

# AT&T Inc. Financial Review 2009



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## Selected Financial and Operating Data

Dollars in millions except per share amounts

At December 31 or for the year ended:	2009	2008	2007	2006 <sup>2</sup>	2005 <sup>3</sup>
<b>Financial Data<sup>1</sup></b>					
Operating revenues	\$123,018	\$124,028	\$118,928	\$ 63,055	\$ 43,764
Operating expenses	\$101,526	\$100,965	\$ 98,524	\$ 52,767	\$ 37,596
Operating income	\$ 21,492	\$ 23,063	\$ 20,404	\$ 10,288	\$ 6,168
Interest expense	\$ 3,379	\$ 3,390	\$ 3,507	\$ 1,843	\$ 1,456
Equity in net income of affiliates	\$ 734	\$ 819	\$ 692	\$ 2,043	\$ 609
Other income (expense) – net	\$ 152	\$ (328)	\$ 810	\$ 398	\$ 398
Income taxes	\$ 6,156	\$ 7,036	\$ 6,252	\$ 3,525	\$ 932
<b>Net Income</b>	<b>\$ 12,843</b>	<b>\$ 13,128</b>	<b>\$ 12,147</b>	<b>\$ 7,361</b>	<b>\$ 4,787</b>
Less: Net Income Attributable to Noncontrolling Interest	\$ (308)	\$ (261)	\$ (196)	\$ (5)	\$ (1)
<b>Net Income Attributable to AT&amp;T</b>	<b>\$ 12,535</b>	<b>\$ 12,867</b>	<b>\$ 11,951</b>	<b>\$ 7,356</b>	<b>\$ 4,786</b>
<b>Earnings Per Common Share:</b>					
Net Income Attributable to AT&T	\$ 2.12	\$ 2.17	\$ 1.95	\$ 1.89	\$ 1.42
<b>Earnings Per Common Share – Assuming Dilution:</b>					
Net Income Attributable to AT&T	\$ 2.12	\$ 2.16	\$ 1.94	\$ 1.89	\$ 1.42
Total assets	\$268,752	\$265,245	\$275,644	\$270,634	\$145,632
Long-term debt	\$ 64,720	\$ 60,872	\$ 57,255	\$ 50,063	\$ 26,115
Total debt	\$ 72,081	\$ 74,991	\$ 64,115	\$ 59,796	\$ 30,570
Construction and capital expenditures	\$ 17,335	\$ 20,335	\$ 17,888	\$ 8,393	\$ 5,612
Dividends declared per common share	\$ 1.65	\$ 1.61	\$ 1.47	\$ 1.35	\$ 1.30
Book value per common share	\$ 17.34	\$ 16.42	\$ 19.15	\$ 18.58	\$ 14.09
Ratio of earnings to fixed charges	4.50	4.80	4.95	5.01	4.11
Debt ratio <sup>7</sup>	41.3%	43.7%	35.6%	34.1%	35.9%
Weighted-average common shares outstanding (000,000)	5,900	5,927	6,127	3,882	3,368
Weighted-average common shares outstanding with dilution (000,000)	5,924	5,958	6,170	3,902	3,379
End of period common shares outstanding (000,000)	5,902	5,893	6,044	6,239	3,877
<b>Operating Data</b>					
Wireless customers (000) <sup>4</sup>	85,120	77,009	70,052	60,962	54,144
In-region network access lines in service (000) <sup>5</sup>	49,392	55,610	61,582	66,469	49,413
In-region broadband connections (000) <sup>6,7</sup>	17,254	16,265	14,802	12,170	6,921
Number of employees	282,720	302,660	309,050	304,180	189,950

<sup>1</sup>Amounts in the above table have been prepared in accordance with U.S. generally accepted accounting principles.

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

<sup>3</sup>Our 2005 income statement amounts reflect results from AT&T Corp. for the 43 days following the November 18, 2005, acquisition. Our 2005 balance sheet and end-of-year metrics include 100% of AT&T Corp.

<sup>4</sup>The number presented represents 100% of AT&T Mobility cellular/PCS customers.

<sup>5</sup>In-region represents access lines serviced by our incumbent local exchange companies (in 22 states since the BellSouth acquisition and in 13 states prior to that acquisition). Beginning in 2006, the number includes BellSouth lines in service.

<sup>6</sup>Broadband connections include in-region DSL lines, in-region U-verse High Speed Internet access, satellite broadband and 3G LaptopConnect cards.

<sup>7</sup>Prior period amounts restated to conform to current period reporting methodology.

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

Dollars in millions except per share amounts

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

### RESULTS OF OPERATIONS

**Consolidated Results** Our financial results are summarized in the table below. We then discuss factors affecting our overall results for the past three years. These factors are discussed in more detail in our "Segment Results" section. We also discuss our expected revenue and expense trends for 2010 in the "Operating Environment and Trends of the Business" section.

	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
Operating Revenues	<b>\$123,018</b>	\$124,028	\$118,928	<b>(0.8)%</b>	4.3%
Operating expenses					
Cost of services and sales	<b>50,405</b>	49,556	46,801	<b>1.7</b>	5.9
Selling, general and administrative	<b>31,407</b>	31,526	30,146	<b>(0.4)</b>	4.6
Depreciation and amortization	<b>19,714</b>	19,883	21,577	<b>(0.8)</b>	(7.9)
Total Operating Expenses	<b>101,526</b>	100,965	98,524	<b>0.6</b>	2.5
Operating Income	<b>21,492</b>	23,063	20,404	<b>(6.8)</b>	13.0
Income Before Income Taxes	<b>18,999</b>	20,164	18,399	<b>(5.8)</b>	9.6
Net Income Attributable to AT&T	<b>12,535</b>	12,867	11,951	<b>(2.6)</b>	7.7
Diluted Earnings Per Share	<b>2.12</b>	2.16	1.94	<b>(1.9)%</b>	11.3%

### OVERVIEW

**Operating income** decreased \$1,571, or 6.8%, in 2009 and increased \$2,659, or 13.0%, in 2008. Our operating income margin increased from 17.2% in 2007 to 18.6% in 2008 and decreased to 17.5% in 2009. Operating income in 2009 decreased primarily due to the decline in voice revenues and directory print advertising, an increase in pension and other postemployment benefits (OPEB) expense, and the higher cost of equipment sales in our Wireless segment attributed to the continued success of Apple iPhone. These changes were partially offset by lower employee-related costs due to workforce reductions, along with the continued growth in wireless service and wireline data revenue. In 2008, operating income increased primarily due to continued growth in wireless service and data revenues, along with a decrease in the amortization of merger-related intangibles.

**Operating revenues** decreased \$1,010, or 0.8%, in 2009 and increased \$5,100, or 4.3%, in 2008. Revenues in 2009 reflect the continuing decline in voice revenues and a decline in directory revenue driven by lower print revenue. These declines were partially offset by continued growth in wireless service revenue due to an increase in average number of customers of 9.4%, driven in part by the continued success

of Apple iPhone and an increase in wireline data revenue largely due to Internet Protocol (IP) data growth, including AT&T U-verse<sup>SM</sup> and broadband growth. Increases in 2008 reflect an increase in wireless subscribers and data revenues, primarily related to IP data, partially offset by the continued decline in voice revenues.

The declines in our wireline voice and advertising revenues reflect continuing economic pressures on our customers as well as competition. Total retail consumer voice connections decreased 11.4% in 2009. Business customers also disconnected switched access lines, reduced usage-based services and reduced print advertising. Customers disconnecting access lines switched to wireless, Voice over Internet Protocol (VoIP) and cable offerings for voice and data or terminated service permanently as businesses closed or consumers left residences. While we lose the voice revenues, we have the opportunity to increase wireless service or wireline data revenues should the customer choose us as their wireless or VoIP provider. We also continue to expand our VoIP service for customers who have access to our U-verse video service.

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

Dollars in millions except per share amounts

**Cost of services and sales** expenses increased \$849, or 1.7%, in 2009 and \$2,755, or 5.9%, in 2008. The increase in 2009 was primarily due to higher upgrade costs and higher equipment costs related to advanced integrated devices, along with an increase in pension/OPEB expenses. Pension/OPEB expense increased due to lower-than-expected return on assets and an increase in amortization of actuarial losses, both primarily from investment losses in 2008. Partially offsetting these increases were decreases in employee-related costs primarily driven by workforce reductions. The increase in 2008 was primarily due to higher equipment costs related to increased sales of advanced integrated devices. Also increasing 2008 expenses was severance associated with announced workforce reductions and hurricane-related expenses affecting both the Wireless and Wireline segments.

**Selling, general and administrative** expenses decreased \$119, or 0.4%, in 2009 and increased \$1,380, or 4.6%, in 2008. The decrease in 2009 was primarily due to declines in employee-related costs (excluding pension/OPEB) due to workforce reductions, decreases in materials and supplies expense along with decreases in wireless advertising and promotions expense. These decreases were partially offset by an increase in pension/OPEB expense, and higher commissions, customer service costs and IT/Interconnect costs resulting from wireless subscriber growth along with increased support for data services and integrated devices. The increase in 2008 was primarily due to higher commissions and residuals due to the growth in wireless subscribers, and higher severance associated with announced workforce reductions. Partially offsetting these increases in 2008 were merger-integration costs recognized in 2007 and not in 2008.

**Depreciation and amortization** expenses decreased \$169, or 0.8%, in 2009 and \$1,694, or 7.9%, in 2008. The decrease in 2009 was primarily due to the declining amortization of identifiable intangible assets, primarily customer relationships, partially offset by increased depreciation resulting from capital additions. The decrease in 2008 was primarily due to lower amortization expense on intangible assets.

**Interest expense** decreased \$11, or 0.3%, in 2009 and \$117, or 3.3%, in 2008. Interest expense decreased slightly during 2009 due to an increase in interest charged during construction, which is capitalized instead of expensed. In 2008, interest expense declined primarily due to a decrease in our weighted-average interest rate and an increase in interest charged during construction, partially offset by an increase in our average debt balances.

**Equity in net income of affiliates** decreased \$85, or 10.4%, in 2009, primarily due to foreign currency translation losses at América Móvil S.A. de C.V. (América Móvil), Telefonos de México, S.A. de C.V. (Telmex) and Telmex Internacional, S.A.B. de C.V. (Telmex Internacional), partially offset by improved results at América Móvil. Equity in net income of affiliates increased \$127, or 18.4%, in 2008, primarily due to improved results from our investments in América Móvil, Telmex and Telmex Internacional, partially offset by foreign currency translation losses.

**Other income (expense) – net** We had other income of \$152 in 2009, other expense of \$328 in 2008 and other income of \$810 in 2007. Results for 2009 included a \$112 gain on the sale of investments, \$100 of interest and leveraged lease income, and \$42 of gains on the sale of a professional services business, partially offset by \$102 of asset impairments.

Other expense for 2008 included losses of \$467 related to asset impairments, partially offset by \$156 of interest and leveraged lease income. Other income for 2007 included \$810 related to a \$409 gain on a spectrum license exchange, \$215 of interest and leveraged lease income and a \$161 gain on the sale of non-strategic assets and investments.

**Income taxes** decreased \$880, or 12.5%, in 2009 and increased \$784, or 12.5%, in 2008. The decrease in 2009 was due to lower income before taxes and the recognition of benefits related to audit issues and judicial developments, while the increase in 2008 was primarily due to higher income before taxes. Our effective tax rate in 2009 was 32.4%, compared to 34.9% in 2008 and 34.0% in 2007. The decrease in our effective tax rate in 2009 was primarily due to the recognition of benefits related to audit issues and judicial developments. The increase in our effective tax rate in 2008 was primarily due to higher income before taxes, which resulted in a greater percentage of our income being taxed at marginal rates.

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## Segment Results

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

The **Wireless segment** accounted for approximately 43% of our 2009 total segment operating revenues as compared to 39% in 2008 and 60% of our 2009 total segment income as compared to 46% in 2008. This segment provides wireless voice and advanced data communications services across the United States.

The **Wireline segment** accounted for approximately 52% of our 2009 total segment operating revenues as compared to 55% in 2008 and 36% of our 2009 total segment income as compared to 47% in 2008. This segment uses our regional, national and global network to provide consumer and business customers with landline voice and data communications services, AT&T U-verse<sup>SM</sup> TV, high-speed broadband and voice services (U-verse) and managed networking to business customers. Additionally, we offer satellite television services through our agency arrangements.

The **Advertising Solutions segment** accounted for approximately 4% of our 2009 and 2008 total segment operating revenues and 6% of our 2009 total segment income as compared to 7% in 2008. This segment includes our directory operations, which publish Yellow and White Pages directories and sell directory advertising, Internet-based advertising and local search.

The **Other segment** accounted for approximately 1% of our 2009 total segment operating revenues as compared to 2% in 2008 and less than 1% of our 2009 and 2008 total segment income. This segment includes results from Sterling Commerce, Inc. (Sterling), customer information services, payphone, and all corporate and other operations. Also, included in the Other segment are impacts of corporate-wide decisions for which the individual operating segments are not being evaluated. During 2008, we announced our intention to discontinue our retail payphone operations previously included in this segment. Additionally, this segment includes our portion of the results from our international equity investments and charges of \$550 and \$978 associated with our workforce reductions in 2009 and 2008.

The following tables show components of results of operations by segment. We discuss significant segment results following each table. We discuss capital expenditures for each segment in "Liquidity and Capital Resources."

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

Dollars in millions except per share amounts

### Wireless Segment Results

				Percent Change	
	2009	2008	2007	2009 vs. 2008	2008 vs. 2007
Segment operating revenues					
Service	\$48,657	\$44,410	\$38,678	9.6%	14.8%
Equipment	4,940	4,925	4,006	0.3	22.9
Total Segment Operating Revenues	53,597	49,335	42,684	8.6	15.6
Segment operating expenses					
Operations and support	34,561	32,481	28,585	6.4	13.6
Depreciation and amortization	5,765	5,770	7,079	(0.1)	(18.5)
Total Segment Operating Expenses	40,326	38,251	35,664	5.4	7.3
Segment Operating Income	13,271	11,084	7,020	19.7	57.9
Equity in Net Income of Affiliates	9	6	16	50.0	(62.5)
Segment Income	\$13,280	\$11,090	\$ 7,036	19.7%	57.6%

### Centennial Acquisition

In November 2009, we acquired Centennial Communications, Corp. (Centennial), a regional provider of wireless and wired communications services with approximately 865,000 customers as of December 31, 2009, and its operations have been included in our consolidated results since the acquisition date.

### Wireless Properties Transactions

In May 2009, we announced a definitive agreement to acquire certain wireless assets from Verizon Wireless (VZ) for approximately \$2,350 in cash. The assets primarily represent former Alltel Wireless assets. We will acquire wireless properties, including licenses and network assets, serving approximately 1.5 million subscribers in 79 service areas across 18 states. In October 2009, the Department of Justice (DOJ) cleared our acquisition of Centennial, subject to the DOJ's condition that we divest Centennial's operations in eight service areas in Louisiana and Mississippi. We are in the process of finalizing definitive agreements and seeking regulatory approvals to sell all eight Centennial service areas ultimately identified in that ruling. We anticipate we will close the sales during the first half of 2010. As of December 31, 2009, the fair value of the assets subject to the sale, net of related liabilities, was \$282. Since the properties we will acquire use a different network technology than our Global System for Mobile Communication (GSM) technology, we expect to incur additional costs to convert that network and subscriber handsets to our GSM technology.

### Dobson Acquisition

In November 2007, we acquired Dobson Communications Corporation (Dobson). Dobson marketed wireless services under the Cellular One brand and had provided roaming services to AT&T subsidiaries since 1990. Dobson had 1.7 million subscribers across 17 states, mostly in rural and suburban areas. Dobson was incorporated into our wireless operations subsequent to its acquisition.

### Wireless Customer and Operating Trends

As of December 31, 2009, we served 85.1 million wireless customers, compared to 77.0 million at December 31, 2008, and 70.1 million at December 31, 2007. Approximately 59% of our wireless customer net additions in 2009 were postpaid customer additions which were lower than the impact in the prior year, as we saw a significant increase in gross and net additions in our reseller customer business in 2009. Sales of emerging devices, such as netbooks and eReaders, are largely included in our reseller customer base. We expect continued growth in sales of emerging devices. Improvement in our postpaid churn levels since 2007 contributed to our net additions and retail customer growth in 2009 and 2008. This improvement was attributable to network enhancements, attractive products and services offerings, including Apple iPhone, customer service improvements, and continued high levels of advertising.

Gross customer additions were 21.4 million in 2009 and 2008. Postpaid customer gross additions have continued to increase due to attractive plan offerings and exclusive product offerings such as Apple iPhone, and unique quick messaging devices.



As the wireless industry continues to mature, we believe that future wireless growth will become increasingly dependent on our ability to offer innovative services, which will encourage existing customers to upgrade their current services and devices and will attract customers from other providers, as well as on our ability to minimize customer churn. Average service revenue per user (ARPU) in 2009 was flat compared to 2008 after increasing 1% in 2008 compared to 2007 primarily due to increased data services ARPU growth offsetting declining voice and other service ARPU. ARPU from postpaid customers increased 2.7% in 2009 and 3.7% in 2008, reflecting usage of more advanced handsets, such as Apple iPhone 3GS, by these customers, evidenced by a 23.5% increase in postpaid data services ARPU in 2009 and a 36.4% increase in postpaid data services ARPU in 2008. The continued increase in postpaid data services revenue was related to increased use of text messaging, Internet access, e-mail and other data services. We expect continued growth from data services, as more customers purchase advanced integrated devices and other emerging devices, such as netbooks, eReaders, and mobile navigation devices, and broadband laptop cards, and as we continue to expand our network. The growth in data services ARPU in 2009 was offset by a 6.7% decline in voice ARPU and the growth in data services ARPU in 2008 was partially offset by a 6.5% decline in voice and other service ARPU. Voice and other service ARPU in 2009 and 2008 declined due to lower access charges, roaming revenues, and long-distance usage. Increases in our FamilyTalk® and reseller customer base, which have lower ARPU than traditional postpaid customers, have also contributed to these declines. For 2009, roaming revenues were lower due to a decline in domestic roaming activity. For 2008, roaming revenues were lower due to acquisitions and rate negotiations as part of roaming cost savings initiatives, which slowed international growth, and lower regulatory cost recovery charges. We expect continued pressure on voice and other service ARPU.

The effective management of customer churn is also critical to our ability to maximize revenue growth and to maintain and improve margins. Customer churn is calculated by dividing the aggregate number of wireless customers who cancel service during each month in a period by the total number of wireless customers at the beginning of each month in that period. Our customer churn rate was 1.48% for 2009, down from 1.68% for 2008 and 1.67% for 2007. The churn

rate for postpaid customers was 1.16% for 2009 and 1.19% for 2008, down from 1.27% for 2007. The decline in postpaid churn reflects network enhancements and broader coverage, more affordable rate plans and exclusive devices, and free mobile-to-mobile calling among our wireless customers.

### Wireless Operating Results

Our Wireless segment operating income margin was 24.8% in 2009, 22.5% in 2008 and 16.4% in 2007. The higher margin in 2009 was primarily due to revenue growth of \$4,262, while the higher margin in 2008 was primarily due to revenue growth of \$6,651. Each revenue increase exceeded the corresponding operating expense increase of \$2,075 in 2009 and \$2,587 in 2008. The expense increase for 2008 is net of a decrease in depreciation and amortization of \$1,309.

**Service** revenues are comprised of local voice and data services, roaming, long-distance and other revenue. Service revenues increased \$4,247, or 9.6%, in 2009 and \$5,732, or 14.8%, in 2008. The increases consisted of the following:

- Data service revenue increases of \$3,539, or 33.4%, in 2009 and \$3,647, or 52.5%, in 2008. The increases were primarily due to the increased number of subscribers and heavier usage by subscribers of advanced handsets and other data-centric emerging devices, such as netbooks, eReaders, and mobile navigation devices. The increases in data service ARPU of 22.0% in 2009 and 33.8% in 2008 reflect this trend. Our significant data growth also reflects an increased number of subscribers using our 3G network. Data service revenues represented approximately 29.0% and 23.9% of our Wireless segment service revenues in 2009 and 2008.
- Voice and other service revenue increases of \$708, or 2.1%, in 2009 and \$2,085, or 6.6%, in 2008. The increase in 2009 was due to a 9.4% increase in the average number of wireless customers, down from 14.0% in 2008. Voice and other service ARPU declined 6.7% in 2009 and 6.5% in 2008.

**Equipment** revenues increased \$15, or 0.3%, in 2009 and increased \$919, or 22.9%, in 2008. The lower incremental increase in 2009 was due to lower traditional handset sales, offset by sales of more advanced integrated devices. The increase in 2008 was due to higher handset revenues, reflecting higher gross customer additions, and customer upgrades to more advanced devices.

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

Dollars in millions except per share amounts

**Operations and support** expenses increased \$2,080, or 6.4%, in 2009, compared to an increase of \$3,896, or 13.6%, in 2008. The increase in 2009 was primarily due to the following:

- equipment cost increases of \$1,246, reflecting the higher cost of acquiring more advanced integrated devices compared to prior periods;
- Interconnect, universal service fee (USF) and reseller expense increases of \$426 due to higher network traffic and revenue growth;
- upgrade commissions and residual expense increases of \$313 due to sales and upgrades to more advanced devices;
- customer service cost increases of \$214 due to customer growth; and
- Finance, IT, and other administrative cost increases of \$306.

These increases were partially offset by selling expense decreases of \$337, attributable to lower traditional handset sales exceeding the impact of the sale of more advanced integrated devices and roaming expense decreases of \$165 due to usage and rate declines. Total equipment costs continue to be higher than equipment revenues due to the sale of discounted devices in connection with promotions.

The increase in 2008 was primarily due to the following:

- equipment sales expense increase of \$2,005;
- upgrade commissions and residual expense increases of \$745;
- selling expense increase of \$362 and customer service cost increase of \$159;
- USF increase of \$204 and reseller expense increase of \$145; and
- Finance, IT, and other administrative cost increases of \$538.

The increase in equipment sales expense, commission expense, and selling expense resulted from an increase in sales of higher-cost 3G devices, the introduction of Apple iPhone 3G handsets in 2008, an increase in the number of handset accessory sales, lower per-unit accessory costs compared to 2007, and higher handset upgrade volume. The increase in commission expense is also attributable to

higher commission rates. Interconnect and other costs also increased by \$141 due to increased usage and integration costs related to the 2007 acquisition of Dobson. The increase in reseller costs in 2008 was attributable to higher license, maintenance and other reseller costs, partially offset by cost reductions from the migration of network usage from the T-Mobile USA (T-Mobile) network in California and Nevada to our networks in these states.

These increases were partially offset by incollect roaming cost decreases of \$249 and network system cost decreases of \$132. The decrease in network system costs was the result of benefits from network and systems integration and cost-reduction initiatives of \$218, decreases in data processing and payroll costs of \$109, partially offset by incremental rents related to Dobson and general building expense increases of \$124, and hurricane and other incremental network cost increases of \$99.

**Depreciation and amortization** decreased \$5, or 0.1%, in 2009 and decreased \$1,309, or 18.5%, in 2008. Amortization expense decreased \$450, or 21.8%, in 2009 due to lower amortization of intangibles attributable to the BellSouth acquisition, partially offset by amortization of intangible assets attributable to subscribers added in the November 2009 acquisition of Centennial and the 2007 acquisition of Dobson. Depreciation expense increased \$445, or 12.0%, in 2009 due to ongoing capital spending for network upgrades and expansion, partially offset by certain network assets becoming fully depreciated.

Depreciation expense decreased \$539, or 12.7%, in 2008. Depreciation expense decreased \$695 in 2008 due to certain network assets becoming fully depreciated and decreased \$612 due to Time Division Multiple Access (TDMA) assets being depreciated on an accelerated basis through 2007. These decreases were partly offset by incremental depreciation on capital assets placed in service during 2008. Amortization expense decreased \$770, or 27.2%, in 2008 due to declining amortization of identified intangible assets, most of which are amortized using the sum-of-the-months-digits method of amortization, partially offset by Dobson intangible assets acquired by AT&T Mobility.

### Wireless Supplementary Operating and Financial Data

	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
Wireless Customers (000)	<b>85,120</b>	77,009	70,052	<b>10.5%</b>	9.9%
Net Customer Additions (000)	<b>7,278</b>	6,699	7,315	<b>8.6</b>	(8.4)
Total Churn	<b>1.48%</b>	1.68%	1.67%	<b>(20) bps</b>	1 bps
Postpaid Customers (000)	<b>65,146</b>	60,098	55,310	<b>8.4%</b>	8.7%
Net Postpaid Customer Additions (000)	<b>4,323</b>	4,634	3,982	<b>(6.7)</b>	16.4
Postpaid Churn	<b>1.16%</b>	1.19%	1.27%	<b>(3) bps</b>	(8) bps



## Wireline Segment Results

	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
Segment operating revenues					
Voice	<b>\$33,082</b>	\$38,198	\$41,630	<b>(13.4)%</b>	(8.2)%
Data	<b>26,723</b>	25,353	24,075	<b>5.4</b>	5.3
Other	<b>5,865</b>	6,304	5,878	<b>(7.0)</b>	7.2
Total Segment Operating Revenues	<b>65,670</b>	69,855	71,583	<b>(6.0)</b>	(2.4)
Segment operating expenses					
Operations and support	<b>44,646</b>	45,440	46,177	<b>(1.7)</b>	(1.6)
Depreciation and amortization	<b>13,093</b>	13,206	13,416	<b>(0.9)</b>	(1.6)
Total Segment Operating Expenses	<b>57,739</b>	58,646	59,593	<b>(1.5)</b>	(1.6)
Segment Operating Income	<b>7,931</b>	11,209	11,990	<b>(29.2)</b>	(6.5)
Equity in Net Income of Affiliates	<b>18</b>	19	31	<b>(5.3)</b>	(38.7)
Segment Income	<b>\$ 7,949</b>	\$11,228	\$12,021	<b>(29.2)%</b>	(6.6)%

### Operating Margin Trends

Our Wireline segment operating income margin was 12.1% in 2009, compared to 16.0% in 2008 and 16.7% in 2007. Results for 2009 and 2008 reflect revenue declines that exceeded expense declines. Our Wireline segment operating income decreased \$3,278, or 29.2%, in 2009 and decreased \$781, or 6.5%, in 2008. Our operating income continued to be pressured by access line declines due to economic pressures on our consumer and business wireline customers and competition, as customers either reduced usage or disconnected traditional landline services and switched to alternative technologies, such as wireless and VoIP. Our strategy is to offset these line losses by increasing non-access-line-related revenues from customer connections for data, video and voice. Additionally, we have the opportunity to increase Wireless segment revenues if customers choose AT&T Mobility as an alternative provider. Wireline operating margins are declining primarily due to reduced voice revenue, partially offset by continued growth in data revenue. Also contributing to pressure on our operating margins was increased pension/OPEB expense in 2009.

**Voice** revenues decreased \$5,116, or 13.4%, in 2009, and decreased \$3,432, or 8.2%, in 2008 primarily due to continuing economic pressures and declining demand for traditional voice and other legacy services by our consumer and business customers. Included in voice revenues are revenues from local voice, long-distance and local wholesale services. Voice revenues do not include VoIP revenues, which are included in data revenues.

- Local voice revenues decreased \$2,763, or 12.2%, in 2009 and decreased \$1,887, or 7.7%, in 2008. The decrease in 2009 was driven primarily by an 11.2% decline in switched access lines and a decrease in average local voice revenue per user. The decrease in 2008 was driven primarily by a loss of revenue of \$1,230 from a decline in access lines and by \$422 from a decline in our national mass-market customer base acquired from AT&T Corp. (ATTC). We expect our local voice revenue to continue to be negatively affected by increased competition from alternative technologies, the disconnection of additional lines and economic pressures.
  - Long-distance revenues decreased \$2,133, or 15.3%, in 2009 and decreased \$1,195, or 7.9%, in 2008 primarily due to decreased demand from business and consumer customers, which decreased revenues \$1,583 in 2009 and \$532 in 2008, and a net decrease in demand for long-distance service, due to expected declines in the number of national mass-market customers, which decreased revenues \$546 in 2009 and \$677 in 2008.
- Data** revenues increased \$1,370, or 5.4%, in 2009 and increased \$1,278, or 5.3%, in 2008. Data revenues accounted for approximately 41% of wireline operating revenues in 2009, 36% in 2008 and 34% in 2007. Data revenues include transport, IP and packet-switched data services.

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

Dollars in millions except per share amounts

IP data revenues increased \$1,969, or 17.8%, in 2009 and increased \$1,537, or 16.1%, in 2008 primarily driven by AT&T U-verse expansion and growth in IP-based strategic business services, which include Ethernet, virtual private networks (VPN), application and managed services. Strategic business service revenues increased \$603 in 2009 and \$741 in 2008, driven mostly by VPN, and U-verse video service increased \$980 in 2009 and \$402 in 2008. Broadband high-speed Internet access increased IP data revenues \$300 in 2009 and \$497 in 2008. The increase in IP data revenues in 2009 and 2008 reflects continued growth in the customer base and migration from other traditional circuit-based services.

Traditional packet-switched data services, which include frame relay and asynchronous transfer mode services, decreased \$536, or 20.8%, in 2009 and \$423, or 14.1%, in 2008. This decrease is primarily due to lower demand as customers continue to shift to IP-based technology such as VPN, DSL and managed Internet services, and the continuing economic recession. We expect these traditional, circuit-based services to continue to decline as a percentage of our overall data revenues.

**Other** operating revenues decreased \$439, or 7.0%, in 2009 and increased \$426, or 7.2%, in 2008. Major items included are integration services and customer premises equipment, government-related services and outsourcing, which account for more than 60% of total revenue for all periods. Equipment sales and related network integration revenues decreased \$405 in 2009 primarily due to economic pressures, and increased \$260 in 2008, driven by an increase in management services partially offset by reduced equipment sales and related network integration. Governmental professional services revenue decreased \$116 in 2009 driven by the divestiture of a professional services business in 2009 and increased \$100 in 2008 driven by growth across various contracts.

**Operations and support expenses** decreased \$794, or 1.7%, in 2009 and \$737, or 1.6 %, in 2008. Operations and support expenses consist of costs incurred to provide our products and services, including costs of operating and maintaining our networks and personnel costs, such as salary, wage and bonus accruals. Costs in this category include our repair technicians and repair services, certain network planning and engineering expenses, operator services, information technology and property taxes. Operations and support expenses also include bad debt expense; advertising costs; sales and marketing functions, including customer service centers; real estate costs, including maintenance and

utilities on all buildings; credit and collection functions; and corporate support costs, such as finance, legal, human resources and external affairs. Pension and postretirement costs, net of amounts capitalized are also included to the extent that they are associated with these employees.

The 2009 decrease was primarily due to lower employee-related costs of \$918, primarily related to workforce reductions. Other cost reductions included decreases in traffic compensation (related to lower international long-distance revenues and lower volume of calls from our declining national mass-market customer base), including portal fees, of \$655, nonemployee-related expenses, such as bad debt expense, materials and supplies costs, of \$441 and \$134 related to contract services.

Partially offsetting these decreases was an increase in pension/OPEB expense of \$1,370 due to a lower-than-expected return on assets and an increase in amortization of actuarial losses, both primarily from investment losses in 2008. See Note 11 for more information related to pension/OPEB expense.

The major decreases in 2008 were \$633 in traffic compensation (related to lower international long-distance revenue, and lower volume of calls from our declining national mass-market customer base), including portal fees, and \$618 of pension/OPEB expense. Other cost reductions included decreases in other support cost of \$616 primarily due to higher advertising costs incurred in 2007 for brand advertising and rebranding related to the BellSouth acquisition and lower compensation expense of \$420 reflecting shifts of workforce levels to sales organizations.

Partially offsetting these decreases, operation and support expenses increased by \$1,135, related to higher nonemployee-related expenses, such as contract services, agent commissions and materials and supplies. Other increases were salary and wages of \$423; and higher cost of equipment sales and related U-verse network integration of \$60.

**Depreciation and amortization** expenses decreased \$113, or 0.9%, in 2009 and \$210, or 1.6%, in 2008. The 2009 decrease was primarily related to lower amortization of intangibles for the customer lists associated with ATTC, BellSouth and Yahoo! partially offset by the inclusion of Centennial related depreciation starting in the fourth quarter of 2009. The 2008 decline was a result of decreasing intangible amortization partially offsetting increased depreciation resulting from capital additions.

## Supplemental Information

**Telephone, Wired Broadband and Video Connections Summary** Our switched access lines and other services provided by our local exchange telephone subsidiaries at December 31, 2009, 2008 and 2007, are shown below and trends are addressed throughout this segment discussion.

(in 000s)	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
<b>Switched Access Lines<sup>1</sup></b>					
Retail consumer	<b>26,378</b>	30,614	35,009	<b>(13.8)%</b>	(12.6)%
Retail business <sup>2</sup>	<b>20,106</b>	21,810	22,795	<b>(7.8)</b>	(4.3)
<b>Retail Subtotal<sup>2</sup></b>	<b>46,484</b>	52,424	57,804	<b>(11.3)</b>	(9.3)
Percent of total switched access lines	<b>94.1%</b>	94.3%	93.9%		
<b>Wholesale Subtotal<sup>2</sup></b>	<b>2,826</b>	3,068	3,527	<b>(7.9)</b>	(13.0)
Percent of total switched access lines	<b>5.7%</b>	5.5%	5.7%		
<b>Payphone (Retail and Wholesale)<sup>3</sup></b>	<b>82</b>	118	251	<b>(30.5)</b>	(53.0)
Percent of total switched access lines	<b>0.2%</b>	0.2%	0.4%		
<b>Total Switched Access Lines</b>	<b>49,392</b>	55,610	61,582	<b>(11.2)</b>	(9.7)
<b>Total Retail Consumer Voice Connections<sup>6</sup></b>	<b>27,332</b>	30,838	35,009	<b>(11.4)</b>	(11.9)
<b>Total Wired Broadband Connections<sup>4</sup></b>	<b>15,789</b>	15,077	14,156	<b>4.7</b>	6.5
Satellite service <sup>5</sup>	<b>2,174</b>	2,190	2,116	<b>(0.7)</b>	3.5
U-verse video	<b>2,065</b>	1,045	231	<b>97.6</b>	—
<b>Video Connections</b>	<b>4,239</b>	3,235	2,347	<b>31.0%</b>	37.8%

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

<sup>2</sup>Prior period amounts restated to conform to current period reporting methodology.

<sup>3</sup>Revenue from retail payphone lines is reported in the Other segment. We are in the process of ending our retail payphone operations.

<sup>4</sup>Total wired broadband connections include DSL, U-verse High Speed Internet access and satellite broadband.

<sup>5</sup>Satellite service includes connections under our agency and resale agreements.

<sup>6</sup>Includes consumer U-verse Voice over IP connections.

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

Dollars in millions except per share amounts

### Advertising Solutions Segment Results

	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
Total Segment Operating Revenues	\$4,809	\$5,502	\$5,851	(12.6)%	(6.0)%
Segment operating expenses					
Operations and support	2,922	2,998	3,066	(2.5)	(2.2)
Depreciation and amortization	649	789	924	(17.7)	(14.6)
Total Segment Operating Expenses	3,571	3,787	3,990	(5.7)	(5.1)
Segment Income	\$1,238	\$1,715	\$1,861	(27.8)%	(7.8)%

### Operating Results

Our Advertising Solutions segment operating income margin was 25.7% in 2009, 31.2% in 2008 and 31.8% in 2007. The decrease in the segment operating income margin in both 2009 and 2008 was primarily the result of decreased operating revenues.

**Operating revenues** decreased \$693, or 12.6%, in 2009 largely driven by continuing declines in print revenue of \$774 and lower sales agency revenue of \$34 due to the sale of the independent line of business segment of the L.M. Berry Company. This decrease was partially offset by Internet advertising revenue growth of \$132. The ongoing economic recession has reduced demand for advertising and customers have continued to shift to Internet-based search services, although the recession has also curbed search usage by consumers. Operating revenues decreased \$349, or 6%, in 2008 largely driven by continuing declines in print revenue

of \$453 and lower sales agency revenue of approximately \$113 due to the sale of the independent line of business segment of the L.M. Berry Company. This decrease was partially offset by increased Internet advertising revenue of \$196.

**Operating expenses** decreased \$216, or 5.7%, in 2009 largely driven by decreases in depreciation and amortization expense of \$140, product related costs of \$74, advertising costs of \$44, and professional and contracted expense of \$17. These expense decreases were partially offset by an increase in pension/OPEB and other benefit costs of \$66. Operating expenses decreased \$203, or 5.1%, in 2008 largely driven by decreased depreciation and amortization of \$135 resulting from use of an accelerated method of amortization for the customer list acquired as part of the BellSouth acquisition, and lower employee, professional and contract related expenses. These expense decreases were partially offset by increased YELLOWPAGES.COM, LLC (YPC) expansion costs.

### Other Segment Results

	2009	2008	2007	Percent Change	
				2009 vs. 2008	2008 vs. 2007
Total Segment Operating Revenues	\$1,731	\$2,042	\$2,229	(15.2)%	(8.4)%
Total Segment Operating Expenses	2,678	2,986	2,040	(10.3)	46.4
Segment Operating Income (Loss)	(947)	(944)	189	(0.3)	—
Equity in Net Income of Affiliates	706	794	645	(11.1)	23.1
Segment Income (Loss)	\$ (241)	\$ (150)	\$ 834	(60.7)%	—

Our Other segment operating results consist primarily of Sterling, customer information services (primarily operator services and payphone), corporate and other operations. Sterling provides business-integration software and services.

**Operating revenues** decreased \$311, or 15.2%, in 2009 and \$187, or 8.4%, in 2008. The decrease in 2009 is primarily due to reduced revenues from our operator services, retail payphone operations and Sterling. The 2008 decline is

primarily related to lower revenues from operator services and retail payphone operations.

**Operating expenses** decreased \$308, or 10.3%, in 2009 and increased \$946, or 46.4%, in 2008. The changes were primarily due to charges of \$550 and \$978 associated with our workforce reductions in 2009 and 2008 as a result of the restructure of our operations from a collection of regional companies to a single national approach.

Our Other segment also includes our equity investments in international companies, the income from which we report as equity in net income of affiliates. Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. Our foreign investments are recorded under generally accepted accounting principles (GAAP), which include adjustments for the equity method of accounting and exclude certain adjustments required for local reporting in specific countries. Our equity in net income of affiliates by major investment is listed below:

	2009	2008	2007
América Móvil	<b>\$505</b>	\$469	\$381
Telmex	<b>133</b>	252	265
Telmex Internacional	<b>72</b>	72	—
Other	<b>(4)</b>	1	(1)
<b>Other Segment Equity in Net Income of Affiliates</b>	<b>\$706</b>	\$794	\$645

**Equity in net income of affiliates** decreased \$88 in 2009. Our investment in Telmex and Telmex Internacional decreased \$119, reflecting lower operating results and currency translation losses, partially offset by \$36 of improved operating results at América Móvil. The \$149 increase in 2008 reflects improved operating results at América Móvil, as well as lower depreciation and tax expenses, and improved results at Telmex and Telmex Internacional. On January 13, 2010, América Móvil announced that its Board of Directors had authorized it to submit an offer for 100% of the equity of Carso Global Telecom, S.A. de C.V. (CGT), a holding company that owns 59.4% of Telmex and 60.7% of Telmex Internacional, in exchange for América Móvil shares; and an offer for Telmex Internacional shares not owned by CGT, to be purchased for cash or to be exchanged for América Móvil shares, at the election of the shareholders.

## OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

**2010 Revenue Trends** We expect our operating environment in 2010 to remain challenging as the economic recession continues, competition remains strong and the federal regulatory framework may or may not remain receptive to investment. Despite this environment, we expect our operating revenues in 2010 to remain stable, reflecting continuing growth in our wireless and broadband/data services. We expect our primary driver of growth to be wireless, especially in sales and increased use of advanced handsets and emerging devices (such as netbooks, eReaders and mobile navigation devices) and that all our major customer categories will continue to increase their use of Internet-based broadband/data services. We expect continuing declines in traditional access lines and in advertising from our print directories. Where available, our U-verse services are proving effective in stemming access line losses, and we expect to continue to expand our U-verse service offerings in 2010.

**2010 Expense Trends** We expect a challenging operating environment for 2010. We will continue to focus sharply on cost-control measures, including areas such as organizational and systems integration. We will continue our ongoing initiatives to improve customer service and billing so we can realize our strategy of bundling services and providing a simple customer experience. We expect our 2010 operating income margin to be stable with the opportunity to improve margins, in the event the U.S. economy improves. We do not expect significant pension funding requirements in 2010. Expenses related to growth areas of our business, especially in the wireless area, will apply some pressure to our operating income margin.

**Market Conditions** During 2009, the securities and mortgage markets and the banking system in general experienced some stabilization compared with 2008 as the year progressed, although bank lending and the housing industry remained weak. The ongoing weakness in the general economy has also affected our customer and supplier bases. We saw lower demand from our residential customers as well as our business customers at all organizational sizes. Some of our suppliers continue to experience increased financial and operating costs. To a large extent, these negative trends were offset by continued growth in our wireless and IP-related services. While the economy appears to have stabilized at a weakened level at year-end, we do not expect a quick return to growth during 2010. Should the economy instead deteriorate further, we likely will experience further pressure on pricing and margins as we compete for both wireline and wireless customers who have less discretionary income. We also may experience difficulty purchasing equipment in a timely manner or maintaining and replacing warranted equipment from our suppliers.

Included on our consolidated balance sheets are assets held by benefit plans for the payment of future benefits. The losses associated with the securities markets declines during 2008 are not expected to have an impact on the ability of our benefit plans to pay benefits. We do not expect to make significant funding contributions to our pension plans in 2010. However, because our pension plans are subject to funding requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA), a continued weakness in the markets could require us to make contributions to the pension plans in order to maintain minimum funding requirements as established by ERISA. In addition, our policy on recognizing losses on investments in the pension and other postretirement plans accelerated the recognition of losses in 2009 earnings (see "Significant Accounting Policies and Estimates").

## OPERATING ENVIRONMENT OVERVIEW

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



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

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

Our wireless operations operate in robust competitive markets but are likewise subject to substantial governmental regulation. Wireless communications providers must be licensed by the FCC to provide communications services at specified spectrum frequencies within specified geographic areas and must comply with the rules and policies governing the use of the spectrum as adopted by the FCC. The FCC has recognized the importance of providing carriers with access to adequate spectrum to permit continued wireless growth

and has begun investigating how to develop policies to promote that goal. While wireless communications providers' prices and service offerings are generally not subject to state regulation, an increasing number of states are attempting to regulate or legislate various aspects of wireless services, such as in the area of consumer protection.

AT&T has previously noted that the broadband marketplace is robustly competitive and that we do not block consumers from accessing the lawful Internet sites of their choice. We therefore believe that prescriptive "net neutrality" rules are not only unnecessary but also counterproductive to the extent they would restrict broadband Internet access providers from developing innovative new services for consumers and/or content and application providers. Nor do we believe that wireless providers should be prohibited from entering into exclusive arrangements with handset manufacturers or that government should regulate wireless early termination fees as is currently being proposed. It is widely recognized that the wireless industry in the United States is characterized by innovation, differentiation, declining prices and extensive competition among handset manufacturers, service providers and applications. For this reason, additional broadband regulation and new wireless requirements are unwarranted.

#### **Expected Growth Areas**

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

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

Our Universal Mobile Telecommunications System/High-Speed Downlink Packet Access 3G network technology covers most major metropolitan areas of the U.S. This technology provides superior speeds for data and video services, and it offers operating efficiencies by using the same spectrum and infrastructure for voice and data on an IP-based platform. Our wireless networks also rely on digital transmission technologies known as GSM, General Packet Radio Services and Enhanced Data Rates for GSM Evolution for data communications. As of December 31, 2009, we served 85.1 million customers. We have also announced plans to transition from 3G network technology to a higher



transmission speed technology called Long-Term Evolution. We expect to test this technology this year and then deploy it beginning in 2011, as we expect network equipment and handsets to become more widely available.

As the wireless industry continues to mature, we believe that future wireless growth will become increasingly dependent on our ability to offer innovative services that will encourage existing customers to upgrade their services, either by adding new types of services, such as data enhancements, or through increased use of existing services, such as through equipment upgrades. These innovative services should attract customers from other providers, as well as minimize customer churn. We intend to accomplish these goals by continuing to expand our network coverage, improve our network quality and offer a broad array of products and services, including exclusive devices such as Apple iPhone 3G and free mobile-to-mobile calling among our wireless customers. Minimizing customer churn is critical to our ability to maximize revenue growth and to maintain and improve our operating margins.

**U-verse Services** We are continuing to expand our deployment of U-verse high-speed broadband and TV services. As of December 31, 2009, we have passed 22.8 million living units (constructed housing units as well as platted housing lots) and are marketing the services to almost 72 percent of those units. Our deployment strategy is to enter each new area on a limited basis in order to ensure that all operating and back-office systems are functioning successfully and then expand within each as we continue to monitor these systems. Our rate of expansion will be slowed if we cannot obtain all required local building permits in a timely fashion. We also continue to work with our vendors on improving, in a timely manner, the requisite hardware and software technology. Our deployment plans could be delayed if we do not receive required equipment and software on schedule.

We believe that our U-verse TV service is subject to federal oversight as a "video service" under the Federal Communications Act. However, some cable providers and municipalities have claimed that certain IP services should be treated as a traditional cable service and therefore subject to the applicable state and local cable regulation. Certain municipalities have delayed our request or have refused us permission to use our existing right-of-ways to deploy or activate our U-verse-related services and products, resulting in litigation. Pending negotiations and current or threatened litigation involving municipalities could delay our deployment plans in those areas. In July 2008, the U.S. District Court for Connecticut affirmed its October 2007 ruling that AT&T's U-verse TV service is a cable service in Connecticut. We have appealed that decision on the basis that state legislation rendered the case moot. Petitions have been filed at the FCC alleging that the manner in which AT&T provisions "public, educational, and governmental" (PEG) programming over its U-verse TV service conflicts with federal law, and a lawsuit has been filed in a California state superior court raising similar allegations under California law. If courts having jurisdiction where we have significant deployments of our U-verse services were to decide that federal, state and/or local cable

regulation were applicable to our U-verse services, or if the FCC, state agencies or the courts were to rule that AT&T must deliver PEG programming in a manner substantially different from the way it does today or in ways that are inconsistent with AT&T's current network architecture, it could have a material adverse effect on the cost, timing and extent of our deployment plans.

## REGULATORY DEVELOPMENTS

Set forth below is a summary of the most significant developments in our regulatory environment during 2009. While these issues, for the most part, apply only to certain subsidiaries in our Wireline segment, the words "we," "AT&T" and "our" are used to simplify the discussion. The following discussions are intended as a condensed summary of the issues rather than as a precise legal description of all of these specific issues.

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

**Federal Regulation** A summary of significant 2009 federal regulatory developments follows.

**Net Neutrality** On October 22, 2009, the FCC adopted a Notice of Proposed Rulemaking (NPRM) seeking comment on six proposed "net neutrality" rules that are intended to preserve the "free and open Internet." The proposed rules apply to providers of "broadband Internet access service" and state that, subject to "reasonable network management," such a provider:

- May not prevent any of its users from sending or receiving the lawful content of the user's choice over the Internet.
- May not prevent any of its users from running the lawful applications or using the lawful services of the user's choice.
- May not prevent any of its users from connecting to and using on its network the user's choice of lawful devices that do not harm the network.
- May not deprive any of its users of the user's entitlement to competition among network providers, application providers, service providers and content providers.
- Must treat lawful content, applications and services in a nondiscriminatory manner.
- Must disclose such information concerning network management and other practices as is reasonably required for users and content, application and service providers to enjoy the protections specified in these rules.

The NPRM states that the proposed rules would apply to all platforms over which broadband Internet access services are provided, including mobile wireless broadband, while recognizing that different platforms involve significantly different technologies, market structures, patterns of consumer usage and regulatory history. The comment cycle on the NPRM concludes in the first quarter of 2010. We are unable to determine the impact of this proceeding on our operating results and financial condition at this time.

## **COMPETITION**

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

### **Wireless**

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

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

### **Wireline**

Our wireline subsidiaries expect continued competitive pressure in 2010 from multiple providers, including wireless, cable and other VoIP providers, interexchange carriers and resellers. In addition, economic pressures are forcing customers to terminate their traditional local wireline service and substitute wireless and Internet-based services, intensifying a pre-existing trend toward wireless and Internet use. At this time, we are unable to quantify the effect of competition on the industry as a whole or financially on this

segment. However, we expect both losses of revenue share in local service and gains resulting from business initiatives, especially in the area of bundling of products and services, including wireless and video, large-business data services and broadband. In most markets, we compete with large cable companies, such as Comcast Corporation, Cox Communications, Inc. and Time Warner Cable Inc., for local, high-speed Internet and video services customers and other smaller telecommunications companies for both long-distance and local services customers.

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

In a number of the states in which we operate as an ILEC, state legislatures or the state public utility commissions have concluded that the voice telecommunications market is competitive and have allowed for greater pricing flexibility for nonbasic residential retail services, including bundles, promotions and new products and services. While it has been a number of years since we have been allowed to raise local service rates in certain states, some of these state actions have been challenged by certain parties and are pending court review.

In addition to these rates and service regulations noted above, our wireline subsidiaries (excluding rural carrier affiliates) operate under state-specific elective "price-cap regulation" for retail services (also referred to as "alternative regulation") that was either legislatively enacted or authorized by the appropriate state regulatory commission. Under price-cap regulation, price caps are set for regulated services and are not tied to the cost of providing the services or to rate-of-return requirements. Price-cap rates may be subject to or eligible for annual decreases or increases and also may be eligible for deregulation or greater pricing flexibility if the associated service is deemed competitive under some state regulatory commission rules. Minimum customer service standards may also be imposed and payments required if we fail to meet the standards.

We continue to lose access lines due to competitors (e.g., wireless, cable and VoIP providers) who can provide comparable services at lower prices because they are not subject to traditional telephone industry regulation (or the

extent of regulation is in dispute), utilize different technologies, or promote a different business model (such as advertising based) and consequently have lower cost structures. In response to these competitive pressures, for several years we have utilized a bundling strategy that rewards customers who consolidate their services (e.g., local and long-distance telephone, high-speed Internet, wireless and video) with us. We continue to focus on bundling wireline and wireless services, including combined packages of minutes and video service through our U-verse service and our relationships with satellite television providers. We will continue to develop innovative products that capitalize on our expanding fiber network.

Additionally, we provide local, domestic intrastate and interstate, international wholesale networking capacity and switched services to other service providers, primarily large Internet Service Providers using the largest class of nationwide Internet networks (Internet backbone), wireless carriers, Competitive Local Exchange Carriers, regional phone ILECs, cable companies and systems integrators. These services are subject to additional competitive pressures from the development of new technologies and the increased availability of domestic and international transmission capacity. The introduction of new products and service offerings and increasing satellite, wireless, fiber-optic and cable transmission capacity for services similar to those provided by us continues to provide competitive pressures. We face a number of international competitors, including Equant, British Telecom and SingTel as well as competition from a number of large systems integrators, such as Electronic Data Systems.

### **Advertising Solutions**

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

## **ACCOUNTING POLICIES AND STANDARDS**

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

**Allowance for Doubtful Accounts** We maintain an allowance for doubtful accounts for estimated losses that result from the failure of our customers to make required payments. When determining the allowance, we consider the probability of recoverability based on past experience, taking into account current collection trends as well as general economic factors, including bankruptcy rates. Credit risks

are assessed based on historical write-offs, net of recoveries, and an analysis of the aged accounts receivable balances with reserves generally increasing as the receivable ages. Accounts receivable may be fully reserved for when specific collection issues are known to exist, such as pending bankruptcy or catastrophes. The analysis of receivables is performed monthly, and the bad-debt allowances are adjusted accordingly. A 10% change in the amounts estimated to be uncollectible would result in a change in uncollectible expense of approximately \$120.

**Pension and Postretirement Benefits** Our actuarial estimates of retiree benefit expense and the associated significant weighted-average assumptions are discussed in Note 11. One of the most significant of these assumptions is the return on assets assumption, which was 8.50% for the year ended December 31, 2009. In setting the long-term assumed rate of return, management considers capital markets' future expectations and the asset mix of the plans' investments. The actual long-term return can, in relatively stable markets, also serve as a factor in determining future expectations. However, the dramatic adverse market conditions in 2008 have skewed the calculation of the long-term actual return; the actual 10-year return was 3.67% through 2009 and 4.21% through 2008, compared with 9.18% through 2007. The severity of the 2008 losses will make the 10-year actual return less of a relevant factor in management's evaluation of future expectations. In 2009, we experienced actual returns on investments much greater than what was expected, creating a reduction in pension and postretirement expense for 2010. Based on future expectations and the plans' asset mix, management has left unchanged the long-term assumed rate of return for 2010. If all other factors were to remain unchanged, we expect that a 1.0% decrease in the assumed long-term rate of return would cause 2010 combined pension and postretirement cost to increase \$639. 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 up to 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 in less than five years. This methodology did not have a material impact on our 2008 or 2007 combined net pension and postretirement costs.

Our assumed discount rate of 6.50% at December 31, 2009, reflects the hypothetical rate at which the projected benefit obligations could be effectively settled or paid out to participants. We determined our discount rate based on a range of factors, including a yield curve comprised of the rates of return on several hundred high-quality, fixed-income corporate bonds available at the measurement date and the related expected duration for the obligations. These bonds

were all rated at least Aa3 or AA- by one of the nationally recognized statistical rating organizations, denominated in U.S. dollars, and neither callable, convertible nor index linked. For the year ended December 31, 2009, we decreased our discount rate by 0.50%, resulting in an increase in our pension plan benefit obligation of \$2,065 and an increase in our postretirement benefit obligation of \$1,847. For the year ended December 31, 2008, we increased our discount rate by 0.50%, resulting in a decrease in our pension plan benefit obligation of \$2,176 and a decrease in our postretirement benefit obligation of \$2,154. Should actual experience differ from actuarial assumptions, the projected pension benefit obligation and net pension cost and accumulated post-retirement benefit obligation and postretirement benefit cost would be affected in future years. Note 11 also discusses the effects of certain changes in assumptions related to medical trend rates on retiree health care costs.

**Depreciation** Our depreciation of assets, including use of composite group depreciation and estimates of useful lives, is described in Notes 1 and 5. We assign useful lives based on periodic studies of actual asset lives. Changes in those lives with significant impact on the financial statements must be disclosed, but no such changes have occurred in the three years ended December 31, 2009. However, if all other factors were to remain unchanged, we expect that a one-year increase in the useful lives of the largest categories of our plant in service (which accounts for more than three-fourths of our total plant in service) would result in a decrease of approximately \$2,420 in our 2010 depreciation expense and that a one-year decrease would result in an increase of approximately \$3,480 in our 2010 depreciation expense.

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

Customer relationships, which are finite-lived intangible assets, are primarily amortized using the sum-of-the-months-digits method of amortization over the period in which those relationships are expected to contribute to our future cash flows. The sum-of-the-months-digits method is a process of allocation, and reflects our belief that we expect greater revenue generation from these customer relationships during the earlier years of their lives. Alternatively, we could have chosen to amortize customer relationships using the straight-line method, which would allocate the cost equally over the amortization period. Amortization of other intangibles, including patents and amortizable tradenames, is determined using the straight-line method of amortization over the expected remaining useful lives. We do not amortize indefinite-lived intangibles, such as wireless FCC licenses or certain tradenames (see Note 6).

Goodwill and wireless FCC licenses are not amortized but tested annually for impairment, as required by GAAP. We conduct our impairment tests as of October 1. Goodwill is tested on a reporting unit basis, and our reporting units generally coincide with our segments, except for certain operations in the Other segment. The carrying amounts of goodwill, by segment (which is the same as reporting unit for Wireless, Wireline and Advertising Solutions), at December 31, 2009 were: Wireless \$35,037; Wireline \$31,608; Advertising Solutions \$5,731; and Other \$883. At December 31, 2008, the carrying amounts of goodwill by segment were: Wireless \$33,851; Wireline \$31,381; Advertising Solutions \$5,694; and Other \$903. Within the Other segment, goodwill associated with our Sterling operations was \$477 for 2009 and 2008. Additionally, FCC licenses are tested for impairment on an aggregate basis, consistent with the management of the business on a national scope. These annual impairment tests resulted in no material impairment of indefinite-lived goodwill or FCC licenses. If there are indications of significant decreases in fair value of these assets, testing may also be done more frequently than the annual test. There were no indications of a significant decrease in fair value in 2009. We review other long-lived assets for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable over the remaining life of the asset or asset group.

Goodwill impairment testing is a two step process. The first step involves determining the fair value of the reporting unit and comparing that to the book value. If the fair value exceeds the book value, then no further testing is required. If the fair value is less than the book value, then a second step is performed.

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

As shown in Note 6, more than 98% of our goodwill resides in the Wireline, Wireless and Advertising Solutions segments. For each of those segments, publicly traded companies whose services are consistent with those primarily offered by the segment exist, giving a market indication of enterprise value. Enterprise value is the sum of a company's equity and debt values. One standard valuation technique is to determine enterprise value as a multiple of a company's operating income before depreciation and amortization. We determined



the multiples of the public companies and then calculated a weighted-average of those multiples. Using those weighted-averages, we then calculated fair values for each of those segments to determine if additional testing was required and, in all circumstances, no additional testing was required. In the event of a 10% drop in the fair values of the reporting units, the fair values would have still exceeded the book values of the reporting units and additional testing would still have not been required.

Consistent with prior years, we performed our test of the fair values of FCC licenses using a discounted cash flow model (the Greenfield Approach). The Greenfield Approach assumes a company is started, owning only the wireless FCC licenses, and then makes investments required to build an operation comparable to the one in which the licenses are presently utilized. We utilized a 17-year discrete period to isolate cash flows attributable to the licenses including modeling the hypothetical build out. The projected cash flows are based on certain financial factors including revenue growth rates, Operating Income Before Depreciation and Amortization (OIBDA) margins, and churn rates. Wireless revenue growth is expected to trend down from our 2008 growth rate of 15.6% to a long-term growth rate that reflects expected long-term inflation trends. Our churn rates are expected to continue declining from 1.68% in 2008, in line with expected trends in the industry but at a rate comparable with industry-leading churn. OIBDA margins should continue to increase from the 2008 level of 38.0% to more than 40.0%.

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

If either the projected rate of growth of cash flows or revenues were to decline by 1%, or if the discount rate were to increase by 1%, the fair values of the wireless FCC licenses, while less than currently projected, would still be higher than the book value of the licenses. The fair value of the licenses exceeded the book value by more than one-fourth.

We review other long-lived assets for impairment under GAAP whenever events or circumstances indicate that the carrying amount may not be recoverable over the remaining life of the asset or asset group. In order to determine that the asset is recoverable, we verify that the expected future cash flows directly related to that asset exceed its fair value, which is based on the undiscounted cash flows. The discounted cash flow calculation uses various assumptions and estimates regarding future revenue, expense and cash flows projections over the estimated remaining useful life of the asset.

Cost investments are evaluated to determine whether mark-to-market declines are temporary and reflected in other comprehensive income, or other than temporary and recorded as an expense in the income statement. This evaluation is based on the length of time and the severity of decline in the investment's value. At the end of the first quarter of 2009 and at the end of 2008, we concluded the severity of decline had led to an other-than-temporary decline in the value of assets contained in an independently managed trust for certain BellSouth employee benefits.

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

In 2007, we adopted new GAAP rules and began accounting for uncertain tax positions under those provisions. As required, we use our judgment to determine whether it is more likely than not that we will sustain positions that we have taken on tax returns and, if so, the amount of benefit to initially recognize within our financial statements. We regularly review our uncertain tax positions and adjust our unrecognized tax benefits in light of changes in facts and circumstances, such as changes in tax law, interactions with taxing authorities and developments in case law. These adjustments to our unrecognized tax benefits may affect our income tax expense. Settlement of uncertain tax positions may require use of our cash.

**New Accounting Standards**

**Revenue Arrangements with Multiple Deliverables** In October 2009, the Financial Accounting Standards Board (FASB) issued "Multiple-Deliverable Revenue Arrangements" (Accounting Standards Update (ASU) 2009-13), which addresses how revenues should be allocated among all products and services included in our sales arrangements. It establishes a selling price hierarchy for determining the selling price of each product or service, with vendor-specific objective evidence (VSOE) at the highest level, third-party evidence of VSOE at the intermediate level, and a best estimate at the lowest level. It replaces "fair value" with "selling price" in revenue allocation guidance, eliminates the residual method as an acceptable allocation method, and requires the use of the relative selling price method as the basis for allocation. It also significantly expands the disclosure requirements for such arrangements, including, potentially, certain qualitative disclosures. ASU 2009-13 will be effective prospectively for sales entered into or materially modified in fiscal years beginning on or after June 15, 2010 (i.e., the year beginning January 1, 2011, for us). The FASB permits early adoption of ASU 2009-13, applied retrospectively, to the beginning of the year of adoption. We are currently evaluating the impact on our financial position and results of operations.

**Software** In October 2009, the FASB issued "Certain Revenue Arrangements That Include Software Elements" (ASU 2009-14), which clarifies the guidance for allocating and measuring revenue, including how to identify software that is out of the scope. ASU 2009-14 amends accounting and reporting guidance for revenue arrangements involving both tangible products and software that is "more than incidental to the tangible product as a whole." That type of software and hardware will be outside of the scope of software revenue guidance, and the hardware components will also be outside of the scope of software revenue guidance and may result in more revenue recognized at the time of the hardware sale. Additional disclosures will discuss allocation of revenue to products and services in our sales arrangements and the significant judgments applied in the revenue allocation method, including impacts on the timing and amount of revenue recognition. ASU 2009-14 will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 (i.e., the year beginning January 1, 2011, for us). ASU 2009-14 has the same effective date, including early adoption provisions, as ASU 2009-13. Companies must adopt ASU 2009-14 and ASU 2009-13 at the same time. We are currently evaluating the impact on our financial position and results of operations.

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

**OTHER BUSINESS MATTERS**

**Retiree Phone Concession Litigation** In May 2005, we were served with a purported class action in U.S. District Court, Western District of Texas (Stoffels v. SBC Communications Inc.), in which the plaintiffs, who are retirees of Pacific Bell Telephone Company, Southwestern Bell and Ameritech, contend that the telephone concession provided by the company is, in essence, a "defined benefit plan" within the meaning of ERISA, as amended. In October 2006, the Court certified two classes. The issue of whether the concession is an ERISA pension plan was tried before the judge in November 2007. In May 2008, the court ruled that the concession was an ERISA pension plan. We asked the court to certify this ruling for interlocutory appeal, and in August 2008, the court denied our request. In May 2009, we filed a motion for reconsideration with the trial court. That motion is pending. A trial on the appropriate remedy has been set for June 1, 2010. We believe that an adverse outcome having a material effect on our financial statements in this case is unlikely, but we will continue to evaluate the potential impact of this suit on our financial results as it progresses.

**NSA Litigation** Twenty-four lawsuits were filed alleging that we and other telecommunications carriers unlawfully provided assistance to the National Security Agency (NSA) in connection with intelligence activities that were initiated following the events of September 11, 2001. In the first filed case, Hepting et al v. AT&T Corp., AT&T Inc. and Does 1-20, a purported class action filed in U.S. District Court in the Northern District of California, plaintiffs alleged that the defendants disclosed and are currently disclosing to the U.S. Government content and call records concerning communications to which Plaintiffs were a party. Plaintiffs sought damages, a declaratory judgment, and injunctive relief for violations of the First and Fourth Amendments to the United States Constitution, the Foreign Intelligence Surveillance Act (FISA), the Electronic Communications Privacy Act, and other federal and California statutes. We filed a motion to dismiss the complaint. The United States asserted the "state secrets privilege" and related statutory privileges and also filed a motion asking the court to dismiss the complaint. The Court denied the motions, and we and the United States appealed. In August 2008, the U.S. Court of Appeals for the Ninth Circuit remanded the case to the district court without deciding the issue in light of the passage of the FISA Amendments Act, a provision of which addresses the allegations in these pending lawsuits (immunity provision). The immunity provision requires the pending lawsuits to be dismissed if the Attorney General certifies to the court either that the alleged assistance was undertaken by court order, certification, directive, or written request or that the telecom



entity did not provide the alleged assistance. In September 2008, the Attorney General filed his certification and asked the district court to dismiss all of the lawsuits pending against the AT&T Inc. telecommunications companies. The court granted the Government's motion to dismiss and entered final judgments in July 2009. In addition, a lawsuit seeking to enjoin the immunity provision's application on grounds that it is unconstitutional was filed. In March 2009, we and the Government filed motions to dismiss this lawsuit. The court granted the motion to dismiss and entered final judgment in July 2009. All cases brought against the AT&T entities have been dismissed. In August 2009, plaintiffs in all cases filed an appeal with the Ninth Circuit Court of Appeals.

Management believes these actions are without merit and intends to continue to defend these matters vigorously.

**Labor Contracts** As of January 31, 2010, we employed approximately 281,000 persons. Approximately 58 percent of our employees are represented by the Communications Workers of America (CWA), the International Brotherhood of Electrical Workers (IBEW) or other unions. Contracts covering approximately 120,000 collectively bargained wireline employees expired during 2009. As of January 31, 2010, the Company and approximately 86,000 employees, covered by these expired collectively bargained wireline contracts, have ratified new labor agreements. In the absence of an effective contract, the union is entitled to call a work stoppage.

For approximately 60,000 employees covered by ratified agreements, the agreements provide for a three-year term and, for the vast majority of those covered employees, a 3 percent wage increase in years one and two, a wage increase in year three of 2.75 percent, and pension band increases of 2 percent for each year of the agreement. For both wage and pension band increases, there is a potential cost-of-living increase based on the consumer price index for the third year. These agreements also provide for continued health care coverage with reasonable cost sharing.

For the remaining approximately 26,000 employees covered by ratified agreements, the agreement provides for a four-year term. The provisions of the tentative agreement are substantially similar to the provisions of the ratified agreements discussed above, with a wage increase in year four of 2.75 percent and a potential cost-of-living increase in year four instead of in year three.

On February 8, 2010, the Company and the CWA announced a tentative agreement covering approximately 30,000 core wireline employees in the nine-state former BellSouth region, subject to ratification by those covered employees. The tentative agreement provides for a three-year term and, for the vast majority of those covered employees, a 3 percent wage increase in years one and two, a wage increase in year three of 2.75 percent, and pension band

increases of 2 percent for each year of the agreement. These agreements also provide for continued health care coverage with reasonable cost sharing.

**Health Care Legislation** We provide a variety of medical and prescription drug benefits to certain active and retired employees under various plans. In 2009, the U.S. Senate and House of Representatives each passed comprehensive health care reform legislation. It is unclear if differences between these bills can be reconciled and a final bill passed in 2010. Among the major provisions of the bills are the taxation of the Medicare Part D subsidy, Medicare payment reforms, an excise tax on "Cadillac" plans as well as mandates for providing coverage and other requirements for delivery of health care to employees and retirees. The final outcome of the legislation could cause negative impacts to our results and bring uncertainty to our future costs.

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

## LIQUIDITY AND CAPITAL RESOURCES

We had \$3,802 in cash and cash equivalents available at December 31, 2009. Cash and cash equivalents included cash of \$437 and money market funds and other cash equivalents of \$3,365. Cash and cash equivalents increased \$2,010 since December 31, 2008. During 2009, cash inflows were primarily provided by cash receipts from operations and the issuance of long-term debt. These inflows were partially offset by cash used to meet the needs of the business including, but not limited to, payment of operating expenses, funding capital expenditures, dividends to stockholders, repayment of debt and payment of interest on debt. We discuss many of these factors in detail below.

### Cash Provided by or Used in Operating Activities

During 2009, cash provided by operating activities was \$34,445 compared to \$33,656 in 2008. Our higher operating cash flow reflects decreased tax payments of \$836, partially offset by reduced net income and increased interest payments of \$146. During 2009, our payments for current income taxes were lower than 2008 due primarily to changes in law impacting the timing of payments. The timing of cash payments for income taxes is governed by the IRS and other taxing authorities and differs from the timing of recording tax expense, which is reported in accordance with GAAP.

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

Dollars in millions except per share amounts

The decrease in current tax payments was partially offset by an increase in audit-related payments in 2009.

We anticipate using approximately \$2,350 of cash in 2010 to complete the acquisition of various assets from Verizon that it was required to divest as part of its acquisition of Alltel.

During 2008, our primary source of funds was cash from operating activities of \$33,656 compared to \$34,242 in 2007. Operating cash flows decreased primarily due to increased tax payments of \$1,294 partially offset by improvement in operating income excluding depreciation. During 2008, tax payments were higher primarily due to increased income.

### Cash Used in or Provided by Investing Activities

During 2009, cash used in investing activities consisted of:

- \$16,595 in capital expenditures, excluding interest during construction.
- \$740 in interest during construction.
- \$787, net of cash acquired, related to the acquisition of Centennial.
- \$111 related to spectrum and licenses.
- \$85 related to other acquisitions.

During 2009, cash provided by investing activities consisted of:

- \$287 from dispositions of non-strategic assets.
- \$55 from the sale of securities, net of investments.
- \$51 related to other activities.

Our capital expenditures are primarily for our wireless and wireline subsidiaries' networks, our U-verse services, and support systems for our communications services. Total capital spending in 2009 was \$16,595, which was a \$3,081 decrease from 2008. Capital spending in our Wireless segment, excluding interest during construction, only increased 1% for 2009; the modest increase in capital spending reflected a 6% increase in network expenditures, tempered by reductions in non-network spending. Expenditures were used for network capacity growth, integration and upgrades to our Universal Mobile Telecommunications System/High-Speed Packet Access network, as well as for IT and other support systems for our wireless service. Capital expenditures in our Wireline segment, excluding interest during construction, which represented 64.3% of our capital expenditures, decreased 21% for 2009, reflecting decreased spending on U-verse services as the upgrades to our existing network become more mature. In addition, capital expenditures decreased due to less spending on wireline voice services, and lower DSL and High Capacity volumes. The Other segment capital expenditures were less than 2% of total capital expenditures for 2009. Included in the Other segment are equity investments, which should be self funding as they are not direct AT&T operations; as well as corporate, diversified business and Sterling operations, which we expect to fund using cash from operations. We expect to fund any Advertising Solutions segment capital expenditures using cash from operations. We expect total 2010 capital investment to be in the \$18 billion to \$19 billion range. This level of investment is framed by the

expectation that regulatory and legislative decisions relating to the telecom sector will continue to be sensitive to investment.

### Cash Used in or Provided by Financing Activities

We paid dividends of \$9,670 in 2009, \$9,507 in 2008 and \$8,743 in 2007, reflecting dividend rate increases. In December 2009, our Board of Directors approved a 2.4% increase in the quarterly dividend from \$0.41 to \$0.42 per share. This follows a 2.5% dividend increase approved by AT&T's Board in December 2008. Dividends declared by our Board of Directors totaled \$1.65 per share in 2009, \$1.61 per share in 2008 and \$1.47 per share in 2007. Our dividend policy considers both the expectations and requirements of stockholders, internal requirements of AT&T and long-term growth opportunities. It is our intent to provide the financial flexibility to allow our Board of Directors to consider dividend growth and to recommend an increase in dividends to be paid in future periods. All dividends remain subject to approval by our Board of Directors.

During 2009, we received net proceeds of \$8,161 from the issuance of \$8,228 in long-term debt. Debt proceeds were used for general corporate purposes, including the repayment of maturing debt. Long-term debt issuances consisted of:

- \$1,000 of 4.85% global notes due in 2014.
- \$2,250 of 5.80% global notes due in 2019.
- \$2,250 of 6.55% global notes due in 2039.
- £750 of 5.875% global notes due in 2017 (equivalent to \$1,107 when issued).
- £1,100 of 7.0% global notes due in 2040 (equivalent to \$1,621 when issued).

We entered into cross-currency swaps to exchange the above foreign currency proceeds and the future principal and interest payments to U.S. dollars.

During 2009, debt repayments totaled \$13,236 and consisted of:

- \$8,633 in repayments of long-term debt (includes repayment of \$1,957 for Centennial debt).
- \$4,583 in repayments of commercial paper and short-term bank borrowings.
- \$20 in repayments of other debt.

At December 31, 2009, we had \$7,361 of debt maturing within one year, which included \$7,328 of long-term debt maturities and \$33 of other borrowings. Debt maturing within one year includes the following notes that may be put back to us by the holders:

- \$1,000 of annual put reset securities issued by BellSouth Corporation can be put each April until maturity in 2021.
- An accreting zero-coupon note may be redeemed each May, excluding May 2011, until maturity in 2022. If the zero-coupon note (issued for principal of \$500 in 2007) is held to maturity, the redemption amount will be \$1,030.

We have a five-year credit agreement with a syndicate of

investment and commercial banks. In June 2009, one of the participating banks, Lehman Brothers Bank, Inc., which had declared bankruptcy, terminated its lending commitment of \$535 and withdrew from the agreement. As a result of this termination, the outstanding commitments under the agreement were reduced from a total of \$10,000 to \$9,465. We still have the right to increase commitments up to an additional \$2,535 provided no event of default under the credit agreement has occurred. The current agreement will expire in July 2011. We also have the right to terminate, in whole or in part, amounts committed by the lenders under this agreement in excess of any outstanding advances; however, any such terminated commitments may not be reinstated. 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. This agreement contains a negative pledge covenant, which requires that, if at any time we or a subsidiary pledges assets or otherwise permits a lien on its properties, advances under this agreement will be ratably secured, subject to specified exceptions. We must maintain a debt-to-EBITDA (earnings before interest, income taxes, depreciation and amortization, and other modifications described in the agreement) financial ratio covenant of not more than three-to-one as of the last day of each fiscal quarter for the four quarters then ended. We comply with all covenants under the agreement. At December 31, 2009, we had no borrowings outstanding under this agreement.

During 2009, the following other financing activities occurred:

- We received \$483 related to derivative collateral; \$261 was a return of collateral we posted to derivative counterparties in 2008 and \$222 was collateral we collected from counterparties in 2009.
- We paid \$275 to minority interest holders.
- We received proceeds of \$28 from the issuance of treasury shares related to the settlement of share-based awards.

We plan to fund our 2010 financing activities through a combination of cash from operations and debt issuances. The timing and mix of debt issuance will be guided by credit market conditions and interest rate trends. The emphasis of our financing activities will be the payment of dividends, subject to approval by our Board of Directors, and the repayment of debt.

#### **Other**

Our total capital consists of debt (long-term debt and debt maturing within one year) and stockholders' equity. Our capital structure does not include debt issued by our international equity investees. Our debt ratio was 41.3%, 43.7% and 35.6% at December 31, 2009, 2008 and 2007. The debt ratio is affected by the same factors that affect total capital.

Total capital increased \$2,665 in 2009 compared to a decrease of \$8,121 in 2008. The 2009 total capital increase was due to increased retained earnings and an increase in other comprehensive income, partially offset by a \$2,910 decrease in debt, all factors which lowered the debt ratio in 2009.

The primary factor contributing to the increase in our 2008 debt ratio was the \$16,677 increase in accumulated other comprehensive loss that reflected a decrease in retirement plans funded status and an increase in debt of \$10,876 related to our financing activities. Our stockholders' equity balance was down \$19,020 primarily due to the decrease in retirement plan funded status.

#### **CONTRACTUAL OBLIGATIONS, COMMITMENTS AND CONTINGENCIES**

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

Our contractual obligations as of December 31, 2009, are in the following table. The purchase obligations that follow are those for which we have guaranteed funds and will be funded with cash provided by operations or through incremental borrowings. The minimum commitment for certain obligations is based on termination penalties that could be paid to exit the contract. Since termination penalties would not be paid every year, such penalties are excluded from the table. Other long-term liabilities were included in the table based on the year of required payment or an estimate of the year of payment. Such estimate of payment is based on a review of past trends for these items, as well as a forecast of future activities. Certain items were excluded from the following table as the year of payment is unknown and could not be reliably estimated since past trends were not deemed to be an indicator of future payment.

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

Dollars in millions except per share amounts

Substantially all of our purchase obligations are in our Wireline and Wireless segments. The table does not include the fair value of our interest rate swaps. Our capital lease obligations and bank borrowings have been excluded from the table due to the immaterial value at December 31, 2009. Many of our other noncurrent liabilities have been excluded from the following table due to the uncertainty of the timing of payments, combined with the absence of historical trending to be used as a predictor of such payments. Additionally, certain other long-term liabilities have been excluded since

settlement of such liabilities will not require the use of cash. However, we have included in the following table obligations which primarily relate to benefit funding and severance due to the certainty of the timing of these future payments. Our other long-term liabilities are: deferred income taxes (see Note 10) of \$23,803; postemployment benefit obligations (see Note 11) of \$27,849; and other noncurrent liabilities of \$13,350, which included deferred lease revenue from our agreement with American Tower of \$509 (see Note 5).

### Contractual Obligations

	Payments Due By Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt obligations <sup>1</sup>	\$ 70,021	\$ 7,328	\$12,372	\$10,614	\$ 39,707
Interest payments on long-term debt	66,233	4,178	7,318	5,990	48,747
Operating lease obligations	20,534	2,429	4,322	3,560	10,223
Unrecognized tax benefits <sup>2</sup>	5,181	299	—	—	4,882
Purchase obligations <sup>3</sup>	10,228	2,890	4,095	2,549	694
<b>Total Contractual Obligations</b>	<b>\$172,197</b>	<b>\$17,124</b>	<b>\$28,107</b>	<b>\$22,713</b>	<b>\$104,253</b>

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

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

<sup>3</sup>We calculated the minimum obligation for certain agreements to purchase goods or services based on termination fees that can be paid to exit the contract. If we elect to exit these contracts, termination fees for all such contracts in the year of termination could be approximately \$404 in 2010, \$469 in the aggregate for 2011 and 2012, \$113 in the aggregate for 2013 and 2014 and \$3 in the aggregate, thereafter. Certain termination fees are excluded from the above table, as the fees would not be paid every year and the timing of such payments, if any, is uncertain.

### MARKET RISK

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

#### Interest Rate Risk

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

interest rate swaps. We have established interest rate risk limits that we closely monitor by measuring interest rate sensitivities in our debt and interest rate derivatives portfolios.

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

Following are our interest rate derivatives subject to material interest rate risk as of December 31, 2009. The interest rates illustrated below refer to the average rates we expect to pay based on current and implied forward rates and the average rates we expect to receive based on derivative contracts. The notional amount is the principal amount of the debt subject to the interest rate swap contracts. The fair value asset (liability) represents the amount we would receive (pay) if we had exited the contracts as of December 31, 2009.

	Maturity							Fair Value 12/31/09
	2010	2011	2012	2013	2014	Thereafter	Total	
<b>Interest Rate Derivatives</b>								
Interest Rate Swaps:								
Receive Fixed/Pay Variable Notional Amount Maturing	—	\$3,200	\$3,050	\$1,750	—	\$1,000	\$9,000	\$399
Weighted-Average Variable Rate Payable <sup>1</sup>	3.1%	4.4%	4.8%	5.6%	6.1%	6.4%		
Weighted-Average Fixed Rate Receivable	5.8%	5.7%	5.3%	5.6%	5.6%	5.6%		

<sup>1</sup>Interest payable based on current and implied forward rates for One, Three or Six Month London Interbank Offered Rate (LIBOR) plus a spread ranging between approximately 36 and 654 basis points.

### Foreign Exchange Risk

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

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

In anticipation of other foreign currency-denominated transactions, we often enter into foreign exchange contracts to provide currency at a fixed rate. Our policy is to measure the risk of adverse currency fluctuations by calculating

the potential dollar losses resulting from changes in exchange rates that have a reasonable probability of occurring. We cover the exposure that results from changes that exceed acceptable amounts.

For the purpose of assessing specific risks, we use a sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our financial instruments and results of operations. To perform the sensitivity analysis, we assess the risk of loss in fair values from the effect of a hypothetical 10% depreciation of the U.S. dollar against foreign currencies from the prevailing foreign currency exchange rates, assuming no change in interest rates. For foreign exchange contracts outstanding at December 31, 2009, the change in fair value was immaterial. Furthermore, because our foreign exchange contracts are entered into for hedging purposes, we believe that these losses would be largely offset by gains on the underlying transactions.



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

Dollars in millions except per share amounts

### Issuer Equity Repurchases

On December 10, 2007, our Board of Directors authorized a share repurchase plan of 400 million shares that expired at December 31, 2009. During 2009, we repurchased 133 thousand shares at a cost of \$3. We anticipate concentrating on reducing debt levels in 2010.

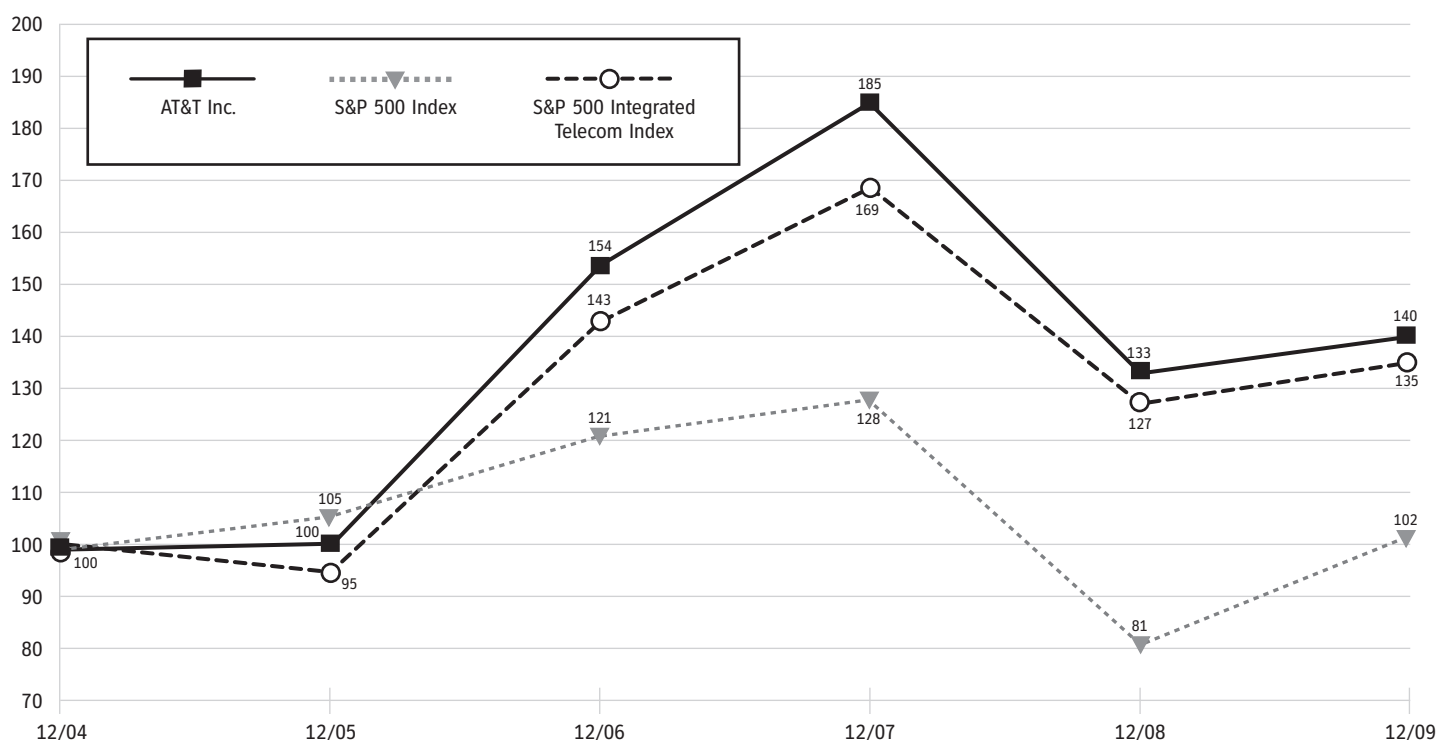
Purchase Period	Total Number of Shares Purchased	Average Price Paid per Share <sup>1</sup>	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
February 1, 2009 – February 28, 2009	133,334	\$25.16	133,334	0
Total	133,334	\$25.16	133,334	0

<sup>1</sup>Average Price Paid per Share excludes transaction costs.

### STOCK PERFORMANCE GRAPH

#### Comparison of Five Year Cumulative Total Return

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



The comparison above assumes \$100 invested on December 31, 2004, in AT&T common stock, Standard & Poor's 500 Index (S&P 500), and Standard & Poor's 500 Integrated Telecom Index (Telecom Index). Total return equals stock price appreciation plus reinvestment of dividends.



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## **RISK FACTORS**

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

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

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

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

Our pension and postretirement costs are subject to increases, primarily due to continuing increases in medical and prescription drug costs, and can be affected by lower returns in prior years on funds held by our pension and other benefit plans, which are reflected in our financial statements over several years. Investment returns on these funds depend largely on trends in the U.S. securities markets and the U.S. economy. In calculating the annual costs included on our financial statements of providing benefits under our plans, we have made certain assumptions regarding future investment returns, medical costs and interest rates. If actual investment returns, medical costs and interest rates are worse than those previously assumed, our annual costs will increase.

The FASB requires companies to recognize the funded status of defined benefit pension and postretirement plans as an asset or liability in our statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Therefore, an increase in our costs will have a negative effect on our balance sheet.

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

The recent instability in the global financial markets and ongoing uncertainty affecting these markets have resulted in extreme volatility in the credit, equity and fixed income markets. This volatility has limited, in some cases severely, most companies’ access to the credit markets, leading to significantly higher borrowing costs for companies or, in many cases, the inability of these companies to fund their ongoing operations. As a result, our larger customers, who tend to be heavy users of our data and wireless services, may be forced to delay or reduce or be unable to finance purchases of our products and services and may delay payment or default on outstanding bills to us. In addition, we contract with large financial institutions to support our own treasury operations, including contracts to hedge our exposure on interest rates and foreign exchange and the funding of credit lines and other short-term debt obligations, including commercial paper. While we have been successful in continuing to access the credit and fixed income markets when needed, a financial crisis could render us unable to access these markets, severely affecting our business operations.

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

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

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

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

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

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

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

On average, we have three to four other wireless competitors in each of our service areas and compete for customers based principally on price, service/device offerings, call quality, coverage area and customer service. In addition, we are likely to experience growing competition from providers offering services using alternative wireless technologies and IP-based networks as well as traditional wireline networks. We expect market saturation may cause the wireless industry's customer growth rate to moderate

in comparison with historical growth rates, leading to increased competition for customers. We expect that the availability of additional 700 MHz spectrum could increase competition and the effectiveness of existing competition. This competition will continue to put pressure on pricing and margins as companies compete for potential customers. Our ability to respond will depend, among other things, on continued improvement in network quality and customer service and effective marketing of attractive products and services, and cost management. These efforts will involve significant expenses and require strategic management decisions on, and timely implementation of, equipment choices, marketing plans and financial budgets.

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

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

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

The trend in telecommunications technology is to shift from the traditional circuit- and wire-based technology to IP-based technology. IP-based technology can transport voice and data, as well as video, from both wired and wireless networks. IP-based networks also potentially cost less to operate than traditional networks. Our competitors, many of which are newer companies, are deploying this IP-based technology. In order to continue to offer attractive and competitively priced services, we are deploying a new broadband network to offer IP-based voice, data and video services. Using a new and sophisticated technology on a very large scale entails risks but also presents opportunities to expand service offerings to customers. Should deployment of our network be delayed or costs exceed expected amounts, our margins would be adversely affected and such effects

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

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

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

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

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

**A majority of our workforce is represented by labor unions. Absent the successful negotiation of certain agreements that expired during 2009, we could experience lengthy work stoppages.**

A majority of our employees are represented by labor unions as of year-end 2009. Labor contracts covering many of the employees expired during 2009. Approximately 75 percent of employees covered by expired contracts have ratified new agreements. We experienced a work stoppage in 2004 when the contracts involving our wireline employees expired, and we may experience additional work stoppages in 2010. A work stoppage could adversely affect our business operations, including a loss of revenue and strained relationships with customers, and we cannot predict the length of any such strike. We cannot predict what will be the provisions for a new contract nor the impact of a new contract on our financial condition.

**CAUTIONARY LANGUAGE CONCERNING  
FORWARD-LOOKING STATEMENTS**

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

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

- Adverse economic and/or capital access changes in the markets served by us or in countries in which we have significant investments, including the impact on customer demand and our ability and our suppliers' ability to access financial markets.
- Changes in available technology and the effects of such changes, including product substitutions and deployment costs.
- Increases in our benefit plans' costs, including increases due to adverse changes in the U.S. and foreign securities markets, resulting in worse-than-assumed investment returns and discount rates, and adverse medical cost trends and unfavorable health care legislation and regulations.
- The final outcome of Federal Communications Commission and other federal agency proceedings and reopenings of such proceedings and judicial review, if any, of such proceedings, including issues relating to access charges, broadband deployment, E911 services, competition, net neutrality, unbundled loop and transport elements, wireless license awards and renewals and wireless services.
- The final outcome of regulatory proceedings in the states in which we operate and reopenings of such proceedings and judicial review, if any, of such proceedings, including proceedings relating to Interconnection terms, access charges, universal service, unbundled network elements and resale and wholesale rates, broadband deployment including our U-verse services, net neutrality, performance measurement plans, service standards and traffic compensation.
- Enactment of additional state, federal and/or foreign regulatory and tax laws and regulations pertaining to our subsidiaries and foreign investments, including laws and regulations that reduce our incentive to invest in our networks, resulting in lower revenue growth and/or higher operating costs.
- Our ability to absorb revenue losses caused by increasing competition, including offerings that use alternative technologies (e.g., cable, wireless and VoIP) and our ability to maintain capital expenditures.
- The extent of competition and the resulting pressure on access line totals and wireline and wireless operating margins.
- Our ability to develop attractive and profitable product/service offerings to offset increasing competition in our wireless and wireline markets.
- The ability of our competitors to offer product/service offerings at lower prices due to lower cost structures and regulatory and legislative actions adverse to us, including state regulatory proceedings relating to unbundled network elements and nonregulation of comparable alternative technologies (e.g., VoIP).
- The timing, extent and cost of deployment of our U-verse services; the development of attractive and profitable service offerings; the extent to which regulatory, franchise fees and build-out requirements apply to this initiative; and the availability, cost and/or reliability of the various technologies and/or content required to provide such offerings.
- Our continued ability to attract and offer a diverse portfolio of devices, some on an exclusive basis.
- The availability and cost of additional wireless spectrum and regulations relating to licensing and technical standards and deployment and usage, including network management rules.
- Our ability to manage growth in wireless data services, including network quality.
- The outcome of pending or threatened litigation, including patent and product safety claims by or against third parties.
- The impact on our networks and business of major equipment failures, our inability to obtain equipment/software or have equipment/software serviced in a timely and cost-effective manner from suppliers, severe weather conditions, natural disasters, pandemics or terrorist attacks.
- Our ability to successfully negotiate new collective bargaining contracts and the terms of those contracts.
- The issuance by the Financial Accounting Standards Board or other accounting oversight bodies of new accounting standards or changes to existing standards.
- The issuance by the Internal Revenue Service and/or state tax authorities of new tax regulations or changes to existing standards and actions by federal, state or local tax agencies and judicial authorities with respect to applying applicable tax laws and regulations and the resolution of disputes with any taxing jurisdictions.
- Our ability to adequately fund our wireless operations, including payment for additional spectrum; network upgrades and technological advancements.
- Changes in our corporate strategies, such as changing network requirements or acquisitions and dispositions, to respond to competition and regulatory, legislative and technological developments.

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