pension cost, and that will reduce the liability (unfunded accrued pension cost) recognized at the date of acquisition.

Pension Benefits

Substantially all of our U.S. employees are covered by one of our noncontributory pension and death benefit plans. At December 31, 2005, management employees from the legacy SBC operations participated in pension plans that require that all future benefit accruals be based upon the plan's traditional pension formula (i.e., a stated percentage of employees' adjusted career income). Effective January 15, 2005, the management pension plan for those employees was amended to freeze benefit accruals

previously earned under a cash balance formula. Each employee's existing cash balance continues to earn interest at a variable annual rate. After this change, those management employees, at retirement, can elect to receive the portion of their pension benefit derived under the cash balance or defined lump sum as a lump sum or an annuity. The remaining pension benefit, if any, will be paid as an annuity if its value exceeds a stated monthly amount. ATTC management employees participate in a cash balance pension plan. The pension benefit formula for most nonmanagement employees is based on a flat dollar amount per year according to job classification. Most nonmanagement employees can elect to receive their pension benefits in either a lump sum payment or an annuity.

Postretirement Benefits

We provide certain medical, dental and life insurance benefits to certain retired employees under various plans and accrue actuarially determined postretirement benefit costs as active employees earn these benefits.

Obligations and Funded Status

For defined benefit pension plans, the benefit obligation is the "projected benefit obligation," the actuarial present value, as of the measurement date, of all benefits attributed by the pension benefit formula to employee service rendered to that date. The amount of benefit to be paid depends on a number of future events incorporated into the pension benefit formula, including estimates of the average life of employees/survivors and average years

of service rendered. It is measured based on assumptions concerning future interest rates and future employee compensation levels.

For postretirement benefit plans, the benefit obligation is the "accumulated postretirement benefit obligation," the actuarial present value as of a date of all future benefits attributed under the terms of the postretirement benefit plan to employee service rendered to that date.

We use a December 31 measurement date for calculating the values reported for plan assets and benefit obligations for our plans. The following table presents this reconciliation and shows the change in the projected benefit obligation for the years ended December 31:

	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Benefit obligation at beginning of year	\$28,189	\$27,617	\$25,114	\$27,231
Service cost – benefits earned during the period	804	818	390	383
Interest cost on projected benefit obligation	1,725	1,642	1,496	1,495
Amendments	(2)	(87)	(442)	(2,320)
Actuarial loss (gain)	1,182	774	613	(423)
Special termination benefits	15	29	2	3
Curtailments	—	—	(77)	—
Benefits paid	(2,679)	(2,604)	(1,234)	(1,255)
Merger with ATTC	16,942	—	9,129	—
Other	—	—	234	—
Benefit obligation at end of year	\$46,176	\$28,189	\$35,225	\$25,114

The following table presents the change in the value of plan assets for the years ended December 31 and the plans' funded status at December 31:

	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Fair value of plan assets at beginning of year	\$29,813	\$28,154	\$ 8,692	\$ 6,967
Actual return on plan assets	2,704	3,259	677	830
Employer contribution	—	1,001	—	1,232
Benefits paid ¹	(2,679)	(2,601)	(381)	(337)
Merger with ATTC	18,917	—	2,429	—
Fair value of plan assets at end of year	\$48,755	\$29,813	\$ 11,417	\$ 8,692
Funded (unfunded) status (fair value of plan assets less benefit obligation) ²	\$ 2,579	\$ 1,624	\$(23,808)	\$(16,422)
Unrecognized prior service cost (benefit)	768	968	(3,073)	(3,022)
Unrecognized net loss	7,804	6,748	10,423	10,173
Unamortized transition asset	—	(11)	—	—
Net amount recognized	\$11,151	\$ 9,329	\$(16,458)	\$(9,271)

¹Pension benefits paid include benefits transferred between plans during the year. At our discretion, certain postretirement benefits are paid from AT&T cash accounts and do not reduce Voluntary Employee Beneficiary Association (VEBA) assets. Future benefit payments may be made from VEBA trusts and thus reduce those asset balances.

²Funded status is not indicative of our ability to pay ongoing pension benefits nor of our obligation to fund retirement trusts. Required pension funding is determined in accordance with ERISA regulations.

Amounts recognized in our Consolidated Balance Sheets at December 31 are listed below:

	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Prepaid pension cost ¹	\$12,699	\$9,329	\$ —	\$ —
Additional minimum pension liability ²	(1)	(1)	—	—
Intangible asset	—	—	—	—
Deferred tax asset	—	—	—	—
Employee benefit obligation ²	(1,548)	—	(16,458)	(9,271)
Accumulated other comprehensive income	1	1	—	—
Net amount recognized	\$11,151	\$9,329	\$(16,458)	\$(9,271)

¹Included in "Other Assets."

²Included in "Postemployment benefit obligation."

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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Included in "Postemployment benefit obligation" on our Consolidated Balance Sheets at December 31, 2004 was a reduction in the liability associated with the "1983 Unfunded Postretirement Benefits Cost Sharing Agreement" and "1983 Force Adjustment Cost-Reimbursement and Indemnification Agreement" (Agreements). Under the Agreements, the Bell System Companies (RBOCs) (which included the former SBC) agreed to provide postemployment benefits to those employees of ATTC who retired prior to the 1983 reorganization that divided ATTC. As part of the Agreement, ATTC agreed to reimburse RBOCs for post-employment benefits paid to these retirees. Since ATTC agreed to provide reimbursement, the accumulated postemployment benefits recorded on our Consolidated Balance Sheets prior to the November 18, 2005 acquisition of ATTC did not include these expected payments. Upon the merger, we no longer will receive third-party reimbursement for these liabilities and have accordingly increased our benefit obligation by \$234. ATTC maintains the Agreements with the remaining RBOCs and we include estimated amounts subject to reimbursement on our Consolidated Balance Sheets as "Other noncurrent liabilities."

Also included in "Postemployment benefit obligation" on our Consolidated Balance Sheets at December 31, 2004 were phone concessions for out-of-region retirees of the former SBC. The out-of-region phone concession, which is not part of the pension plan and not subject to ERISA, allowed for out-of-region retirees to receive reimbursements for phone services provided by a carrier other than the former SBC. During 2005, we notified out-of-region retirees of changes which allowed us to reduce this obligation by approximately \$96.

In December 2004, we announced a prospective change in the calculation of pension benefits provided to legacy SBC management employees. Effective January 15, 2005, the pension calculation formula for management employees is now based upon a stated percentage of employees' adjusted career income. When we initially implemented the cash balance formula, the change in liability required the establishment of a prior service cost deferral for the plan. With the current change to eliminate future service contributions to the cash balance plan, we determined during our annual review of prior service costs that the cash balance prior service cost was impaired and that the remaining amounts deferred must be immediately recognized. Accordingly, we wrote off approximately \$99 of prior service cost in 2004.

Effective January 1, 2005, medical coverage for legacy SBC nonmanagement retirees was amended to increase co-pays and deductibles for prescription drugs and certain medical services.

In December 2005, we agreed to new contracts with the Communications Workers of America (CWA) and International Brotherhood of Electrical Workers (IBEW) for certain employees covered under labor agreements previously negotiated by ATTC. The new labor agreements are for three years and four months, cover approximately 11,000 employees and replace three-year contracts that expired in December 2005. The union members ratified the labor agreements which provide for employment security and changes to active nonmanagement employees' pension benefits and medical coverage.

During 2004, we agreed to new five-year labor agreements with the CWA and the IBEW for legacy SBC nonmanagement employees. The agreements provided for additional contributions from current employees toward certain medical and prescription drug co-pays. We also agreed in an agreement with the CWA, that prior to expiration of the agreement, we would contribute \$2,000 to a VEBA trust to partially fund current and future retiree health care, \$1,000 of which was contributed during 2004.

Shown below is a summary of our pension obligations and the fair value of pension assets for the years ended December 31:

	2005	2004
Projected benefit obligation	\$46,176	\$28,189
Accumulated benefit obligation	44,139	26,849
Fair value of plan assets	48,755	29,813

The accumulated benefit obligation for our pension plans represents the actuarial present value of benefits based on employee service and compensation as of a certain date and does not include an assumption about future compensation levels. On a plan-by-plan basis, if the accumulated benefit obligation for our pension plan exceeds that plan's assets and at least this amount has not been accrued, an additional minimum liability must be recognized, partially offset by an intangible asset for unrecognized prior service cost, with the remainder a direct charge to equity, net of deferred tax benefits. These items are included in the table above that presents the amounts recognized in our Consolidated Balance Sheets at December 31. At December 31, 2005, for one of our pension plans, the accumulated benefit obligation exceeded plan assets by less than \$1. This resulted in an additional minimum liability of \$1 (net of deferred taxes of \$1). At December 31, 2004, for one of our pension plans, the accumulated benefit obligation of \$2 exceeded plan assets of \$1. This resulted in an additional minimum liability of \$1 (net of deferred taxes of less than \$1). These reclassifications in equity, while adjusting comprehensive income, will not affect our future results of operations or cash flows.

Net Periodic Benefit Cost

Our combined net pension and postretirement cost recognized in our Consolidated Statements of Income was \$1,336, \$1,287 and \$1,835 for the years ended December 31, 2005, 2004 and 2003. The following table presents the components of net pension and postemployment benefit cost (gains are denoted with parentheses and losses are not):

	Pension Benefits			Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Service cost – benefits earned during the period	\$ 804	\$ 818	\$ 732	\$ 390	\$ 383	\$ 378
Interest cost on projected benefit obligation	1,725	1,642	1,666	1,496	1,495	1,602
Expected return on plan assets	(2,736)	(2,684)	(2,456)	(781)	(720)	(525)
Amortization of prior service cost (benefit) and transition asset	186	188	94	(344)	(349)	(122)
Recognized actuarial loss	156	44	53	440	470	413
Net pension and postretirement cost ¹	\$ 135	\$ 8	\$ 89	\$1,201	\$1,279	\$1,746

¹During 2005, 2004 and 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) reduced postretirement benefit cost by \$304, \$255 and \$22. This effect is included in several line items above.

During 2005, 2004 and 2003, as part of our workforce reduction programs, an enhanced retirement program was offered to eligible Pacific Telesis Group (PTG) nonmanagement employees. This program offered eligible employees who voluntarily decided to terminate employment an enhanced pension benefit and increased eligibility for postretirement medical, dental and life insurance benefits. Employees who accepted this offer and terminated employment before December 31 totaled approximately 71 in 2005, 144 in 2004 and 339 in 2003. In addition to the net costs reported in the tables above, enhanced pension benefits related to this program were recognized as an expense of approximately \$11 in 2005, \$22 in 2004 and \$42 in 2003; enhanced benefits related to the PTG nonmanagement early retirement program were recognized as expenses of \$1, \$3 and \$2 in 2005, 2004 and 2003.

The IRS determines monthly interest rates applicable for calculations of lump sum payments from pension plans (plan sponsors may elect whether the interest rate changes apply monthly, quarterly or annually). An increase in the interest rate has a negative impact on the lump sum pension calculation for some of our employees. During certain quarters of 2004 and 2003, we chose to extend the pension plan lump sum benefit payout rate for a specified period of time, allowing our employees to receive a higher payout of their pension benefits. The extension of the lump sum benefit payout rate was accounted for as a special termination benefit and was recorded in addition to the net pension cost reported in the tables above. We recognized expenses of approximately \$7 in 2004 and \$28 in 2003 associated with these special termination benefits.

Assumptions

In determining the projected benefit obligation and the net pension and postemployment benefit cost, we used the following significant weighted-average assumptions:

	2005	2004	2003
Discount rate for determining projected benefit obligation at December 31	5.75%	6.00%	6.25%
Discount rate in effect for determining net cost (benefit) ¹	6.00%	6.25%	6.75%
Long-term rate of return on plan assets	8.50%	8.50%	8.50%
Composite rate of compensation increase for determining projected benefit obligation at December 31	4.00%	4.00%	4.25%
Composite rate of compensation increase for net pension cost (benefit)	4.00%	4.25%	4.25%

¹Discount rate in effect for determining net cost (benefit) of ATTC pension and postretirement plans for the 43-day period ended December 31, 2005 was 5.75%.

Primarily resulting from assumption changes for 2006, we expect combined net pension and postretirement costs of between \$1,700 and \$1,800 in 2006. Approximately 10% of these costs will be capitalized as part of construction labor, providing a small reduction in the net expense recorded. While we will continue our cost-cutting efforts, certain factors, such as investment returns, depend largely on trends in the U.S. securities markets and the general U.S. economy. In particular, uncertainty in the securities markets and U.S.

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economy could result in investment returns less than those assumed and a decline in the value of plan assets used in pension and postretirement calculations, which under GAAP we will recognize over the next several years. Should the securities markets decline and medical and prescription drug costs continue to increase significantly, we would expect increasing annual combined net pension and postretirement costs for the next several years. Additionally, should actual experience differ from actuarial assumptions, combined net pension and postretirement cost would be affected in future years.

Discount Rate Our assumed discount rate of 5.75% at December 31, 2005 reflects the hypothetical rate at which the projected benefit obligations could be effectively settled or paid out to participants on that date. We determined our discount rate based on a range of factors, including the rates of return on high-quality, fixed-income corporate bonds available at the measurement date and the related expected duration for the obligations. For each year, at December 31, 2005 and 2004 we reduced the discount rate by 0.25%, resulting in an increase in our pension plan benefit obligation of approximately \$609 in 2005 and \$575 in 2004 and an increase in our postretirement benefit obligation of approximately \$844 in 2005 and \$803 in 2004. 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.

Expected Long-Term Rate of Return Our expected long-term rate of return on plan assets of 8.50% for 2006 and 2005 reflects the average rate of earnings expected on the funds invested, or to be invested, to provide for the benefits included in the projected benefit obligations. We consider many factors that include, but are not limited to, historic returns on plan assets, current market information on long-term returns (e.g., long-term bond rates) and current and target asset allocations between asset categories. The target asset allocation is determined based on consultations with external investment advisors. This assumption, which is based on our long-term expectations of market returns in future years, is one of the most significant of the weighted-average assumptions used to determine our actuarial estimates of pension and postretirement benefit expense. If all other factors were to remain unchanged, we expect a 1% decrease in the expected long-term rate of return would cause 2006 combined pension and postretirement cost to increase approximately \$579 over 2005 (analogous decrease in cost would result from a 1% increase).

Under GAAP, the expected long-term rate of return is calculated on the market-related value of assets (MRVA). GAAP requires that actual gains and losses on pension and postretirement plan assets be recognized in the MRVA equally over a period of not more than five years. We use a methodology, allowed under GAAP, under which we hold the MRVA to within 20% of the actual fair value of plan assets, which can have the effect of accelerating the recognition of excess actual gains and losses into the MRVA to less than five years. Due to investment losses on

plan assets experienced through 2002, this methodology contributed approximately \$605 to our combined net pension and postretirement cost in 2003 as compared with the methodology that recognizes gains and losses over a full five years. This methodology did not have a significant effect on our 2004 or 2005 combined net pension and postretirement benefit costs and we do not expect a significant incremental impact on our combined net pension and postretirement cost in 2006.

Composite Rate of Compensation Increase Our expected composite rate of compensation increase of 4.0% for 2005 and 2004 reflects the long-term average rate of salary increases. Based on historic salary increase experience and management's expectations of future salary increases, we reduced our expected composite rate of compensation increase assumption from 4.25% at December 31, 2003 to 4.0% at December 31, 2004.

Health Care Cost Trend The following table provides the medical cost trend.

	2006	2005
Health care cost trend rate assumed for following year		
Retirees 64 and under	7.0%	8.0%
Retirees 65 and over	8.0%	9.0%
Rate to which the cost trend is assumed to decline (the ultimate trend rate)	5.0%	5.0%
Year that rate reaches the ultimate trend rate	2009	2009

A one percentage-point change in the assumed combined medical and dental cost trend rate would have the following effects:

	One Percentage-Point Increase	One Percentage-Point Decrease
Increase (decrease) in total of service and interest cost components	\$291	\$(228)
Increase (decrease) in accumulated postretirement benefit obligation	4,200	(3,442)

For the majority of our labor contracts that contain an annual dollar value cap for the purpose of determining contributions required from nonmanagement retirees, we have waived the cap during the relevant contract periods and thus not collected contributions from those retirees. Therefore, in accordance with the substantive plan provisions required in accounting for postretirement benefits under GAAP, we do not account for the cap in the value of our accumulated postretirement benefit obligation (i.e., for GAAP purposes, we assumed the cap would be waived for all future contract periods).

Plan Assets

Plan assets consist primarily of private and public equity, government and corporate bonds and real estate. The asset allocations of the pension plans are maintained to meet ERISA requirements. Any plan contributions, as determined by ERISA regulations, are made to a pension trust for the

benefit of plan participants. We maintain VEBA trusts to partially fund postretirement benefits; however, there are no ERISA or regulatory requirements that these postretirement benefit plans be funded annually.

The principal investment objectives are: to ensure the availability of funds to pay pension and postretirement benefits as they become due under a broad range of future economic scenarios; to maximize long-term investment return with an acceptable level of risk based on our pension and postretirement obligations; and to be broadly diversified across and within the capital markets to insulate asset values against adverse experience in any one market. Each asset class has a broadly diversified style. Substantial biases toward any particular investing style or type of security are sought to be avoided by managing the aggregation of all accounts with portfolio benchmarks. Asset and benefit obligation forecasting studies are conducted periodically, generally every two to three years, or when significant changes have occurred in market

conditions, benefits, participant demographics or funded status. Decisions regarding investment policy are made with an understanding of the effect of asset allocation on funded status, future contributions and projected expenses. The current asset allocation policy is based on a forecasting study conducted in 2004 for our pension plan and 2005 for our postretirement benefit plan.

The table below presents the asset targets by asset category as determined by AT&T and does not reflect updated targets for the November 18, 2005 acquisition of ATTC due to the proximity of that transaction to year end. It is our intention to perform forecasting studies during 2006 that will establish appropriate investment strategies for all AT&T plan assets.

The plans' weighted-average asset target and actual allocations as a percentage of plan assets, including the notional exposure of future contracts by asset categories at December 31 are as follows:

	Pension Assets			Postretirement (VEBA) Assets		
	Target	2005	2004	Target	2005	2004
Equity securities						
Domestic	40% – 50%	41%	47%	40% – 50%	51%	51%
International	12% – 18%	17	17	12% – 18%	16	14
Debt securities	25% – 35%	29	29	20% – 30%	28	32
Real estate	3% – 6%	6	2	0% – 10%	1	—
Other	4% – 7%	7	5	5% – 15%	4	3
Total		100%	100%		100%	100%

At December 31, 2005, the pension assets included 2.3 million shares of AT&T common stock with a fair value of approximately \$57 and AT&T bonds with a notional amount of \$51 and fair value of \$60. As a result of our acquisition of ATTC, pension assets increased by 2.1 million shares of AT&T stock with a fair value of \$51 and AT&T bonds with a notional value of \$41 and fair value of \$49. During 2005, the pension plans purchased and sold AT&T bonds totaling approximately \$13 and \$3, respectively, and sold AT&T common stock of \$1. Pension plan holdings in AT&T securities represented approximately 0.2% of total plan assets at December 31, 2005.

At December 31, 2005, the VEBA assets included 352,700 shares of AT&T common stock with a fair value of approximately \$9 and AT&T bonds with a notional amount and fair value of \$1. As a result of our acquisition of ATTC, the VEBA assets increased by 68,000 shares of AT&T stock with a fair value of \$2. During 2005, the VEBAs did not purchase any bonds and sold approximately \$2. VEBA holdings in AT&T securities represented approximately 0.1% of total plan assets at December 31, 2005.

Estimated Future Benefit Payments

Expected benefit payments are estimated using the same assumptions used in determining our benefit obligation at December 31, 2005. Because benefit payments will depend

on future employment and compensation levels, average years employed and average life spans, among other factors, changes in any of these factors could significantly affect these expected amounts. The following table provides expected benefit payments under our pension and postretirement plans:

	Pension Benefits	Postretirement Benefits	Medicare Subsidy Receipts
2006	\$3,649	\$1,884	\$(90)
2007	3,519	1,945	(102)
2008	3,597	2,028	(112)
2009	3,716	2,105	(121)
2010	3,767	2,172	(130)
Years 2011 – 2015	18,873	11,414	(863)

Supplemental Retirement Plans

We also provide senior- and middle-management employees with nonqualified, unfunded supplemental retirement and savings plans. While these plans are unfunded, we have assets in a designated nonbankruptcy remote trust that are used to provide for these benefits. These plans include supplemental pension benefits as well as compensation deferral plans, some of which include a corresponding match by us based on a percentage of the compensation deferral.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

We use the same significant assumptions for the discount rate and composite rate of compensation increase used in determining the projected benefit obligation and the net pension and postemployment benefit cost. The following tables provide the plans' benefit obligations and fair value of assets, a statement of the funded status at December 31 and the components of the supplemental retirement pension benefit cost.

	2005	2004
(Unfunded) benefit obligations		
at end of year	\$(1,800)	\$(1,181)
Unrecognized net loss	404	371
Unrecognized prior service cost	15	24
Net amount recorded	\$(1,381)	\$(786)

Amounts recognized on our Consolidated Balance Sheets at December 31 are listed below:

	2005	2004
Employee benefit obligation ¹	\$(1,747)	\$(1,116)
Intangible asset	15	24
Accumulated other comprehensive income	351	306
Net amount recognized	\$(1,381)	\$(786)

¹Included in "Other noncurrent liabilities."

At December 31, 2005, the accumulated benefit obligation of certain of the plans exceeded the recorded liability, requiring us to recognize a direct charge to equity of \$217 (net of deferred taxes of \$134). At December 31, 2004, the accumulated benefit obligation of certain of the plans exceeded the recorded liability, requiring us to recognize a direct charge to equity of \$190 (net of deferred taxes of \$116).

	2005	2004
Service cost – benefits earned during the period	\$ 8	\$ 6
Interest cost on projected benefit obligation	73	70
Amortization of prior service cost	9	9
Recognized actuarial loss	23	21
Net supplemental retirement pension cost	\$113	\$106

In addition to the supplemental retirement pension benefit cost, we had other supplemental retirement benefit expenses of \$1, with a projected benefit obligation of \$84 included as "Other noncurrent liabilities." Deferred compensation expense was \$46 in 2005 and \$44 in 2004, with liability balances of \$574 and \$610, respectively, also included in "Other noncurrent liabilities."

Non-U.S. Plans

As part of our ATTC acquisition, we acquired certain non-U.S. operations that have varying types of pension programs providing benefits for substantially all of their employees. As described earlier, in accordance with FAS 106 we eliminated previously existing unrecognized net gains or losses, unrecognized prior service costs and unrecognized net transition obligations. The following table provides the plans' benefit obligations and fair value of assets, and a statement of the funded status at December 31:

	2005
Benefit obligations at end of year	\$(906)
Fair value of plan assets	650
(Unfunded) benefit obligation	(256)
Unrecognized net loss	20
Net amount recorded ¹	\$(236)

¹Included in "Postemployment benefit obligation" on our Consolidated Balance Sheet.

The following table provides information for certain non-U.S. defined benefit pension plans with accumulated benefit obligations in excess of plan assets:

	2005
Projected benefit obligation	\$906
Accumulated benefit obligation	765
Fair value of plan assets	650

The benefit obligations were determined using a weighted-average discount rate of 4.55% and a weighted-average rate of compensation increase of 4.25%. Net periodic pension cost was approximately \$4 for the 43 days ended December 31, 2005 and was determined using the following weighted-average assumptions: discount rate of 4.90%, compensation increase of 4.25% and return on plan assets of 6.15%.

NOTE 11. EMPLOYEE STOCK OWNERSHIP PLANS (ESOP)

We maintain contributory savings plans that cover substantially all employees. Under the savings plans, we match in company stock a stated percentage of eligible employee contributions, subject to a specified ceiling. There are no debt-financed shares held by the ESOPs, allocated or unallocated.

In November 2005, we completed our acquisition of ATTC and intend to maintain its savings plans, which provide for a match of a percentage of the employee contributions up to certain limits.

Our match of employee contributions to the savings plans is fulfilled with purchases of our stock on the open market. Benefit cost is based on the cost of shares allocated to participating employees' accounts and was \$334, \$316 and \$300 for the years ended December 31, 2005, 2004 and 2003.

NOTE 12. STOCK-BASED COMPENSATION

In September 2005, we adopted FAS 123(R), which is a revision of FAS 123. FAS 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and amends Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows."

We adopted FAS 123(R) using the "modified retrospective" method. The modified retrospective method requires that compensation cost be recognized beginning with the effective date (a) based on the requirements of FAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of FAS 123 for all awards granted to employees prior to the effective date of FAS 123(R) that remain unvested on the effective date. The modified retrospective method also allowed for companies to restate based on the amounts previously recognized under FAS 123 for purposes of pro forma disclosures for all prior years for which FAS 123 was effective. Accordingly, we have adjusted our December 31, 2004 Consolidated Balance Sheets to increase "Capital in excess of par value" and decrease "Retained earnings" by \$546.

We had previously adopted the fair-value-based method of accounting for share-based payments allowed under FAS 123 effective January 1, 2002, using the retroactive restatement method of adoption described in Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." This included restatement of results from January 1, 2000 forward, as those were the years for which audited income statements were included in the 2002 SBC Annual Report. Upon adoption of FAS 123(R), because we elected to use the modified retrospective method, we also restated results for 1995 through 1999 for the effects on our equity. We will continue to use the Black-Scholes option pricing model to estimate the fair value of stock options granted to employees.

By using the modified retrospective method to adopt FAS 123(R), we increased the amount of excess tax benefits we had previously recorded on our Consolidated Balance Sheets. Our accounting under FAS 123(R) may affect our ability to fully realize the value shown on our balance sheet of deferred tax assets associated with compensation expense. Full realization of these deferred tax assets requires stock options to be exercised at a price equaling or exceeding the sum of the strike price plus the fair value of the option at the grant date. The provisions of FAS 123(R) do not allow a valuation allowance to be recorded unless the company's future taxable income is expected to be insufficient to recover the asset. Accordingly, there can be no assurance that the current stock price of our common shares will rise to levels sufficient to realize the entire tax benefit currently reflected in our balance sheet. However, to the extent that additional tax benefits are generated in excess of the deferred taxes associated with compensation expense previously recognized, the potential future impact on income would be reduced.

Because of the requirements of FAS 123(R) to estimate forfeitures, our December 31, 2005 income before income taxes and income from continuing operations increased by approximately \$9 and our net income increased by \$6. Adopting FAS 123(R) did not affect any prior period income

before income taxes, income from continuing operations and net income. Our adoption of FAS 123(R) did not affect our basic and diluted earnings per share for any period reported.

When the tax deduction exceeds the compensation cost resulting from the exercise of options, a tax benefit is created. Prior to the adoption of FAS 123(R), we presented all such tax benefits as operating cash flows on our Consolidated Statements of Cash Flows. FAS 123(R) requires the cash flows resulting from such tax benefits to be classified as financing cash flows. Had we not adopted FAS 123(R), we would have classified excess tax benefits of \$3, \$5 and \$1 for the years ended December 31, 2005, 2004 and 2003, respectively, as operating cash inflows.

In connection with the November 2005 acquisition of ATTC, all outstanding ATTC stock-based compensation plans were restructured based on the 0.77942 per share conversion rate and the special dividend, and subsequently issued in AT&T shares of stock or stock units. We converted and recorded approximately 86 million stock options.

At December 31, 2005, we had various stock-based compensation plans, which are described below. The compensation cost recognized for those plans for the years ended December 31 was approximately \$143 in 2005, \$153 in 2004 and \$244 in 2003 and are included in "Selling, general and administrative" on our Consolidated Statements of Income. The total income tax benefit recognized on the Consolidated Statements of Income for stock-based compensation arrangements for the years ended December 31, 2005, 2004 and 2003 was approximately \$54, \$58 and \$93.

Under our various plans, legacy SBC senior and other management and nonmanagement employees and nonemployee directors have received stock options, performance stock units and other nonvested stock units. Stock options issued through December 31, 2005 carry exercise prices equal to the market price of our stock at the date of grant and have maximum terms ranging from five to ten years. Beginning in 1994 and ending in 1999, certain employees of SBC Teleholdings, Inc. (formerly known as Ameritech) were awarded grants of nonqualified stock options with dividend equivalents. Depending upon the grant, vesting of stock options may occur up to five years from the date of grant, with most options vesting on a graded basis over three years (1/3 of the grant vests after one year, another 1/3 vests after two years and the final 1/3 vests after three years from the grant date). Performance stock units, which are nonvested stock units, are granted to key employees based upon the stock price at the date of grant and are awarded in the form of common stock and cash at the end of a two- or three-year period, subject to the achievement of certain performance goals. Other nonvested stock units are valued at the market price of our stock at the date of grant and vest over a three- to five-year period. As of December 31, 2005, we were authorized to issue up to 81 million shares of stock (in addition to shares that may be issued upon exercise of outstanding options or upon vesting of performance stock units or other nonvested stock units) to officers, employees and directors pursuant to these various plans.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

We use an accelerated method of recognizing compensation cost for fixed awards with graded vesting, which essentially treats the grant as three separate awards, with vesting periods of 12, 24 and 36 months for those grants that vest over three years. As noted above, a majority of our options vest over three years, and for those we recognize approximately 61% of the associated compensation expense in the first year, 28% in the second year and the remaining 11% in the third year.

The compensation cost that has been charged against income for our stock-based compensation plans is as follows:

	2005	2004	2003
Stock option expense	\$ 19	\$ 75	\$183
Performance stock units	116	65	27
Mark-to-market effect on dividend equivalents	2	—	4
Other	6	13	30
Total	\$143	\$153	\$244

A summary of option activity as of December 31, 2005, and changes during the period then ended, is presented below (shares in millions):

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value ¹
Outstanding at January 1, 2005	214	\$37.46		
Granted	3	23.96		
Converted from ATTC ²	86	43.90		
Exercised	(8)	21.60		
Forfeited or expired	(18)	38.48		
Outstanding at December 31, 2005	277	\$39.74	4.8	\$73
Exercisable at December 31, 2005	270	\$40.07	4.8	\$71

¹Aggregate intrinsic value includes only those options with intrinsic value (options where the exercise price is below the market price).

²Options converted from ATTC used the following weighted-average assumptions: risk-free interest rate of 4.35%, dividend yield of 5.16%, expected volatility factor of 22.47% and had an expected option life of 2.7 years. The weighted-average fair value of each option converted was \$1.34.

The weighted-average fair value of each option granted during the year ended December 31 was \$3.39 in 2005, \$4.06 in 2004 and \$3.88 in 2003. The total intrinsic value of options exercised during the year was approximately \$24 in 2005, \$33 in 2004 and \$10 in 2003.

A summary of the status of our nonvested stock units, which includes performance stock units as of December 31, 2005, and changes during the period then ended is presented below (shares in millions):

Nonvested Stock Units	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2005	10	\$25.61
Granted	6	23.75
Vested	(1)	24.54
Forfeited	—	—
Nonvested at December 31, 2005	15	\$24.91

As of December 31, 2005, there was approximately \$143 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted. That cost is expected to be recognized over a weighted-average

The estimated fair value of the options when granted is amortized to expense over the options' vesting period. The fair value for these options was estimated at the date of grant based on the expected life of the option and historical exercise experience, using a Black-Scholes option pricing model with the following weighted-average assumptions:

	2005	2004	2003
Risk-free interest rate	4.15%	4.21%	3.64%
Dividend yield	5.38%	5.00%	4.40%
Expected volatility factor	22.47%	23.78%	22.38%
Expected option life in years	8.00	7.00	6.74

period of 1.6 years. The total fair value of shares vested during the years ended December 31, 2005, 2004 and 2003 was approximately \$38, \$24 and \$24.

Cash received from option exercise under all stock-based payment arrangements for year ended December 31 was approximately \$192 in 2005, \$234 in 2004 and \$112 in 2003. The actual tax benefit realized for the tax deductions from option exercise from these arrangements for the years ended December 31, 2005, 2004 and 2003 totaled approximately \$9, \$12 and \$4.

It is our policy to satisfy share option exercises using our treasury shares.

NOTE 13. STOCKHOLDERS' EQUITY

From time to time, we repurchase shares of common stock for distribution through our employee benefit plans or in connection with certain acquisitions. In December 2003, the Board of Directors authorized the repurchase of up to 350 million shares of our common stock. This authorization replaced previous authorizations and will expire on December 31, 2008. As of December 31, 2005, we had repurchased approximately 93.5 million shares under the program.

NOTE 14. ADDITIONAL FINANCIAL INFORMATION

	December 31,		
	2005	2004	
Balance Sheets			
Deferred directory expenses (included in Other current assets)	\$ 500	\$ 505	
Accounts payable and accrued liabilities:			
Accounts payable	\$ 4,466	\$ 2,241	
Accrued payroll	2,104	1,138	
Current portion of postemployment benefit obligation	1,883	1,117	
Deferred directory revenue	1,832	1,876	
Advance billing and customer deposits	1,717	1,325	
Compensated future absences	875	798	
Accrued interest	473	376	
Other	3,738	2,588	
Total accounts payable and accrued liabilities	\$17,088	\$11,459	
Deferred compensation (included in Other noncurrent liabilities)	\$ 1,127	\$ 900	
Statements of Income			
	2005	2004	2003
Advertising expense	\$ 812	\$ 862	\$ 867
Interest expense incurred	\$1,492	\$ 1,054	\$ 1,228
Capitalized interest	(36)	(31)	(37)
Total interest expense	\$1,456	\$ 1,023	\$ 1,191

Goodwill and Other Intangible Assets

Changes in the carrying amounts of goodwill for the years ended December 31, 2005 and 2004 are as follows:

	Wireline Segment	AT&T Corp. Segment	Directory Segment	Other Segment	Total
Balance as of January 1, 2004	\$717	\$ —	\$ 8	\$886	\$ 1,611
Goodwill acquired	7	—	—	—	7
Goodwill reclassification	—	—	—	7	7
Balance as of December 31, 2004	724	—	8	893	1,625
Goodwill acquired	98	12,343	—	—	12,441
Goodwill written off related to sale of business unit	—	—	—	(11)	(11)
Balance as of December 31, 2005	\$822	\$12,343	\$ 8	\$882	\$14,055

Goodwill is tested annually for impairment, with any impairments being expensed in that period's income statement. Goodwill recorded in our AT&T Corp. segment relates to our November acquisition of ATTC and, as allowed by GAAP, is subject to adjustment for one-year as we finalize the valuations of assets acquired and liabilities assumed in that transaction. As part of the final valuation we will determine to which entities and to what extent the benefit of the acquisition applies, and will record the appropriate goodwill to that entity, which may affect our segment presentation.

Our other intangible assets are summarized as follows:

	December 31, 2005		December 31, 2004	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Other Intangible Assets				
Amortized intangible assets:				
Customer lists and relationships	\$3,430	\$397	\$ 365	\$174
Other	1,100	589	758	545
Total	\$4,530	\$986	\$1,123	\$719
Indefinite life intangible assets:				
Trade name	\$4,900		\$ —	
Licenses	59		25	
Total	\$4,959		\$ 25	

	2005	2004	2003
Statements of Cash Flows			
Cash paid during the year for:			
Interest	\$1,395	\$ 1,043	\$ 1,310
Income taxes, net of refunds	2,038	506	1,321

	2005	2004	2003
Statements of Stockholders' Equity			
Accumulated other comprehensive income is comprised of the following components, net of taxes, at December 31:			
Foreign currency translation adjustment	\$ (505)	\$ (555)	\$ (427)
Unrealized gains on securities	340	391	427
Unrealized (losses) on cash flow hedges	(191)	(196)	—
Accumulated other comprehensive (loss)	\$ (356)	\$ (360)	\$ —

No customer accounted for more than 10% of consolidated revenues in 2005, 2004 or 2003.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

Amortized intangible assets are definite-life assets, and as such we record amortization expense based on a method that most appropriately reflects our expected cash flows from these assets with a weighted-average amortization period of 8.1 years. Amortization expense for definite-life intangible assets was \$271, \$117 and \$203 for the years ended December 31, 2005, 2004 and 2003, respectively. Amortization expense is estimated to be \$1,010 in 2006, \$680 in 2007, \$490 in 2008, \$410 in 2009 and \$320 in 2010.

Indefinite life intangible assets are not subject to amortization.

NOTE 15. TRANSACTIONS WITH CINGULAR

We and BellSouth, the two owners of Cingular, have each made a subordinated loan to Cingular (shareholder loans). Our shareholder loan to Cingular totaled approximately \$4,108 at December 31, 2005 and \$5,855 at December 31, 2004, reflecting repayments under the revolving credit agreement discussed below. This loan bears interest at an annual rate of 6.0% and matures in June 2008. We earned interest income on this loan of \$311 during 2005, \$354 in 2004 and \$397 in 2003.

Effective August 1, 2004, we and BellSouth agreed to finance Cingular's capital and operating cash requirements to the extent Cingular requires funding above the level provided by operations. We and BellSouth entered into a one-year revolving credit agreement with Cingular to provide short-term financing for operations on a pro rata basis at an interest rate of LIBOR (London Interbank Offered Rate) plus 0.05% which may be renewed upon agreement of the parties. This agreement includes a provision for the repayment of our and BellSouth's shareholder loans made to Cingular in the event there are no outstanding amounts due under the revolving credit agreement and to the extent Cingular has excess cash, as defined by the agreement. Effective June 28, 2005, this agreement was amended to extend the termination date of the agreement to July 31, 2007. All other terms of the agreement remain substantially identical.

Under the revolving credit agreement we received net repayments from Cingular totaling \$2,442 in 2005. After applying the net repayments, our share of advances to Cingular under the revolving credit agreement was approximately \$307 at December 31, 2005 and \$1,002 at December 31, 2004 and is reflected in "Investments in and Advances to Cingular Wireless" on our Consolidated Balance Sheets. Under the terms of the agreement, approximately \$1,747 of net repayments were applied to reduce the balance of our shareholder loan to Cingular.

In May 2005, we transferred wireless properties to Cingular to settle a liability related to the formation of Cingular. This transfer resulted in a decrease of approximately \$35 to our "Investment in Cingular" account and resulted in a gain of \$24, which was reflected in our "Other Income" account.

We generated revenues of \$869 in 2005, \$602 in 2004 and \$539 in 2003 for services sold to Cingular. These revenues were primarily from access and long-distance services sold to Cingular on a wholesale basis and commissions revenue related to customers added through AT&T sales sources. The offsetting expense amounts are

recorded by Cingular, and 60% of these expenses are included in our "Equity in net income of affiliates" line on our Consolidated Statements of Income when we report our 60% proportionate share of Cingular's results.

NOTE 16. CINGULAR ACQUISITION OF AT&T WIRELESS

On October 26, 2004, Cingular acquired AT&T Wireless for approximately \$41,000 in cash. In connection with the acquisition, we entered into an investment agreement with BellSouth and Cingular. Under the investment agreement, we and BellSouth funded, by means of an equity contribution to Cingular, a significant portion of the merger consideration for the acquisition. Based on our 60% equity ownership of Cingular and after taking into account cash on hand at AT&T Wireless, we provided additional equity of approximately \$21,600 to fund the consideration. In exchange for this equity contribution, Cingular issued to us and BellSouth new membership interests in Cingular. Equity ownership and management control of Cingular remain unchanged after the acquisition.

As a joint venture, we account for our investment in Cingular under the equity method of accounting, recording 60% of Cingular's earnings as "Equity in net income of affiliates." As a result of this transaction, we recorded the \$21,600 contributed to Cingular to complete the AT&T Wireless acquisition as an increase in "Investments in and Advances to Cingular Wireless."

NOTE 17. DISCONTINUED OPERATIONS

In September 2004, we sold our interest in the directory advertising business in Illinois and northwest Indiana to Donnelley and received net proceeds of approximately \$1,397. As part of this transaction we recorded a gain of approximately \$1,357 (\$827 net of tax) in our 2004 results.

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets," we have reclassified the results from our directory advertising business in Illinois and northwest Indiana as discontinued operations, restating previously reported results to reflect the reclassification on a comparable basis. The operational results and the gain associated with the sale of this business are presented in the "Income From Discontinued Operations, net of tax" line item on the Consolidated Statements of Income. Prior to the reclassification, these results were reported in our directory segment.

Summarized financial information for the Illinois and northwest Indiana directory advertising business is as follows:

Year ended December 31,	2005	2004	2003
Operating revenues	\$ —	\$311	\$481
Operating income	—	132	186
Income taxes	—	51	74
Net income from operations	—	81	112
Gain on disposal, net of tax	—	827	—

At December 31, 2005 and 2004, the assets of the discontinued operations were \$0. The liabilities of the discontinued operations were \$0 at December 31, 2005 and \$310 at December 31, 2004 and are presented separately under the

caption "Liabilities of discontinued operations" on our Consolidated Balance Sheets. The December 31, 2004, liabilities of \$310 were primarily tax liabilities associated with the gain on the disposition. These liabilities were all paid in 2005, as reflected on the Consolidated Statements of Cash Flows. Except for the net proceeds of \$1,397, which related to discontinued investing activities in 2004, all other amounts on the Consolidated Statements of Cash Flows related to discontinued operations relate to cash provided by or used in operating activities.

NOTE 18. CONTINGENT LIABILITIES

In addition to issues specifically discussed elsewhere, we are party to numerous lawsuits, regulatory proceedings and other matters arising in the ordinary course of business. In accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," in evaluating these matters on an ongoing basis, we take

into account amounts already accrued on the balance sheet. In our opinion, although the outcomes of these proceedings are uncertain, they should not have a material adverse effect on the company's financial position, results of operations or cash flows.

We have contractual obligations to purchase certain goods or services from various other parties. Our purchase obligations are expected to be approximately \$1,235 in 2006, \$1,234 in total for 2007 and 2008, \$387 in total for 2009 and 2010 and \$249 in total for years thereafter.

Included in our purchase obligations was approximately \$410 of total purchase commitments with WITel for services to be provided on WITel's network. Our AT&T Corp. segment has contractual obligations to utilize network facilities from local exchange carriers with terms greater than one year. These contracts have no minimum volume requirements and are based on an interrelationship of volumes and discounted rates.

NOTE 19. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following table represents our quarterly financial results:

Calendar Quarter	Total Operating Revenues	Operating Income	Net Income	Basic Earnings Per Share ¹	Diluted Earnings Per Share ¹	Discontinued Operations			Stock Price		
						Income	Basic Earnings Per Share ¹	Diluted Earnings Per Share ¹	High	Low	Close
2005											
First	\$10,248	\$1,556	\$ 885	\$0.27	\$0.27	\$ —	\$ —	\$ —	\$25.98	\$22.99	\$23.69
Second	10,328	1,518	1,000	0.30	0.30	—	—	—	24.33	22.78	23.75
Third	10,320	1,962	1,246	0.38	0.38	—	—	—	24.97	23.20	23.97
Fourth	12,966	1,132	1,655	0.46	0.46	—	—	—	25.60	21.75	24.49
Annual	\$43,862	\$6,168	\$4,786	1.42	1.42	\$ —	—	—			
2004											
First ²	\$10,012	\$1,516	\$1,937	\$0.59	\$0.58	\$ 26	\$0.01	\$ —	\$27.73	\$23.18	\$24.54
Second	10,196	1,440	1,168	0.35	0.35	33	0.01	0.01	25.68	23.50	24.25
Third	10,292	1,698	2,094	0.63	0.63	849	0.25	0.25	26.88	22.98	25.95
Fourth	10,287	1,247	688	0.21	0.21	—	—	—	27.29	24.55	25.77
Annual	\$40,787	\$5,901	\$5,887	1.78	1.77	\$908	0.28	0.27			

¹Quarterly earnings per share impacts may not add to full-year earnings per share impacts due to the difference in weighted-average shares for the quarters versus the weighted-average shares for the year.

²The first-quarter 2004 diluted earnings per share was reduced by \$0.01 in the Discontinued Operations column to correct a miscalculation.

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles. The integrity and objectivity of the data in these financial statements, including estimates and judgments relating to matters not concluded by year end, are the responsibility of management, as is all other information included in the Annual Report, unless otherwise indicated.

The financial statements of AT&T Inc. (AT&T) have been audited by Ernst & Young LLP, Independent Registered Public Accounting Firm. Management has made available to Ernst & Young LLP all of AT&T's financial records and related data, as well as the minutes of stockholders' and directors' meetings. Furthermore, management believes that all representations made to Ernst & Young LLP during its audit were valid and appropriate.

Management maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed by AT&T is recorded, processed, summarized, accumulated and communicated to its management, including its principal executive and principal financial officers, to allow timely decisions regarding required disclosure, and reported within the time periods specified by the Securities and Exchange Commission's rules and forms.

Management also seeks to ensure the objectivity and integrity of its financial data by the careful selection of its managers, by organizational arrangements that provide an appropriate division of responsibility and by communication programs aimed at ensuring that its policies, standards and managerial authorities are understood throughout the organization.

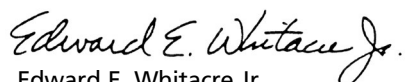
The Audit Committee of the Board of Directors meets periodically with management, the internal auditors and the independent auditors to review the manner in which they are performing their respective responsibilities and to discuss auditing, internal accounting controls and financial reporting matters. Both the internal auditors and the independent auditors periodically meet alone with the Audit Committee and have access to the Audit Committee at any time.

Assessment of Internal Control

The management of AT&T is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) or 15d-15(f) under the Securities Exchange Act of 1934. AT&T's internal control system was designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.

AT&T management assessed the effectiveness of its internal control over financial reporting as of December 31, 2005. In making this assessment, AT&T management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. We have excluded from the scope of our assessment of internal control over financial reporting the operations and related assets of AT&T Corp., which we acquired on November 18, 2005. At December 31, 2005 and for the period from November 18 through December 31, 2005, total assets and total segment revenues subject to AT&T Corp.'s internal control over financial reporting represented 29.0% and 6.6% of AT&T's consolidated total assets and total revenues as of and for the year ended December 31, 2005. Based on our assessment we believe that, as of December 31, 2005, AT&T's internal control over financial reporting is effective based on those criteria.

Ernst & Young LLP, an independent registered public accounting firm, has issued an attestation report on management's assessment of the company's internal control over financial reporting. The attestation report is included on page 86.



Edward E. Whitacre Jr.
Chairman of the Board and
Chief Executive Officer



Richard G. Lindner
Senior Executive Vice President and
Chief Financial Officer

The Board of Directors and Stockholders
AT&T Inc.

We have audited the accompanying consolidated balance sheets of AT&T Inc. (AT&T, formerly SBC Communications Inc.) as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of AT&T's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of AT&T at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in 2003 AT&T changed its method of recognizing revenues and expenses related to publishing directories, as well as the method of accounting for the costs of removal of long-term assets.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of AT&T's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 16, 2006 expressed an unqualified opinion thereon.

Ernst + Young LLP

San Antonio, Texas
February 16, 2006

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Board of Directors and Stockholders
AT&T Inc.

We have audited management's assessment as described in the "Assessment of Internal Control", included in the accompanying Report of Management, that AT&T Inc. (AT&T, formerly SBC Communications Inc.) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). AT&T's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of AT&T's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying "Assessment of Internal Control", management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of AT&T Corp., which was acquired on November 18, 2005 and is included in the 2005 consolidated financial statements of AT&T and constituted 29.0% of total assets as of December 31, 2005 and 6.6% of revenues for the year then ended. Our audit of internal control over financial reporting of AT&T also did not include an evaluation of the internal control over financial reporting of AT&T Corp.

In our opinion, management's assessment that AT&T maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, AT&T maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of AT&T as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005 of AT&T and our report dated February 16, 2006 expressed an unqualified opinion thereon.

Ernst + Young LLP

San Antonio, Texas
February 16, 2006