LUCENT TECHNOLOGIES

# FINANCIAL REVIEW 2001


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# MANAGEMENT'S DISCUSSION AND ANALYSIS

*of Results of Operations and Financial Condition*

## OVERVIEW

Lucent Technologies designs and delivers networks for the world's largest communications service providers. Backed by Bell Labs research and development, we rely on our strengths in mobility, optical, data and voice networking technologies, as well as software and services, to develop next-generation networks. Our systems, services and software are designed to help customers quickly deploy and better manage their networks and create new, revenue-generating services that help businesses and consumers.

During fiscal year 2001, we reorganized the company to become more focused and better positioned to capitalize on market opportunities. This reorganization included:

- on August 31, 2001, we sold our Oklahoma and Ohio manufacturing operations to Celestica Corporation (see LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Sale of manufacturing operations*);
- on July 24, 2001, we announced that we had entered into agreements to sell our optical fiber business, and the sale was completed on November 16, 2001 (see LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Sale of optical fiber business*);
- on April 2, 2001, Agere Systems Inc. (our microelectronics business) completed an initial public offering ("IPO") of 600 million shares of Class A common stock. We intend to spin-off our 57.8% remaining interest in Agere through a tax-free distribution to our shareowners (see Note 3 to the consolidated financial statements and LIQUIDITY AND CAPITAL RESOURCES – Agere Spin-Off Update);
- on January 24, 2001 and on July 24, 2001, we announced phase I and phase II of our restructuring program. In connection with this program, we recorded pretax charges of $11.4 billion during the year ended September 30, 2001 (see RESULTS OF OPERATIONS – Gross Margin and Operating Expenses – *Restructuring charges and asset impairments* and LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Restructuring program*); and
- on December 29, 2000, we completed the sale of our power systems business to Tyco International Ltd. for $2.5 billion in cash.

## STRATEGIC DIRECTION

We are realigning our business around two customer-focused units: the Integrated Network Solutions unit, targeting wireline service providers, and the Mobility Solutions unit, targeting wireless service providers. As part of this realignment, we expect to orient our product lines, research and development efforts, sales and marketing, and supply chain and services to meet the needs of the world's largest service providers.

While market demand continues to be uncertain, we believe our strategy to target the world's largest service providers offers the most stable and attractive opportunity for us. We have substantial experience in building and supporting the complex networks that large service providers use to meet the needs of their customers. We have strong relationships with most of the large service providers in the United States, as well as many large service providers outside the United States.

The successful implementation of our restructuring efforts is essential to implementing our new strategy in the manner and on the timeline we intend (see LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Restructuring program*).

## RESULTS OF OPERATIONS

### Revenues

The following table presents our U.S. and non-U.S. revenues and the approximate percentage of total revenues (dollars in millions):

| | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| U.S. | $ 13,776 | $ 19,829 | $ 18,407 |
| Non-U.S. | 7,518 | 9,075 | 8,586 |
| Total revenues | $21,294 | $28,904 | $26,993 |
| | *As a percentage of total revenues* | | |
| U.S. | 64.7% | 68.6% | 68.2% |
| Non-U.S. | 35.3% | 31.4% | 31.8% |
| Total revenues | 100.0% | 100.0% | 100.0% |

The decrease in revenues globally for the year ended September 30, 2001 compared to the prior fiscal year was primarily due to a deterioration in global telecommunications market conditions, a significant decrease in the competitive local exchange carrier ("CLEC") market and a significant reduction in capital spending by established service providers. In addition, we implemented a more selective customer financing program, which also had an impact on revenues. Approximately 50% of the decline in the U.S. was related to lower spending by our largest customers. A limited number of our large customers provide a substantial portion of our revenues. These customers include, among others, Verizon, AT&T, Verizon Wireless, AT&T Wireless, SBC, BellSouth, Sprint and Qwest. The remainder of the revenue decrease was primarily due to the deteriorating CLEC market. The decrease in non-U.S. revenues for the year ended September 30, 2001 compared with the prior year reflects the winddown of a project with Saudi Telecommunications Company ("STC") in Saudi Arabia and lower revenues from two other projects, including One.Tel Corp., which went into receivership in fiscal year 2001.

The increase in U.S. revenues for the year ended September 30, 2000 compared with fiscal year 1999 included higher revenue from sales to incumbent local exchange carriers (wireline and wireless) and CLECs. Revenues in fiscal year 2000 increased despite a decline in revenues from AT&T, which has historically been a significant customer. The higher non-U.S. revenues reflected increases in all regions except the Europe/Middle East/Africa region, which was negatively affected by the substantial reduction of revenues from the STC project.

As a result of the sale of our optical fiber business and other dispositions we may undertake, our new strategic direction that focuses on large service providers and the continued uncertainty in the telecommunications market, we expect that revenues for the year ended September 30, 2002 will be less than the year ended September 30, 2001.

**Segment Revenues**

The following table presents our U.S. and non-U.S. revenues by segment and the approximate percentage of total revenues (dollars in millions):

| | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| U.S.: | | | |
| Products | $10,622 | $15,888 | $14,640 |
| Services | 2,870 | 3,272 | 2,828 |
| Non-U.S.: | | | |
| Products | $ 6,225 | $ 7,473 | $ 7,182 |
| Services | 1,292 | 1,654 | 1,383 |
| Total: | | | |
| Products | $16,847 | $23,361 | $21,822 |
| Services | 4,162 | 4,926 | 4,211 |
| | *As a percentage of total revenues* | | |
| Products | 79.1% | 80.8% | 80.8% |
| Services | 19.5% | 17.0% | 15.6% |

Decreases in Products' and Services' revenues for the year ended September 30, 2001, compared with the year ended September 30, 2000, were primarily attributable to the factors noted above. Products' revenues decreased in all product lines, except optical fiber. Sales of Products are a primary driver of Services' revenues, therefore Services' revenues tend to follow the trend of Products' revenues.

Of our major customers in the U.S., AT&T was the largest contributor to the revenue decline. Compared with the prior year, revenues from AT&T declined by $1.7 billion, of which $1.6 billion was in the Products' segment. This decrease negatively affected our wireless, switching and access, and optical networking products. Non-U.S. revenues were affected by the STC project noted above. Revenues from the STC project were approximately $1 billion less than in the prior year, of which $646 million of the decrease was in the Products' segment. In addition, the STC project represented over 40% of the volume decline in the Services' segment.

Increases in Products' revenues for the year ended September 30, 2000, compared with the year ended September 30, 1999, were driven by sales of service provider Internet infrastructure and wireless systems, offset in part by a decline in switching and optical networking products. Lower than expected revenues in optical networking were largely due to delayed market entry with the OC-192 product. In addition, lower revenues from switching products were primarily due to the shift in customer spending away from circuit switching, competitive pricing and the impact of a substantial reduction in the STC project.

Increases in Services' revenues in the U.S. for the year ended September 30, 2000, compared with the year ended September 30, 1999, were driven by factors noted in the Products' revenues discussion along with increased installation revenues driven by improved sales to large service providers. Non-U.S. Services' revenues increased in fiscal year 2000 as compared with the prior fiscal year, primarily due to increased system support business in the Europe/Middle East/Africa and Asia/Pacific regions.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin 101, "Revenue Recognition in Financial Statements" ("SAB 101"). SAB 101 provides guidance on the recognition, presentation and disclosure of revenues in financial statements. The adoption of SAB 101 in fiscal year 2001 did not have a significant impact on segment revenues or the comparability of results of operations for the periods presented (see Note 5 to the consolidated financial statements).

**Gross Margin**

The telecommunications market conditions noted in the Revenues section significantly reduced our gross margin and gross margin as a percentage of revenues in the year ended September 30, 2001. The gross margin percentage for the year ended September 30, 2001 decreased to 9.7% from 40.5% in the prior fiscal year. The fiscal year 2001 gross margin percentage includes inventory charges of approximately $1.2 billion associated with product rationalizations and discontinuance of products under our business restructuring program. Excluding this amount, the gross margin percentage would have been 15.6%. Other factors contributing to the gross margin percentage decline were:

- reduced spending by service providers that caused lower sales volumes across most product lines and services, and consequently resulted in less absorption of fixed costs;
- one-time charges associated with customers experiencing financial difficulties;
- lower software revenues compared with the prior year;
- costs associated with supplier and customer contract settlements;
- the impact of several international contracts with lower margins;
- higher provisions for slow-moving and obsolete inventory; and
- a shift of approximately 4% in the geographic revenue mix from the U.S. region, which typically yields higher gross margins, to non-U.S. regions.

We expect our gross margin percentage to increase from its year ended September 30, 2001 level. Based upon our estimated view of the telecommunications market in the future, improved product mix, reduction of one-time charges, successful implementation of cost reductions initiated in fiscal year 2001, market and product rationalization work and the introduction of new products, our gross margin percentage will improve in the future. However, future market conditions and economic conditions could affect the achievement of this objective.

As a percentage of revenue, gross margin decreased to 40.5% for the year ended September 30, 2000 from 48.0% in fiscal year 1999. This decrease was primarily due to decreased volumes and margins in optical networking and switching products, including lower software revenues, an increase in competitive pricing 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 $350 million of lower personnel costs, including lower incentive compensation awards and a higher net pension credit, and 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").

## Operating Expenses

The following table presents our operating expenses (dollars in millions):

| | Years ended September 30, | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| Selling, general and administrative ("SG&A") expenses, excluding the following two items | $ 4,240 | $ 4,743 | $ 5,009 |
| Provision for uncollectibles and customer financings | 2,249 | 505 | 66 |
| Amortization of goodwill and other acquired intangibles | 921 | 362 | 296 |
| Total SG&A | 7,410 | 5,610 | 5,371 |
| Research and development ("R&D") | 3,520 | 3,179 | 3,536 |
| Purchased in-process research and development ("IPRD") | – | 559 | 276 |
| Business restructuring charges and asset impairments | 10,157 | – | – |
| Operating expenses | $21,087 | $9,348 | $9,183 |

### *SG&A expenses*

Excluding the amortization of goodwill and other acquired intangibles and the provision for uncollectibles and customer financings, SG&A expenses were lower for the year ended September 30, 2001 as compared with fiscal year 2000 resulting primarily from headcount reductions under our restructuring program and other company directed savings initiatives that limited discretionary spending. We expect SG&A expenses to continue to decline in fiscal year 2002 for these reasons (see LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Restructuring program*).

SG&A expenses, excluding the amortization of goodwill and other acquired intangibles and provision for uncollectibles and customer financings, decreased for the year ended September 30, 2000 as compared with the year ended September 30, 1999 due to lower personnel costs of $475 million, including lower incentive compensation awards, a higher net pension credit and the impact of adopting SOP 98-1 partially offset by $61 million of expenses primarily associated with the mergers with International Network Services, Excel Switching Corporation and Xedia. Included in SG&A expenses for the year ended September 30, 1999 was a reversal of 1995 business restructuring charges of $85 million and expenses associated with the mergers with Ascend, Nexabit, RAScom and VitalSigns in the aggregate of approximately $110 million.

### *Provision for uncollectibles and customer financings*

The deterioration of certain customers' credit worthiness resulted in higher provisions for uncollectibles and customer financings in fiscal year 2001 as compared with the prior year. Three customer financings, including provisions for amounts due from One.Tel and Winstar, accounted for approximately 60% of the fiscal year 2001 expense (see LIQUIDITY AND CAPITAL RESOURCES – Customer Financing).

The increase in the provision for uncollectibles and customer financings for the year ended September 30, 2000 as compared with fiscal year 1999 was due to increased reserves for bad debt on trade receivables due to specific credit concerns with certain customers for which financing was provided.

### *Amortization of goodwill and other acquired intangibles*

The full-year effect of the acquisitions of Chromatis Networks, Inc. in June 2000 and Spring Tide Networks in September 2000 was the primary reason for the increase in the amortization of goodwill and acquired intangibles in fiscal year 2001 as compared to the prior fiscal year. Under our restructuring program, we discontinued and rationalized certain product lines and product development efforts, including discontinuing the Chromatis product portfolio. As a result of these actions, certain goodwill impairment charges were recorded. These actions will result in lower amortization of goodwill and acquired intangibles in future years (see *Restructuring charges and asset impairments*).

The increase in the amortization of goodwill and acquired intangibles for the year ended September 30, 2000 as compared to fiscal year 1999 was associated with the acquisitions noted above.

### *R&D*

The increase in R&D expenses for the year ended September 30, 2001 as compared with the prior fiscal year was primarily due to acquisitions made late in fiscal year 2000 and new product development, particularly in next-generation wireless products, optical networking products and switching and access products, partially offset by program reductions included in our restructuring program. As a result of our restructuring program, we expect R&D expenses to decline in fiscal year 2002 (see LIQUIDITY AND CAPITAL RESOURCES – Liquidity – *Restructuring program*). The decrease in R&D expenses for the year ended September 30, 2000 as compared with fiscal year 1999 was largely the result of $325 million of lower personnel costs, including lower incentive compensation awards and a higher net pension credit, and the impact of adopting SOP 98-1.

***IPRD***

The IPRD of $559 million for the year ended September 30, 2000, reflected $131 million and $428 million from the Spring Tide and Chromatis acquisitions, respectively. The IPRD of $276 million for the year ended September 30, 1999 related primarily to the acquisition of Stratus for $243 million and to a lesser extent, the acquisitions of XNT, Quantum, InterCall, Quadritek and WaveAccess. See further discussion under IN-PROCESS RESEARCH AND DEVELOPMENT.

***Restructuring charges and asset impairments***

On January 24, 2001 and on July 24, 2001, we announced phase I and phase II of our restructuring program. Under the restructuring program, we exited certain non-strategic wireless, optical networking and switching and access product lines and streamlined our cost structure in various businesses and corporate operations. These actions are expected to significantly enhance our ability to achieve the goals associated with our new strategic direction. The total charge for business restructuring and asset impairments was $11.4 billion, of which $10.2 billion is included in Operating expenses. The operating expense charge includes restructuring costs of $4.8 billion and asset write-downs of $5.4 billion. The remaining $1.2 billion of the business restructuring charge relates to inventory and was charged to Costs.

Restructuring costs included:

- employee separation costs of $3.4 billion associated with approximately 39,000 voluntary and involuntary employee separations;
- contract settlements of $944 million, including settlements of purchase commitments with suppliers of $508 million and contract renegotiations or cancellations of contracts with customers of $436 million; and
- facility closings and other costs of $383 million.

Asset write-downs included:

- impairment charges for goodwill and other acquired intangibles of $4.1 billion, primarily related to the write-off of $3.7 billion of goodwill and other acquired intangibles as a result of the discontinuance of the Chromatis product portfolio;
- property, plant and equipment, net write-downs of $425 million;
- capitalized software write-downs of $362 million; and
- other asset write-downs of $522 million.

For additional information, see LIQUIDITY AND CAPITAL RESOURCES – Liquidity - *Restructuring program* and Note 2 to the consolidated financial statements.

**Other Income (Expense) – Net**

Other income (expense) – net consisted of the following items (dollars in millions):

*Years ended September 30,*

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Interest income | $ 255 | $ 118 | $ 129 |
| Minority interests in earnings of consolidated subsidiaries | (81) | (50) | (27) |
| Net losses from equity method investments | (60) | (31) | (3) |
| Other-than-temporary write-downs of investments | (266) | (14) | – |
| Loss on foreign currency transactions | (58) | (18) | (8) |
| Net gains on sales and settlements of financial instruments | 34 | 347 | 270 |
| Write-off of embedded derivative assets | (42) | – | – |
| Miscellaneous – net | (139) | (19) | (4) |
| Other income (expense) – net | $(357) | $333 | $357 |

The decrease in other income (expense) – net was primarily related to other-than-temporary write-downs of investments and lower net gains on sales and settlements of financial instruments, partially offset by higher interest income in fiscal year 2001 compared with the prior year. Due to adverse market conditions in fiscal year 2001, we recorded impairment charges on several of our investments. Conversely, in fiscal year 2000 we had gains on sales of investments, which were primarily attributable to a gain of $189 million from the sale of a certain equity investment. The write-off of the embedded derivative assets was primarily related to One.Tel.

**Interest Expense**

Interest expense for the year ended September 30, 2001 increased to $518 million as compared with $342 million for fiscal year 2000. The increase in interest expense is due to higher weighted average short-term debt levels, primarily related to borrowings under our credit facilities. In addition, interest expense included the amortization of fees associated with entering into our credit facility arrangements in fiscal year 2001. As of September 30, 2001, we had reduced our total debt level by approximately $2.1 billion from the prior year. If current debt levels are maintained or further reduced, we expect interest expense to be lower in fiscal year 2002.

Interest expense for the year ended September 30, 2000 increased $24 million to $342 million as compared with $318 million in fiscal year 1999 primarily due to higher weighted average interest rates on commercial paper.

### Provision (Benefit) for Income Taxes

The following table presents our provision (benefit) for income taxes and the related effective tax (benefit) rates (dollars in millions):

| | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| Provision (benefit) for income taxes | $(5,734) | $ 924 | $ 1,456 |
| Effective tax (benefit) rate | (28.8)% | 39.2% | 38.1% |

The effective tax benefit rate for the year ended September 30, 2001, was lower than the U.S. statutory rate primarily from the impact of non-tax deductible goodwill amortization and certain non-tax deductible business restructuring charges and asset impairments, both of which decreased the effective tax benefit rate, offset in part by research and development tax credits, which increased the effective tax benefit rate on the pretax loss from continuing operations.

We recorded a tax benefit resulting in related net deferred tax assets of $5.2 billion as of September 30, 2001, reflecting net operating loss and credit carryforwards and deductible temporary differences. Although realization is not assured, we have concluded that it is more likely than not that the net deferred tax assets will be realized based on the scheduling of deferred tax liabilities and projected taxable income. The amount of the net deferred tax assets actually realized, however, could vary if there are differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the actual amounts of future taxable income.

The effective income tax rates exceed the U.S. federal statutory income tax rates for the years ended September 30, 2000 and 1999 primarily due to the write-offs of IPRD costs and merger-related expenses that are not deductible for tax purposes.

### Income (Loss) from Continuing Operations

As a result of the above, income (loss) from continuing operations and related per share amounts are as follows (amounts in millions, except per share amounts):

| | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| Income (loss) from continuing operations | $(14,170) | $ 1,433 | $ 2,369 |
| Basic earnings (loss) per share from continuing operations | $ (4.18) | $ 0.44 | $ 0.76 |
| Diluted earnings (loss) per share from continuing operations | $ (4.18) | $ 0.43 | $ 0.74 |
| Weighted average number of common shares outstanding – basic | 3,400.7 | 3,232.3 | 3,101.8 |
| Weighted average number of common shares outstanding – diluted | 3,400.7 | 3,325.9 | 3,218.5 |

### Income (Loss) from Discontinued Operations, Net

Income (loss) from discontinued operations, net for each of the three years in the period ended September 30, 2001 was ($3.2) billion or ($0.93) per basic and diluted share, ($214) million or ($0.06) per basic and diluted share and $1.1 billion or $0.34 per diluted share, respectively (see LIQUIDITY AND CAPITAL RESOURCES – Agere Spin-Off Update and Note 3 to the consolidated financial statements).

### Extraordinary Gain, Net

During the year ended September 30, 2001, we recorded a gain of $1.2 billion, net of a $780 million tax provision, or $0.35 per basic and diluted share from the sale of our power systems business (see Note 4 to the consolidated financial statements).

### Cumulative Effect of Accounting Changes, Net

Effective October 1, 2000, we recorded a net $38 million charge for the cumulative effect of certain accounting changes. This comprised a $30 million earnings credit ($0.01 per basic and diluted share) from the adoption of Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" and a $68 million charge to earnings ($0.02 per basic and diluted share) from the adoption of SAB 101 (see RISK MANAGEMENT and Note 5 to the consolidated financial statements).

Effective October 1, 1998, we recorded a cumulative effect of accounting change, net of $1.3 billion ($0.41 per diluted share) resulting from changing our method of calculating annual net pension and postretirement benefit costs (see Note 12 to the consolidated financial statements).

## LIQUIDITY AND CAPITAL RESOURCES

### Cash Flow for the Years Ended September 30, 2001, 2000 and 1999

#### *Net cash used in operating activities*

Net cash used in operating activities was $3.4 billion for the year ended September 30, 2001 and was primarily due to the loss from continuing operations (adjusted for non-cash items) of $6.6 billion, a decrease in accounts payable of $759 million and changes in other operating assets and liabilities of $548 million. Changes in other operating assets and liabilities primarily include a net increase in notes receivable and higher software development assets, offset in part by business restructuring liabilities. The increases in net cash used in operating activities were partially offset by decreases in receivables of $3.6 billion and in inventories and contracts in process of $881 million. Receivable improvement is largely due to improved collections in fiscal year 2001. Average receivable days outstanding improved by 34 days from 114 days at September 30, 2000 to 80 days at September 30, 2001. Improvements in inventory and contracts in process resulted from our efforts in fiscal year 2001 to streamline inventory supply

chain operations, as well as lower amounts in net contracts in process due to the wind-down of the STC project.

Net cash used in operating activities of $703 million for the year ended September 30, 2000 was primarily a result of increases in receivables and inventories and contracts in process of $1.6 billion and $2.2 billion, respectively, and changes in other operating assets and liabilities of $1.7 billion. Changes in other operating assets and liabilities primarily include higher software development assets and decreases in accrued income tax and payroll and benefit related liabilities. Net cash used in operating activities was partially offset by income from continuing operations (adjusted for non-cash items) of $3.6 billion and tax benefits from stock options of $1.1 billion, and an increase in accounts payable of $263 million. The receivable deterioration in fiscal year 2000 resulted from slower collections, partially offset by smaller revenue growth in the fourth fiscal quarter of 2000 as compared with the same period in fiscal year 1999. Average receivable days outstanding increased by 19 days to 114 days at September 30, 2000. The increase in inventories and contracts in process resulted from our increased production to meet current and anticipated sales commitments to customers and the start-up of several long-term projects.

Net cash used in operating activities of $1.6 billion for the year ended September 30, 1999 was primarily a result of increases in receivables and inventories and contracts in process of $3.2 billion and $1.6 billion, respectively, and changes in other operating assets and liabilities of $2.3 billion, offset in part by income from continuing operations (adjusted for non-cash items) of $4.3 billion and tax benefits from stock options of $394 million, and an increase in accounts payable of $636 million. Changes in other operating assets and liabilities primarily included increases in notes receivable and prepaid expenses.

***Net cash provided by (used in) investing activities***

Net cash provided by investing activities was $2.0 billion for the year ended September 30, 2001 and was primarily from $2.5 billion in proceeds from the sale of the power systems business, $572 million from the sale of two of our manufacturing operations to Celestica (see Liquidity – *Sale of manufacturing operations*) and sales or disposals of property, plant and equipment of $177 million. These proceeds were partially offset by capital expenditures of $1.4 billion.

Net cash used in investing activities was $1.6 billion for the year ended September 30, 2000 primarily from capital expenditures of $1.9 billion and purchases of investments of $680 million, offset in part by proceeds from the sales or maturity of investments of $820 million and from the disposition of businesses of $250 million, largely related to the sale of the remaining consumer products business.

Net cash used in investing activities was $1.1 billion for the year ended September 30, 1999 and primarily includes capital expenditures of $1.4 billion and purchases of investments of $872 million, offset in part by proceeds from the sales or maturity of investments of $1.4 billion.

Capital expenditures primarily relate to expenditures for equipment and facilities used in manufacturing, research and development and internal use software.

***Net cash provided by financing activities***

Net cash provided by financing activities for the year ended September 30, 2001 was $2.6 billion and was primarily due to net proceeds received from the issuance of redeemable convertible preferred stock in August 2001 of $1.8 billion (a portion of which was used to reduce borrowings under our credit facilities), net borrowings under our credit facilities of $3.5 billion ($2.5 billion of the debt associated with borrowings was assumed by Agere – see Note 10 to the consolidated financial statements) and proceeds from a real estate debt financing of $302 million under which certain real estate was transferred to a separate, consolidated wholly-owned subsidiary. Borrowings under our credit facilities were primarily used to fund our operations and to pay down $2.1 billion of short-term borrowings, which primarily represented commercial paper. We had no commercial paper outstanding as of September 30, 2001. In addition, we repaid the current portion of long-term debt that matured in July 2001 of $750 million. Dividends paid on our common stock in fiscal year 2001 were $204 million. On July 24, 2001, we announced that we will no longer pay dividends on our common stock, which will improve our cash flow. This saving would be offset by annual preferred dividend requirements of approximately $150 million, if we elect to pay such dividends in cash.

Net cash provided by financing activities for the year ended September 30, 2000 of $2.2 billion resulted primarily from issuances of common stock related to the exercise of stock options of $1.4 billion and a net increase in short-term borrowings of $1.4 billion, partially offset by repayments of long-term debt of $387 million and dividends paid of $255 million.

Net cash provided by financing activities for the year ended September 30, 1999 of $3.4 billion resulted primarily from issuances of long-term debt of $2.2 billion, issuances of common stock related to the exercise of stock options of $725 million and a net increase in short-term borrowings of $705 million, partially offset by dividends paid of $222 million.

**Liquidity**

Our cash requirements through the end of fiscal year 2002 are primarily to fund:

- operations, including spending on R&D;
- capital expenditures;
- cash restructuring outlays (see *Restructuring program*);
- capital requirements in connection with our customer financing commitments;
- debt service; and
- preferred stock dividend requirements, if we elect to pay such dividends in cash.

Although we have implemented a more selective customer financing program in fiscal year 2001, we have existing, and expect to continue to enter into, financing arrangements for our customers that involve significant capital requirements. In addition, our capital needs associated with customer financing may increase if our ability to sell the notes representing existing customer financing or transfer future funding commitments on acceptable terms to financial institutions and investors is limited by a deterioration in the credit quality of the customers to which we have extended financing (see Customer Financing).

***Restructuring program***

We expect the implementation of our restructuring program to reduce, on an annualized basis, our operating expenses and working capital, as defined below, compared with our first fiscal quarter of 2001 levels as follows:

- reduce annual operating expense run rate by $4.0 billion by the end of fiscal year 2002. As of September 30, 2001, we had achieved over 60% of this objective on an annualized basis;
- reduce working capital (defined as the change in receivables and inventory adjusted for non-cash charges and asset securitizations, and normalized for the change in quarterly sales) by $4.0 billion. As of September 30, 2001, we had achieved over 75% of this objective; and
- reduce our annual capital spending rate to approximately $750 million.

Subject to its timely and successful implementation, we expect our restructuring program to yield gross cash savings in excess of $5 billion annually. These anticipated savings result primarily from reduced headcount. Total cash outlays under the restructuring program are expected to be approximately $2.1 billion, of which approximately $530 million was paid during the current fiscal year with the majority of the remainder to be paid by the end of fiscal year 2002.

We expect to complete the restructuring program by the end of fiscal year 2002. If implemented in the manner and on the timeline we intend, we expect to realize the full benefits of our restructuring program by the end of fiscal year 2002.

We cannot assure you that our restructuring program will achieve all of the expense reductions and other benefits we anticipate or on the timetable contemplated. Because this restructuring program involves realigning our business units and sales forces, it may be disruptive to our customer relationships. Decreases in spending by these large service providers would likely also have an adverse effect on revenues.

If we do not complete our restructuring program and achieve our anticipated expense reductions in the time frame we contemplate, our cash requirements to fund our operations are likely to be significantly higher than we currently anticipate. In addition, because market demand continues to be uncertain and because we are currently implementing our restructuring program and new business strategy, it is difficult to estimate our ongoing cash requirements. Our restructuring program may also have other unanticipated adverse effects on our business.

If our restructuring program is successful, we expect to fund our currently expected cash requirements for fiscal year 2002 through a combination of the following sources:

- cash and cash equivalents as of September 30, 2001;
- available credit under our credit facilities (see *Credit facilities*);
- proceeds from the sale of our optical fiber business;
- accounts receivable securitization facility;
- capital market transactions;
- dispositions and sales of assets; and
- cash flows from operations, subject to the successful implementation of our business strategy.

We had net liquidity of approximately $5.4 billion on September 30, 2001, resulting from cash and cash equivalents of $2.4 billion and availability under our credit facilities of $3.0 billion. As of September 30, 2001, we had $1.0 billion outstanding under these credit facilities, which was repaid on November 20, 2001.

On June 28, 2001, we established a $750 million revolving accounts receivable securitization facility. As of September 30, 2001, we had obtained net proceeds of $286 million, collateralized by $1.3 billion in accounts receivable. Our ability to maintain the facility at the September 30, 2001 level is subject to our ability to generate the amount of eligible accounts receivable sufficient to support such level under the terms of the facility. Our ability to obtain further proceeds depends on a combination of factors, including our credit ratings and increasing the level of our eligible accounts receivable. This facility was reduced to $500 million in October 2001.

***Credit facilities***

As of September 30, 2001, we had a 364-day $2 billion credit facility that expires on February 21, 2002 and a $2 billion credit facility that expires on February 26, 2003. These credit facilities are secured by liens on substantially all of our assets, including the pledge of Agere stock owned by us. Our ability to access our credit facilities is subject to our compliance with the terms and conditions of the credit facilities, including financial covenants. These financial covenants require us to have minimum earnings before interest, taxes, depreciation and amortization ("EBITDA") and minimum net worth measured at the end of each fiscal quarter. As of September 30, 2001, we were in compliance with these covenants, as amended (see below). In addition, in the event a subsidiary defaults on its debt, as defined in the credit facilities, it would constitute a default under our credit facilities.

On August 16, 2001, we amended both of our credit facilities. The amendments modified the financial covenants and certain other conditions and terms, including those necessary to allow the distribution of Agere stock to our shareowners (see Agere Spin-Off Update). In addition, we cannot resume payment of dividends on our common stock unless we achieve certain credit ratings or EBITDA levels and no

event of default exists under the credit facilities. Payment of dividends on the common stock is limited to the rate of dividends paid prior to the discontinuation of the cash dividend. We are permitted to pay cash dividends on our convertible preferred stock if no event of default exists under the credit facilities.

The total lending commitments under our credit facilities are reduced if we undertake certain debt reduction transactions or generate additional funds from specified non-operating sources in excess of $2.5 billion. The first $2 billion in excess of the amount above would result in the termination of the 364-day $2 billion credit facility. Additional amounts would reduce the total lending commitments under the remaining $2 billion credit facility that expires in February 2003; however, this lending commitment can be reduced to no less than $1.5 billion. Any outstanding borrowings under our credit facilities that exceed the reduced lending commitments are required to be repaid. As of November 16, 2001, we had generated $4.5 billion of funds from specified non-operating sources, including the $1.8 billion of proceeds we received from the issuance of our redeemable convertible preferred stock, the $2.1 billion of proceeds from the sale of our optical fiber business, $519 million of debt reduction from a debt for equity exchange (see Note 3 to the consolidated financial statements) and the balance from other specified types of transactions. On November 20, 2001, the total lending commitments under our credit facilities were reduced to approximately $2 billion.

***Credit ratings***

Our credit ratings as of October 31, 2001 were as follows:

| *Rating Agency* | *Rating for our long-term debt* | *Rating for our commercial paper* | *Rating for our preferred stock* | *Last update* |
|---|---|---|---|---|
| Standard & Poor's | BB- | C | B- | August 16, 2001 |
| Moody's [a] | Ba3 | Not Prime | B3 | August 17, 2001 |
| Fitch [a] | BB- | B | B | August 17, 2001 |

(a) The rating for our senior unsecured long-term debt has a negative outlook.

The Standard & Poor's, Moody's and Fitch ratings are below investment grade. We expect both the recent, and any future, lowering of the ratings of our debt to result in higher financing costs and reduced access to the capital markets. As a result of the reductions of our credit ratings in fiscal year 2001, commercial paper and some other types of borrowings became unavailable and financing costs increased. We cannot assure you that our credit ratings will not be reduced in the future by Standard & Poor's, Moody's or Fitch.

***Sale of optical fiber business***

On November 16, 2001, we completed the sale of our optical fiber business to The Furukawa Electric Co., Ltd. for $2.3 billion, approximately $200 million of which was paid to us in CommScope, Inc. securities. Furukawa and CommScope have agreed to enter into one or more joint ventures that will be formed to operate the optical fiber business. The transaction is expected to result in a gain in the first quarter of fiscal year 2002. In addition, we entered into an agreement on July 24, 2001 to sell two Chinese joint ventures – Lucent Technologies Shanghai Fiber Optic Co., Ltd. and Lucent Technologies Beijing Fiber Optic Cable Co., Ltd. – to Corning Incorporated for $225 million. This transaction, which is subject to U.S. and foreign governmental approvals and other customary closing conditions, is expected to close by the end of the first quarter of fiscal year 2002.

***Sale of manufacturing operations***

In August 2001, we received $572 million from the closing of our transaction with Celestica Corporation to transition our manufacturing operations at Oklahoma City, Oklahoma and Columbus, Ohio. At closing, we entered into a five-year supply agreement for Celestica to be the primary manufacturer for our switching and access and wireless networking systems products. Until the inventory is sold to an end user, inventory associated with the transaction remains in our inventory balance, with a corresponding liability for proceeds received. This inventory amounted to approximately $310 million at September 30, 2001. Additionally, we may be required to repurchase up to $90 million of this inventory not used within one year of the transaction. The work force related to these two operations is expected to be reduced and/or transferred to Celestica during the first quarter of fiscal year 2002, resulting in a non-cash charge of approximately $380 million, which is included as a component of our business restructuring employee separation charge.

***Future capital requirements***

We believe our cash on hand, availability under our credit facilities and other planned sources of liquidity are currently sufficient to meet our requirements through the end of fiscal year 2002. We cannot assure you, however, that these sources of liquidity will be available when needed or that our actual cash requirements will not be greater than we currently expect. As described under *Credit facilities*, the receipt of proceeds from specified asset sales in excess of a specified threshold results in a reduction in the amount of available borrowings under our credit facilities. If our remaining sources of liquidity are not available or if we cannot generate positive cash flow from operations, we will be required to obtain additional sources of funds through additional operating improvements, asset sales and financing from third parties or a combination thereof. Although we believe that we have the ability to take these actions, we cannot assure you that these additional sources of funds, if available, would have reasonable terms.

**Agere Spin-Off Update**

Our agreement with Agere provides that if the Agere distribution was not completed on or before September 30, 2001, we would complete the Agere spin-off as promptly as practicable following our satisfaction or waiver of all conditions of such agreement. This agreement also provides that we may terminate our obligation to complete the distribution if, after consultation with Agere senior management, our board of directors determines, in its sole discretion, that the distribution is not in the best interests of us or our shareowners. The amendments to our credit facilities, completed on August 16, 2001, have delayed our ability to complete the spin-off. We remain committed to completing the process of separating Agere from our company, and we intend to move forward with our distribution of our shares of Agere stock in a tax-free spin-off to our shareowners. However, we cannot assure you that the conditions to our obligation to complete the distribution will be satisfied by a particular date or that the terms and conditions of our indebtedness will permit the distribution by a particular date or at all.

The amendments to our credit facilities revised the conditions necessary for us to secure a release of the pledge of Agere stock we own. The pledge can be released and the distribution can occur at our request if all the following terms and conditions as defined under the credit facilities are met:

- no event of default exists under the credit facilities;
- we have generated positive EBITDA for the fiscal quarter immediately preceding the distribution;
- we meet a minimum current asset ratio;
- we have received $5.0 billion in cash from certain non-operating sources; and
- the 364-day $2 billion credit facility has been terminated and the $2 billion credit facility, expiring in February 2003, has been reduced to $1.75 billion or less.

The current terms of our credit facilities will not allow the distribution unless, at the time of the distribution, we have generated $5.0 billion of additional funds or reduction in debt from specified non-operating sources. As of November 16, 2001, we had generated $4.8 billion of funds to satisfy this requirement ($1.8 billion of proceeds from our issuance of redeemable convertible preferred stock, $572 million of proceeds received from the transaction involving our Oklahoma and Ohio manufacturing operations, $2.1 billion of cash proceeds received from the sale of our optical fiber business, and funds from other specified types of transactions of approximately $300 million). We expect to raise the additional proceeds to satisfy the requirement under our credit facilities.

We have received a private letter ruling from the Internal Revenue Service holding that the distribution of our shares of Agere common stock to our shareowners in the spin-off and to holders of our debt in the debt for equity exchange will be tax free to us and our shareowners. The effectiveness of the original ruling was conditioned on completion of the spin-off by September 30, 2001. However, we have received a supplemental ruling from the Internal Revenue Service that maintains the effectiveness of the original ruling so long as the spin-off is completed on or before June 30, 2002. The supplemental ruling also favorably resolves certain additional tax issues arising from the issuance of preferred stock.

**Customer Financing**

The following table presents our customer financing commitments at September 30, 2001 and September 30, 2000 (dollars in billions):

| | *September 30, 2001* | | |
|---|---|---|---|
| | *Total loans and guarantees* | *Loans* | *Guarantees* |
| Drawn commitments | $3.0 | $2.6 | $0.4 |
| Available but not drawn | 1.4 | 1.4 | – |
| Not available | 0.9 | 0.6 | 0.3 |
| Total commitments | $5.3 | $4.6 | $0.7 |

| | *September 30, 2000* | | |
|---|---|---|---|
| | *Total loans and guarantees* | *Loans* | *Guarantees* |
| Drawn commitments | $2.0 | $1.3 | $0.7 |
| Available but not drawn | 3.9 | 3.3 | 0.6 |
| Not available | 2.2 | 2.1 | 0.1 |
| Total commitments | $8.1 | $6.7 | $1.4 |

Some of our 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. We use a disciplined credit evaluation and business review process that takes into account the credit quality of individual borrowers and their related business plans, as well as market conditions. We consider requests for financing on a case-by-case basis and offer financing only after careful review. As market conditions permit, our 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 us to reduce the amount of our commitments and free up additional financing capacity. As part of the revenue recognition process, we determine whether the notes receivable under these contracts are reasonably assured of collection based on various factors, including our ability to sell these notes.

Our credit process monitors the drawn and undrawn commitments and guarantees of debt to our customers. Customers are reviewed on a quarterly or annual basis depending upon their risk profile. As part of our review, we assess the customer's short-term and long-term liquidity position, current operating performance versus plan, execution challenges facing the company, changes in competitive landscape, industry and macroeconomic conditions, and changes to

management and sponsors. Depending upon the extent of any deterioration of a customer's credit profile or non-compliance with our legal documentation, we undertake actions that could include canceling the commitment, compelling the borrower to take corrective measures, and increasing efforts to mitigate potential losses. These actions are designed to mitigate unexpected events that could have an impact on our future results of operations and cash flows; however, there can be no assurance that this will be the case. Adverse industry conditions, such as the continued softening in the CLEC market, have negatively affected the creditworthiness of several customers that participate in our customer financing program. For the year ended September 30, 2001, we recorded provisions for uncollectibles and customer financings of $2.2 billion, of which approximately $1.3 billion was related to three customer finance projects, including Winstar and One.Tel. On April 18, 2001, Winstar filed for Chapter 11 protection and in late May 2001, One.Tel filed for voluntary administration (e.g. bankruptcy) and subsequently announced that it will be liquidated and its assets sold. We have built a mobile fiber-optic network for One.Tel, which is substantially complete. During November 2001, we entered into an agreement with the liquidator affirming our ownership of the network. Reserves associated with total drawn commitments were $2.1 billion, reflecting a net exposure of approximately $900 million.

Our overall customer financing exposure, coupled with a continued decline in telecommunications market conditions, negatively affected revenue, results of operations and cash flows in fiscal year 2001. We will continue to provide or commit to financing where appropriate for our business. Our ability to arrange or provide financing for our customers will depend on a number of factors, including our capital structure, credit rating and level of available credit, and our continued ability to sell or transfer commitments and drawn-down borrowings on acceptable terms. Due to recent economic uncertainties and reduced demand for financings in capital and bank markets, we may be required to continue to hold certain customer financing obligations for longer periods prior to the sale to third-party lenders. In addition, specific risks associated with customer financing, including the risks associated with new technologies, new network construction, market demand and competition, customer business plan viability and funding risks may require us to hold certain customer financing obligations over a longer term. Any unexpected developments in our customer financing arrangements could negatively affect revenue, results of operations and cash flows in the future. In addition, we may be required to record additional reserves related to customer financing in the future.

## Risk Management

We are exposed to market risk from changes in foreign currency exchange rates, interest rates and equity prices that could affect our results of operations and financial condition. We manage our exposure to these market risks through our regular operating and financing activities and, when deemed appropriate, hedge these risks through the use of derivative financial instruments. We use the term hedge to mean a strategy designed to manage risks of volatility in prices or rate movements on certain assets, liabilities or anticipated transactions and by creating a relationship in which gains or losses on derivative instruments are expected to counterbalance the losses or gains on the assets, liabilities or anticipated transactions exposed to such market risks. We use derivative financial instruments as risk management tools and not for trading or speculative purposes. In addition, derivative financial instruments are entered into with a diversified group of major financial institutions in order to manage our exposure to nonperformance on such instruments. Our risk management objective is to minimize the effects of volatility on our cash flows by identifying the recognized assets and liabilities or forecasted transactions exposed to these risks and appropriately hedging them with either forward contracts, or to a lesser extent, option contracts, swap derivatives or by embedding terms into certain contracts that affect the ultimate amount of cash flows under the contract. We generally do not hedge our credit risk on customer receivables.

### Foreign Currency Risk

We use foreign exchange forward contracts and, to a lesser extent, option contracts to minimize 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 and option contracts are utilized for recognized receivables and payables, firmly committed or anticipated cash inflows and outflows. The use of these derivative financial instruments allows us to reduce our 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. Cash inflows and outflows denominated in the same foreign currency are netted on a legal entity basis and the corresponding net cash flow exposure is appropriately hedged. We do not hedge our net investment in non-U.S. entities because we view those investments as long-term in nature. As of September 30, 2001, our primary net foreign currency market exposures were as follows (dollars in millions):

| *Currency* | *Foreign currency transaction exposure long (short) positions* | *Notional amounts of forward and option hedge contracts* | *Fair value of forward and option contracts asset (liability)* | *Impact on derivative contracts of a 10% depreciation of foreign currency vs. the U.S. dollar gain (loss)* |
|---|---|---|---|---|
| Euro and legacy currencies | $ 548 | $488 | $ 4 | $ 49 |
| Brazilian real | 163 | 163 | (4) | 16 |
| Japanese yen | (32) | 23 | (6) | (2) |
| Australian dollar | 136 | 132 | 6 | 13 |
| Danish kroner | (236) | 235 | 2 | (24) |
| New Zealand dollar | 95 | 89 | 4 | 9 |

The exposure positions above represent a portfolio containing all identified booked and firmly committed exposures and 50% of the first six months of all identified anticipated exposures, which is used as a benchmark by us for risk management purposes. The hedge contracts represent the actual external derivative transactions executed with financial counterparties to offset our net exposure. The exposure and hedge positions are not always equal due to the fact that some anticipated exposures included within these portfolios may be hedged as little as 25% or as much as 100%, as deemed appropriate in accordance with our corporate policy.

The fair value of foreign exchange forward and option contracts is subject to changes in foreign currency exchange rates. For the purposes 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. The financial instruments included in our sensitivity analysis are foreign currency forward and option contracts. Such contracts generally have durations of one to three months and are primarily used to hedge recognized receivables and payables and anticipated transactions, and to a lesser extent, unrecognized firm commitments. The sensitivity analysis excludes the value of foreign currency denominated receivables and payables (other than loans) because of their short maturities. To perform the sensitivity analysis, we assess the risk of loss in fair values from the effect of a hypothetical 10% change in the value of foreign currencies, assuming no change in interest rates. However, these calculated exposures do not generally affect our use of derivative financial instruments as described above. For contracts outstanding as of September 30, 2001 and 2000, a 10% appreciation in the value of foreign currencies against the U.S. dollar from the prevailing market rates would result in an incremental pretax net unrealized loss of approximately $63 million and $71 million, respectively. Conversely, a 10% depreciation in these currencies from the prevailing market rates would result in an incremental pretax net unrealized gain of approximately $63 million and $71 million, as of September 30, 2001 and 2000, respectively. Consistent with the nature of the economic hedge of such foreign exchange forward and option contracts, such unrealized gains or losses would be offset by corresponding decreases or increases, respectively, of the underlying instrument or transaction being hedged.

The model to determine sensitivity assumes a parallel shift in all foreign currency exchange spot rates, although exchange rates rarely move in the same direction. Additionally, the amounts above do not necessarily represent the actual changes in fair value we would incur under normal market conditions because all variables other than the exchange rates are held constant in the calculations. We have not changed our foreign exchange risk management strategy from the prior year. We are reviewing plans to further centralize the foreign exchange and liquidity management needs of many of our operating subsidiaries under the model of an in-house bank. While this implementation would not change the fundamental objective of our foreign currency risk management policy, it is expected to yield benefits by way of economic efficiency, process efficiency and improved visibility of financial flows. In conjunction with this, we foresee replacing our existing sensitivity analysis of foreign exchange and interest rate instruments with one based on value-at-risk or similar methodologies commonly accepted within financial markets.

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

**Interest Rate Risk**

We use a combination of financial instruments, including medium-term and short-term financings, variable-rate debt instruments and, to a lesser extent, interest rate swaps to manage the interest rate mix of our total debt portfolio and related cash flows. To manage this mix in a cost-effective manner, we, from time to time, may enter into interest rate swap agreements in which we agree to exchange various combinations of fixed and/or variable interest rates based on agreed-upon notional amounts. We had no material interest rate swap agreements in effect at September 30, 2001 or September 30, 2000. The objective of maintaining the mix of fixed and floating rate debt is to mitigate the variability of cash flows resulting from interest rate fluctuations as well as reduce the cash flows attributable to debt instruments. Our portfolio of customer finance notes receivable predominantly comprises variable-rate notes at LIBOR plus a stated percentage and subjects us to variability in cash flows and earnings for the effect of changes in LIBOR. We do not enter into derivative transactions on our cash equivalents and short-term investments, since our relatively short maturities do not create significant risk.

The fair value of our 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 the differences between the market interest rates and rates at the inception of the debt obligation. We perform a sensitivity analysis on our fixed-rate long-term debt to assess the risk of changes in fair value. These debt instruments have original maturities ranging from five years to 30 years. The model to determine sensitivity assumes a hypothetical 150 basis point parallel shift in interest rates. At September 30, 2001 and 2000, a 150 basis point increase in interest rates would reduce the market value of our fixed-rate long-term debt by approximately $191 million and $317 million, respectively. Conversely, a 150 basis point decrease in interest rates would result in a net increase in the market value of our fixed-rate long-term debt outstanding at September 30, 2001 and 2000 of approximately $232 million and $397 million, respectively. Our sensitivity analysis on debt obligations excludes commercial paper, variable-rate debt instruments, secured borrowings and bank loans because the changes in interest rates would not significantly affect the fair value of such instruments. Interest rate swaps have also been excluded from the sensitivity analysis since they are not material.

The earnings and cash flows to be received under our variable-rate customer finance notes or paid under our credit facilities are sensitive to changes in LIBOR. These notes have original maturities ranging from one year to 10 years. To determine the specific risks on earnings and cash flows from this portfolio, a sensitivity analysis was per-

formed with a model assuming a 150 basis point parallel shift in LIBOR. Under this model, the maximum annual variability on earnings and cash flows we could experience on this portfolio as of September 30, 2001 would be approximately $36 million. However, this model does not necessarily reflect the actual volatility we would experience because interest income on certain notes is not recognized until collected; certain notes provide for interest to be capitalized to the principal balance and notes may be sold off to third parties in the normal course of business.

We have not changed our interest rate risk management strategy from the prior year and do not foresee or expect any significant changes in our exposure to interest rate fluctuations, but we are considering expanding the use of interest rate swaps in the near future on our debt obligations.

**Equity Price Risk**

Our investment portfolio consists of equity investments accounted for under the cost and equity methods as well as equity investments in publicly-held companies that are classified as available-for-sale. These available-for-sale securities are exposed to price fluctuations and are generally concentrated in the high-technology communications industry, many of which are small capitalization stocks. At September 30, 2001, the fair value of one available-for-sale security totaled $48 million out of a total available-for-sale portfolio valued at $58 million. We generally do not hedge our equity price risk, however, on occasion, we may use equity derivative financial instruments that are subject to equity price risks to complement our investment strategies. As of September 30, 2001, a 20% adverse change in equity prices would result in an approximate $12 million decrease in the fair value of our available-for-sale securities. As of September 30, 2001, we had no outstanding hedging instruments for our equity price risk. The model to determine sensitivity assumes a corresponding shift in all equity prices; however, equity prices on individual companies dispersed across many different industries may not always move in the same direction. This analysis excludes stock purchase warrants as we do not believe that the value of such warrants is significant.

## IN-PROCESS RESEARCH AND DEVELOPMENT ("IPRD")

In connection with the acquisitions in fiscal years 2000 and 1999 of Chromatis, Spring Tide and Stratus, we allocated non-tax impacting charges of $428 million, $131 million and $267 million, respectively, of the total purchase price to IPRD. As part of the process of analyzing each of these acquisitions, we made a decision to buy technology that had not yet been commercialized rather than develop the technology internally. We based this decision on a number of factors including the amount of time it would take to bring the technology to market. We also considered Bell Labs' resource allocation and its progress on comparable technology, if any. We expect to use the same decision process in the future.

We 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 our 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. We believe that the estimated IPRD amounts so determined represented fair value and did not exceed the amount a third party would pay for the projects.

Where appropriate, we 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, our anticipated product pricing and growth rates may not be achieved and we may not realize the financial benefits expected from the projects.

Set forth below are descriptions of significant acquired IPRD projects:

**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 ($24 million of IPRD was subsequently reversed in March 1999) 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, Signaling System 7 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 fiscal year 2002 and decline thereafter through the end of the product's life (2009) as new product technologies were expected to be introduced by us. Revenue growth was expected to decrease from 310% in fiscal year 2000 to 6% in fiscal year 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 year 1999, product development relating to the HARMONY, SPHINX and Continuum 448 projects was discontinued due to our reprioritization of product direction. In addition, it was decided that development relating to the Continuum 1248 project would cease by the quarter ended December 31, 1999. Consequently, we did not realize the forecasted revenues from these projects. During fiscal year 2001, substantially all of the goodwill and acquired intangibles related to the purchase of Stratus were written off as part of our restructuring program, which resulted in the exit of all but two of the remaining projects within the original portfolio.

**Chromatis Networks**

On June 28, 2000, we 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 metro optical product, which was expected to integrate data, voice and video services on metropolitan networks and combine this traffic onto a wave division multiplexing ("WDM") system.

Revenues attributable to the metro optical product were estimated to be $375 million in fiscal year 2001 and $1 billion in fiscal year 2002. Revenue was expected to peak in fiscal year 2005 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by us. Revenue growth was expected to decrease from 196% in fiscal year 2002 to 10% in fiscal year 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.

As part of our restructuring program in fiscal year 2001, the Chromatis product portfolio was discontinued and all of the remaining assets, primarily goodwill and other acquired intangibles, were written off.

**Spring Tide Networks**

On September 19, 2000, we 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 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 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 fiscal year 2001 and $337 million in fiscal year 2002. Revenue was expected to peak in fiscal year 2006 and decline thereafter through the end of the product's life as new product technologies were expected to be introduced by us. Revenue growth was expected to decrease from 209% in 2002 to 4.4% in fiscal year 2006, and be negative for the remainder of the projection period. Although the actual results to date have been significantly less than anticipated at the time of the acquisition, we believe this shortfall will be made up in future years. 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 fiscal years 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 are risks 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.

## 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 March 1, 2002, the participating countries will introduce Euro notes and coins and withdraw all legacy currencies so that they will no longer be available.

We have in place a joint European-United States team representing affected functions within the company that is coordinated by a corporate program office. This team has evaluated our Euro-related issues affecting our pricing/marketing strategy, conversion of information technology systems and existing contracts. We are now in the process of completing the conversion/upgrade of our affected systems, applications, data, contracts, and processes.

We will continue to evaluate issues involving introduction of the Euro as further accounting, tax and governmental legal and regulatory guidance becomes available. Based on current information and our current assessment, we do not expect that the Euro conversion will have a material adverse effect on our business or financial condition.

## Recent Pronouncements

See discussion in Note 18 to the consolidated financial statements.

## Legal Proceedings and Environmental Matters

See discussion in Note 17 to the consolidated financial statements.

## 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 our management's current expectations, estimates, forecasts and projections about the industries in which we operate, our beliefs, and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by or on behalf of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "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 that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecast in such forward-looking statements. Except as required under the federal securities laws and the rules and regulations of the Securities and Exchange Commission ("SEC"), we do not have any intention or obligation to update publicly any forward-looking statements, whether as a result of new information, future events, changes in assumptions or otherwise.

The risks, uncertainties and assumptions include:

- increasing price, products and services competition by U.S. and non-U.S. competitors, including new entrants;
- rapid technological developments and changes and our ability to continue to introduce and our dependence upon the development of 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;
- control of costs and expenses;
- the realization of deferred tax assets;
- credit concerns in the emerging service provider market and the potential for deterioration of the credit quality of customers for which we have provided financing;
- customer demand for our products and services;
- reliance on resellers and distributors;
- the timely completion on the anticipated timetable of the intended distribution of our remaining shares of Agere;
- the timely completion of the expected sale of manufacturing facilities, assets and operations and the continued availability of quality products and components at reasonable prices after the sales;
- the timely implementation of our restructuring program and financial plans;
- our ability to successfully implement our new strategic direction focused on offering fewer products to large service providers, including our ability to focus our business on the mix of products and services necessary to take advantage of the most desirable opportunities in our industry and to implement our product rationalizations and other aspects of our new strategic direction in a manner that does not disrupt the business of our customers;
- dependence of achieving our targets and objectives for fiscal 2002 and 2003 on global economic and industry conditions;
- 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;
- technological, implementation and cost/financial risks in the use of large, multiyear contracts;
- our credit ratings and ability to provide customer financing when appropriate;
- continued availability of financing, financial instruments and financial resources in the amounts, at the times and on the terms required to support our future business;
- compliance with the covenants and restrictions of our bank credit facilities; and
- the outcome of pending and future litigation and governmental proceedings.

These are representative of the risks, uncertainties and assumptions 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 and political conditions, including the global economic slowdown and interest rate and currency exchange rate fluctuations and other future events or otherwise.

In addition, see the prospectus and reports filed by Agere with the SEC for a further list and description of risks and uncertainties related to Agere.

# Five-Year Summary of Selected Financial Data (Unaudited)

| *(Dollars in millions, except per share amounts)* | *Years ended September 30,* | | | | |
|---|---|---|---|---|---|
| **RESULTS OF OPERATIONS** | **2001** | **2000** | **1999** | **1998** | **1997** |
| Revenues | $ 21,294 | $28,904 | $26,993 | $21,307 | $18,734 |
| Gross margin [a] | 2,058 | 11,714 | 12,969 | 9,817 | 7,795 |
| Operating income (loss) [a] | (19,029) | 2,366 | 3,786 | 1,384 | 597 |
| Income (loss) from continuing operations | (14,170) | 1,433 | 2,369 | 360 | 73 |
| Earnings (loss) per common share from continuing operations [b]: | | | | | |
| Basic | (4.18) | 0.44 | 0.76 | 0.12 | 0.03 |
| Diluted | (4.18) | 0.43 | 0.74 | 0.12 | 0.03 |
| Dividends per common share [b] | 0.06 | 0.08 | 0.08 | 0.0775 | 0.0563 |
| **FINANCIAL POSITION** | | | | | |
| Total assets | $ 33,664 | $47,512 | $34,246 | $24,289 | $20,176 |
| Working capital | 5,934 | 10,380 | 10,197 | 5,108 | 2,708 |
| Total debt | 4,409 | 6,498 | 5,788 | 2,861 | 4,180 |
| 8.00% redeemable convertible preferred stock | 1,834 | – | – | – | – |
| Shareowners' equity | 11,023 | 26,172 | 13,936 | 7,960 | 4,573 |

(a) Includes business restructuring charges and asset impairments of $11,416, including $1,259 of inventory write-downs which affected gross margin, in the year ended September 30, 2001.

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

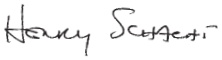
## Report of Management

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.

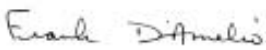
To provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that accounting records are reliable for preparing financial statements, management maintains a system of accounting and other controls, including an internal audit function. Even an effective 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 independent directors, 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.



**Henry B. Schacht**
Chairman and
Chief Executive Officer



**Frank A. D'Amelio**
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 operations, 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, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2001, 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 5 to the consolidated financial statements, in 2001 the Company changed its accounting methods for revenue recognition and for derivative financial instruments. Also, as discussed in Notes 1 and 12, in 2000 and 1999 the Company changed its accounting methods for computer software developed or obtained for internal use and for calculating annual net pension and postretirement benefit costs, respectively.



**PRICEWATERHOUSECOOPERS LLP**

New York, New York
October 23, 2001,
except for the fifth paragraph of Note 10 and Note 19, as to which the date is November 20, 2001

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES

# CONSOLIDATED STATEMENTS OF OPERATIONS

| *(Amounts in Millions, Except Per Share Amounts)* | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| Revenues | $ 21,294 | $28,904 | $26,993 |
| Costs | 19,236 | 17,190 | 14,024 |
| Gross margin | 2,058 | 11,714 | 12,969 |
| Operating expenses: | | | |
| Selling, general and administrative | 7,410 | 5,610 | 5,371 |
| Research and development | 3,520 | 3,179 | 3,536 |
| Purchased in-process research and development | – | 559 | 276 |
| Business restructuring charges and asset impairments | 10,157 | – | – |
| Total operating expenses | 21,087 | 9,348 | 9,183 |
| Operating income (loss) | (19,029) | 2,366 | 3,786 |
| Other income (expense) – net | (357) | 333 | 357 |
| Interest expense | 518 | 342 | 318 |
| Income (loss) from continuing operations before provision (benefit) for income taxes | (19,904) | 2,357 | 3,825 |
| Provision (benefit) for income taxes | (5,734) | 924 | 1,456 |
| Income (loss) from continuing operations | (14,170) | 1,433 | 2,369 |
| Income (loss) from discontinued operations (net of taxes) | (3,172) | (214) | 1,112 |
| Income (loss) before extraordinary item and cumulative effect of accounting changes | (17,342) | 1,219 | 3,481 |
| Extraordinary gain (net of taxes) | 1,182 | – | – |
| Cumulative effect of accounting changes (net of taxes) | (38) | – | 1,308 |
| Net income (loss) | (16,198) | 1,219 | 4,789 |
| Preferred stock dividends and accretion | (28) | – | – |
| Net income (loss) applicable to common shareowners | $(16,226) | $ 1,219 | $ 4,789 |
| EARNINGS (LOSS) PER COMMON SHARE – BASIC | | | |
| Income (loss) from continuing operations | $ (4.18) | $ 0.44 | $ 0.76 |
| Net income (loss) applicable to common shareowners | $ (4.77) | $ 0.38 | $ 1.54 |
| EARNINGS (LOSS) PER COMMON SHARE – DILUTED | | | |
| Income (loss) from continuing operations | $ (4.18) | $ 0.43 | $ 0.74 |
| Net income (loss) applicable to common shareowners | $ (4.77) | $ 0.37 | $ 1.49 |
| Weighted average number of common shares outstanding – basic | 3,400.7 | 3,232.3 | 3,101.8 |
| Weighted average number of common shares outstanding – diluted | 3,400.7 | 3,325.9 | 3,218.5 |

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES

# CONSOLIDATED BALANCE SHEETS

| *(Dollars in Millions, Except Per Share Amounts)* | *September 30,* 2001 | 2000 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 2,390 | $ 1,467 |
| Receivables, less allowance of $634 in 2001 and $479 in 2000 | 4,594 | 8,782 |
| Inventories | 3,646 | 5,100 |
| Contracts in process, net of progress billings of $7,841 in 2001 and $6,744 in 2000 | 1,027 | 1,881 |
| Deferred income taxes, net | 2,658 | 1,101 |
| Other current assets | 1,788 | 1,575 |
| Net current assets of discontinued operations | – | 634 |
| Total current assets | 16,103 | 20,540 |
| Property, plant and equipment, net | 4,416 | 5,046 |
| Prepaid pension costs | 4,958 | 6,238 |
| Deferred income taxes, net | 2,695 | 33 |
| Goodwill and other acquired intangibles, net of accumulated amortization of $1,768 in 2001 and $852 in 2000 | 1,466 | 6,463 |
| Other assets | 2,724 | 3,560 |
| Net long-term assets of discontinued operations | 1,302 | 5,632 |
| Total assets | $33,664 | $47,512 |
| **LIABILITIES** | | |
| Accounts payable | $ 1,844 | $ 2,583 |
| Payroll and benefit-related liabilities | 1,500 | 1,010 |
| Debt maturing within one year | 1,135 | 3,468 |
| Other current liabilities | 5,285 | 3,099 |
| Net current liabilities of discontinued operations | 405 | – |
| Total current liabilities | 10,169 | 10,160 |
| Postretirement and postemployment benefit liabilities | 5,481 | 5,395 |
| Long-term debt | 3,274 | 3,030 |
| Deferred income taxes, net | 152 | 1,203 |
| Other liabilities | 1,731 | 1,552 |
| Total liabilities | 20,807 | 21,340 |
| Commitments and contingencies | | |
| 8.00% redeemable convertible preferred stock | 1,834 | – |
| **SHAREOWNERS' EQUITY** | | |
| Preferred stock – par value $1.00 per share; issued and outstanding shares: none | – | – |
| Common stock – par value $.01 per share; authorized shares: 10,000,000,000; 3,414,815,908 issued and 3,414,167,155 outstanding shares at September 30, 2001 and 3,384,332,104 issued and outstanding shares at September 30, 2000 | 34 | 34 |
| Additional paid-in capital | 21,702 | 20,374 |
| Retained earnings (accumulated deficit) | (10,272) | 6,129 |
| Accumulated other comprehensive income (loss) | (441) | (365) |
| Total shareowners' equity | 11,023 | 26,172 |
| Total liabilities, redeemable convertible preferred stock and shareowners' equity | $33,664 | $47,512 |

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES

# CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNERS' EQUITY

| *(Dollars in Millions)* | *Prefered Stock* | *Common Stock* | *Additional Paid-In Capital* | *Retained Earnings (Accumulated Deficit)* | *Accumulated Other Comprehensive Income (Loss)* | *Total Shareowners' Equity* | *Total Comprehensive Income (Loss)* |
|---|---|---|---|---|---|---|---|
| Balance at October 1, 1998 | $ – | $31 | $ 6,725 | $ 1,487 | $(283) | $ 7,960 | |
| Net income (excluding undistributed S-Corporation earnings) | | | | 4,781 | | | $ 4,781 |
| Foreign currency translation adjustment | | | | | (33) | | (33) |
| Unrealized holding gains on certain investments (net of tax of $235) | | | | | 307 | | 307 |
| Reclassification adjustment for realized holding gains on certain investments (net of tax benefit of $178) | | | | | (246) | | (246) |
| Effect of immaterial poolings | | | 106 | (26) | | | |
| Common stock dividends declared | | | | (222) | | | |
| Issuance of common stock | | | 745 | | | | |
| Tax benefit from employee stock options | | | 394 | | | | |
| Adjustment to conform pooled companies' fiscal year | | | | 170 | | | |
| Other | | | (9) | (2) | 11 | | 19 |
| Total comprehensive income | | | | | | | $ 4,828 |
| Balance at September 30, 1999 | – | 31 | 7,961 | 6,188 | (244) | 13,936 | |
| Net income | | | | 1,219 | | | $ 1,219 |
| Foreign currency translation adjustment | | | | | (185) | | (185) |
| Reclassification of foreign currency translation losses realized upon spin-off of Avaya | | | | | 64 | | 64 |
| Unrealized holding gains on certain investments (net of tax of $124) | | | | | 190 | | 190 |
| Reclassification adjustment for realized holding gains on certain investments (net of tax benefit of $126) | | | | | (194) | | (194) |
| Common stock dividends declared | | | | (254) | | | |
| Issuance of common stock | | | 1,397 | | | | |
| Tax benefit from employee stock options | | | 1,064 | | | | |
| Issuance of common stock and conversion of stock options for acquisitions | | 3 | 9,901 | | | | |
| Other | | | 45 | (15) | 2 | | 2 |
| Spin-off of Avaya | | | 6 | (1,009) | 2 | | |
| Total comprehensive income | | | | | | | $ 1,096 |
| Balance at September 30, 2000 | – | 34 | 20,374 | 6,129 | (365) | 26,172 | |
| Net loss | | | | (16,198) | | | $ (16,198) |
| Foreign currency translation adjustment (net of tax benefit of $16 related to temporary investments in foreign operations) | | | | | (30) | | (30) |
| Reclassification of foreign currency translation losses realized upon the sale of foreign entities (net of tax of $2) | | | | | (3) | | (3) |
| Unrealized holding losses on certain investments (net of tax benefit of $72) | | | | | (95) | | (95) |
| Reclassification adjustment for realized holding gains and impairment losses on certain investments (net of tax of $32) | | | | | 50 | | 50 |
| Cumulative effect of accounting change (SFAS 133) | | | | | 11 | | 11 |
| Agere initial public offering | | | 922 | | | | |
| Preferred stock dividends and accretion | | | (28) | | | | |
| Common stock dividends declared | | | | (205) | | | |
| Tax benefit from employee stock options | | | 18 | | | | |
| Issuance of common stock | | | 234 | | | | |
| Compensation on equity-based awards | | | 87 | | | | |
| Other | | | 95 | 2 | (9) | | (9) |
| Total comprehensive loss | | | | | | | $(16,274) |
| Balance at September 30, 2001 | $ – | $34 | $21,702 | $(10,272) | $(441) | $11,023 | |

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| *(Dollars in Millions)* | *Years ended September 30,* | | |
|---|---|---|---|
| | **2001** | **2000** | **1999** |
| **OPERATING ACTIVITIES** | | | |
| Net income (loss) | $(16,198) | $ 1,219 | $ 4,789 |
| Less: Income (loss) from discontinued operations | (3,172) | (214) | 1,112 |
| Extraordinary gain | 1,182 | – | – |
| Cumulative effect of accounting changes | (38) | – | 1,308 |
| Income (loss) from continuing operations | (14,170) | 1,433 | 2,369 |
| Adjustments to reconcile income (loss) from continuing operations to net cash used in operating activities, net of effects of acquisitions and dispositions of businesses: | | | |
| Non-cash portion of business restructuring charges and asset impairments | 9,322 | – | 127 |
| Business restructuring reversal | – | (5) | (108) |
| Depreciation and amortization | 2,536 | 1,667 | 1,282 |
| Provision for uncollectibles and customer financings | 2,249 | 505 | 66 |
| Tax benefit from employee stock options | 18 | 1,064 | 394 |
| Deferred income taxes | (5,935) | 491 | 936 |
| Purchased in-process research and development | – | 559 | 2 |
| Net pension and postretirement benefit credit | (1,137) | (822) | (481) |
| Adjustment to conform pooled companies' fiscal years | – | 11 | 170 |
| Other adjustments for non-cash items | 495 | (258) | 65 |
| Changes in operating assets and liabilities: | | | |
| Decrease (increase) in receivables | 3,627 | (1,626) | (3,150) |
| Decrease (increase) in inventories and contracts in process | 881 | (2,242) | (1,631) |
| (Decrease) increase in accounts payable | (759) | 263 | 636 |
| Changes in other operating assets and liabilities | (548) | (1,743) | (2,296) |
| Net cash used in operating activities from continuing operations | (3,421) | (703) | (1,619) |
| **INVESTING ACTIVITIES** | | | |
| Capital expenditures | (1,390) | (1,915) | (1,387) |
| Proceeds from the sale or disposal of property, plant and equipment | 177 | 26 | 78 |
| Dispositions of businesses | 2,615 | 250 | 16 |
| Proceeds from the sale of manufacturing operations | 572 | – | – |
| Acquisitions of businesses – net of cash acquired | – | (52) | (176) |
| Sales or maturity of investments | 57 | 820 | 1,358 |
| Purchases of investments | (101) | (680) | (872) |
| Other investing activities | 21 | (8) | (83) |
| Net cash provided by (used in) investing activities from continuing operations | 1,951 | (1,559) | (1,066) |
| **FINANCING ACTIVITIES** | | | |
| Net borrowings under credit facilities | 3,500 | – | – |
| Net (repayments of) proceeds from other short-term borrowings | (2,147) | 1,355 | 705 |
| Payment of credit facility fees | (119) | – | – |
| Issuance of long-term debt | 302 | 72 | 2,193 |
| Repayments of long-term debt | (754) | (387) | (11) |
| Issuance of redeemable convertible preferred stock | 1,831 | – | – |
| Issuance of common stock | 222 | 1,444 | 725 |
| Dividends paid on common stock | (204) | (255) | (222) |
| Other financing activities | (6) | – | (40) |
| Net cash provided by financing activities from continuing operations | 2,625 | 2,229 | 3,350 |
| Effect of exchange rate changes on cash and cash equivalents | 4 | 10 | 41 |
| Net cash provided by (used in) continuing operations | 1,159 | (23) | 706 |
| Net cash used in discontinued operations | (236) | (196) | (164) |
| Net increase (decrease) in cash and cash equivalents | 923 | (219) | 542 |
| Cash and cash equivalents at beginning of year | 1,467 | 1,686 | 1,144 |
| Cash and cash equivalents at end of year | $ 2,390 | $ 1,467 | $ 1,686 |

See Notes to Consolidated Financial Statements.