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

Overview

In fiscal 2000, Lucent Technologies Inc. ("Lucent" or the "Company") completed its plan to spin off its Enterprise Networks business to shareowners, forming a separate and independent company. The new company is called Avaya Inc. ("Avaya") (see DISCONTINUED OPERATIONS).

In addition, on July 20, 2000, Lucent announced its intention to spin off its microelectronics business, which includes the optoelectronics components and integrated circuits divisions, into a separate and independent company. The new company is called Agere Systems Inc. ("Agere Systems"). On December 11, 2000, a Form S-1 registration statement was filed with the SEC in anticipation of an initial public offering ("IPO") of Agere Systems. Lucent intends to distribute the remaining shares in a tax-free distribution. This report does not constitute the offering of any securities, which will be made only by a prospectus filed with the SEC. In connection with the spin-off, Lucent may be adjusting its capital structure including a possible reduction in the amount of debt outstanding. The IPO is expected to be completed in the quarter ending March 31, 2001, and completion of the spin-off is expected by the end of the 2001 fiscal year. The IPO and spin-off are subject to certain conditions, including a favorable tax ruling by the IRS.

On November 13, 2000, Lucent entered into an agreement to sell its power systems business to Tyco International Ltd., a diversified manufacturing and service company, for $2,500 million in cash. The sale, which is subject to regulatory approval and other customary closing conditions, is expected to close by December 31, 2000 and result in a one-time gain to be recorded as an extraordinary item, net of tax, in the quarter in which the sale closes.

These actions will allow Lucent to concentrate its investments, resources and management attention on optical, data and wireless solutions, along with the network design, consulting and integration services to support them. Lucent expects to take a business restructuring charge associated with the redesign of its business in the quarter ending March 31, 2001. Lucent expects to give details of the charge in late January, 2001. A review of our internal processes will continue throughout 2001 and may result in additional restructuring and associated charges (see KEY BUSINESS CHALLENGES).

On a total basis, Lucent reported net income of $1,219 million, or $0.37 per share (diluted) for the year ended September 30, 2000, as compared with year-ago net income of $4,789 million, or $1.49 per share (diluted). Fiscal 2000 net income includes a $462 million loss, or $0.14 per share (diluted), from discontinued operations, net of tax, compared with $455 million of income, or $0.14 per share (diluted), net of tax, for fiscal 1999. The fiscal 2000 net income also includes a reduction of costs and operating expenses of $252 million representing the impact of adopting Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). In addition, in fiscal 1999 Lucent changed its method for determining annual net pension and postretirement benefit costs. As a result, included in 1999 net income is a $1,308 million, or $0.41 per share (diluted), cumulative effect of accounting change. Lucent's income before the cumulative effect of accounting change was $3,481 million for the year ended September 30, 1999. See Note 12 to the accompanying Consolidated Financial Statements for further details of the accounting change.

Discontinued Operations

On March 1, 2000, Lucent announced plans to spin off Avaya and, on September 30, 2000, the spin-off was accomplished through a tax-free distribution of shares to Lucent's shareowners.

Avaya represented a significant segment of the Company's business. Pursuant to Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" ("APB 30"), Lucent has reclassified its Consolidated Financial Statements to reflect the spin-off of Avaya. The revenues, costs and expenses, assets and liabilities, and cash flows of Avaya have been segregated in the Consolidated Statements of Income, Consolidated Balance Sheets and Consolidated Statements of Cash Flows. The net operating results, net assets and net cash flows of this business have been reported as "Discontinued Operations" in the accompanying Consolidated Financial Statements.

Lucent recorded a $462 million loss from discontinued operations (net of a tax benefit of $78 million) for the year ended September 30, 2000. The net loss is comprised of $303 million of net income from discontinued operations for the period prior to the measurement date and a $765 million net loss on disposal of Avaya. The loss on disposal of Avaya reflects the costs directly associated with the spin-off and the net loss of Avaya between the measurement date and the spin-off date of September 30, 2000. The costs reflect those components of the Avaya reorganization plan, including a business restructuring charge and directly related asset write-downs of $545 million recorded during the year, along with transaction costs of $56 million for the spin-off. Major components of this charge include $365 million for employee separation and $101 million for real estate consolidation.

In addition, the loss from discontinued operations includes an allocation of Lucent's interest expense based on the amount of debt assumed by Avaya. Approximately $780 million of commercial paper borrowings were assumed by Avaya as part of the spin-off transaction.

Lucent's financial results for discontinued operations are different from the results reported by Avaya due to different assumptions and allocations required to be made by the two companies.

The following discussion will focus on Lucent's results from continuing operations.

Financial Highlights

Lucent reported income from continuing operations of $1,681 million, or $0.51 per share (diluted), for the year ended September 30, 2000, compared with year-ago income from continuing operations of $3,026 million, or $0.94 per share (diluted).

Income from continuing operations for 2000 includes $1,005 million ($1,001 million after-tax) of purchased in-process research and development ("IPRD") expenses related to the acquisitions of Spring Tide Networks, Chromatis Networks, Herrmann Technology, Ortel Corporation, Agere, Inc. and VTC Inc., a pre-tax gain of $189 million ($115 million after-tax) associated with the sale of an equity investment, a reduction to costs and operating expenses of $252 million related to the impact of adopting SOP 98-1 and a pre-tax charge of $61 million ($40 million after-tax) primarily associated with the mergers with International Network Services ("INS"), Excel Switching Corporation and Xedia Corporation.

Income from continuing operations in 1999 includes a $108 million ($71 million after-tax) reversal of business restructuring charges, a $110 million non-tax deductible charge for merger-related costs and a $236 million charge ($169 million after-tax) primarily associated with asset impairments and integration-related charges related to the Ascend Communications, Inc. and Nexabit Networks, Inc. mergers, a $274 million gain ($167 million after-tax) on the sale of an equity investment, and $292 million ($280 million after-tax) of IPRD expenses related to the acquisitions of Stratus Computer, Inc., XNT Systems, Inc., Quantum Telecom Solutions, Inc., InterCall Communications and Consulting, Inc., Quadritek Systems, Inc., Sybarus Technologies, WaveAccess Ltd. and the Ethernet local area network ("LAN") component business of Enable Semiconductor ("Enable").

Acquisitions

As part of Lucent's continuing efforts to provide its customers with end-to-end communications solutions, the Company completed numerous acquisitions and mergers during the three years ended September 30, 2000. For more information, see Note 4 to the accompanying Consolidated Financial Statements.

Operating Segments

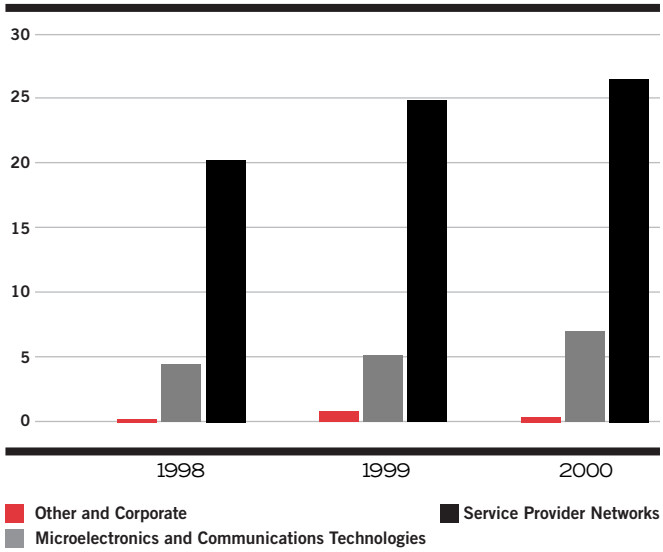
Lucent operates in the global telecommunications networking industry and has two reportable segments: Service Provider Networks ("SPN") and Microelectronics and Communications Technologies ("MCT"). SPN provides public networking systems, software and services to telecommunications service providers and public network operators around the world. MCT provides high-performance optoelectronic components and integrated circuits, power systems and optical fiber for applications in the communications and computing industries. In addition, MCT also includes Lucent's new ventures business. The results of other smaller units and corporate operations are reported in Other and Corporate.

The two reportable operating segments are strategic market units that offer distinct products and services. These segments were determined based on the customers and the markets that Lucent serves. Each market unit is managed separately as each operation requires different technologies and marketing strategies.

As a result of reorganization initiatives (see KEY BUSINESS CHALLENGES), the Company is evaluating changes to its management model and organizational structure which will result in changes to the reportable segments in the next fiscal year.

Segment Revenues

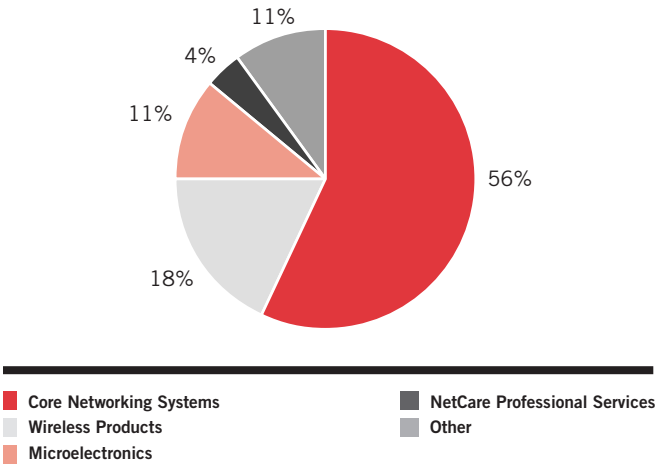
(dollars in billions) For the years ended September 30, 1998, 1999 and 2000



Lucent's Service Provider Networks segment represents about 78% of the total external sales for 2000. Lucent offers a wide range of products and services representing a full-service package for the next generation of networks.

Product and Service Revenues

For the year ended September 30, 2000



Key Business Challenges

Lucent is in the process of reorganizing its business to become more focused and better positioned to capitalize on market opportunities. This reorganization includes the recent spin-off of Avaya, the expected sale of the power systems business and the announced IPO and spin-off of Agere Systems, as well as a comprehensive review and restructuring of Lucent's internal systems and processes. Specific initiatives include performing a comprehensive product and service portfolio review aimed at aligning research and development and effective redeployment of sales and marketing teams and other investments as appropriate, consolidating corporate infrastructure and improving supply chain management. Lucent expects to take a significant business restructuring charge in the quarter ending March 31, 2001. Lucent expects to give details of the charge in late January, 2001. A review of our internal processes will continue throughout 2001 and may result in additional restructuring and associated charges. The reorganization, including the spin-off of Agere Systems, is expected to be completed by September 30, 2001.

A limited number of large customers provide a substantial portion of Lucent's revenues. These customers include Verizon, AT&T and certain incumbent and competitive local exchange carriers. The spending patterns of these customers can vary significantly during the year. An elimination or change in the spending patterns of, or a significant reduction in orders from, any one of these customers could negatively affect Lucent's operating results. Lucent's fiscal year 2000 results were negatively affected by the decline in sales to one large U.S. customer and one large non-U.S. customer. The communications industry has recently experienced a consolidation of both U.S. and non-U.S. companies. As a result, Lucent's operating results could become more dependent on a smaller number of large carriers. Lucent continually endeavors to diversify its customer base by adding new and different types of customers. Lucent, however, is often required to provide or arrange for long-term financing for customers as a condition to obtain or bid on infrastructure contracts. Thus, our ability to develop certain customer relationships may be dependent upon our ability to raise capital and extend credit.

Lucent operates in a highly competitive industry and expects the level of competition relating to pricing and product offerings will intensify. Lucent expects that new competitors will enter its markets as a result of expansion by market participants and advancements in technology. These competitors may include entrants from the telecommunications, software, data networking, cable television and semiconductor industries, and may have strong financial capabilities, technological expertise and established name recognition. Lucent attempts to direct the Company's resources to meet market needs and competitive challenges based on ongoing assessments of market conditions. However, due to misjudgment of the market demand for specific product offerings, Lucent's results for fiscal year 2000 were adversely affected by a larger than expected reduction in revenue and gross margin for its traditional circuit switching products and related software, and lower revenues and gross margins for specific optical networking products.

For the first fiscal quarter of 2001, Lucent anticipates a substantial decline in revenues compared to the year-ago quarter, and a substantial loss from continuing operations. This reflects a significant sales decline in North America due to an overall softening in the competitive local exchange carrier market, slowdown in capital spending by established service providers, lower software sales and a more focused use of vendor financing by Lucent.

On December 21, 2000, Moody's Investors Service lowered Lucent's credit rating on senior unsecured long-term debt from A2 to A3 and on commercial paper from Prime-1 to Prime-2; the A3 rating remains on review for possible further downgrade, and Moody's concluded the review of the commercial paper rating. Also on December 21, 2000, Standard & Poor's lowered Lucent's credit rating on senior unsecured long-term debt from A to BBB+ and the commercial paper rating from A-1 to A-2, both of which remain on CreditWatch with the possibility of further downgrades. Lucent believes that it will have sufficient capital resources to fulfill its own operational and capital needs, as well as to extend credit to customers when appropriate, although there can be no assurance that this will occur.

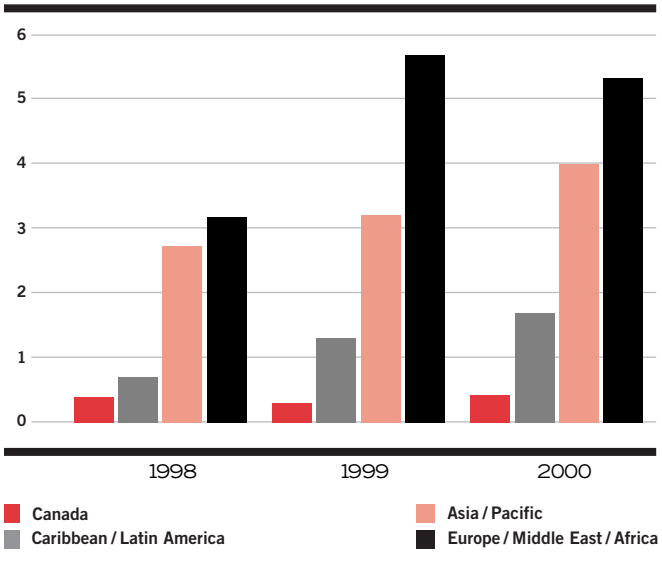
RESULTS OF OPERATIONS:

Revenues

Total revenues for 2000 increased 10.4% to $33,813 million compared with 1999, due to increases in sales from both reportable operating segments, partially offset by a decrease in Other and Corporate, predominantly from the remaining consumer products business, which was sold in the second fiscal quarter of 2000. Revenue growth was driven by sales increases globally. For 2000, sales within the United States grew 10.9% compared with 1999. Non-U.S. revenues increased 9.7% compared with 1999. These non-U.S. sales represented 33.9% of total revenues compared with 34.2% in 1999.

Revenues by Non-U.S. Regions

(dollars in billions) For the years ended September 30, 1998, 1999 and 2000



Revenues are attributed to geographic areas based on the location of customers.

Total revenues for 1999 increased 25.6% to $30,617 million compared with 1998. Revenue growth was driven by sales increases globally. For 1999, U.S. sales grew 15.6% compared with 1998 and non-U.S. sales increased 50.8% compared with 1998. These non-U.S. sales represented 34.2% of total revenues compared with 28.5% in 1998.

The following table presents Lucent's revenues by segment and the percentage of total revenues for the years ended September 30, 2000, 1999, and 1998:

(dollars in millions)

	2000		1999		1998	
		% of Total		% of Total		% of Total
Service Provider Networks	$26,509	78	$24,833	81	$20,116	83
Microelectronics and Communications Technologies	6,953	21	5,026	16	4,134	17
Other and Corporate	351	1	758	3	117	–
Total Lucent	$33,813	100	$30,617	100	$24,367	100

Revenues in 2000 from the SPN segment increased by 6.8%, or $1,676 million, compared with 1999, and increased 23.4%, or $4,717 million, for 1999 compared with 1998. The 2000 increases were driven by sales of service provider Internet infrastructure, wireless systems and professional services, offset in part by a decline in optical networking products, primarily due to lower revenues in the fiscal fourth quarter and a decline in switching revenues. Lower than expected revenues in optical networking, due primarily to being late to market with the OC-192 product, which affected the entire product cycle, from engineering and manufacturing to deployment and launch, had a negative impact on the fiscal year's revenue growth. In addition, lower revenues from switching products primarily due to the shift in customer spending away from circuit switching, pricing pressures and the impact of a substantial reduction in a major long-term foreign project also negatively impacted growth. The 1999 increases resulted primarily from higher sales of switching and wireless systems products with associated software, optical networking and data networking systems and communications software.

U.S. revenues in 2000 from the SPN segment increased by 7.1% over 1999, and by 10.9% comparing 1999 with 1998. The 2000 and 1999 U.S. revenue increases included revenue gains from sales to incumbent local exchange carriers, which in certain cases provide wireless service, and competitive local exchange carriers. Revenues in 2000 increased despite a decline in revenues from AT&T, historically a significant customer. In addition, the 1999 U.S. revenue increase included long distance carriers. Non-U.S. revenues for 2000 increased 6.0% compared with 1999, reflecting gains in all regions except Europe/Middle East/Africa ("EMEA"), which was negatively impacted by the substantial reduction of revenues from a major long-term foreign project, and represented 32.6% of revenues for 2000 compared with 32.8% for 1999. Non-U.S. revenues for 1999 increased 60.7% compared with 1998 due to revenue growth in the EMEA region, primarily due to the same major long-term foreign project, Caribbean/Latin America and Asia/Pacific regions and represented 32.8% of revenues for 1999 compared with 25.2% in 1998.

Lucent expects that product transition associated with a decline in circuit switching revenue and the substantial reduction of revenues from AT&T and a major long-term foreign project will not be fully offset immediately by the ramp-up of newer products. In addition, component shortages have led to a longer than expected full-volume ramp-up in optical networking.

Revenues in 2000 from the MCT segment increased 38.3%, or $1,927 million, compared with 1999. This increase was driven by sales of optical fiber, optoelectronic components, power systems, wired and wireless LAN systems and customized chips for computing and high-speed communications systems. Revenues in 1999 increased 21.6%, or $892 million, compared with 1998, due to higher sales of optoelectronic components and integrated circuits for high-speed communications, data networking, wireless and computing systems. Increased sales of power systems also contributed to the increase.

U.S. sales in 2000 increased 51.8% compared with 1999 and 16.2% in 1999 compared with 1998. Non-U.S. revenues increased 22.5% compared with 1999, with revenue growth in all regions. Non-U.S. revenues increased 28.6% in 1999 compared with 1998, driven by sales in the Asia/Pacific and EMEA regions. Non-U.S. revenues represented 40.7% of sales in 2000 compared with 46.0% in 1999 and 43.5% in 1998.

As previously discussed, in fiscal 2001 Lucent intends to spin off Agere Systems, which is currently part of the MCT segment.

Revenues in 2000 from sales of OTHER AND CORPORATE decreased $407 million compared with 1999, due to lower revenues from the Company's remaining consumer products business, which was sold in the second fiscal quarter of 2000. Revenues in 1999 increased $641 million compared with 1998, primarily due to the consolidation of the businesses regained from the PCC venture.

On October 22, 1998, Lucent and Philips announced they would end their PCC venture. The venture was terminated in late 1998. The results of operations and net assets of the remaining businesses Lucent previously contributed to PCC had been consolidated as of October 1, 1998. Revenues are included in Other and Corporate. In December 1998, Lucent sold certain assets of the wireless handset business to Motorola, Inc. and completed the sale of its remaining consumer products business in the second fiscal quarter of 2000.

COSTS AND GROSS MARGIN

(dollars in millions)

	2000	1999	1998
Costs	$19,539	$15,605	$12,938
Gross margin	$14,274	$15,012	$11,429
Gross margin percentage	42.2%	49.0%	46.9%

Total costs in 2000 increased $3,934 million, or 25.2%, compared with 1999. As a percentage of revenue, gross margin decreased to 42.2% from 49.0% in 1999. This decrease was primarily due to decreased volumes and margins in the optical networking and switching businesses, including lower

software revenues, increased pricing pressures in other product lines and continued expansion into overseas markets, which generally yield lower margins. This decrease in gross margin percentage was partially offset by $400 million resulting from lower personnel costs, including lower incentive compensation awards and a higher net pension credit, and the impact of adopting SOP 98-1. In addition, Lucent anticipates a further shift from higher margin switching products to newer products with initially lower margins. Total costs in 1999 increased $2,667 million, or 20.6%, compared with 1998 due to the increase in sales volume. Gross margin percentage increased 2.1 percentage points from 1998. The increase in gross margin percentage for the year was due to a more favorable mix of products.

OPERATING EXPENSES

(dollars in millions)

	2000	1999	1998
Selling, general and administrative ("SG&A")	$6,266	$5,806	$4,424
As a percentage of revenues	18.5%	19.0%	18.2%
As a percentage of revenues excluding amortization of goodwill and other acquired intangibles	16.9%	18.0%	17.7%

SG&A expenses increased $460 million, or 7.9%, and decreased 0.5 percentage points as a percentage of revenues in 2000 as compared with 1999 and increased $1,382 million, or 31.2%, and increased 0.8 percentage points as a percentage of revenues in 1999 as compared with 1998. The dollar increases are attributable to higher sales volume and increased amortization of goodwill and other acquired intangibles. The current year expense was also negatively impacted by increased reserves for bad debt on trade receivables due to specific credit concerns primarily in the emerging service provider market. These increases were partially offset by $500 million resulting from lower personnel costs, including lower incentive compensation awards and a higher net pension credit, and the impact of adopting SOP 98-1. In addition, included in the current year expense is $61 million primarily associated with the mergers with INS, Excel and Xedia. Included in the 1999 expense is $110 million associated with the mergers with Ascend, Nexabit, RAScom and VitalSigns.

Amortization expense associated with goodwill and other acquired intangibles was $551 million, $310 million and $105 million for the years ended September 30, 2000, 1999 and 1998, respectively. As a result of the 2000 acquisition activity, Lucent expects amortization of goodwill and other acquired intangibles to significantly increase in future periods. On a pro forma basis, assuming the 2000 acquisitions occurred on October 1, 1999, the amortization of goodwill and other acquired intangibles would have increased by approximately $931 million for the year ended September 30, 2000. The 1999 increase largely relates to the $109 million write-off of Livingston goodwill and other acquired intangibles. For further details see IN-PROCESS RESEARCH AND DEVELOPMENT.

In addition, 1999 includes an $85 million reversal of 1995 business restructuring charges.

(dollars in millions)

	2000	1999	1998
Research and development ("R&D")	$4,018	$4,220	$3,667
As a percentage of revenues	11.9%	13.8%	15.0%
Purchased in-process research and development ("IPRD")	$1,005	$ 292	$1,385

R&D expenses in 2000 decreased $202 million, or 4.8%, and decreased 1.9 percentage points as a percentage of revenues compared with 1999, and increased $553 million, or 15.1%, and decreased 1.2 percentage points in 1999 as a percentage of revenues compared with 1998. The 2000 dollar decrease, as well as the percentage of revenues decrease in 2000, were largely the result of $350 million of lower personnel costs, including lower incentive compensation awards and a higher net pension credit, and the impact of adopting SOP 98-1. The 1999 dollar increase was primarily due to increased expenditures in support of substantially all product lines. The 1999 decrease in R&D as a percentage of revenues reflects more custom contract work that was recorded in costs as opposed to R&D.

IPRD expenses for 2000 were $1,005 million, reflecting the charges associated with the acquisitions of Spring Tide, Chromatis, Herrmann, Ortel, Agere and VTC in 2000, as compared with $292 million related primarily to the acquisitions of Stratus, XNT, Quantum, InterCall, Quadritek, Sybarus, WaveAccess and Enable in 1999. See further discussion under IN-PROCESS RESEARCH AND DEVELOPMENT.

OTHER INCOME-NET, INTEREST EXPENSE AND PROVISION FOR INCOME TAXES

(dollars in millions)

	2000	1999	1998
Other income-net	$ 366	$ 402	$ 110
Interest expense	$ 348	$ 318	$ 143
Provision for income taxes	$1,322	$1,752	$1,151
Effective income tax rate	44.0%	36.7%	59.9%
Adjusted income tax rate*	29.7%	32.6%	34.0%

**Excludes non-tax deductible IPRD expenses, merger-related costs, amortization of goodwill and other acquired intangibles, certain one-time gains on sales of equity investments in 2000 and 1999, and the gain on the sale of the Company's ATS business in 1998.*

During 2000, other income, net, included interest income of $125 million and net gains on sales and settlements of financial instruments of $361 million, including a $189 million gain from the sale of an equity investment. During 1999, other income, net, included interest income of $133 million and net gains on sales and settlements of financial instruments of $302 million, including a $274 million gain from the sale of an equity investment. During 1998, other income, net, included interest income of $122 million, gains from the sale of businesses of $208 million, including a gain related to the sale of the Advanced Technology Systems unit of $149 million and net equity losses from investments of $207 million primarily related to the investment in PCC.

Interest expense increased primarily due to higher debt levels in 2000 and 1999. In addition, interest expense in 2000 increased from higher weighted average interest rates on commercial paper.

The effective income tax rates exceed the U.S. federal statutory income tax rates primarily due to the write-offs of IPRD costs and merger-related expenses that are not deductible for tax purposes. The adjusted income tax rate decreased 2.9 percentage points in 2000 compared with 1999. This decrease was primarily due to increased research tax credits and the tax impact of non-U.S. activity. The adjusted income tax rate decreased 1.4 percentage points in 1999 compared with 1998. This decrease was primarily due to a reduced state effective tax rate and the tax impact of non-U.S. activity.

The 1998 effective income tax rate does not include a federal income tax provision for Kenan since Kenan was an S-Corporation prior to its merger with Lucent.

CASH FLOWS

(dollars in millions)

	2000	1999	1998
Net cash provided by (used in):			
Operating activities	$ 304	$ (962)	$ 1,452
Investing activities	$(2,480)	$(1,782)	$(2,697)
Financing activities	$ 2,211	$ 3,345	$ 852

Cash provided by operating activities increased $1,266 million to $304 million in 2000 compared with 1999. This improvement was primarily due to smaller increases in receivables, other operating assets and liabilities and a larger tax benefit from stock options exercised during the current year. The change in receivables resulted from smaller revenue growth in the fiscal fourth quarter of 2000 as compared with the same period in 1999, partially offset by a higher average days outstanding (see FINANCIAL CONDITION). These improvements were partially offset by increased inventories and contracts in process to meet current and anticipated sales commitments to customers and the start-up of several long-term projects, lower accounts payable due to the timing of payments and lower net income as adjusted for non-cash operating items.

Cash from operating activities decreased $2,414 million in 1999 compared with 1998. This was primarily due to larger increases in receivables and inventories as well as lower decreases in payroll and benefit-related liabilities. Cash payments of $61 million were charged against the 1995 business restructuring reserves in 1999, compared with $162 million in 1998. All projects associated with the 1995 business restructuring reserve were substantially completed as of September 30, 1999.

Cash used in investing activities increased $698 million to $2,480 million in 2000 compared with 1999. The increase was primarily due to increased capital expenditures (see below) and decreased proceeds from the sales of investments, partially offset by decreased purchases of investments and higher proceeds from the dispositions of businesses.

Cash used in investing activities decreased $915 million in 1999 compared with 1998, primarily due to increased proceeds from the sales of investments and a reduction in cash used for acquisitions and purchases of investments, partially offset by increased capital expenditures.

Capital expenditures were $2,701 million, $2,042 million and $1,615 million for 2000, 1999 and 1998, respectively. The increases in capital expenditures primarily relate to expenditures for equipment and facilities used in manufacturing and research and development, including expansion of manufacturing capacity, and expenditures for efficiency improvements and non-U.S. growth. In addition, in 2000 capital expenditures included capitalized internal use software.

Cash provided by financing activities decreased $1,134 million to $2,211 million in 2000 compared with 1999. This decrease was primarily due to lower issuances of long-term debt and increases in repayments of long-term debt, partially offset by an increase in short-term borrowings and an increase in proceeds from the issuances of common stock primarily for stock option exercises.

Cash provided by financing activities increased $2,493 million in 1999 compared with 1998. This increase was primarily due to increased issuances of debt.

FINANCIAL CONDITION

(dollars in millions)

	2000	1999
Total assets	$48,792	$35,372
Total liabilities	$22,620	$21,436
Working capital	$10,613	$10,090
Debt to total capital (debt plus equity)	20.0%	29.6%
Inventory turnover ratio	4.1x	4.4x
Average days outstanding – receivables	102 days	89 days

Total assets as of September 30, 2000, increased $13,420 million, or 37.9%, from September 30, 1999. This increase was primarily from increases of $8,985 million in goodwill and other acquired intangibles, as well as from increases in receivables, inventories, contracts in process, prepaid pension costs, and other assets of $759 million, $1,437 million, $779 million, $981 million and $994 million, respectively. These increases were partially offset by a decrease in net assets of discontinued operations of $907 million as a result of completing the Avaya spin-off on September 30, 2000. The increase in goodwill and other acquired intangibles is due to the acquisitions made in fiscal 2000 (see ACQUISITIONS). Receivables increased primarily due to higher sales volume coupled with higher average days outstanding (see below). During the fourth fiscal quarter of 2000, approximately $550 million of receivables for one large non-U.S. customer were sold. The increase in inventories resulted from the need to meet current and anticipated sales commitments to customers. Contracts in process increased as a result of the start-up of several long-term projects. Prepaid pension costs increased primarily due to higher return on plan assets and an increase in the discount rate in 2000. Other assets increased due largely to the capitalization of internal use software, increased investments and an increase in other intangible assets.

The fair value of Lucent's pension plan assets is greater than the projected pension obligations. Lucent records pension income when the expected return on plan assets plus amortization of the transition asset is greater than the interest cost on the projected benefit obligation plus service cost for the year and amortization of prior service cost.

Total liabilities increased $1,184 million, or 5.5%, from September 30, 1999. This increase was due primarily to higher commercial paper balances.

Working capital, defined as current assets less current liabilities, increased $523 million from September 30, 1999, primarily resulting from an increase in receivables, inventories and contracts in process, partially offset by the increase in short-term debt.

Debt to total capital decreased 9.6 basis points in 2000 compared with 1999. This decrease was related to the 2000 increase in additional paid-in capital primarily associated with the issuance of common stock for business acquisitions made during the year and, to a lesser extent, the exercise of stock options and sales of stock through the employee stock purchase plan.

For the year ended September 30, 2000, Lucent's inventory turnover ratio decreased to 4.1x compared with 4.4x for the year ended September 30, 1999. The decrease is due to higher inventory in fiscal 2000. Inventory turnover ratio is calculated by dividing cost of sales for the three months ended September 30 by the fiscal fourth quarter average ending inventory balance, using a two-point average.

Average days outstanding – receivables were up 13 days to 102 days in 2000 compared with 1999 reflecting the growth in Lucent's sales outside the United States, which typically carry longer payment terms and growth in very competitive emerging markets that currently require longer payment terms. Average days outstanding is calculated by dividing the fiscal fourth quarter average ending receivables balance, using a two-point average, by total revenues for the three months ended September 30.

LIQUIDITY AND CAPITAL RESOURCES

Lucent expects that, from time to time, outstanding commercial paper balances may be replaced with short- or long-term borrowings as market conditions permit. At September 30, 2000, Lucent maintained approximately $4.7 billion in credit facilities, of which a portion is used to support Lucent's commercial paper program. At September 30, 2000, approximately $4.5 billion was unused.

Future financings will be arranged to meet Lucent's requirements with the timing, amount and form of issue depending on the prevailing market and general economic conditions. Lucent anticipates that borrowings under its bank credit facilities, the issuance of additional commercial paper, cash generated from operations, short- and long-term debt financings, receivable securitizations, the expected proceeds from the sale of the power systems business and the planned IPO of Agere Systems will be adequate to satisfy its future cash requirements, although there can be no assurance that this will be the case.

Lucent's customers worldwide are requiring their suppliers to arrange or provide long-term financing for them as a condition of obtaining or bidding on infrastructure projects. These projects may require financing in amounts ranging from modest sums to more than a billion dollars. Lucent has increasingly provided or arranged long-term financing for customers, and continually monitors and reviews the creditworthiness of such arrangements. As market conditions permit, Lucent's intention is to sell or transfer these long-term financing arrangements, which may include both commitments and drawn-down borrowings, to financial institutions and other investors. This enables Lucent to reduce the amount of its commitments and free up additional financing capacity.

As of September 30, 2000, Lucent had made commitments or entered into agreements to extend credit to certain customers for an aggregate of approximately $6.7 billion. Excluding amounts that are not available because the customer has not yet satisfied the conditions precedent for borrowing, at September 30, 2000, approximately $3.3 billion in loan commitments was undrawn and available for borrowing and approximately $1.3 billion had been advanced and was outstanding. As part of the revenue recognition process, Lucent determines whether the notes receivable under these contracts are reasonably assured of collection based on various factors, among which is the ability of Lucent to sell these notes.

In addition, Lucent had made commitments to guarantee customer debt of about $1.4 billion at September 30, 2000. Excluding amounts not available for guarantee because conditions precedent have not been satisfied, approximately $600 million of guarantees was undrawn and available and about $770 million was outstanding on September 30, 2000.

In addition to the above arrangements, Lucent will continue to provide or commit to financing where appropriate for its business. The ability of Lucent to arrange or provide financing for its customers will depend on a number of factors, including Lucent's capital structure, credit rating and level of available credit, and its continued ability to sell or transfer commitments and drawn-down borrowings on acceptable terms. Lucent believes that it will be able to access the capital markets on terms and in amounts that will be satisfactory to Lucent and that it will be able to obtain bid and performance bonds, to arrange or provide customer financing as necessary, and to engage in hedging transactions on commercially acceptable terms, although there can be no assurance that this will be the case.

For a discussion of the Company's sales of receivables and notes, see Note 16 to the accompanying Consolidated Financial Statements.

Risk Management

Lucent is exposed to market risk from changes in foreign currency exchange rates and interest rates that could impact its results of operations and financial condition. Lucent manages its exposure to these market risks through its regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. Lucent uses derivative financial instruments as risk management tools and not for trading purposes. In addition, derivative financial instruments are entered into with a diversified group of major financial institutions in order to manage Lucent's exposure to nonperformance on such instruments.

Certain securities held in Lucent's equity and investment portfolio are subject to equity price risk. Lucent generally does not hedge its equity price risk; however, on occasion, may use equity derivative financial instruments that are subject to equity price risks to complement its investment

strategies. As of September 30, 2000, Lucent had no outstanding positions.

Lucent uses foreign exchange forward and options contracts to reduce significant exposure to the risk that the eventual net cash inflows and outflows resulting from the sale of products to non-U.S. customers and purchases from non-U.S. suppliers will be adversely affected by changes in exchange rates. Foreign exchange forward contracts are designated for recorded, firmly committed or anticipated purchases and sales. The use of these derivative financial instruments allows Lucent to reduce its overall exposure to exchange rate movements, since the gains and losses on these contracts substantially offset losses and gains on the assets, liabilities and transactions being hedged. As of September 30, 2000, Lucent's primary net foreign currency market exposures were dispersed through various countries and primarily included the Euro and its legacy currencies. As of September 30, 1999, Lucent's primary net foreign currency market exposures included Canadian dollars and Brazilian reals. Lucent has not changed its policy regarding how such exposures are managed since the year ended September 30, 1999. Management does not foresee or expect any significant changes in foreign currency exposure in the near future.

The fair value of foreign exchange forward contracts is sensitive to changes in foreign currency exchange rates. As of September 30, 2000 and 1999, a 10% appreciation in the value of foreign currencies against the U.S. dollar from the prevailing market rates would result in an incremental net unrealized loss of approximately $59 million and $31 million, respectively. Conversely, a 10% depreciation in these currencies from the prevailing market rates would result in an incremental net unrealized gain of approximately $59 million and $31 million, as of September 30, 2000 and 1999, respectively. Consistent with the nature of the economic hedge of such foreign exchange forward contracts, such unrealized gains or losses would be offset by corresponding decreases or increases, respectively, of the underlying instrument or transaction being hedged.

While Lucent hedges certain foreign currency transactions, the decline in value of non-U.S. dollar currencies may, if not reversed, adversely affect Lucent's ability to contract for product sales in U.S. dollars because Lucent's products may become more expensive to purchase in U.S. dollars for local customers doing business in the countries of the affected currencies.

Lucent manages its ratio of fixed to floating rate debt with the objective of achieving a mix that management believes is appropriate. To manage this mix in a cost-effective manner, Lucent, from time to time, enters into interest rate swap agreements in which it agrees to exchange various combinations of fixed and/or variable interest rates based on agreed-upon notional amounts. Lucent had no material interest rate swap agreements in effect at September 30, 2000 or 1999. Management does not foresee or expect any significant changes in its exposure to interest rate fluctuations or in how such exposure is managed in the near future.

The fair value of Lucent's fixed-rate long-term debt is sensitive to changes in interest rates. Interest rate changes would result in gains/losses in the market value of this debt due to differences between the market interest rates and rates at the inception of the debt obligation. Based on a hypothetical immediate 150 basis point increase in interest rates at September 30, 2000 and 1999, the market value of Lucent's fixed-rate long-term debt would be reduced by approximately $317 million and $360 million, respectively. Conversely, a 150 basis point decrease in interest rates would result in a net increase in the market value of Lucent's fixed-rate long-term debt outstanding at September 30, 2000 and 1999 of approximately $397 million and $456 million, respectively.

IN-PROCESS RESEARCH AND DEVELOPMENT

In connection with the acquisitions of Livingston, Yurie, Stratus, Agere, Ortel, Chromatis and Spring Tide, Lucent allocated non-tax impacting charges of $427 million, $620 million, $267 million, $94 million, $307 million, $428 million and $131 million, respectively, of the total purchase price to IPRD. As part of the process of analyzing each of these acquisitions, Lucent made a decision to buy technology that had not yet been commercialized rather than develop the technology internally. Lucent based this decision on a number of factors including the amount of time it would take to bring the technology to market. Lucent also considered Bell Labs' resource allocation and its progress on comparable technology, if any. Lucent management expects to use the same decision process in the future.

Lucent estimated the fair value of IPRD for each of the above acquisitions using an income approach. This involved estimating the fair value of the IPRD using the present value of the estimated after-tax cash flows expected to be generated by the IPRD, using risk-adjusted discount rates and revenue forecasts as appropriate. The selection of the discount rate was based on consideration of Lucent's weighted average cost of capital, as well as other factors, including the useful life of each technology, profitability levels of each technology, the uncertainty of technology advances that were known at the time, and the stage of completion of each technology. Lucent believes that the estimated IPRD amounts so determined represent fair value and do not exceed the amount a third party would pay for the projects.

Where appropriate, Lucent deducted an amount reflecting the contribution of the core technology from the anticipated cash flows from an IPRD project. At the date of acquisition, the IPRD projects had not yet reached technological feasibility and had no alternative future uses. Accordingly, the value allocated to these projects was capitalized and immediately expensed at acquisition. If the projects are not successful or are not completed in a timely manner, management's anticipated product pricing and growth rates may not be achieved and Lucent may not realize the financial benefits expected from the projects.

Set forth below are descriptions of significant acquired IPRD projects:

Livingston

On December 15, 1997, Lucent completed the purchase of Livingston. Livingston was involved in the development of equipment used by Internet service providers to connect subscribers to the Internet. The allocation to IPRD of $427 million represented its estimated fair value using the methodology described above. Approximately $421 million was allocated to the PortMaster4, a remote-access concentrator targeted at large independent telecommunication companies, cable television companies and Internet service

providers, and the remaining $6 million was allocated to another project.

Revenues attributable to the PortMaster4 were estimated to be $48 million in 1998 and $261 million in 1999. Revenue was expected to peak in 2002 and decline thereafter through the end of the product's life (2007) as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 69% in 2000 to 11% in 2002 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the PortMaster4 were expected to be $5 million.

A risk-adjusted discount rate of 20% was used to discount projected cash flows.

Livingston's PortMaster4 was commercially released in July 1998 and started generating revenues immediately after commercial launch. As a result of the merger between Lucent and Ascend in June 1999, the decision was made to discontinue future development and sales of the PortMaster4 platform in order to maximize research and development efficiency by concentrating on the MAX TNT platform. Instead of having two platforms to address the full spectrum of access switching products, Lucent will be able to have one platform that can address a broad spectrum of applications while minimizing duplicative research and development.

Yurie

On May 29, 1998, Lucent completed the purchase of Yurie. Yurie was involved in the development of ATM access solutions. The allocation to IPRD of $620 million represented its estimated fair value using the methodology described above. The $620 million was allocated to the following projects: (i) LDR 50/200/250 ($609 million) and (ii) LDR 4 ($11 million).

Revenues attributable to the LDR 50/200/250 were estimated to be $132 million in 1999. Revenue was expected to peak in 2000 and decline thereafter through the end of the product's life (2009) as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 84% in 2000 to 9% in 2007 and be negative for the remainder of the projection period. Costs to complete the research and development efforts related to the LDR 50/200/250 were expected to be $29 million at the acquisition date.

A risk-adjusted discount rate of 20% was used to discount projected cash flows.

The LDR 50, LDR 200 and LDR 250 were all completed on time or have met all of their scheduled milestones. Some of the product releases have been renamed.

Stratus

On October 20, 1998, Ascend completed the purchase of Stratus. Stratus was a manufacturer of fault-tolerant computer systems. The allocation to IPRD of $267 million represented its estimated fair value using the methodology described above. The primary projects that made up the IPRD were as follows: HP-UX, Continuum 1248, Continuum 448, M708, SPHINX, HARMONY, LNP, CORE IN, Personal Number Portability (PN), Signaling System 7 (SS7) Gateway and Internet Gateway.

Revenues attributable to the projects were estimated to be $84 million in 1999 and $345 million in 2000. Revenue was expected to peak in 2002 and decline thereafter through the end of the product's life (2009) as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 310% in 2000 to 6% in 2002 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the projects were expected to be $48 million.

A risk-adjusted discount rate of 35% was used to discount projected cash flows.

The actual results to date have been consistent, in all material respects, with our assumptions at the time of the acquisition, except as noted below. During fiscal 1999 the product development relating to the HARMONY, SPHINX and Continuum 448 projects were discontinued due to management's reprioritization of product direction. In addition, it was decided that development relating to the Continuum 1248 would cease by the quarter ended December 31, 1999. Consequently, Lucent did not realize the forecast revenues from these projects.

Agere, Inc.

On April 20, 2000, Lucent completed the purchase of Agere. Agere was involved in the development of programmable network processors for use in managing traffic on high-speed voice and data networks. The allocation to IPRD of $94 million represented its estimated fair value using the methodology described above. The $94 million was allocated to the development of a fully programmable, multiprotocol network processor for OC-48 (2.5 gigabits per second) wire speeds.

Revenues attributable to the OC-48 product were estimated to be $21 million in 2001 and $65 million in 2002. Revenue was expected to peak in 2007 and decline thereafter through the end of the product's life (2009) as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 205% in 2002 to 5% in 2007 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $3 million.

A risk-adjusted discount rate of 30% was used to discount projected cash flows.

Ortel Corporation

On April 27, 2000, Lucent completed the purchase of Ortel. Ortel was involved in the development of semiconductor-based optoelectronic components used in fiber-optic systems for telecommunications and cable television networks. The allocation to IPRD of $307 million represented its estimated fair value using the methodology described above. The $307 million was allocated to the following projects: 10G New Products ($61 million), 10G OC-192 Receiver/Daytona ($105 million), 980 ($95 million), 1550 ($27 million) and CATV ($19 million).

Revenues attributable to the 10G New Products were estimated to be $5 million in 2001 and $30 million in 2002. Revenue was expected to peak in 2009 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 447% in 2002 to 8% in 2009, and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $3 million.

Revenues attributable to the 10G OC-192 Receiver/ Daytona were estimated to be $16 million in 2001 and $33 million in 2002. Revenue was expected to peak in 2009 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 166% in 2003 to 8% in 2009 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $1 million.

Revenues attributable to the 980 were estimated to be $44 million in 2001 and $108 million in 2002. Revenue was expected to peak in 2008 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 143% in 2002 to 17% in 2008, and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $1 million.

Revenues attributable to the 1550 were estimated to be $2 million in 2001 and $63 million in 2002. Revenue was expected to peak in 2008 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 33% in 2003 to 17% in 2008, and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $2 million.

Revenues attributable to the CATV product were estimated to be $28 million in 2001 and $58 million in 2002. Revenue was expected to peak in 2004 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 107% in 2002 to 4% in 2004 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $1 million.

A risk-adjusted discount rate of 25% was used to discount projected cash flows.

Chromatis Networks

On June 28, 2000, Lucent completed the purchase of Chromatis. Chromatis was involved in the development of next-generation optical transport solutions that provide telecommunications carriers with improvements in the cost, efficiency, scale and management of multiservice metropolitan networks. The allocation to IPRD of $428 million represented its estimated fair value using the methodology described above. The $428 million was allocated to the first generation of its Metropolis product, which will integrate data, voice and video services on metropolitan networks and combine this traffic onto a wave division multiplexing ("WDM") system.

Revenues attributable to the Metropolis product were estimated to be $375 million in 2001 and $1 billion in 2002. Revenue was expected to peak in 2005 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 196% in 2002 to 10% in 2004 and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $7.8 million.

A risk-adjusted discount rate of 25% was used to discount projected cash flows.

Spring Tide Networks

On September 19, 2000, Lucent completed the purchase of Spring Tide. Spring Tide was involved in the development of carrier-class network equipment that enables service providers to offer new, value-added Internet protocol ("IP") services and virtual private networks ("VPN") with low cost and complexity. Spring Tide was involved in the development of Versions 2.0 and 2.1 of the IP Service Switch, the next generations of Spring Tide's flagship product. The allocation to IPRD of $131 million represented their estimated fair value using the methodology described above. Approximately $128 million was allocated to the next-generation IP Service Switch products, carrier-class platforms that will combine the connectivity of a remote access server, the network intelligence of a remote access server, and the switching capacity and quality of service ("QoS") capabilities of an ATM switch in one integrated solution. The remaining $3 million was allocated to projects designed to enhance the capabilities and decrease production costs associated with the IP Service Switch.

Revenues attributable to the IP Service Switch products were estimated to be $109 million in 2001 and $337 million in 2002. Revenue was expected to peak in 2006 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by Lucent. Revenue growth was expected to decrease from 209% in 2002 to 4.4% in 2006, and be negative for the remainder of the projection period. At the acquisition date, costs to complete the research and development efforts related to the product were expected to be $0.5 million and $4.3 million in 2000 and 2001, respectively.

A risk-adjusted discount rate of 25% was used to discount projected cash flows.

Given the uncertainties of the development process, the aforementioned estimates are subject to change, and no assurance can be given that deviations from these estimates will not occur. Management expects to continue development of these efforts and believes there is a reasonable chance of successfully completing the development efforts. However, there is risk associated with the completion of the projects and there can be no assurance that the projects will realize either technological or commercial success. Failure to successfully develop and commercialize the IPRD would result in the loss of the expected economic return inherent in the fair value allocation.

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis of Results of Operations and Financial Condition and other sections of this report contain forward-looking statements that are based on current expectations, estimates, forecasts and projections about the industries in which Lucent operates, management's beliefs, and assumptions made by management. In addition, other written or oral statements that constitute forward-looking statements may be made by or on behalf of Lucent. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("Future Factors") that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecast in such forward-looking statements. Lucent undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Future Factors include increasing price, products and services competition by U.S. and non-U.S. competitors, including new entrants; rapid technological developments and changes and the Company's ability to continue to introduce competitive new products and services on a timely, cost-effective basis; the mix of products and services; the availability of manufacturing capacity, components and materials; the ability to recruit and retain talent; the achievement of lower costs and expenses; credit concerns in the emerging service provider market; customer demand for the Company's products and services; the ability to successfully integrate the operations and business of acquired companies; timely completion of the proposed IPO and spin-off of Agere Systems and the sale of the power systems business; the successful implementation of the strategic reorganization; U.S. and non-U.S. governmental and public policy changes that may affect the level of new investments and purchases made by customers; changes in environmental and other U.S. and non-U.S. governmental regulations; protection and validity of patent and other intellectual property rights; reliance on large customers and significant suppliers; the ability to supply customer financing; technological, implementation and cost/financial risks in the use of large, multiyear contracts; the Company's credit ratings; the outcome of pending and future litigation and governmental proceedings and continued availability of financing, financial instruments and financial resources in the amounts, at the times and on the terms required to support the Company's future business. These are representative of the Future Factors that could affect the outcome of the forward-looking statements. In addition, such statements could be affected by general industry and market conditions and growth rates, general U.S. and non-U.S. economic conditions, including interest rate and currency exchange rate fluctuations and other Future Factors.

Competition

See discussion under KEY BUSINESS CHALLENGES.

Dependence on New Product Development

The markets for the Company's principal products are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and evolving methods of building and operating communications systems for service providers and other customers. The Company's operating results will depend to a significant extent on its ability to continue to introduce new systems, products, software and services successfully on a timely basis and to reduce costs of existing systems, products, software and services. The success of these and other new offerings is dependent on several factors, including proper identification of customer needs, cost, timely completion and introduction, differentiation from offerings of the Company's competitors and market acceptance. In addition, new technological innovations generally require a substantial investment before any assurance is available as to their commercial viability, including, in some cases, certification by non-U.S. and U.S. standard-setting bodies.

Reliance on Major Customers

See discussion under KEY BUSINESS CHALLENGES.

European Monetary Union – Euro

Several member countries of the European Union have established fixed conversion rates between their existing sovereign currencies and the Euro and have adopted the Euro as their new single legal currency. The legacy currencies will remain legal tender in the participating countries for a transition period until January 1, 2002. During the transition period, cashless payments can be made in the Euro. Between January 1, 2002 and July 1, 2002, the participating countries will introduce Euro notes and coins and withdraw all legacy currencies so that they will no longer be available.

Lucent has in place a joint European-United States team representing affected functions within the Company. This team is evaluating Euro-related issues affecting the Company that include its pricing/marketing strategy, conversion of information technology systems and existing contracts. The Euro conversion may affect cross-border competition by creating cross-border price transparency.

Lucent will continue to evaluate issues involving introduction of the Euro as further accounting, tax and governmental legal and regulatory guidance is available. Based on current information and Lucent's current assessment, Lucent does not expect that the Euro conversion will have a material adverse effect on its business or financial condition.

Multiyear Contracts

Lucent has significant contracts for the sale of infrastructure systems to network operators that extend over multiyear periods and expects to enter into similar contracts in the future, with uncertainties affecting recognition of revenues, stringent acceptance criteria, implementation of new technologies and possible significant initial cost overruns and losses. See also discussion under LIQUIDITY AND CAPITAL RESOURCES and KEY BUSINESS CHALLENGES.

Future Capital Requirements

See discussion under LIQUIDITY AND CAPITAL RESOURCES.

Non-U.S. Growth, Foreign Exchange Rates and Interest Rates

Lucent intends to continue to pursue growth opportunities in non-U.S. markets. In many non-U.S. markets, long-standing relationships between potential customers of Lucent and their local providers, and protective regulations, including local content requirements and type approvals, create barriers to entry. In addition, pursuit of such non-U.S. growth opportunities may require significant investments for an extended period before returns on such investments, if any, are realized. Such projects and investments could be adversely affected by reversals or delays in the opening of non-U.S. markets to new competitors, exchange controls, currency fluctuations, investment policies, repatriation of cash, nationalization, social and political risks, taxation, and other factors, depending on the country in which such opportunity arises. Difficulties in non-U.S. financial markets and economies, and of non-U.S. financial institutions, could adversely affect demand from customers in the affected countries.

See discussion under RISK MANAGEMENT with respect to foreign exchange and interest rates. A significant change in the value of the U.S. dollar against the currency of one or more countries where Lucent sells products to local customers or makes purchases from local suppliers may materially adversely affect Lucent's results. Lucent attempts to mitigate any such effects through the use of foreign currency exchange contracts, although there can be no assurances that such attempts will be successful.

Legal Proceedings and Environmental Matters

See discussion in Note 17 to the accompanying Consolidated Financial Statements.

Five-Year Summary of Selected Financial Data (Unaudited)

Lucent Technologies Inc. and Subsidiaries

(dollars in millions, except per share amounts)

	Years Ended September 30,				Nine Months Ended September 30,
RESULTS OF OPERATIONS[5]	2000	1999	1998	1997	1996[1]
Revenues	$33,813	$30,617	$24,367	$21,483	$12,432
Gross margin	14,274	15,012	11,429	9,215	4,868
Depreciation and amortization expense	2,318	1,580	1,228	1,348	822
Operating income	2,985	4,694	1,953	1,219	256
Income from continuing operations	1,681	3,026	769	453	125
Income (loss) from discontinued operations	(462)	455	296	17	263
Income before cumulative effect of accounting change	1,219	3,481	1,065	470	388
Cumulative effect of accounting change	–	1,308	–	–	–
Net income	1,219	4,789	1,065	470	388
Earnings (loss) per common share – basic[2][3]:					
Income from continuing operations	$ 0.52	$ 0.97	$ 0.25	$ 0.15	$ 0.04
Income (loss) from discontinued operations	(0.14)	0.15	0.10	0.01	0.10
Cumulative effect of accounting change	–	0.42	–	–	–
Net income	$ 0.38	$ 1.54	$ 0.35	$ 0.16	$ 0.14
Earnings (loss) per common share – diluted[2][3]:					
Income from continuing operations	$ 0.51	$ 0.94	$ 0.25	$ 0.15	$ 0.04
Income (loss) from discontinued operations	(0.14)	0.14	0.09	0.01	0.10
Cumulative effect of accounting change	–	0.41	–	–	–
Net income	$ 0.37	$ 1.49	$ 0.34	$ 0.16	$ 0.14
Earnings per common share – pro forma[3][4]	n/a	n/a	n/a	n/a	$ 0.13
Dividends per common share[3]	$ 0.08	$ 0.08	$0.0775	$0.0563	$0.0375
FINANCIAL POSITION[5]					
Total assets	$48,792	$35,372	$25,144	$21,045	$20,242
Working capital	10,613	10,090	5,355	1,494	1,963
Total debt	6,559	5,867	2,861	4,182	2,795
Shareowners' equity	26,172	13,936	7,960	4,570	3,479
OTHER INFORMATION					
Gross margin percentage	42.2%	49.0%	46.9%	42.9%	39.2%
Selling, general and administrative expenses as a percentage of revenues	18.5%	19.0%	18.2%	19.5%	22.4%
Research and development expenses as a percentage of revenues	11.9%	13.8%	15.0%	14.1%	14.7%
Ratio of total debt to total capital (debt plus equity)	20.0%	29.6%	26.4%	47.8%	44.5%
Capital expenditures	$ 2,701	$ 2,042	$ 1,615	$ 1,569	$ 981

(1) Beginning September 30, 1996, Lucent changed its fiscal year-end from December 31 to September 30 and reported results for the nine-month transition period ended September 30, 1996.

(2) The calculation of earnings per share on a historical basis includes the retroactive recognition to January 1, 1995, of the 2,098,499,576 shares (524,624,894 shares on a pre-split basis) owned by AT&T on April 10, 1996.

(3) All per share data have been restated to reflect the two-for-one splits of Lucent's common stock that became effective on April 1, 1998, and April 1, 1999.

(4) The calculation of earnings (loss) per share on a pro forma basis assumes that all 2,951,466,467 shares outstanding on April 10, 1996, were outstanding since January 1, 1996, and gives no effect to the use of proceeds from the IPO.

(5) Certain prior year amounts have been reclassified to conform to the fiscal year 2000 presentation.

n/a Not applicable.

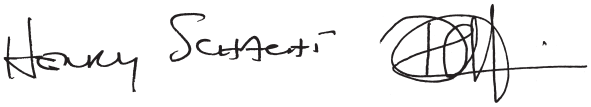
REPORT OF MANAGEMENT

Management is responsible for the preparation of Lucent Technologies Inc.'s consolidated financial statements and all related information appearing in this Annual Report. The consolidated financial statements and notes have been prepared in conformity with accounting principles generally accepted in the United States of America and include certain amounts that are estimates based upon currently available information and management's judgment of current conditions and circumstances.

To provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that accounting records are reliable for preparing financial statements, management maintains a system of accounting and other controls, including an internal audit function. Even an effective internal control system, no matter how well designed, has inherent limitations – including the possibility of circumvention or overriding of controls – and therefore can provide only reasonable assurance with respect to financial statement presentation. The system of accounting and other controls is improved and modified in response to changes in business conditions and operations and recommendations made by the independent accountants and the internal auditors.

The Audit and Finance Committee of the Board of Directors, which is composed of directors who are not employees, meets periodically with management, the internal auditors and the independent accountants to review the manner in which these groups are performing their responsibilities and to carry out the Audit and Finance Committee's oversight role with respect to auditing, internal controls and financial reporting matters. Both the internal auditors and the independent accountants periodically meet privately with the Audit and Finance Committee and have access to its individual members.

Lucent engaged PricewaterhouseCoopers LLP, independent accountants, to audit the consolidated financial statements in accordance with auditing standards generally accepted in the United States of America, which include consideration of the internal control structure. Their report appears on this page.



Henry B. Schacht
Chairman and
Chief Executive Officer

Deborah C. Hopkins
Executive Vice President and
Chief Financial Officer

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and
Shareowners of Lucent Technologies Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in shareowners' equity and cash flows present fairly, in all material respects, the financial position of Lucent Technologies Inc. and its subsidiaries at September 30, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2000, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, in 2000 the Company changed its accounting method for computer software developed or obtained for internal use. Also, as discussed in Note 12, in 1999 the Company changed its method for calculating annual net pension and postretirement benefit costs.



PricewaterhouseCoopers LLP
New York, New York
December 20, 2000