LUCENT TECHNOLOGIES FINANCIAL REVIEW 2003

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") contains forward-looking statements that are based on current expectations, estimates, forecasts and projections about us, our future performance, the industries in which we operate, our beliefs and our management's assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. 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 assess. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. These risks and uncertainties include the failure of the telecommunications market to improve or to improve at the pace we anticipate; continued net losses and negative operating cash flow that may affect our ability to satisfy our cash requirements; our ability to realize the benefits we expect from our strategic direction and restructuring program; our ability to secure additional sources of funds on reasonable terms; our credit ratings; our ability to compete effectively; our reliance on a limited number of key customers; our exposure to the credit risk of our customers; our reliance on third parties to manufacture most of our products; the cost and other risks inherent in our long-term sales agreements; our product portfolio and ability to keep pace with technological advances in our industry; the complexity of our products; our ability to retain and recruit key personnel; existing and future litigation; our ability to protect our intellectual property rights and the expenses we may incur in defending such rights; changes in environmental health and safety law; changes to existing regulations or technical standards; the social, political and economic risks of our foreign operations; and the costs and risks associated with our pension and postretirement benefit obligations. For a more complete list and description of such risks and uncertainties, see the reports filed by us with the Securities and Exchange Commission. Except as required under the federal securities laws and the rules and regulations of the SEC, we do not have any intention or obligation to update publicly any forward-looking statements after the distribution of this MD&A, whether as a result of new information, future events, changes in assumptions or otherwise.

OVERVIEW

We design and deliver 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 in 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.

Beginning in fiscal 2001, the global telecommunications market deteriorated, reflecting a significant decrease in the competitive local exchange carrier market and a significant reduction in capital spending by established service providers. This trend intensified during fiscal 2002 and continued into fiscal 2003. Reasons for the market deterioration included the general economic slowdown, network overcapacity, customer bankruptcies, network build-out delays and limited availability of capital. As a result, our sales and results of operations have been and may continue to be adversely affected. The significant slowdown in capital spending in our target markets has created uncertainty as to the level of demand, which can change quickly and can vary over short periods of time, including from month to month. As a result of this uncertainty, accurate forecasting of near- and long-term results, earnings and cash flow remains difficult. In addition, since a limited number of customers account for a significant amount of our revenue, our results are subject to volatility from changes in spending by one or more of these significant customers.

As discussed in more detail throughout our MD&A:

- Our results of operations during the past three years were adversely affected by the rapid and sustained deterioration of the telecommunications market. After several years of significant growth, our revenues declined by 31%, 42% and 26% during fiscal 2003, 2002 and 2001, respectively, compared with the respective prior fiscal year. The significant reduction in capital spending by service providers, among other factors, contributed to this decline. The impact of product rationalizations and discontinuances under our restructuring program did not have a significant effect on the overall reduction in our revenues during the past three fiscal years, although certain product rationalization initiatives, such as our decision to exit GSM, have reduced our total available market opportunities.

- Our gross margin rate was 31%, 13% and 10% during fiscal 2003, 2002 and 2001, respectively. The improvement in fiscal 2003 primarily resulted from lower inventory-related charges and continued focus on cost reductions. For fiscal 2002 and 2001, product line discontinuances and the significant and rapid declines in revenues led to significant inventory charges and high-unabsorbed fixed costs, which adversely affected our gross margin rate.

- We continued to reduce our operating expenses through restructuring actions. However, these actions resulted in net business restructuring and asset impairment charges of $2.3 billion and $11.4 billion during fiscal 2002 and 2001, respectively. During fiscal 2003, net reversals of $149 million were required due to lower than estimated actual costs for prior year plans. These reversals were particularly related to the true-up of termination benefits.

- We had net recoveries of bad debt and customer financings of $223 million in fiscal 2003, primarily due to the favorable settlement of certain fully-reserved notes receivable and accounts receivable. We recognized significant provisions for bad debts and customer financings of $1.3 billion and $2.2 billion during fiscal 2002 and 2001, respectively, as a result of the significant deterioration of the financial health of certain customers. Most of these provisions were related to commitments made and loans drawn under our customer-financing program during prior years.

- We recognized a charge of $481 million during fiscal 2003 in connection with the settlement of purported class action securities lawsuits and other related lawsuits against us and certain of our current and former directors and officers for alleged violations of federal securities laws, ERISA and related claims.

- We continued to maintain a full valuation allowance on our net deferred tax assets during fiscal 2003, which primarily originated in fiscal 2002. However, we recognized an income tax benefit of $233 million during fiscal 2003, which included several discrete items that were partially offset by current tax expense related to certain non-U.S. operations. The discrete items included tax benefits from the realization of certain fully-reserved net operating losses as a result of carryback claims for taxes paid in prior years, plus additional benefits from the expected favorable resolution of certain tax audit matters. Fiscal 2002 included a tax provision of $4.8 billion despite a pre-tax loss from continuing operations of $7.1 billion due to the requirement for a full valuation allowance.

We have two segments, each organized around a separate customer set to which it sells products or services. The Integrated Network Solutions segment ("INS") sells to global wireline service providers, including long-distance carriers, traditional local telephone companies and Internet service providers. It offers a broad range of software, equipment and services primarily related to voice networking (offerings primarily consisting of switching products, which we sometimes referred to as convergence solutions, and voice messaging products), data and network management (offerings primarily consisting of access and data networking equipment and operating support software) and optical networking. The Mobility segment sells to global wireless service providers and offers software, equipment and services to support the needs of its customers for radio access and core networks. We support these two segments through a number of central organizations, including our services organization and corporate headquarters.

Manufacturing and supply chain functions are part of a single global supply chain network organization that manages the materials and activities necessary to produce and deliver products to our customers.

During this prolonged market downturn, we are working closely with our customers to position the full breadth of our products and services and we are significantly reducing our cost structure. We expect our revenues to remain flat or to increase slightly during fiscal 2004. We also expect to achieve sustained profitability some time in fiscal 2004 at a gross margin rate of approximately 35%. However, if the telecommunications market continues to decline or does not improve, or improves at a slower pace than we anticipate, our revenues and profitability will continue to be adversely affected. In that case, additional restructuring actions may be undertaken to further reduce costs, which may result in additional charges.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are based on the selection of accounting policies and the application of significant accounting estimates, some of which require management to make significant assumptions. We believe that some of the more critical estimates and related assumptions that affect our financial condition and results of operations are in the areas of revenue recognition, receivables and customer financing, inventories, income taxes, intangible assets, pension and postretirement benefits, business restructuring and legal contingencies. We have discussed the application of these critical accounting estimates with our board of directors and Audit and Finance Committee.

The impact of changes in the estimates and assumptions pertaining to revenue recognition, receivables and inventories is directly reflected in our segments' operating loss. Although any charges related to our net deferred tax assets and goodwill and other acquired intangibles are not reflected in the segment results, the long-term forecasts supporting the realization of those assets and changes in them are significantly affected by the actual and expected results of each segment. Generally, the changes in estimates related to pension and postretirement benefits, our restructuring program and litigation will not affect our segment results, although execution of the restructuring program by each segment may cause related changes in the estimates.

Other than the adoption of Statement of Financial Accounting Standards No. 142 ("SFAS 142"), which is more fully explained in Note 1 to our consolidated financial statements, there was no initial adoption of any accounting policy during fiscal 2003 that had a material effect on our financial condition and results of operations.

Revenue recognition

Most of our sales are generated from complex contractual arrangements, which require significant revenue recognition judgments, particularly in the areas of multiple-element arrangements and collectibility.

Revenues from contracts with multiple element arrangements, such as those including installation and integration services, are recognized as each element is earned based on objective evidence regarding the relative fair value of each element and when there are no undelivered elements that are essential to the functionality of the delivered elements. We have determined that the customer or a third party can install most of our equipment, and as a result, revenue may be recognized upon delivery of the equipment, provided all other revenue recognition criteria are met.

In the current market environment, the assessment of collectibility is particularly critical in determining whether revenues should be recognized. As part of the revenue recognition process, we determine whether trade and notes receivables are reasonably assured of collection based on various factors, including our ability to sell those receivables and whether there has been deterioration in the credit quality of our customers that could result in our inability to collect or sell the receivables. In situations where we have the ability to sell the receivable, revenue is recognized to the extent of the value we could reasonably expect to realize from the sale. We defer revenue and related costs if we are uncertain as to whether we will be able to sell or collect the receivable. We defer revenue but recognize costs when we determine that the collection or sale of the receivable is unlikely.

For sales generated from long-term contracts, primarily those related to customized network solutions and network build-outs, we generally use the percentage of completion method of accounting. In doing so, we make important judgments in estimating revenue and cost and in measuring progress toward completion. Progress is usually measured by units of delivery. These judgments underlie our determinations regarding overall contract value, contract profitability and timing of revenue recognition. Revenue and cost estimates are revised periodically based on changes in circumstances; any expected losses on contracts are recognized immediately upon contract signing or as soon thereafter as identified. Revenues related to long-term contracts, using the percentage of completion method of accounting, represented approximately 18%, 13% and 9% of total revenues during fiscal 2003, 2002 and 2001, respectively.

We also sell products through multiple distribution channels, including resellers and distributors. For products sold through these channels, revenue is generally recognized when the reseller or distributor sells the product to the end user.

Deferred revenue related to collectibility concerns, undelivered elements and multiple distribution channels was approximately $222 million and $267 million as of September 30, 2003 and 2002, respectively.

Receivables and customer financing

We are required to estimate the collectibility of our trade receivables and notes receivable. A considerable amount of judgment is required in assessing the realization of these receivables, including the current creditworthiness of each customer and the related aging of past due balances. We evaluate specific accounts when we become aware of information indicating that a customer may not be able to meet its financial obligations due to a deterioration of its financial condition, lower credit ratings or bankruptcy. Reserve requirements are based on the best facts available to us and are re-evaluated and adjusted as additional information is received, such as information regarding settlements of prior financing arrangements. Our reserves are also determined by using percentages applied to certain categories of aged receivables.

Our provision for (recovery of) bad debts and customer financings during fiscal 2003, 2002 and 2001 amounted to approximately ($223) million, $1.3 billion and $2.2 billion, respectively. As of September 30, 2003 and 2002, our receivables of $1.5 billion and $1.6 billion, respectively, included reserves of $246 million and $325 million, respectively. Under our customer financing program, there were approximately $415 million and $951 million of reserves on the $442 million and $1.1 billion of drawn commitments as of September 30, 2003 and 2002, respectively. Significant provisions or recoveries related to changes in reserves occurred during fiscal 2003, 2002 and 2001 and may occur in the future due to the market environment or as settlements of past due balances are reached.

As of September 30, 2003, there were approximately $500 million of gross receivables from long-term projects that have been winding down in Saudi Arabia (primarily retention receivables included in other assets). We are in the process of resolving various contractual claims and counter-claims with the customer in order to collect these receivables. During fiscal 2003 there were minimal project revenues realized, and collections on the related receivables slowed considerably. We believe that the financial resolution of these project close-out issues will not have an adverse effect on our results of operations.

Inventories

We are required to state our inventories at the lower of cost or market. In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease, due to market conditions, technological and product life cycle changes and longer than previously expected usage periods.

We have experienced significant charges related to changes in required reserves in recent periods due to changes in strategic direction, such as discontinuances of product lines, as well as declining market

conditions. As a result, we incurred net inventory charges of approximately $56 million, $620 million and $2.4 billion during fiscal 2003, 2002 and 2001, respectively. As of September 30, 2003 and 2002, inventories of $632 million and $1.4 billion, respectively, were net of reserves of approximately $980 million and $1.5 billion, respectively. It is possible that significant changes in required inventory reserves may continue to occur in the future if there is a rapid change in the demand for our products due to a further decline in market conditions or to new technological developments.

Income taxes

We currently have significant deferred tax assets, resulting from tax credit carryforwards, net operating loss carryforwards and deductible temporary differences. These deferred tax assets may reduce taxable income in future periods. A valuation allowance is required when it is more likely than not that all or a portion of a deferred tax asset will not be realized. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Cumulative losses weigh heavily in the overall assessment.

As of September 30, 2001, and continuing through March 31, 2002, we provided valuation allowances on future tax benefits with relatively short carryforward periods, such as foreign tax credits, foreign net operating losses, capital losses and most state net operating losses. During this period, we believed it was more likely than not that the remaining net deferred tax assets of $5.2 billion at both September 30, 2001, and March 31, 2002, would be realized, principally based upon forecasted taxable income, generally within the 20-year research and development ("R&D") credit and net operating loss carryforward periods, giving consideration to substantial benefits realized to date through our restructuring program.

During the review of the third quarter of fiscal 2002, several significant developments were considered in determining the need for a full valuation allowance, including the continuing and recently more severe market decline, increasing uncertainty and lack of visibility in the telecommunications market as a whole, a significant decrease in sequential quarterly revenue levels, a decrease in sequential earnings after several quarters of sequential improvement and the possible need for further restructuring and cost reduction actions to attain profitability. As a result of our assessment, we established a full valuation allowance for our remaining net deferred tax assets at June 30, 2002. Since June 30, 2002, we have continued to maintain a full valuation allowance on our net deferred tax assets.

We expect to continue to maintain a full valuation allowance on future tax benefits until an appropriate level of profitability is sustained, or we are able to develop tax strategies that would enable us to conclude that it is more likely than not that a portion of our deferred tax assets would be realizable. For example, during fiscal 2003, we did realize $213 million in tax benefits from certain net operating losses (which were fully-reserved) as a result of carryback claims for taxes paid in prior years, principally by previously merged companies and our former foreign sales corporation. We have also recently filed other net operating loss carryback claims, which might result in refunds that are significantly more substantial than the amounts realized in fiscal 2003 if ultimately resolved in our favor. We have maintained a full valuation allowance on these amounts since they are related to complex matters and are in the early stages of resolution.

Our income tax provision (benefit) included charges related to changes in valuation allowances of approximately $156 million, $7.9 billion and $545 million during fiscal 2003, 2002 and 2001, respectively. As of September 30, 2003 and 2002, our total valuation allowance on net deferred tax assets was approximately $9.9 billion and $10.0 billion, respectively.

Intangible assets

We currently have intangible assets, including goodwill and other acquired intangibles of $188 million, development costs for software to be sold, leased or otherwise marketed of $323 million and internal use software development costs of $183 million. Prior to October 1, 2002, goodwill and identifiable intangible assets were amortized on a straight-line basis over their estimated useful lives. In connection with the adoption of SFAS 142 on October 1, 2002, goodwill is no longer amortized but is tested for impairment annually, or more often, if an event or circumstance indicates that an impairment loss has been incurred.

Other acquired intangibles are amortized on a straight-line basis over the periods benefited, principally in the range of four to six years.

Long-lived assets, other than goodwill, are reviewed for impairment whenever events such as product discontinuances, plant closures, product dispositions or other changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized when the carrying amount of a long-lived asset exceeds the sum of the undiscounted cash flows expected to result from the asset's use and eventual disposition. The impairment loss is measured by the amount by which the carrying amount exceeds its fair value, which is typically calculated using discounted expected future cash flows. The discount rate applied to these cash flows is based on our weighted average cost of capital, which represents the blended after-tax costs of debt and equity.

The initial goodwill impairment test was completed during the first quarter of fiscal 2003, which resulted in no transitional impairment loss. We assessed the realizability of goodwill related to our multi-service switching reporting unit within INS during the third quarter of fiscal 2003 as a result of business decisions to partner with other suppliers to use their products in our sales offerings. The reporting unit's fair value was determined using projected cash flows over a seven-year period discounted at 15% after considering terminal value and related cash flows associated with services revenues. The excess of the reporting unit's goodwill carrying value over its implied fair value in the amount of $35 million was recognized as an impairment charge in the third quarter of fiscal 2003. The annual goodwill impairment test was completed during the fourth quarter of fiscal 2003 and did not result in an additional impairment loss.

In the fourth quarter of fiscal 2003, we recognized a $50 million impairment charge related to capitalized software. This charge was required after reconsideration of the specific software that might be deployed due to continuing universal mobile telecommunications systems ("UMTS") market delays.

During fiscal 2002, the continued decline in the telecommunications market prompted a reassessment of all key assumptions underlying our goodwill valuation judgments, including those relating to short- and long-term growth rates. As a result of our analysis, we determined that impairment charges of $975 million, including $826 million of goodwill impairment charges, were required because the forecast undiscounted cash flows were less than the carrying values of certain businesses. The charges were measured on the basis of a comparison of the estimated fair values of the businesses with the corresponding carrying values. The goodwill impairment related primarily to goodwill recognized in connection with our September 2000 acquisition of Spring Tide Networks. Fair values were determined on the basis of discounted cash flows.

In addition, in the fourth quarter of fiscal 2002, we recognized approximately $200 million of charges related to capitalized software impairments and $50 million of charges related to property, plant and equipment impairments. These charges were primarily related to delays and increasing uncertainties in the development of the UMTS market.

Pension and postretirement benefits

Included in our results of operations are significant pension and postretirement benefit costs and credits, which are measured using actuarial valuations. Inherent in these valuations are key assumptions, including assumptions about discount rates and expected returns on plan assets. These assumptions are updated on an annual basis at the beginning of each fiscal year. We are required to consider current market conditions, including changes in interest rates, in making these assumptions. Changes in the related pension and postretirement benefit costs or credits may occur in the future due to changes in the assumptions. Our net pension and postretirement benefit credit was approximately $669 million, $972 million and $1.1 billion during fiscal 2003, 2002 and 2001, respectively, excluding the impact of restructuring actions. Approximately two-thirds of these amounts are reflected in operating expenses, with the balance in costs. The reduction in the net pension and postretirement credit during fiscal 2003 was primarily a result of lower plan assets, a reduction in the discount rate from 7.0% to 6.5%, and a reduction in the expected return on plan assets, from 9.0% to 8.75% for pensions and from 9.0% to 7.93% for postretirement benefits. The impact of these factors was partially offset by plan amendments

related to retiree benefits, including the elimination of certain retiree death benefits and reductions in certain retiree healthcare benefits.

To develop our discount rate, we considered the available yields on high-quality fixed-income investments with maturities corresponding to our benefit obligations. To develop our expected return on plan assets, we also considered the historical long-term asset return experience, the expected investment portfolio mix of plan assets and an estimate of long-term investment returns. To develop our expected portfolio mix of plan assets, we considered the duration of the plan liabilities and gave more weight to equity positions, including public and private equity investments and real estate, than to fixed-income securities. Our actual 10-year average rates of return on pension plan assets were 9.9%, 9.5% and 11.5% during fiscal 2003, 2002 and 2001, respectively. The expected return on plan assets is determined using the expected rate of return and a calculated value of assets referred to as the "market-related value." The aggregate market-related value of pension and postretirement plan assets was $39.6 billion as of September 30, 2003, which exceeded the fair value of plan assets by $7.1 billion. Differences between the assumed and actual returns are amortized to the market-related value on a straight-line basis over a five-year period. The amortization of these differences, including those resulting from the actual losses incurred during fiscal 2002 and 2001, will continue to reduce both the market-related value and our pension credit. Gains and losses resulting from changes in these assumptions and from differences between assumptions and actual experience (except those differences being amortized to the market-related value) are amortized over the expected remaining service periods of active plan participants to the extent they exceed 10% of the higher of the market-related value or the projected benefit obligation of each respective plan.

Holding all other assumptions constant, a 0.5 percent increase or decrease in the discount rate would have decreased or increased the fiscal 2003 net pension and postretirement credit by approximately $50 million. Likewise, a 0.5 percent increase or decrease in the expected return on plan assets would have increased or decreased the fiscal 2003 net pension and postretirement credit by approximately $200 million.

The estimated accumulated benefit obligation related to the U.S. management employees' pension plan and several other smaller pension plans exceeded the fair value of the plan assets as of September 30, 2003 and 2002. This was due primarily to: (1) the decline in the discount rate used to estimate the pension liability as a result of declining interest rates in the United States, and (2) negative returns on the pension funds as a result of the overall decline in the equity markets in 2002. We used a discount rate of 5.75% and 6.5% to determine the pension obligation as of September 30, 2003 and September 30, 2002, respectively. We recognized a $594 million and a $2.9 billion direct charge to equity for minimum pension liabilities during the fourth quarter of fiscal 2003 and 2002, respectively. Market conditions and interest rates significantly affect the future assets and liabilities of our pension plans, and similar charges might be required in the future. It is difficult to predict these factors due to highly volatile market conditions. Holding all other assumptions constant, a 0.5 percent decrease or increase in the discount rate would have increased or decreased the minimum pension liability by approximately $800 million as of September 30, 2003.

Business restructuring

Our restructuring reserves reflect many estimates, including those pertaining to employee separation costs, inventory, settlements of contractual obligations, facility exit costs and proceeds from asset sales. We reassess the reserve requirements for completing each individual plan under our restructuring program at the end of each reporting period. Actual experience has been and may continue to be different from these estimates. For example, we recognized significant reversals or charges related to revisions of our estimates for certain restructuring plans initiated in prior periods, which resulted in a net credit of $225 million and $333 million during fiscal 2003 and 2002, respectively. As of September 30, 2003 and 2002, liabilities associated with our restructuring program were $467 million and $1.1 billion, respectively. Most of the remaining reserve requirements as of September 30, 2003, are related to leases on exited facilities. Facility exit costs of $367 million are expected to be paid over the remaining lease terms, ranging from several months to 13 years, and are reflected net of expected sublease income of $248 million. Additional charges may be required in the future if the expected sublease income is not realized. Refer to Note 2 to our consolidated financial statements for more information.

Legal contingencies

We are subject to proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to securities, environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments in or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for these contingencies is based on a careful analysis of each individual issue, often with the assistance of outside legal counsel. The required reserves may change in the future due to new developments in each matter or changes in approach, in dealing with these matters, such as a change in settlement strategy. Refer to Note 18 to our consolidated financial statements for more information, including a discussion of our securities and related cases and a dispute with an insurer regarding the coverage of certain customer finance loans.

RESULTS OF OPERATIONS

Revenues

The following table summarizes revenues by segment, region and product:

	Years ended September 30,					
(in millions)	2003		2002		2001	
Revenues by segment:						
INS	$ 4,235	50%	$ 6,262	51%	$ 12,111	57%
Mobility	4,001	47%	5,535	45%	6,370	30%
Other	234	3%	524	4%	2,813	13%
Total revenues	$ 8,470	100%	$ 12,321	100%	$ 21,294	100%
Revenues by region:						
U.S.	$ 5,121	60%	$ 8,199	67%	$13,781	65%
Other Americas (Canada, Central & Latin America)	422	5%	714	6%	1,370	6%
EMEA (Europe, Middle East & Africa)	1,237	15%	1,746	14%	3,355	16%
APAC (Asia Pacific & China)	1,690	20%	1,662	13%	2,788	13%
Total revenues	$ 8,470	100%	$12,321	100%	$21,294	100%
Revenues by product:						
Wireless	$ 3,080	36%	$ 4,443	36%	$ 5,283	25%
Voice networking	1,557	19%	2,117	17%	3,784	17%
Data and network management	1,072	13%	1,180	10%	2,064	10%
Optical networking	706	8%	1,345	11%	3,147	14%
Services	1,804	21%	2,727	22%	4,199	20%
Optical fiber	-	-	114	1%	2,023	10%
Other	251	3%	395	3%	794	4%
Total revenues	$ 8,470	100%	$12,321	100%	$21,294	100%

Fiscal 2003 vs. 2002

As discussed in the “Overview” of this MD&A, the significant reduction in capital spending by large service providers was the primary reason for the 31% decline in revenues during fiscal 2003 as compared with fiscal 2002. The decline in revenues affected all geographic areas, with the exception of the APAC region, and included both product revenues (31%) and services revenues (34%). Refer to the segment discussion later in this MD&A for information on changes in segment revenues.

United States and Other Americas revenues both declined in fiscal 2003 from fiscal 2002 by approximately 40%, primarily as a result of spending reductions by large service providers, particularly in the United States, and economic instability in Latin America. EMEA revenues declined by 29% compared with the prior period, primarily due to: (1) lower spending for optical networking products, resulting from service provider overcapacity, and (2) to a lesser extent, due to lower revenues from a long-term project. Revenues in the APAC region were relatively constant compared with the prior period, due to new code division multiple access ("CDMA") Wireless network build-outs in India and ongoing build-outs in China.

The decrease in product revenues occurred in all product lines, including wireless (31%), voice networking (26%), data and network management (9%) and optical networking (48%). Wireless revenue declines are primarily attributable to capital spending constraints by large service providers, reductions in TDMA infrastructure spending and delayed UMTS deployments. Optical networking declines were more severe than those for other wireline products, due to network overcapacity and delays in customer spending on next-generation products. The $923 million decline in services revenues was primarily due to lower engineering and installation activity, mostly in support of INS customers. The decline in installation revenues was due to lower product deployments, as well as competitive pricing pressure. Total services revenues supporting INS customers decreased by $691 million, or 37%, to $1.2 billion, primarily within the United States.

Fiscal 2002 vs. 2001

As discussed in the "Overview" of this MD&A, the deterioration in the global telecommunications market began in fiscal 2001 and intensified during fiscal 2002. The significant reductions in capital spending primarily affected our INS segment and all of its product offerings. Regional revenues as a percentage of total revenues were fairly constant in fiscal 2002 compared with fiscal 2001, with the largest dollar declines in the United States and EMEA. In addition, business dispositions during fiscal 2002 and fiscal 2001 accounted for $2.3 billion, or about 25% of the total revenue decline, of which approximately 84% was a result of the sale of the Optical Fiber Solutions ("OFS") business during fiscal 2002.

Excluding optical fiber and other revenues, the fiscal 2002 revenue decline included both product revenues (36%) and services revenues (35%). The product revenue declines were reflected in all product lines, particularly those related to wireline products sold by the INS segment. Voice networking declined 44%, data and network management declined 43% and optical networking declined 57% in fiscal 2002, as compared with fiscal 2001. The $1.5 billion decline in services revenues was primarily due to lower engineering and installation activity, primarily in support of INS customers.. Total services revenues supporting INS customers decreased by $1.4 billion, or 42%, to $1.9 billion, primarily within the United States.

Gross Margin

The following table summarizes our gross margin and the percentage to total revenues:

	Years ended September 30,		
(in millions)	2003	2002	2001
Gross margin	$ 2,652	$ 1,552	$ 2,058
Gross margin rate	31%	13%	10%

Fiscal 2003 vs. 2002

The gross margin rate increased by approximately 18 percentage points in fiscal 2003 from fiscal 2002, despite a 31% decline in sales volume.

Inventory and other charges negatively affected the gross margin rate by approximately three percentage points during fiscal 2003 and 13 percentage points during fiscal 2002, resulting in an improvement of 10 percentage points. The higher charges during fiscal 2002 were primarily related to items or events associated with customers experiencing financial difficulties (in some cases, declaring bankruptcy or

becoming insolvent), costs associated with supplier and customer contract settlements, higher provisions for slow-moving and obsolete inventory, adjustments to long-term projects and higher than expected costs due to certain customer obligations and product performance issues.

During fiscal 2003 and 2002, we recognized $26 million in reversals and $64 million in charges, respectively, for inventory associated with product line rationalizations and product line discontinuances under our restructuring program. The inventory reversal had a negligible favorable impact on the gross margin rate in fiscal 2003 and had a one-percentage point negative impact on the gross margin rate in fiscal 2002.

The remaining improvement in the gross margin rate was due to cost reductions realized from supply chain rationalization and efficiency gains, which accounted for six percentage points of improvement. We reduced costs across the supply chain through internal restructuring and efficiencies, product redesign and resourcing products to lower cost regions. To a lesser extent, the improvement was due to a higher proportion of Mobility and intellectual property licensing revenues to total revenues; both have higher gross margin rates than INS.

The gross margin attributable to services during fiscal 2003 decreased by only $28 million, to $346 million, despite the $923 million decline in revenues over the same period. This was due to a five-percentage point increase in the services gross margin rate, to 19%, in fiscal 2003. The gross margin rate improvement was primarily due to a larger proportion of services revenues being derived from maintenance services, which historically have higher gross margin rates than engineering and installation services, and significant cost reduction efforts aimed at aligning our cost structure with market opportunities.

Fiscal 2002 vs. 2001

The gross margin rate increased by approximately three percentage points in fiscal 2002 from fiscal 2001, despite a 42% decline in sales volume.

Inventory and other charges negatively affected the gross margin rate in fiscal 2002 and 2001 by approximately 13 percentage points and 11 percentage points, respectively, reflecting a decline of two percentage points. The total dollar amount of charges was lower in fiscal 2002, primarily due to lower inventory levels resulting from our strategy of focusing on large service providers, our restructuring program and improved inventory management. However, due to the significant revenue decline in fiscal 2002, the charges had a greater impact on the gross margin rate. These charges were primarily related to items or events associated with customers experiencing financial difficulties (in some cases declaring bankruptcy or becoming insolvent), costs associated with supplier and customer contract settlements, higher provisions for slow-moving and obsolete inventory, adjustments to certain long-term projects and higher than expected costs due to certain customer obligations and product performance issues.

During fiscal 2002 and 2001, we recognized $64 million and $1.2 billion, respectively, of inventory charges associated with product line rationalizations and product line discontinuances under our restructuring program. These inventory charges negatively affected the gross margin rate for fiscal 2002 and 2001 by one and six percentage points, respectively, resulting in an improvement of five percentage points.

Also, significant reductions in capital spending by service providers reduced sales volumes across all product lines and services more quickly than the reduction in our fixed costs, which resulted in less absorption of fixed costs. The net change in unabsorbed fixed costs, as well as all other factors affecting gross margin, including changes in geographic and product mix, negatively affected the gross margin rate for fiscal 2002 and 2001. Our product mix was also negatively affected by the sale of OFS.

The gross margin attributable to services during fiscal 2002 decreased by $181 million, to $374 million, due primarily to the $1.5 billion decline in revenues over the same period. The gross margin rate increased by one percentage point to 14% in fiscal 2002, primarily due to cost reductions.

Operating Expenses

The following table summarizes our operating expenses:

(in millions)	Years ended September 30, 2003	2002	2001
Selling, general and administrative ("SG&A") expenses, excluding the following two items:	$ 1,717	$ 2,466	$ 4,240
Provision for (recovery of) bad debts and customer financings	(223)	1,253	2,249
Amortization of goodwill and other acquired intangibles	15	250	921
Total SG&A	1,509	3,969	7,410
Research and development ("R&D")	1,488	2,310	3,520
Goodwill impairment	35	826	3,849
Business restructuring charges (reversals) and asset impairments, net	(158)	1,426	6,308
Operating expenses	$ 2,874	$ 8,531	$ 21,087

SG&A expenses

Fiscal 2003 vs. 2002

Excluding provisions for bad debts and customer financings and amortization of goodwill and other acquired intangibles, SG&A expenses decreased by 30% during fiscal 2003. The decrease was primarily a result of headcount reductions under our restructuring program and other cost savings initiatives that limited discretionary spending. These savings were partially offset by accelerated depreciation and other related charges of $108 million in fiscal 2003 as a result of shortening the estimated useful lives of several properties that have been or are in the process of being sold. The restructuring program is essentially complete and therefore is not expected to further reduce SG&A expenses. Approximately 60% and 16% of the fiscal 2003 reductions were in the INS and Mobility segments, respectively, with the remaining decrease attributable to reductions in general corporate functions.

Fiscal 2002 vs. 2001

Excluding provisions for bad debts and customer financings and amortization of goodwill and other acquired intangibles, SG&A expenses decreased by 42% during fiscal 2002. The decrease was primarily a result of headcount reductions under our restructuring program and other cost savings initiatives that limited discretionary spending. Approximately 80% of the fiscal 2002 reductions were in INS due to the greater degree of product rationalization and cost reduction efforts in INS . The remaining decreases were attributed to reductions in general corporate functions.

Provision for (recovery of) bad debts and customer financings

In the past, we provided substantial long-term financing to some of our customers as a condition of obtaining or bidding on infrastructure projects. Such financing took the form of both commitments to extend credit and third-party financial guarantees. These commitments were extended to established companies, as well as start-up companies, and ranged from modest amounts to more than a billion dollars. Our overall customer financing exposure, coupled with the rapid and sustained decline in telecommunications market conditions, negatively affected our results of operations and cash flows in fiscal 2002 and 2001. However, we had net recoveries in fiscal 2003 due to more selective customer financing practices and a reduction in customer defaults.

Fiscal 2003 vs. 2002

During fiscal 2003, we had net recoveries of bad debts and customer financings of $223 million. These recoveries were primarily due to the favorable settlement of certain fully-reserved notes receivable and accounts receivable and significantly lower bad debt and customer financing exposure. The significant provisions reflected in fiscal 2002 were due to the deterioration in the creditworthiness of certain customers as a result of the decline in the telecommunications market.

Fiscal 2002 vs. 2001

During fiscal 2002 and 2001, poor market conditions contributed to the weakening financial condition of certain customer as well as bankruptcy filings and corresponding defaults. We were unable to sell or transfer significant amounts of the drawn and undrawn commitments to financial institutions or other investors on reasonable terms or at all. As a result, we provided reserves for certain trade and notes receivables and sold others at significant discounts. During fiscal 2002, $765 million of provisions were related to customer financings, with the balance relating to trade receivables. Approximately one-third of the provision for customer financings was related to one customer that defaulted under the terms and conditions of its customer financing agreement. Approximately 55% of the total provisions were related to INS customers and 39% to Mobility customers. The remaining provisions were not related to reportable segments.

Amortization of goodwill and other acquired intangibles

Fiscal 2003 vs. 2002

We adopted SFAS 142 during the first quarter of fiscal 2003. As a result, our remaining goodwill of $185 million is no longer amortized but is tested for impairment annually or more often if an event or circumstance indicates that an impairment loss has been incurred.

Amortization of other acquired intangibles was $15 million during fiscal 2003 and $19 million during fiscal 2002.

Fiscal 2002 vs. 2001

Amortization of goodwill and other acquired intangibles was significantly lower in fiscal 2002 as a result of restructuring actions taken in fiscal 2001. These goodwill and acquired intangible reductions were related to the discontinuance of the Chromatis product portfolio, that reduced goodwill and other acquired intangibles by $4.1 billion. In addition, as a result of the continued downturn in the telecommunications market during fiscal 2002, impairment charges of $975 million were recognized in fiscal 2002, primarily related to goodwill associated with the Spring Tide product portfolio.

R&D

Fiscal 2003 vs. 2002

The 36% decrease in R&D expenses in fiscal 2003 was primarily due to headcount reductions and product rationalizations under our restructuring program. The restructuring program is essentially complete and is not expected to further reduce R&D expenses. Substantially all of the reduction for the fiscal year was in INS, due to the greater number of product rationalizations in INS.

R&D attributed to Mobility was approximately 64% and 39% of total R&D during fiscal 2003 and 2002, respectively. Mobility spending was primarily related to CDMA and UMTS next-generation technologies. INS spending was primarily related to next-generation technologies and additional feature and function enhancements on optical networking, multi-service switching, network operating systems and circuit and packet switching products.

Fiscal 2002 vs. 2001

The 34% decrease in R&D expenses in fiscal 2002 was primarily due to headcount reductions and product rationalizations under our restructuring program. Approximately 70% of the fiscal 2002 reductions were in INS, due to the greater number of product rationalizations in INS.

R&D attributed to INS was approximately 55% and 60% of total R&D during fiscal 2002 and 2001, respectively. INS spending was primarily related to optical networking, multi-service switching, network operating systems and circuit and packet switching products. Mobility spending was primarily related to CDMA and UMTS next-generation technologies.

Goodwill impairment

Fiscal 2003

Recent business decisions to partner with other suppliers to use their products in our sales offerings prompted an assessment of the recoverability of certain goodwill associated with the multi-service switching reporting unit within INS during the third quarter of fiscal 2003. The excess of the reporting unit's goodwill carrying value over its implied fair value was recognized as a $35 million impairment charge during fiscal 2003.

Fiscal 2002

The continued, sharper decline in the telecommunications market prompted an assessment of all key assumptions underlying goodwill valuation judgments, including those related to short- and long-term growth rates. It was determined that the carrying value of goodwill previously recognized in connection with the acquisition of Spring Tide was less than the forecasted undiscounted cash flows. As a result, a goodwill impairment charge of $826 million was recognized, based on the difference between the estimated fair value and corresponding carrying value. Fair value was determined on the basis of discounted cash flows.

Fiscal 2001

We recognized a $3.8 billion goodwill impairment charge primarily as a result of the discontinuance of the Chromatis product portfolio.

Business restructuring charges (reversals) and asset impairments, net

	Years ended September 30,		
(in millions)	2003	2002	2001
Employee separations	$ (47)	$ 799	$ 3,440
Contract settlements	(16)	(93)	944
Facility closings	17	301	304
Other	(18)	16	79
Total restructuring costs (reversals)	$ (64)	$ 1,023	$ 4,767
Total asset write-downs	(120)	458	2,568
Losses on sales	-	(140)	-
Impairment of goodwill	35	826	3,849
Impairment of other intangible assets	-	149	232
Total net charge (reversal)	$ (149)	$ 2,316	$ 11,416
Reflected in costs	$ (26)	$ 64	$ 1,259
Reflected in operating expenses	$ (158)	$ 1,426	$ 6,308
Reflected as goodwill impairment	$ 35	$ 826	$ 3,849

During the second quarter of fiscal 2001, we committed to and began executing a restructuring program aimed at realigning our resources in order to focus on the large service provider market. We eliminated some marginally profitable or non-strategic product lines, merged certain technology platforms,

consolidated development activities, eliminated management positions and duplications in marketing functions and programs, centralized our sales support functions, sold or leased certain of our manufacturing facilities and made greater use of contract manufacturers. We sold or disposed of the assets related to the eliminated product lines, closed facilities and reduced work forces in many of the countries where we operated at the end of fiscal 2000. As a result, we incurred net business restructuring charges and asset impairments in fiscal 2001 and 2002 of $11.4 billion and $2.3 billion (including goodwill impairment charges), respectively. In fiscal 2003, we recognized net reversals of $149 million.

Since the inception of the restructuring program, we have reduced our headcount by approximately 71,500 employees, to 34,500 employees as of September 30, 2003 (this figure includes the impacts of attrition and other headcount reductions in the ordinary course of business). In addition, the restructuring plans included facility closing charges related to exiting a significant number of owned and leased facilities, totaling approximately 15.9 million square feet, substantially all of which were exited as of September 30, 2003.

We have essentially completed the restructuring actions but continue to evaluate the remaining restructuring reserves at the end of each reporting period. There may be additional charges or reversals, since the companywide-restructuring program is an aggregation of many individual plans requiring judgments and estimates. Actual costs have differed from estimated amounts in the past.

The net reversals recognized in fiscal 2003 primarily related to lower than previously estimated costs of completing the restructuring actions. The actual termination benefits and curtailment costs were lower than the estimated amounts due to certain differences in actual versus assumed demographics, including the age, service lives and salaries of the separated employees. Net contract settlement reversals were related to the settlement of certain contractual obligations and purchase commitments for amounts lower than originally estimated. The additional facility closing charges were primarily due to lower estimates for expected sublease rental income on certain properties, offset by reversals resulting from negotiated settlements for lower amounts than originally planned on certain other properties. The adjustments to prior asset write-downs included changes to original plans for certain owned facility closings and reversals of inventory reserves as we utilized more discontinued product inventory than anticipated.

The net charges recognized in fiscal 2002 primarily related to additional headcount reductions; revisions to facility closings as a result of changes in estimates as to the amount and timing of expected sublease rental income; net asset write-downs primarily related to property, plant and equipment, capitalized software and inventory associated with additional product exits and the disposition of a manufacturing facility. The net gains (losses) on sales were related to business dispositions in fiscal 2002, including the enterprise professional services business and the billing and customer care business.

The charges recognized in fiscal 2001 primarily related to headcount reductions; contract settlement charges for the settlement of purchase commitments with suppliers and contract renegotiations or cancellations of contracts with customers; facility closings; asset write-downs primarily related to the impairment of goodwill and other acquired intangibles; and product discontinuances.

Refer to Note 2 to our consolidated financial statements for additional details on our business restructuring program and the related charges and reversals.

Other Income (Expense) and Interest Expense

The following table summarizes the components of other income (expense) and provides interest expense amounts:

	Years ended September 30,		
(in millions)	2003	2002	2001
Legal settlements	$ (401)	$ (212)	$ -
Debt conversion cost and gain on extinguishments, net	(97)	-	-
Gains on sales of businesses, net	49	725	56
Interest income	86	114	255
Income (loss) from equity method investments, net	(1)	14	(60)
Write-off of embedded derivative assets	-	-	(42)
Minority interests in earnings of consolidated subsidiaries	(10)	(12)	(81)
Gain (loss) on foreign currency transactions	10	(46)	(58)
Other-than-temporary write-downs of investments	(63)	(209)	(266)
Miscellaneous, net	(1)	(82)	(161)
Other income (expense), net	$ (428)	$ 292	$(357)
Interest expense	$ 353	$ 382	$ 518

Other income (expense)

Fiscal 2003

Other income (expense) included a $481 million charge for the settlement of purported class action lawsuits and other lawsuits against us and certain of our current and former directors and officers for alleged violation of federal securities laws, as well as for ERISA, and related claims. The charge included $315 million for payment in cash, stock or a combination of both; warrants, originally valued at $95 million, which increased to $161 million as a result of a change in their estimated fair value; and $5 million in administrative fees. Partially offsetting the charge was an $80 million reserve reduction for a legal settlement associated with our former consumer products leasing business, due to lower than anticipated claims experience. Refer to Note 18 to our consolidated financial statements for more information on legal settlements.

The debt conversion cost and gain on extinguishments was a result of the exchange of a portion of our 7.75% trust preferred securities and certain other debt obligations for shares of our common stock and cash. Refer to Note 11 to our consolidated financial statements for more information on these exchanges, including the number of securities exchanged.

The write-downs of equity investments were due to sustained weakness in the private equity markets. Refer to the section “Quantitative and Qualitative Disclosures About Market Risk” for a discussion of Equity Price Risk.

The gains on sales of businesses included $41 million of business disposition reserve reversals, primarily associated with the resolution of contingencies related to the sale of OFS.

Fiscal 2002

Other income (expense) included $725 million of gains from business dispositions, $664 million of which was from the sale of the OFS business and China joint ventures, and interest income of $114 million related to our cash and cash equivalents. This was partially offset by a legal settlement of $162 million related to our former consumer products telephone leasing business, a $50 million purchase price

adjustment to settle a claim with VTech Holdings Limited and VTech Electronics Netherlands B.V., and other-than-temporary investment write-downs of $209 million, primarily related to our investment in Commscope.

Fiscal 2001

Other income (expense) included other-than-temporary write-downs on several of our investments due to adverse market conditions and net losses from minority interests and equity-method investments, offset in part by interest income. A write-off of embedded derivative assets was primarily related to one customer.

Interest Expense

Fiscal 2003 vs. 2002

Interest expense decreased by $29 million due to lower borrowings and amortization of fees related to the terminated credit facility, partially offset by higher average outstanding balances related to our trust preferred securities.

Fiscal 2002 vs. 2001

Interest expense decreased by $136 million due to a significant reduction in short-term debt, partially offset by interest expense related to our trust preferred securities, which were issued in March 2002.

Provision (Benefit) for Income Taxes

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

	Years ended September 30,		
(in millions)	2003	2002	2001
Provision (benefit) for income taxes	$ (233)	$4,757	$(5,734)
Effective tax (benefit) rate	(23.2)%	67.3%	(28.8)%

Fiscal 2003

The tax benefit for fiscal 2003 included a full valuation allowance on our net deferred tax assets and current tax expense, primarily related to certain non-U.S. operations, and several discrete items. These discrete items included the realization of $213 million in tax benefits from fully-reserved net operating losses as a result of carryback claims for taxes paid in prior years, principally by previously merged companies and our former foreign sales corporation. In addition, a $77 million tax benefit was recognized as a result of an expected favorable resolution of certain tax audit matters.

Fiscal 2002

The provision for income taxes during fiscal 2002 was primarily due to a charge for a full valuation allowance on our net deferred tax assets. At that time, several significant developments were considered in determining the need for a full valuation allowance, including the continuing severe market decline, uncertainty and lack of visibility in the telecommunications market as a whole, a significant decrease in current sequential quarterly revenue levels, a decrease in sequential earnings after several quarters of sequential improvement, and the possible need for further restructuring and cost reduction actions to attain profitability. Refer to Note 8 to our consolidated financial statements for more detail regarding this full valuation allowance.

Fiscal 2001

The effective tax benefit rate for fiscal 2001 was lower than the U.S. statutory rate, primarily due to the impact of non-tax deductible goodwill amortization, certain non-tax deductible business restructuring charges and asset impairments, as well as to an increase in our deferred tax valuation allowances, all of which decreased the effective tax benefit rate. Such decrease was offset in part by research and development tax credits.

Loss from Continuing Operations

As a result of the items discussed above, the loss from continuing operations and related per share amounts are as follows:

	Years ended September 30,		
(in millions, except per share amounts)	2003	2002	2001
Loss from continuing operations	$ (770)	$ (11,826)	$ (14,170)
Loss per share from continuing operations–basic and diluted	$ (0.29)	$ (3.51)	$ (4.18)
Weighted average number of common shares outstanding-basic and diluted	3,950	3,427	3,401

Income (Loss) from Discontinued Operations, Net

The income (loss) from discontinued operations, net during fiscal 2002 was $73 million, or $0.02 per basic and diluted share, and ($3.2) billion, or ($0.93) per basic and diluted share, during fiscal 2001 (refer to Note 3 to our consolidated financial statements). The discontinued operations consisted of Agere, our former microelectronics business, and our power systems business.

Extraordinary Gain, Net

During fiscal 2001, we realized 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.

Cumulative Effect of Accounting Changes, Net

Effective fiscal 2001, we incurred a $38 million net 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 SFAS 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 Staff Accounting Bulletin 101, “Revenue Recognition in Financial Statements” (“SAB 101”).

Results of Operations by Segment

INS

The following table summarizes external revenues (both U.S. and non-U.S.), gross margin and operating loss:

	Years ended September 30,				
(in millions)	2003	2002	% change	2001	% change
U.S.	$ 2,205	$ 3,440	(36%)	$ 7,030	(51%)
Non-U.S.	2,030	2,822	(28%)	5,081	(44%)
Total	$ 4,235	$ 6,262	(32%)	$12,111	(48%)
Gross margin %	22%	0%	22 pts	10%	(10 pts)
Operating loss	$ (119)	$ (2,954)	96%	$ (4,729)	38%
Return on sales	(3%)	(47%)	44 pts	(39%)	(8 pts)

Fiscal 2003 vs. 2002

During fiscal 2003, INS revenues declined by 32%. The decline was reflected in all product lines and geographic regions. Approximately 61% of the decline was in the United States, and approximately 39% was non-U.S., primarily in EMEA. In the United States, the decline primarily resulted from reductions and delays in capital spending by the large telecommunications service providers. The decline in non-U.S. revenues was particularly concentrated in EMEA, as certain European service providers responded to excess network capacity, principally within the optical area. To a lesser extent, the decline was also due to lower revenues associated with a long-term project. The five largest INS customers represented approximately 41% and 42% of INS revenues during fiscal 2003 and 2002, respectively. INS revenues were approximately $1.0 billion during each quarter of fiscal 2003 but are subject to volatility from changes in spending by significant customers.

During fiscal 2003, the operating loss declined by $2.8 billion, to $119 million. The improvement was driven by a $1.9 billion decrease in operating expenses and a $938 million increase in gross margin. The gross margin rate increased 22 percentage points, to 22%, despite the lower sales volume. The higher gross margin rate was primarily due to lower inventory-related charges, which accounted for eight percentage points of the improvement, and continued cost reductions from supply chain rationalization and efficiency gains, which accounted for nine percentage points of the improvement. The remaining improvement was due to a more favorable product mix. Operating expenses declined $1.9 billion due to a number of factors. INS benefited in fiscal 2003 from approximately $770 million of lower provisions for bad debts and customer financings, which included the impact of approximately $100 million of net recoveries of certain amounts provided for in prior years. The remaining decline of $1.1 billion was primarily due to the restructuring program and less discretionary spending, of which nearly two-thirds was from lower spending for R&D through product rationalizations.

Fiscal 2002 vs. 2001

During fiscal 2002, INS revenues declined by 48% as a result of continuing reductions and delays in capital spending by service providers. The decline was reflected in all product lines and geographic regions. The deterioration of the creditworthiness or financial condition of certain service providers also adversely affected revenues, although to a much lesser degree. Approximately 61% of the decline was in the United States, and approximately 39% was non-U.S., primarily in EMEA. The five largest INS customers represented 42% and approximately 45% of its revenues during fiscal 2002 and 2001, respectively.

During fiscal 2002, the operating loss declined by $1.8 billion, to $3.0 billion. The INS gross margin rate was under significant pressure and declined 10 percentage points during fiscal 2002. The low gross

margin rate was primarily due to unabsorbed fixed costs as a result of significantly lower revenue levels, as well as significant inventory-related charges. Operating expenses declined by approximately 50%, to $3.0 billion, of which $2.2 billion resulted from headcount reductions and less discretionary spending. The remaining decrease was from lower provisions for bad debts and customer financings of $755 million, primarily due to the significant charges incurred for amounts due from one customer, Winstar, in the prior year.

Mobility

The following table summarizes external revenues (both U.S. and non-U.S.), gross margin and operating income (loss):

	Years ended September 30,				
(in millions)	2003	2002	% change	2001	% change
U.S.	$ 2,681	$ 4,337	(38%)	$ 4,960	(13%)
Non-U.S.	1,320	1,198	10%	1,410	(15%)
Total	$ 4,001	$ 5,535	(28%)	$ 6,370	(13%)
Gross margin %	38%	28%	10 pts	20%	8 pts
Operating income (loss)	$ 322	$ (587)	155%	$ (1,605)	63%
Return on sales	8%	(11%)	19 pts	(25%)	14 pts

Fiscal 2003 vs. 2002

During fiscal 2003, Mobility revenues decreased by 28%. The decrease resulted from reductions in capital spending, primarily in the United States, as large service providers continued to preserve capital resources. The declines in U.S. revenues were also attributable to two large service providers, AT&T Wireless and Cingular, that selected alternatives to our TDMA technologies. The decline in revenues attributable to these two customers represented approximately 50% of the Mobility U.S. revenue decline during fiscal 2003. Non-U.S. revenues increased by 10% during fiscal 2003, primarily as a result of large CDMA network build-outs in the APAC region, primarily China and India. The five largest Mobility customers represented approximately 71% and 77% of its revenues during fiscal 2003 and 2002, respectively. Future revenue trends may remain volatile as a result of this concentration among a limited number of customers. Quarterly revenues ranged from $826 million to nearly $1.3 billion during fiscal 2003.

During fiscal 2003, operating income increased by $909 million due to a $934 million decrease in operating expenses, partially offset by a slight decline in gross margin. Despite the decline in U.S. revenues, the gross margin rate increased 10 percentage points, to 38%, in fiscal 2003. The higher gross margin rate was due to lower inventory-related charges, which accounted for seven percentage points of the improvement, supply chain rationalization and efficiency gains, which accounted for two percentage points of the improvement, and, to a lesser extent, favorable product mix. The operating expense decrease was primarily due to approximately $640 million of lower provisions for bad debts and customer financings, including the impact of approximately $130 million of net recoveries of certain amounts reserved in prior years. In addition, approximately $100 million of the decline was due to the net impact of impairment charges of $50 million and $250 million during fiscal 2003 and 2002, respectively, related to certain capitalized software development assets and equipment for UMTS offset by expensing our UMTS development costs as incurred during fiscal 2003. The remainder of the operating expense decline was primarily due to cost reductions realized from our restructuring program and to less discretionary spending.

Fiscal 2002 vs. 2001

During fiscal 2002, Mobility revenues decreased by 13%. The decrease in the United States resulted primarily from reductions in capital spending by certain service providers. The decrease in non-U.S. revenues for fiscal 2002 resulted from reductions in Central and Latin America and the APAC region,

primarily due to a loss of fiscal 2002 revenues from One.Tel, which went into receivership during 2001, partially offset by higher revenues in China and the EMEA region. In addition, approximately 20% of the decline was related to lower revenues from a U.S. customer that defaulted on its customer financing commitment. The five largest Mobility customers represented 77% and approximately 70% of its revenues during fiscal 2002 and 2001, respectively.

During fiscal 2002, the Mobility operating loss declined by $1.0 billion, to $587 million. Driving this improvement was an increase in gross margin of $262 million and a decrease in operating expenses of $756 million. The gross margin rate increased eight percentage points to 28% due to lower inventory-related and warranty-related charges, as well as cost reductions. However, the gross margin rate in fiscal 2002 was still significantly affected by similar charges. The reduction in operating expenses resulted from a reduction in provisions for bad debts and customer financings of $266 million, as well as a reduction in other operating expenses of $490 million, primarily related to headcount reductions under our restructuring program and lower discretionary spending. In fiscal 2002, approximately 50% of Mobility's provisions for bad debts and customer financings were due to one customer that defaulted on its customer financing commitment. In fiscal 2001, Mobility incurred significant provisions for bad debts and customer financings for amounts due from two significant customers.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow overview

Cash and cash equivalents increased $927 million during fiscal 2003, to $3.8 billion, primarily from $1.6 billion of cash proceeds received from the issuance of convertible senior debentures and an $845 million net reduction in short-term investments. This increase was partially offset by $948 million of cash used in operations and approximately $500 million of repayments of certain debt obligations and convertible preferred securities.

Operating activities

Cash used in operating activities of $948 million for fiscal 2003 primarily resulted from a loss from operations of $779 million (adjusted for non-cash items) and changes in other operating assets and liabilities of $864 million. This was partially offset by a reduction in working capital requirements (receivables, inventories and contracts in process and accounts payable) of $695 million. The reduction in working capital was due to the decrease in sales volume during the fourth quarter of fiscal 2003 compared with the fourth quarter of fiscal 2002. Generally, working capital requirements will increase or decrease with quarterly revenue levels. Our working capital requirements have also been reduced through more favorable billing terms, collection efforts and streamlined supply chain operations. The changes in other operating assets and liabilities include cash outlays for our restructuring program of $629 million and capitalized software of $313 million.

Cash used in operating activities was $756 million for fiscal 2002. This primarily resulted from a loss from continuing operations of $2.9 billion (adjusted for non-cash items) and changes in other operating assets and liabilities of $2.4 billion, offset in part by a reduction in working capital requirements of $4.5 billion. The reduction in working capital primarily resulted from the significant decrease in sales volume during fiscal 2002 compared with fiscal 2001. In addition to the effect of reduced sales volume, the decline in inventory and contracts in process was also a result of our continued efforts to streamline supply chain operations and accelerate billings for our long-term contracts. The changes in other operating assets and liabilities include cash outlays under our restructuring program of $1.0 billion and a reduction in other operating assets and liabilities due to the decrease in sales volume and headcount. Federal and state income tax refunds in fiscal 2002 amounted to approximately $1.0 billion, including $616 million received in connection with changes to tax legislation.

Cash used in operating activities was $3.4 billion for fiscal 2001. This primarily resulted from a loss from continuing operations of $6.6 billion (adjusted for non-cash items) and changes in other operating assets and liabilities of $602 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 a reduction in working capital requirements of $3.7 billion. The receivables improvement was largely due to improved collections and lower sales volumes in fiscal 2001 as compared with fiscal 2000. Improvements in inventory and contracts in process resulted from streamlining inventory supply chain operations, as well as lower amounts in net contracts in process due to the wind-down of a project in Saudi Arabia.

Investing activities

Cash provided by investing activities of $758 million for fiscal 2003 was primarily due to net maturities of short-term investments of $845 million, proceeds from the sale of facilities of $158 million and the sale of certain other investments of $78 million. Capital expenditures were $291 million, which included $102 million for the repurchase of certain real estate under a synthetic lease agreement that was previously used to fund certain real estate construction costs. In addition, during fiscal 2003 we purchased the remaining 10% minority interest in AGCS for $23 million. We currently do not expect any significant cash proceeds from business or asset dispositions in the near future.

Cash provided by investing activities of $757 million for fiscal 2002 was primarily from the $2.6 billion of net cash proceeds received from the disposition of businesses and the sale of certain manufacturing operations, partially offset by $1.5 billion of purchases of short-term investments and $449 million of capital expenditures of. Cash proceeds from dispositions primarily included the $2.1 billion received from the sale of our OFS businesses, $60 million from the sale of our voice enhancement and echo cancellation business, $93 million from the sale of New Venture Partners II LP, $250 million from the sale of our billing and customer care business and $96 million from the sale of certain manufacturing operations to Solectron.

Cash provided by investing activities of $2.0 billion for fiscal 2001 was primarily due to $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 and $177 million of sales or disposals of property, plant and equipment. These proceeds were partially offset by capital expenditures of $1.4 billion.

Financing activities

Cash provided by financing activities of $1.1 billion for fiscal 2003 was primarily due to the issuance of 2.75% Series A and Series B convertible senior debentures for a net amount of $1.6 billion. A portion of the net proceeds was used to repay or retire certain debt obligations and convertible preferred securities, all of which have higher interest or dividend rates than the debentures we issued (the remainder of the proceeds could be used for general corporate purposes). Specifically, we paid approximately $500 million toward these obligations, including the prepayment of $240 million of a mortgage loan for three of our primary facilities, retirement of $176 million of certain other long-term debt obligations and $69 million for the partial retirement of our 8% redeemable convertible preferred stock. We also received other proceeds of $113 million from prepaid forward sales agreements for our investment in Corning common stock, which we received in connection with the sale of our OFS business. These forward sales agreements were reflected as secured borrowings as of September 30, 2003, and matured on October 1, 2003. We also settled our 8% redeemable convertible preferred stock dividend requirement of $91 million with 46 million shares of our common stock and $6 million of cash.

Cash provided by financing activities of $468 million for fiscal 2002 included $1.8 billion of proceeds from the sale of 7.75% convertible trust preferred securities in March 2002. Fees paid in connection with this transaction were approximately $46 million. Partially offsetting these proceeds were repayments of $1.1 billion for amounts outstanding under our credit facilities and other short-term borrowings and $149 million for preferred stock dividends.

Cash provided by financing activities for fiscal 2001 was $2.6 billion, primarily due to net proceeds received from the issuance of 8% redeemable convertible preferred stock in August 2001 of $1.8 billion (a portion of the proceeds received were 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), 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 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 2001 were $204 million.

We are currently authorized by our board of directors to issue shares of our common stock or use cash in exchange for the above-referenced convertible securities and certain other debt obligations. As disclosed in more detail in Note 11 to our consolidated financial statements, we retired approximately $2.1 billion of our convertible securities and certain other debt obligations in exchange for approximately 621 million shares of our common stock and $487 million in cash through September 30, 2003, in several separate and privately negotiated transactions. These transactions reduced future obligations at a discount and are expected to reduce annual interest and dividend requirements. We may issue more of our common shares in similar transactions in the future, which would result in additional dilution to our common shareowners.

Subsequent to September 30, 2003, and through December 5, 2003, we retired $23 million of our convertible securities for $24 million of cash. We may retire additional debt obligations and convertible securities for cash in the future.

On November 24, 2003, we exchanged all of our outstanding 8% redeemable convertible preferred stock for 8% convertible subordinated debentures. This exchange was made pursuant to rights we had under the terms of the preferred stock to exchange them for the convertible subordinated debentures. These debentures have the same payment dates and record dates as the preferred stock dividends. However, the interest payments on the debentures must be paid in cash. The subordinated debentures have terms substantially the same as the preferred stock with respect to put rights, redemptions and conversion into common stock. Any outstanding amounts related to these securities will be classified as debt maturing within one year due to the August 2004 redemption feature. This action increased our flexibility to settle this obligation by eliminating certain legal requirements related to available capital surplus as defined by Delaware law.

Future capital requirements

We expect our operations will continue to use cash during fiscal 2004. The lower cash requirements for restructuring actions and the effects of cost reduction actions, including the full-year impact of actions completed during fiscal 2003, are expected to be offset by less favorable working capital impacts and cash required for postretirement healthcare benefits.

Our near-term cash requirements are primarily related to funding our operations (including our restructuring program), capital expenditures, debt and other obligations discussed below. We expect to continue to use cash to meet these requirements throughout fiscal 2004. We believe our cash and cash equivalents of $3.8 billion and short-term investments of $686 million as of September 30, 2003, are sufficient to fund our cash requirements for the next 12 months. However, we cannot provide assurance that our actual cash requirements will not be greater than we currently expect. If sources of liquidity are not available or if we cannot generate sufficient cash flow from operations, we might be required to obtain additional sources of funds through additional operating improvements, capital market transactions, asset sales or financing from third parties, or a combination thereof. We cannot provide assurance that these additional sources of funds will be available or, if available, would have reasonable terms.

The cash requirements of our restructuring program are approximately $2.7 billion, of which approximately $2.2 billion had been paid through September 30, 2003. The remaining cash requirement is expected to be paid over several years, including approximately $200 million during fiscal 2004. Most of the remaining cash requirement is for lease obligations, which are net of expected sublease rental income of approximately $248 million. If we do not receive this expected income, our cash requirements under the restructuring program could increase.

We do not expect to make contributions to our U.S. pension plans in fiscal 2004 or fiscal 2005. Our current expected funding requirements for postretirement healthcare benefits are approximately $300 million in fiscal 2004. For more information on these obligations, including their expected longer-term effects on liquidity, see the detailed risk factors included in Part 1, Item 1, of our Form 10-K for the year ended September 30, 2003. In addition, legislative and regulatory changes are being considered that could alter the manner in which liabilities are determined for the purpose of calculating required pension contributions under ERISA. Depending on the outcome of the proposals, our longer-term funding requirement for our pension plans could be significantly affected. Until the proposals are finalized, we cannot predict the impact on our financial position.

We have agreed to indemnify the Insured Special Purpose Trust ("ISPT") and its lenders and investors for certain defaulted principal and interest payments related to customer finance loans that were held by the ISPT and are subject to a dispute with an unaffiliated insurer. These funding requirements are $78 million in fiscal 2004 and $208 million thereafter through 2008. The ISPT has been included in our consolidated financial statements since April 1, 2003. Refer to Note 18 to our consolidated financial statements for additional information on the ISPT and the dispute regarding insurance coverage.

Our 8% subordinated debentures are redeemable at the option of the holders on various dates, the earliest of which is August 2, 2004. Provided certain criteria are met, we have the option to satisfy this put with cash, shares of our common stock or a combination of both. The principal amount of these securities was $852 million as of December 5, 2003.

As discussed in more detail in Note 18 to our consolidated financial statements, we may fund up to $315 million of our shareowner litigation settlement with cash, shares of our common stock or a combination of both. We expect to finalize this settlement during fiscal 2004 or 2005.

Letters of credit are obtained to ensure the performance or payment to third parties in accordance with specified terms and conditions. On May 28, 2003, we entered into two new senior secured credit agreements that currently provide for the issuance of new letters of credit and the renewal of existing letters of credit until December 31, 2004. The agreements are subject to certain cash collateral requirements that may increase if we fail to maintain specified levels of consolidated minimum operating income (adjusted for certain defined items) or if we fail to maintain a minimum amount of unrestricted cash and short-term investments. As of September 30, 2003, outstanding letters of credit and amounts unused and available to us under these agreements were $298 million and $290 million, respectively.

On May 28, 2003, we also amended our Guarantee and Collateral Agreement and our Collateral Sharing Agreement. Under these agreements, certain of our U.S. subsidiaries have guaranteed certain of our obligations, and these subsidiaries have pledged substantially all of their assets as collateral. These agreements provide security for certain of our obligations, including letters of credit, specified hedging arrangements, guarantees to lenders for vendor financing, lines of credit, an agreement relating to our ISPT, cash management and other bank operating arrangements. The amount of these outstanding obligations was $543 million as of September 30, 2003.

We have effective shelf registration statements with the SEC for the issuance of up to approximately $1.9 billion of securities, including shares of common stock and preferred stock, debt securities, warrants, stock purchase contracts and stock purchase units.

Customer financing commitments

The following table summarizes our customer financing commitments as of September 30, 2003 and September 30, 2002:

	September 30, 2003			September 30, 2002		
(in millions)	Total loans and guarantees	Loans	Guarantees	Total loans and guarantees	Loans	Guarantees
Drawn commitments	$ 442	$ 354	$ 88	$ 1,098	$ 909	$ 189
Available but not drawn	49	6	43	93	51	42
Not available	14	14	-	151	151	-
Total commitments	$ 505	$ 374	$ 131	$ 1,342	$ 1,111	$ 231
Reserves	$ 415			$ 951		

We may provide or commit to additional customer financings on a limited basis. We are focusing on the larger service providers, that typically have less demand for such financing. We carefully review requests for customer financing on a case-by-case basis. Such review assesses the credit quality of the individual borrowers, their respective business plans and market conditions. We also assess our ability to sell or transfer the undrawn commitments and drawn borrowings to unrelated third parties.

We continue to monitor drawn borrowings and undrawn commitments by assessing, among other things, each customer's short-term and long-term liquidity positions, the customer's current operating performance versus plan, the execution challenges facing the customer, changes in the competitive landscape and the customer's management experience and depth. When potential problems are evident, we undertake certain mitigating actions, including cancellation of commitments. Although these actions can limit the extent of our losses, exposure remains to the extent of drawn amounts, which may not be recoverable. Our customer financing commitments were reduced to $505 million during fiscal 2003, as a result of the collections, settlement or write-off of certain fully-reserved notes and the expiration of several commitments.

Credit ratings

Our credit ratings are below investment grade. Any credit downgrade affects our ability to enter into and maintain certain contracts on favorable terms and increases our cost of borrowing. Our credit ratings as of December 5, 2003, are as follows:

Rating Agency	Long-term debt	8% subordinated debentures	Trust preferred securities	Last change
Standard & Poor's (a)	B-	CCC-	CCC-	September 4, 2003
Moody's (b)	Caa1	Caa3	Caa3	December 2, 2003

(a) Ratings affirmed and removed from Credit Watch; ratings outlook is negative.
(b) Ratings outlook is negative.

Contractual obligations and other commercial commitments and contingencies

The following tables quantify our future contractual obligations and commercial commitments as of September 30, 2003:

Contractual obligations

		Payments due in fiscal					
(in millions)	Total	2004	2005	2006	2007	2008	Thereafter
Long-term debt (including company-obligated trust preferred securities) (a)	$ 5,710	$ 114	$ 91	$ 607	$ -	$ -	$ 4,898
8% redeemable convertible preferred stock (a)	868	-	-	-	-	-	868
Operating leases (b)	1,394	243	174	131	109	99	638
Unconditional purchase obligations (c)	1,447	984	409	41	7	6	-
Total	$9,419	$ 1,341	$ 674	$ 779	$ 116	$ 105	$ 6,404

(a) Refer to Notes 9 and 10 to our consolidated financial statements for additional information related to long-term debt and redeemable convertible securities, including early redemption features.
(b) The contractual obligations under operating leases exclude approximately $360 of potential lease obligations that were assigned to Avaya, Agere and other entities for which we remain secondarily liable.
(c) Refer to Note 18 to our consolidated financial statements for additional information related to purchase obligations.

Other commercial commitments

		Amounts expiring in fiscal					
(in millions)	Total	2004	2005	2006	2007	2008	Thereafter
Letters of credit	$ 588	$ 526	$ 34	$ 7	$ 3	$ 2	$ 16
Undrawn customer commitments	63	5	-	14	-	16	28
Total	$ 651	$ 531	$ 34	$ 21	$ 3	$ 18	$ 44

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk from changes in foreign currency exchange rates, interest rates and equity prices. We manage our exposure to these market risks through the use of derivative financial instruments, coupled with other strategies. Our risk management objective is to minimize the effects of volatility on our cash flows by identifying the assets, liabilities or forecasted transactions exposed to these risks and hedging them. Hedges may be achieved by either forward or option contracts, swap derivatives, or embedded terms into certain contracts that affect the ultimate amount of cash flows under the contract. Since there is a high correlation between the hedging instruments and the underlying exposures, the gains and losses on these exposures are generally offset by reciprocal changes in value of the hedging instruments when used. We use derivative financial instruments as risk management tools and not for trading or speculative purposes.

Foreign currency risk

As a multinational company, we conduct our business in a wide variety of currencies and are therefore subject to market risk for changes in foreign exchange rates. We use foreign exchange forward and option contracts to minimize exposure to the risk of the eventual net cash inflows and outflows resulting from foreign currency denominated transactions with customers, suppliers and non-U.S. subsidiaries. Our objective is to hedge all types of foreign currency risk to preserve our economic cash flows, but we generally do not expect to designate these derivative instruments as hedges under current accounting

standards unless the benefits of doing so are material. 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. To the extent that the forecast cash flow exposures are overstated or understated or if there is a shift in the timing of the anticipated cash flows during periods of currency volatility, we may experience unanticipated currency gains or losses. We do not hedge our net investment in non-U.S. entities because we view those investments as long-term in nature.

Our primary net foreign currency exposures as of September 30, 2003 and 2002, included the British pound, Chinese yuan, Japanese yen, euro and Indian rupee. We use a sensitivity analysis to determine the effects that market risk exposures may have on the fair value of the foreign currency forwards and options and on our results of operations. 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. For contracts outstanding as of September 30, 2003 and 2002, a 10% adverse movement in the value of foreign currencies against the U.S. dollar from the prevailing market rates, including the primary foreign currency exposures noted above, would have resulted in an incremental pre-tax net unrealized loss of $12 million and $21 million, respectively. Consistent with the nature of the economic hedge, any unrealized gains or losses on such forwards and options 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 together in the same direction. We have not changed our foreign exchange risk management strategy from the prior year.

Interest rate risk

The fair values of our fixed-rate long-term debt, interest rate swaps, 7.75% trust preferred securities and short-term investments are sensitive to changes in interest rates. Prior to May 2002, our debt obligations primarily consisted of fixed-rate debt instruments, while our interest rate sensitive assets were primarily variable-rate instruments. In the latter half of fiscal 2002, we began to mitigate this interest rate sensitivity by adding short-term fixed-rate assets to our investment portfolio and simultaneously entering into interest rate swaps on a portion of our debt obligations to make them variable-rate debt instruments. Under these swaps, we receive a fixed interest rate of 7.25% and pay an average floating rate of LIBOR (1.17% as of September 30, 2003) plus 2.91% on the $500 million notional amounts of the swaps. Subsequent to September 30, 2003, we entered into additional interest rate swaps on a portion of our debt obligations to make them variable-rate debt. Under these swaps, we receive a fixed interest rate of 5.5% and pay an average floating rate of LIBOR plus 1.85% on a notional amount of $200 million. The objective of maintaining the mix of fixed and floating-rate debt and investments is to mitigate the variability of cash inflows and outflows resulting from interest rate fluctuations, as well as to reduce the overall cost of borrowing. We do not enter into derivative transactions on our cash equivalents because their relatively short maturities do not create significant risk. We do not foresee any significant changes in our interest rate risk management strategy or in our exposure to interest rate fluctuations.

The impacts of a sensitivity analysis we performed under a model that assumes a hypothetical 75 basis point parallel shift in interest rates are as follows:

(in millions)	Fair value as of September 30, 2003	Hypothetical increase or decrease in fair value as of September 30, 2003	Fair value as of September 30, 2002	Hypothetical increase or decrease in fair value as of September 30, 2002
Assets:				
Short-term investments	$ 686	$ 4	$ 1,526	$ 7
Interest rate swaps	28	10	28	13
Liabilities:				
Long-term debt (including company-obligated trust preferred securities)	$ 4,597	$ 241	$ 1,681	$ 33

Our sensitivity analysis on long-term debt obligations excludes variable-rate debt instruments because the changes in interest rates would not significantly affect the fair values of such instruments. In addition, our variable-rate customer finance notes have been excluded because a significant portion of the principal balances and related receivables for accrued interest are fully-reserved. Refer to Notes 9 and 15 to our consolidated financial statements for information related to long-term debt.

Equity price risk

Our investment portfolio includes equity investments in publicly held companies that are classified as available-for-sale and other strategic equity holdings in privately held companies and venture funds. These securities are exposed to price fluctuations and are generally concentrated in high-technology industries. As of September 30, 2003, the carrying values of our available-for-sale equity securities and privately held securities were $5 million and $131 million, respectively. As of September 30, 2002, the carrying values of our available-for-sale equity securities and privately held securities were $117 million and $213 million, respectively.

The fair values of two available-for-sale securities (Commscope and Corning) that were obtained in connection with the sale of our optical fiber businesses totaled $101 million out of a total available-for-sale portfolio valued at $117 million as of September 30, 2002. As described below, we entered into prepaid forward sales agreements for all of our Corning shares. The process of determining the fair values of our privately held equity investments inherently requires certain assumptions and subjective judgments. These valuation assumptions and judgments include consideration of: (1) the investee's earnings and cash flow position, cash flow projections, and rate of cash consumption; (2) recent rounds of equity infusions by us and other investors; (3) the strength of the investee's management; and (4) valuation data provided by the investee that may be compared with data for peers. We have and may continue to record impairment losses and write down the carrying value of certain equity investments when the declines in fair value are other-than-temporary. Investment impairment charges recognized in fiscal 2003 and 2002 were $63 million and $209 million, respectively.

We generally do not hedge our equity price risk due to hedging restrictions imposed by the issuers, illiquid capital markets or our inability to hedge non-marketable equity securities in privately held companies. As of September 30, 2003 and 2002, a 20% adverse change in equity prices would have resulted in an approximate $1 million decrease and $23 million decrease, respectively, in the fair value of our available-for-sale equity securities. The model to determine sensitivity assumes a corresponding shift in all equity prices. This analysis excludes stock purchase warrants, as we do not believe that the value of such warrants is significant. During fiscal 2003, the reported decrease in equity price sensitivity was primarily due to a decrease in the amount of available-for-sale securities outstanding as of September 30, 2003. An adverse movement in the equity prices of our holdings in privately held companies cannot be easily quantified, as our ability to realize returns on investments depends on the investees' ability to raise additional capital or derive cash inflows from continuing operations or through liquidity events such as initial public offerings, mergers or private sales. During fiscal 2003, we entered into prepaid forward sales agreements for all of our Corning shares, under which we received $113 million and locked in $64 million of unrealized appreciation. On October 1, 2003, these forward sales agreements matured, and as a result we realized $64 million of appreciation that will be recognized in other income (expense) in the first quarter of fiscal 2004. As of September 30, 2002, we had no outstanding hedging instruments for our equity price risk.

Five-Year Summary of Selected Financial Data
(in millions, except per share amounts)

	Years ended September 30,				
	2003	2002	2001	2000	1999
RESULTS OF OPERATIONS					
Revenues	$ 8,470	$ 12,321	$ 21,294	$ 28,904	$ 26,993
Business restructuring charges (reversals) and asset impairments	(184)	1,490	7,567	-	-
Impairment of goodwill	35	826	3,849	-	-
Provision (benefit) for income taxes	(233)	4,757	(5,734)	924	1,456
Income (loss) from continuing operations	(770)	(11,826)	(14,170)	1,433	2,369
Earnings (loss) per common share from continuing operations:					
Basic	(0.29)	(3.51)	(4.18)	0.44	0.76
Diluted	(0.29)	(3.51)	(4.18)	0.43	0.74
Dividends per common share	-	-	0.06	0.08	0.08
FINANCIAL POSITION					
Cash, cash equivalents and short-term investments	$ 4,507	$ 4,420	$ 2,390	$ 1,467	$ 1,686
Total assets	15,765	17,791	33,664	47,512	34,246
Total debt	5,980	5,106	4,409	6,498	5,788
8.00% redeemable convertible preferred stock	868	1,680	1,834	-	-
Shareowners' (deficit) equity	(4,239)	(4,734)	11,023	26,172	13,936

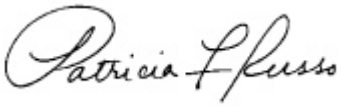
REPORT OF MANAGEMENT

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.

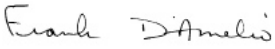
To provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and that accounting records are reliable for preparing financial statements, management maintains a system of accounting and other controls, including an internal audit function. Even an effective 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 auditors 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 auditors periodically meet privately with the Audit and Finance Committee and have access to its individual members.

Lucent engaged PricewaterhouseCoopers LLP, independent auditors, to audit the consolidated financial statements in accordance with auditing standards generally accepted in the United States of America, which includes consideration of our internal control structure for purposes of designing their audit procedures.



Patricia F. Russo
Chairman and Chief Executive Officer



Frank A. D'Amelio
Executive Vice President and Chief Financial Officer

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareowners of
LUCENT TECHNOLOGIES INC.:

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, changes in shareowners' (deficit) equity and cash flows present fairly, in all material respects, the financial position of Lucent Technologies Inc. and its subsidiaries as of September 30, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2003, 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 1 to the consolidated financial statements, in 2003 the Company changed its accounting method for goodwill and other intangible assets. As discussed in Note 17 to the consolidated financial statements, in 2001 the Company changed its accounting methods for revenue recognition and for derivative financial instruments.

PricewaterhouseCoopers LLP

Florham Park, New Jersey
October 22, 2003,
except for the second paragraph of Note 10, as to which the date is November 24, 2003.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in millions, except per share amounts)

	Years ended September 30,		
	2003	2002	2001
Revenues:			
Products	$ 6,666	$ 9,594	$ 17,095
Services	1,804	2,727	4,199
Total revenues	8,470	12,321	21,294
Costs:			
Products	4,360	8,416	15,592
Services	1,458	2,353	3,644
Total costs	5,818	10,769	19,236
Gross margin	2,652	1,552	2,058
Operating expenses:			
Selling, general and administrative	1,509	3,969	7,410
Research and development	1,488	2,310	3,520
Goodwill impairment	35	826	3,849
Business restructuring charges (reversals) and asset impairments, net	(158)	1,426	6,308
Total operating expenses	2,874	8,531	21,087
Operating loss	(222)	(6,979)	(19,029)
Other income (expense), net	(428)	292	(357)
Interest expense	353	382	518
Loss from continuing operations before income taxes	(1,003)	(7,069)	(19,904)
Provision (benefit) for income taxes	(233)	4,757	(5,734)
Loss from continuing operations	(770)	(11,826)	(14,170)
Income (loss) from discontinued operations, net	-	73	(3,172)
Loss before extraordinary item and cumulative effect of accounting changes	(770)	(11,753)	(17,342)
Extraordinary gain, net	-	-	1,182
Cumulative effect of accounting changes, net	-	-	(38)
Net loss	(770)	(11,753)	(16,198)
Conversion and redemption costs – 8% redeemable convertible preferred stock	(287)	(29)	-
Preferred stock dividends and accretion	(103)	(167)	(28)
Net loss applicable to common shareowners	$ (1,160)	$ (11,949)	$ (16,226)
Loss per common share — basic and diluted			
Loss from continuing operations	$ (0.29)	$ (3.51)	$ (4.18)
Net loss applicable to common shareowners	$ (0.29)	$ (3.49)	$ (4.77)
Weighted average number of common shares Outstanding — basic and diluted	3,950	3,427	3,401

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in millions, except per share amounts)

	September 30, 2003	September 30, 2002
ASSETS		
Cash and cash equivalents	$ 3,821	$ 2,894
Short-term investments	686	1,526
Receivables, less allowance of $246 in 2003 and $325 in 2002	1,511	1,647
Inventories	632	1,363
Contracts in process, net	33	10
Other current assets	1,150	1,715
Total current assets	7,833	9,155
Property, plant and equipment, net	1,593	1,977
Prepaid pension costs	4,659	4,355
Goodwill and other acquired intangibles, net of accumulated amortization of $925 in 2003 and $910 in 2002	188	224
Other assets	1,492	2,080
Total assets	$ 15,765	$ 17,791
LIABILITIES		
Accounts payable	$ 1,072	$ 1,298
Payroll and benefit-related liabilities	1,080	1,094
Debt maturing within one year	389	120
Other current liabilities	2,474	3,814
Total current liabilities	5,015	6,326
Postretirement and postemployment benefit liabilities	4,669	5,246
Pension liabilities	2,494	2,752
Long-term debt	4,439	3,236
Company-obligated 7.75% mandatorily redeemable convertible preferred securities of subsidiary trust	1,152	1,750
Other liabilities	1,367	1,535
Total liabilities	19,136	20,845
Commitments and contingencies		
8.00% redeemable convertible preferred stock	868	1,680
SHAREOWNERS' DEFICIT		
Preferred stock—par value $1.00 per share; authorized shares: 250; issued and outstanding: none	-	-
Common stock — par value $.01 per share; Authorized shares: 10,000; 4,170 issued and 4,169 outstanding shares as of September 30, 2003, and 3,491 issued and 3,490 outstanding shares as of September 30, 2002	42	35
Additional paid-in capital	22,252	20,606
Accumulated deficit	(22,795)	(22,025)
Accumulated other comprehensive loss	(3,738)	(3,350)
Total shareowners' deficit	(4,239)	(4,734)
Total liabilities, redeemable convertible preferred stock and shareowners' deficit	$ 15,765	$ 17,791

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNERS' (DEFICIT) EQUITY
(in millions)

	Shares of Common Stock	Common Stock	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Loss	Total Shareowners' (Deficit) Equity
Balance as of September 30, 2000	3,384	$ 34	$20,374	$ 6,129	$ (365)	$ 26,172
Net loss				(16,198)		(16,198)
Minimum pension liability adjustment					(8)	(8)
Foreign currency translation adjustment					(30)	(30)
Reclassification of foreign currency translation losses realized upon the sale of foreign entities					(3)	(3)
Unrealized holding losses on certain investments					(95)	(95)
Reclassification adjustment for realized holding gains and impairment losses on certain investments					50	50
Net unrealized holding losses on derivatives					(1)	(1)
Cumulative effect of accounting change (SFAS 133)					11	11
Comprehensive loss						(16,274)
Common stock dividends declared				(204)		(204)
Issuance of common stock	30		234			234
Tax benefit from employee stock options			18			18
Preferred stock dividends and accretion			(28)			(28)
Agere initial public offering			922			922
Compensation on equity-based awards			87			87
Other			95	1		96
Balance as of September 30, 2001	3,414	34	21,702	(10,272)	(441)	11,023
Net loss				(11,753)		(11,753)
Minimum pension liability adjustment					(2,927)	(2,927)
Foreign currency translation adjustment					40	40
Reclassification of foreign currency translation gain realized upon the sale of foreign entities					20	20
Unrealized holding losses on certain investments					(27)	(27)
Reclassification adjustment for realized holding losses and impairment losses on certain investments					(8)	(8)
Net unrealized holding losses on derivatives					(1)	(1)
Amounts transferred to Agere					(6)	(6)
Comprehensive loss						(14,662)
Issuance of common stock in connection with exchange of 8% convertible redeemable preferred stock	58	1	174			175
Other issuance of common stock	18		55			55
Preferred stock dividends and accretion			(167)			(167)
Spin-off of Agere			(1,191)			(1,191)
Other			33			33
Balance as of September 30, 2002	3,490	35	20,606	(22,025)	(3,350)	(4,734)
Net loss				(770)		(770)
Minimum pension liability adjustment					(594)	(594)
Foreign currency translation adjustment					135	135
Unrealized holding gains on certain investments					71	71
Comprehensive loss						(1,158)
Issuance of common stock in connection with the exchange of convertible securities and certain other debt obligations	563	6	1,430			1,436
Conversion costs in connection with the exchange of 7.75% trust preferred securities			129			129
Issuance of common stock in connection with the payment of preferred stock dividend	46	1	85			86
Issuance of common stock in connection with contribution to Lucent Technologies Inc. Represented Employees Post-Retirement Health Benefits Trust	46		76			76
Other issuance of common stock	24		51			51
Preferred stock dividends and accretion			(103)			(103)
Other			(22)			(22)
Balance as of September 30, 2003	4,169	$ 42	$22,252	$(22,795)	$ (3,738)	$ (4,239)

See Notes to Consolidated Financial Statements.

LUCENT TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)

	Years ended September 30, 2003	2002	2001
Operating activities:			
Net loss	$ (770)	$ (11,753)	$ (16,198)
Less: Income (loss) from discontinued operations	-	73	(3,172)
Extraordinary gain	-	-	1,182
Cumulative effect of accounting changes	-	-	(38)
Loss from continuing operations	(770)	(11,826)	(14,170)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities, net of effects of acquisitions and dispositions of businesses and manufacturing operations:			
Non-cash portion of business restructuring (reversals) charges	(205)	827	5,473
Impairment of goodwill	35	826	3,849
Depreciation and amortization	978	1,470	2,536
Provision for (recovery of) bad debts and customer financings	(223)	1,253	2,249
Tax benefit from employee stock options	-	-	18
Deferred income taxes	(213)	5,268	(5,935)
Net pension and postretirement benefit credit	(669)	(972)	(1,083)
Gains on sales of businesses	(49)	(725)	(56)
Other adjustments for non-cash items	337	992	551
Changes in operating assets and liabilities:			
Decrease in receivables	205	2,493	3,627
Decrease in inventories and contracts in process	747	2,552	881
Decrease in accounts payable	(257)	(539)	(759)
Changes in other operating assets and liabilities	(864)	(2,375)	(602)
Net cash used in operating activities from continuing operations	(948)	(756)	(3,421)
Investing activities:			
Capital expenditures	(291)	(449)	(1,390)
Dispositions of businesses and manufacturing operations	9	2,576	3,187
Purchases of short-term investments	(684)	(1,518)	-
Maturities of short-term investments	1,529	-	-
Proceeds from the sale or disposal of property, plant and equipment	158	194	177
Other investing activities	37	(46)	(23)
Net cash provided by investing activities from continuing operations	758	757	1,951
Financing activities:			
Issuance of long-term debt	1,631	-	302
Issuance of 7.75% trust preferred securities	-	1,750	-
Proceeds from (repayments of) credit facilities	-	(1,000)	3,500
Net proceeds (repayments) of other short-term borrowings	46	(104)	(2,147)
Repayments of long-term debt	(535)	(47)	(754)
Issuance of 8% redeemable convertible preferred stock	-	-	1,831
Issuance of common stock	38	64	222
Repayment of 8% convertible redeemable preferred stock	(69)	-	-
Dividends paid on preferred and common stock	(6)	(149)	(204)
Other financing activities	(54)	(46)	(125)
Net cash provided by financing activities from continuing operations	1,051	468	2,625
Effect of exchange rate changes on cash and cash equivalents	66	35	4
Net cash provided by continuing operations	927	504	1,159
Net cash used in discontinued operations	-	-	(236)
Net increase in cash and cash equivalents	927	504	923
Cash and cash equivalents at beginning of year	2,894	2,390	1,467
Cash and cash equivalents at end of year	$ 3,821	$ 2,894	$ 2,390
Income tax refunds (payments), net	$ 109	$ 804	$ (161)
Interest payments	$ 336	$ 349	$ 490

See Notes to Consolidated Financial Statements.