LUCENT TECHNOLOGIES FINANCIAL REVIEW 2004

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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: fluctuations in the telecommunications market; our ability to compete effectively; our product portfolio and ability to keep pace with technological advances in our industry; our reliance on a limited number of key customers; our exposure to the credit risk of our customers; the pricing, cost and other risks inherent in our long-term sales agreements; the costs and risks associated with our pension and postretirement benefit obligations; the social, political and economic risks of our foreign operations; our reliance on third parties to manufacture most of our products; our ability to generate positive cash flow; existing and future litigation; our ability to protect our intellectual property rights and the expenses we may incur in defending such rights; the complexity of our products; changes to existing regulations or technical standards; compliance with environmental health and safety laws; and our ability to retain and recruit key personnel. 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.

EXECUTIVE SUMMARY

We design and deliver the systems, software and services that drive next-generation communications networks. Backed by Bell Labs research and development, we use our strengths in mobility, optical, access, data and voice networking technologies, as well as services, to create new revenue-generating opportunities for our customers, while enabling them to quickly deploy and better manage their networks. Our customer base includes communications service providers, governments and enterprises worldwide.

We have three segments organized around the products and services we sell. The reportable segments are Integrated Network Solutions ("INS"), Mobility Solutions ("Mobility") and Lucent Worldwide Services ("Services"). INS provides a broad range of software and wireline equipment related to voice networking (primarily consisting of switching products, which we sometimes refer to as convergence solutions, and voice messaging products), data and network management (primarily consisting of access and related data networking equipment and operating support software) and optical networking. Mobility provides software and wireless equipment to support radio access and core networks. Services provides deployment, maintenance, professional and managed services in support of both our product offerings as well as multi-vendor networks.

Beginning in fiscal 2001, the global telecommunications market deteriorated, resulting from a 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 general economic slowdown, network overcapacity, customer bankruptcies, network build-out delays and limited availability of capital.

We believe that the market for telecommunications equipment has stabilized and is starting to grow in certain areas. The growing demands of enterprises and consumers for additional services tailored to their needs is creating the need for a new convergence of networks, technologies and applications.

Service providers are looking for ways to bundle packages of voice, data and video services by deploying converged networks that will give users more seamless and simple access to communications across both wireline and mobile networks. At the same time, they are looking for help to streamline their network operations and to manage their operating expenses more effectively.

We have been seeing a significant increase in discussions with our customers about how they will make that transition. They are looking for partners who have the knowledge, skill and staying power to help smooth the transition. More and more major multi-year plans are being developed for next-generation networks that will deliver IP-based multimedia services.

This is a long-term technology transition, which creates opportunities for us and our customers in growth areas such as mobile high-speed data, broadband access, metro optical networking and Voice over Internet Protocol (or VoIP) solutions, as well as professional and managed services. We are working to turn these technologies and opportunities into cost-effective offers for our customers.

To effectively compete, we have to continue our work to expand our customer base, continue to improve overall productivity and efficiency and be innovative in delivering new solutions to customers.

Capital spending in our target markets can change rapidly and can vary over short periods of time. As a result of this uncertainty, it is difficult to make accurate forecasts of near- and long-term results and cash flow. In addition, because a limited number of customers account for a significant amount of our revenue, our results are subject to fluctuation from changes in spending by one or more of these customers. This exposure to fluctuation is most prevalent in our Mobility segment.

As discussed in more detail throughout our MD&A:

- Results of operations improved significantly during fiscal 2004. This improvement was driven by an increase in revenues, a higher gross margin rate and lower operating expenses as compared with fiscal 2003.

- Revenues increased by 7% during fiscal 2004, following three consecutive years of significant declines in annual revenues. The increase in fiscal 2004 was driven by higher Mobility revenues, primarily due to higher CDMA sales in the U.S. as two of our large customers continued to upgrade their wireless networks and deploy additional capacity to support subscriber growth. Partially offsetting this increase were lower INS revenues, primarily driven by lower voice networking sales in the U.S., specifically with traditional circuit switching products, as carriers face weaker wireline demand and explore next generation networking technologies. The sustained weakening of the telecommunications market and significant reduction in capital spending by service providers, among other factors, contributed to a 31% decline in revenues during fiscal 2003. The impact of product rationalizations and discontinuances under our restructuring program did not have a significant effect on the overall changes in our revenues during the past three fiscal years. However, certain product rationalization initiatives have reduced our total available market opportunities, such as our decision to discontinue our GSM offerings.

- Our gross margin rate was 42%, 31% and 13% during fiscal 2004, 2003 and 2002, respectively. The improvement in fiscal 2004 and fiscal 2003 primarily resulted from the impact of cost reductions and product mix, as well as certain other items including lower inventory- and warranty-related charges. Product line discontinuances and the significant and rapid decline in revenues led to significant inventory charges and high-unabsorbed fixed costs during fiscal 2002.

- We continued to reflect lower operating expenses through the completion of restructuring actions taken during the past few years. These actions resulted in net charges of $2.3 billion during fiscal 2002. During fiscal 2004 and 2003, net reversals of $20 million and $149 million were recognized due to changes in previously estimated costs for prior year plans. These revisions were mostly related to employee termination benefits and facility closing costs.

- We recognized net recoveries of bad debt and customer financings of $230 million and $223 million in fiscal 2004 and 2003, respectively. These recoveries were primarily due to the favorable settlement of certain fully reserved notes and accounts receivable, and the expiration of certain customer financing guarantees. We recognized provisions for bad debts and customer financings of $1.3 billion during fiscal 2002 as a result of the significant weakening of the financial condition of certain customers.

- We recognized charges of $56 million and $481 million during fiscal 2004 and 2003, respectively, 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. The charges in fiscal 2004 primarily resulted from changes in the estimated fair value of the warrants that we expect to issue in connection with the global shareowner settlement.

- We maintained a valuation allowance on substantially all of our deferred tax assets that primarily originated during fiscal 2002. As a result, federal and certain state and non-U.S. income taxes attributable to pre-tax income were not provided during fiscal 2004, nor did we record income tax benefits attributable to pre-tax losses during fiscal 2003 and 2002. We recognized an income tax benefit of $939 million and $233 million during fiscal 2004 and 2003, respectively, primarily as a result of valuation allowance reversals due to the recognition of certain carryback claims, including an $816 million federal net operating loss carryback claim during fiscal 2004 and additional benefits from the favorable resolution of certain income tax audit matters. Fiscal 2002 results included a tax provision of $4.8 billion despite a pre-tax loss from continuing operations of $7.1 billion due to the impact of establishing a full valuation allowance.

- Cash and cash equivalents and marketable securities increased by $366 million to $4.9 billion during fiscal 2004, primarily from cash provided by operating activities.

Looking ahead to fiscal 2005, we expect our market and our business to grow as customers invest in revenue-generating services and more efficient network operations. Mobility should remain a strong growth sector as service providers continue their transition to 3G networks for mobile high-speed data services. We will continue to invest in every key area of convergence, manage the product cycle of declining legacy business and focus on growth in next-generation areas like VoIP, broadband access and metro optical. We will continue to manage our cost and expense profile as we work on expanding our revenue base in each of our segments as well as government and emerging markets outside of the United States. We expect fiscal 2005 annual revenues to grow on a percentage basis in the mid-single digits, which we believe is at or above the market growth rate; we expect our annual gross margin rate on a percentage basis will be in the low 40's; and we expect annual operating expenses as a percentage of revenue to be about 30%. Actual results could be different from these expectations.

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. Actual results could differ materially from the estimated amounts. 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, pension and postretirement benefits, income taxes, legal contingencies, receivables and customer financing, inventories, business restructuring and intangible assets. Our critical accounting estimates were discussed with our Audit and Finance Committee of the Board of Directors.

The impact of changes in the estimates and assumptions pertaining to revenue recognition, inventories and goodwill and other acquired intangibles arising in fiscal 2004 is directly reflected in our segment results. The impact of changes in the estimates and assumptions related to goodwill and other acquired intangibles arising prior to fiscal 2004 and net deferred tax assets are not reflected in the segment results. However, the long-term forecasts supporting the realization and changes of those assets are significantly affected by the actual and expected results of each segment. Generally, the changes in estimates related

to receivables, pension and postretirement benefits, restructuring program and litigation will not affect our segment results.

There were no accounting policies adopted during fiscal 2004 that had a material effect on our financial condition and results of operations. Refer to Note 1 to our consolidated financial statements for our significant accounting policies.

Revenue recognition

Most of our sales are generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the areas of multiple-element arrangements, the application of software revenue recognition rules, contract accounting and collectibility.

Revenues from contracts with multiple-element arrangements, such as those including products with installation and integration services, are recognized as the revenue for each unit of accounting is earned based on the relative fair value of each unit of accounting as determined by internal or third party analyses of market-based prices. A delivered element is considered a separate unit of accounting if it has value to the customer on a standalone basis, there is objective and reliable evidence of the fair value of undelivered elements in the arrangement, and delivery or performance of undelivered elements is considered probable and substantially under our control.

Many of our products are integrated with software that is embedded in our hardware at delivery. In those cases where indications are that software is more than incidental and was a significant factor in the customer's purchasing decision, such as where the transaction includes software upgrades or enhancements, we apply software revenue recognition rules which may affect the amount and timing of revenue recognition. In multiple element arrangements where software is considered more than incidental, fair value of an undelivered element is determined using vendor specific objective evidence.

The percentage of completion method of accounting is used for sales generated from certain contracts, primarily those related to customized network solutions and network build-outs with durations of at least six months. We make important judgments in estimating revenue and cost and in measuring progress toward completion. 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. Revenues recognized under the percentage of completion method of accounting have increased during recent fiscal years and represented 24%, 18% and 13% of total revenues during fiscal 2004, 2003 and 2002, respectively.

The assessment of collectibility is critical in determining whether revenues should be recognized. As part of the revenue recognition process, we determine whether trade and notes receivable are reasonably assured of collection based on various factors, including our ability to sell the 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 up to the value we could reasonably expect to realize from the sale. Revenue and related costs are deferred if we are uncertain as to whether the receivable can be collected or sold. Revenue is deferred but costs are recognized when we determine that the collection or sale of the receivable is unlikely.

Deferred revenues were $593 million and $536 million as of September 30, 2004 and 2003, respectively.

Pension and postretirement benefits

Our results of operations include the impact of significant pension and postretirement benefits that are measured using actuarial valuations. Inherent in these valuations are key assumptions, including assumptions about discount rates, expected return on plan assets and expected participation rates in retirement health care plans. These assumptions are updated on an annual basis at the beginning of each fiscal year or more frequently upon the occurrence of significant events. 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 credit ("net pension credit") was $868 million, $669 million and $972 million during fiscal 2004, 2003 and 2002, respectively, excluding the impact of restructuring actions and discontinued operations. Approximately two-thirds of these amounts are allocated to operating expenses, with the balance in costs used to determine gross margin. The allocation is based on a recent comparison of salaries that are related to costs and those that are related to operating expenses. Refer to our Results of Operations section of this MD&A for a further discussion of changes in the net pension credit and the related impact on our results.

The expected rate of return on pension plan assets used to develop our pension credit is 8.75%, 8.75% and 9.0% during fiscal 2004, 2003 and 2002, respectively, and is determined at the beginning of the period. We plan to use an expected rate of return of 8.5% during fiscal 2005. Changes in the rate were generally due to lower expectations of future returns based on studies performed by our external investment advisors. Similar changes were made to our expected rate of return on postretirement plan assets for these reasons as well as for changes in the mix of assets held. A lower expected rate of return will reduce our net pension credit and profitability. The discount rate used to determine our pension credit was 5.75%, 6.5% and 7.0% during fiscal 2004, 2003 and 2002, respectively, and is determined at the beginning of the period. We expect to use 5.5% during fiscal 2005. Changes in the discount rate were due to declining interest rates. The discount rate is also volatile because it is determined based upon the prevailing rate as of the measurement date. Similar changes were made to the discount rate used to determine our postretirement benefit cost for these reasons. An additional 0.25% reduction will also be reflected in fiscal 2005 due to a shorter expected duration of postretirement plan obligations as compared to pension plan obligations. A lower discount rate generally will increase our net pension credit and profitability. The expected rate of return on pension plan assets and discount rate were determined in accordance with consistent methodologies as described in Note 9 to our consolidated financial statements.

Holding all other assumptions constant, a 0.5% increase or decrease in the discount rate would have decreased or increased the fiscal 2004 net pension credit by approximately $60 million. Likewise, a 0.5% increase or decrease in the expected return on plan assets would have increased or decreased the fiscal 2004 net pension credit by approximately $190 million.

There have also been several recent developments related to retiree health care benefits, including changes in benefits, cost sharing and legislation, such as Medicare Part D of the Medicare Prescription Drug Improvement and Modernization Act of 2003. These legislative changes and recent experience with participation rates for management retiree plans have required us to assess the expected future participation rates of certain retirees in the existing plans. We now assume that approximately 3% of all retirees subject to cost sharing will opt out of our plans on an annual basis beginning July 1, 2004. The impact of these participation rates favorably impacts our annual net pension credit and profitability by approximately $60 million. The impact of differences between actual and assumed experience will affect our net pension credit and profitability in the future through the amortization of actuarial gains or losses.

We have implemented various actions to reduce our share of retiree health care costs during recent periods, including the shifting of certain costs to our retirees. Our retiree health care obligations are determined using the terms of the current plans and consider the existing communication to retirees. Health care benefits for employees who retired prior to March 1, 1990 are not subject to annual dollar caps on the Company’s share of future benefit costs. The benefit obligation associated with this retiree group approximated 60% of the total retiree health care obligation. Management employees who retired on or after March 1, 1990 have paid amounts above their caps since 2001. The obligation related to plans covering formerly represented retirees who retired on or after March 1, 1990 assumed that annual dollar caps are effective and will be enforced beginning November 1, 2004. We have either waived or increased these caps in two prior negotiations. Our collective bargaining agreements expired on October 31, 2004 but were extended through November 8, 2004.

We entered into a tentative agreement with the unions on November 9, 2004, that will be submitted to union members for ratification by mid-December. The agreement will be effective November 1, 2004 and will expire on May 26, 2012, if ratified. The agreement addresses retiree health care benefits, among other items. We agreed to continue to subsidize these benefits up to the established cap level that is consistent with our current actuarial assumptions. Except for costs attributable to an implementation period ending on or before March 1, 2005 (which we will absorb), costs that are in excess of this capped level will be borne by the retirees in the form of premiums and plan design changes. We also agreed to establish a new $400 million trust that will be funded by us over eight years and managed jointly by trustees appointed by the Company and the unions. The trust will be used to mitigate the cost impact of premiums or plan design changes on retirees. The agreement also acknowledged that retiree health care benefits will no longer be a subject of bargaining between the Company and the unions.

As a result of these changes, our required obligation for retiree health care benefits is expected to increase by the net present value of the $400 million of committed contributions to the trust. This incremental cost will be amortized over the contract period. We also considered the substantive plan requirements of SFAS No. 106 and have determined that our obligation for retiree health care benefits is appropriately stated based on our past practice of shifting certain costs to retirees and the actions that are contemplated as a result of the new agreement. The net present value of the required contributions to the new trust is approximately one-third of the amount of the costs that are expected to be in excess of the capped level during the contract period.

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, 2004, 2003 and 2002. This was due primarily to the decline in the discount rate used to estimate the pension liability as a result of declining interest rates in the United States and negative returns on the pension funds as a result of the overall decline in the equity markets in 2002 and 2001. Changes in the minimum pension liability reduced our shareowners' deficit by $150 million during fiscal 2004 and increased our shareowners' deficit by $594 million and $2.9 billion during fiscal 2003 and 2002, respectively.

The discount rate used to determine the minimum pension liability was 5.5%, 5.75% and 6.5% as of September 30, 2004, 2003 and 2002, respectively. Changes in the discount rates were due to the reasons described above. Market conditions and interest rates significantly affect the future assets and liabilities of our pension plans, and similar changes 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% decrease or increase in the discount rate would have increased or decreased the minimum pension liability by approximately $850 million as of September 30, 2004.

Income taxes

Changes in valuation allowances favorably impacted our results of operations by $1.2 billion during fiscal 2004 and unfavorably impacted our results of operations by $129 million and $7.9 billion during fiscal 2003 and 2002, respectively. Our valuation allowance on net deferred tax assets was $7.9 billion and $9.9 billion as of September 30, 2004 and 2003, respectively.

We have significant deferred tax assets, resulting from tax credit carryforwards, net operating loss carryforwards and deductible temporary differences that 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 even if income is reported in the current or recent quarters. Cumulative losses weigh heavily in the overall assessment. We determine cumulative losses on a rolling twelve-quarter basis.

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. We believed it was more likely than

not that the remaining net deferred tax assets of $5.2 billion as of September 30, 2001 and March 31, 2002, would be realized, principally based upon forecasted taxable income, generally within the 20-year research and development credit and net operating loss carryforward periods, giving consideration to substantial benefits realized to date through our restructuring program.

Several significant developments were considered in determining the need for a full valuation allowance during the third quarter of fiscal 2002, including the continuing and 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 as of June 30, 2002. Our net deferred tax assets have essentially remained fully reserved since then. Accordingly, federal and certain state and non-U.S. income taxes attributable to pre-tax income were not provided for during fiscal 2004. Income tax benefits attributable to pre-tax losses were also not provided for during fiscal 2003 and 2002. This has significantly impacted our results in each of these years.

During the fourth quarter of fiscal 2003, we filed a net operating loss carryback claim related to the carryback of our fiscal year 2001 federal net operating loss to 1996, a year in which we filed our federal income tax return as part of the AT&T consolidated group. We reached a tentative agreement with the Internal Revenue Service (the "IRS") on September 1, 2004 that allowed for a tax refund of $816 million (plus statutory interest to the date of payment), subject to approval by the Congressional Joint Committee on Taxation (the "Joint Committee"). The tax benefit related to the claim was not recognized at that time or prior to that time because it was related to a complex matter and there was no assurance that the approval from the Joint Committee would be obtained. On November 8, 2004, we received written confirmation from the IRS that the Joint Committee approved our tentative agreement with the IRS and that our agreement with the IRS was final. We were required to reassess the realizability of our net operating loss carryforwards as of September 30, 2004, because the Joint Committee's final approval was received prior to the issuance of our consolidated financial statements. As a result, we recognized an $816 million income tax benefit from the reversal of valuation allowances and interest income of $45 million during the fourth quarter of fiscal 2004.

We expect to receive the refund during fiscal 2005, following completion of the IRS's audit of our 2001 federal income tax return. The refund will be paid by the IRS to AT&T and the entire refund amount will become payable by AT&T to us under our tax sharing agreements with AT&T. We do not believe there are any other matters that would impact the refund claim.

We reversed $17 million of valuation allowances related to three non-U.S. tax jurisdictions during fiscal 2004. We determined that it was more likely than not that these net deferred tax assets were realizable based upon the income projections and certain other factors for those jurisdictions. We were not in a cumulative loss position in these jurisdictions as of September 30, 2004.

We expect to continue to maintain a full valuation allowance on our remaining net deferred tax assets 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 will be realizable.

We were profitable during all quarters of fiscal 2004 and the fourth quarter of fiscal 2003. If we continue to generate comparable profits we will no longer be in a U.S. cumulative loss position by the fourth quarter of fiscal 2005. If this occurs, we will consider the extent to which we can rely on future income forecasts to support the realization of our net U.S. deferred tax assets. These income forecasts will be considered in conjunction with other positive and negative evidence, including our forecasts of taxable income over the applicable carryforward periods, our current financial performance, our market environment, and other factors, in evaluating the need for a full or partial valuation allowance. Similar analysis will continue to be performed in other jurisdictions where we are no longer in a cumulative loss position.

As a result, we may determine in fiscal 2005 that it is more likely than not that a portion of our net deferred tax assets is realizable and a portion of the valuation allowance should be reversed. Although any reversal of valuation allowances will favorably impact our results of operations in the period of the reversal, federal and certain state and non-U.S. income taxes attributable to pre-tax income will need to be provided for in subsequent periods, which will reduce net income.

We assess the likelihood of the ultimate determination of various contingent tax liabilities that arise in many different tax jurisdictions. These tax matters can be complex in nature and uncertain as to the ultimate outcome. We establish reserves for tax contingencies when we believe an unfavorable outcome is likely to occur and the liability can be reasonably estimated, similar to accounting for other contingencies. Although we believe these positions are fully supportable, we consider the likelihood of potential challenges and sustainability of such challenges upon examination. Changes in our tax reserves have occurred and are likely to continue to occur as our assessments change based on current facts and circumstances such as further developments and progress of tax examinations in various jurisdictions. The net impact of the reassessments of such changes resulted in the recognition of income tax benefits of $142 million, $77 million and $82 million during fiscal 2004, 2003 and 2002, respectively.

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. These contingencies are often resolved over long periods of time. We assess the likelihood of any adverse judgments in or outcomes to these contingencies, as well as potential ranges of possible losses. Reserves are established when it is probable that a liability has been incurred or an asset has been impaired and the amount of the loss can be reasonably estimated based on a detailed analysis of each individual issue, often with the assistance of outside legal counsel. We also determine whether disclosures are required for each individual contingency based on this assessment. There are several hundred contingencies that are currently being assessed. Most of these contingencies are not currently reserved because we have determined that it is not probable that a loss has been incurred. New developments, such as a change in settlement strategy, may change our assessment as to the likely outcome or potential range of possible losses. Our most significant reserves are related to our global shareowners' settlement and environmental matters that are discussed in Note 13 to our consolidated financial statements along with our other significant matters.

In connection with our global shareowner settlement, we expect to issue warrants to purchase 200 million shares of our common stock at $2.75 per share. The estimated fair value of the warrants was $252 million and $161 million as of September 30, 2004 and 2003, respectively. Key assumptions used to determine the estimated fair value of the warrants using the Black-Scholes option pricing model as of September 30, 2004 and 2003, respectively, included the closing price of our common stock of $3.17 and $2.16, a risk-free interest rate of 3.36% and 2.42% and volatility of 49.91% and 66.93%. Volatility was based on the implied volatility (bid) of our publicly traded 2007 option with a $2.50 strike price. Charges related to the warrants were $91 million and $161 million during fiscal 2004 and 2003, respectively. Our future results of operations are likely to be impacted by changes in the estimated fair value of the warrants until they are issued.

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. Our reserves are determined by using percentages applied to certain categories of aged receivables. We also 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. Typically, reserves are reduced only when agings improve or customer settlement proceeds are recovered. Recoveries are generally the result of direct negotiations with the customer, resolutions in bankruptcy or legal actions.

Our provision for (recovery of) bad debts and customer financings were ($230) million, ($223) million and $1.3 billion during fiscal 2004, 2003 and 2002, respectively. Receivables of $1.4 billion and $1.5 billion were net of reserves of $110 million and $246 million as of September 30, 2004 and 2003, respectively. Drawn commitments of $4 million and $27 million under our customer-financing program were net of $135 million and $415 million of reserves as of September 30, 2004 and 2003, respectively. Additional provisions or recoveries may occur in the future due to changes in the financial condition of our customers or as settlements of past due balances are reached.

Inventories

In assessing the ultimate realization of inventories, we make judgments as to future demand requirements and compare these with the current or committed inventory levels. 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 incurred net inventory charges of $17 million, $56 million and $621 million during fiscal 2004, 2003 and 2002, respectively. We experienced significant charges related to changes in required reserves during fiscal 2002 due to changes in strategy, discontinuing product lines, and rapid weakening of market conditions. Inventories of $822 million and $632 million were net of reserves of $720 million and $980 million as of September 30, 2004 and 2003, respectively. It is possible that changes in inventory reserves may be required in the future if there is a rapid change in the demand for our products due to fluctuations in market conditions or to new technological developments.

Business restructuring

Our restructuring reserves reflect many estimates, including those pertaining to employee separation costs, inventory, 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. We have recognized significant reversals or charges related to revisions of our estimates for certain restructuring plans initiated in prior periods. Liabilities associated with our restructuring program were $220 million and $467 million as of September 30, 2004 and 2003, respectively. Most of the remaining reserve requirements are related to leases on exited facilities as of September 30, 2004. Facility exit costs of $202 million are expected to be paid over the remaining lease terms, ranging from several months to 11 years, and are reflected net of expected sublease rental income of $137 million. Additional charges or reversals may be required if the expected amount of sublease rental income changes in the future or if other circumstances change. Refer to Note 2 to our consolidated financial statements for more information including the impact of restructuring actions on our results of operations.

Intangible assets

Our intangible assets include goodwill and other acquired intangibles of $434 million, development costs for software to be sold, leased or otherwise marketed of $284 million and internal use software development costs of $142 million as of September 30, 2004. As a result of the Telica acquisition in fiscal 2004, we recorded $238 million of goodwill and acquired intangible assets. Refer to Note 3 to our consolidated financial statements for information related to the purchase price allocation.

Prior to October 1, 2002, goodwill and identifiable intangible assets were amortized on a straight-line basis over their estimated useful lives. With the adoption of SFAS No. 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 intangible assets 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. We recognized significant impairment charges during fiscal 2003 and 2002, and similar charges may be required in the future.

The initial goodwill impairment test under SFAS No. 142 was completed during the first quarter of fiscal 2003 and 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 service revenues. The excess of the carrying amount of the reporting unit's goodwill over its implied fair value in the amount of $35 million was recognized as an impairment charge in the third quarter of fiscal 2003. Annual goodwill impairment tests completed during the fourth quarter of fiscal 2004 and 2003 did not result in an impairment loss.

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 an impairment charge of $975 million, including $826 million related to goodwill was required because the forecasted cash flows were less than the carrying values of certain businesses. 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.

We recognized approximately $200 million of impairment charges related to capitalized software and $50 million of impairment charges related to property, plant and equipment during fiscal 2002. These charges were primarily related to delays and increasing uncertainties in the development of the universal mobile telecommunications systems ("UMTS") market. We recognized an additional $50 million impairment charge related to the remaining UMTS capitalized software during fiscal 2003. Software development costs related to UMTS technology were expensed as incurred during fiscal 2004 and 2003.

RESULTS OF OPERATIONS

Revenues

	Years ended September 30,					
(in millions)	2004		2003		2002	
INS	$ 2,984	33%	$ 3,300	39%	$ 4,599	37%
Mobility	4,007	44%	3,080	36%	4,444	36%
Services	1,932	21%	1,840	22%	2,761	23%
Optical fiber business	-	-%	-	-%	114	1%
Other	122	2%	250	3%	403	3%
Revenues	$ 9,045	100%	$ 8,470	100%	$ 12,321	100%
U.S.	$ 5,517	61%	$ 5,149	61%	$ 8,150	66%
Other Americas (Canada, Caribbean & Latin America)	538	6%	424	5%	717	6%
EMEA (Europe, Middle East & Africa)	1,293	14%	1,207	14%	1,762	14%
APAC (Asia Pacific & China)	1,697	19%	1,690	20%	1,692	14%
Revenues	$ 9,045	100%	$ 8,470	100%	$ 12,321	100%

Fiscal 2004 vs. 2003

Revenues increased by 7% during fiscal 2004, primarily due to a $927 million increase in Mobility and a $92 million increase in Services, partially offset by a $316 million decline in INS and a $128 million decline in other revenues. The decrease in other revenues was due to decline in patent licensing revenue. The segment discussion later in this MD&A contains information on changes in revenues by segment and product.

The increase in the United States was primarily due to higher spending by Verizon Wireless and Sprint to upgrade their CDMA wireless networks and deploy additional capacity to support subscriber growth. Sales to these two customers increased by approximately $1.0 billion and accounted for 38% of our consolidated sales during fiscal 2004. The increase in Other Americas was primarily driven by higher DSL and wireless revenue in Canada, Mexico and Brazil. The increase in EMEA was primarily due to higher sales of optical products and UMTS data cards in Europe and sales in Iraq. Revenues from customers located in China represented 10% and 11% of consolidated revenues during fiscal 2004 and 2003, respectively.

Our revenues are subject to fluctuation as a result of changes in customer spending patterns and short-term capital requirements, as well as the timing of customer acceptances. The impact of changes in foreign currency rates did not have a significant effect on our consolidated revenues in all periods presented.

Fiscal 2003 vs. 2002

Revenues decreased by 31% during fiscal 2003. The significant reduction in capital spending by large service providers was the primary reason for the decline. The net decrease in revenues was primarily due to a $1.3 billion decrease in INS, a $1.4 billion decrease in Mobility, and a $921 million decrease in Services.

The decline in revenues affected all geographic areas. United States revenues declined 37% in fiscal 2003, primarily as a result of spending reductions by large service providers. Other Americas revenues declined in fiscal 2003 by 41%, primarily due to the economic instability in Latin America. EMEA revenues declined by 31% compared with the prior period, primarily due to lower spending for optical networking products, resulting from service provider overcapacity and to a lesser extent, lower revenues from a long-term project in Saudi Arabia. Revenues in the APAC region were fairly consistent with the prior period, due to sales related to a CDMA wireless network build-out in India and ongoing wireline and wireless build-outs in China.

Gross Margin

	Years ended September 30,		
(in millions)	2004	2003	2002
Gross margin	$ 3,779	$ 2,652	$ 1,552
Gross margin rate	42%	31%	13%

The most significant costs used in determining our gross margin are the cost of materials, components and manufacturing that are sourced from third parties. These costs are negotiated through supply agreements and fluctuate with changes in sales volume. Employee-related costs, such as salaries and related benefits associated with services, logistics and warehousing and other direct supply chain functions, are also included. Employee-related costs are more fixed in nature and will not usually fluctuate based on changes in sales volume. However, employee-related costs may change as a result of actions to align our resources to market conditions, annual salary or wage increases or changes in employee benefits, including those related to pension or health care costs for active employees and retirees. A portion of employee-related costs are subject to collective bargaining agreements. To a lesser extent, amortization of software development costs, certain other overhead items related to IT and facility related costs, as well as charges associated with warranty and inventory values, are also used in

determining gross margin. Most of the costs used in determining gross margin are included in our reportable segments.

Our gross margin rate is subject to fluctuation due to changes in volume, or mix, the impact of significant inventory-related charges and revisions to estimates related to long-term contracts. In addition, our gross margin rate may be impacted by other factors, such as competitive pricing pressures, the initial impact of sales of next generation products, our efforts in entering emerging markets and our ability to continue to realize cost reductions.

Fiscal 2004 vs. 2003

The gross margin rate increased by 11 percentage points in fiscal 2004 from fiscal 2003.

Certain items accounted for four percentage points of the improvement in the gross margin rate in fiscal 2004. These items favorably affected the gross margin rate by approximately one percentage point during fiscal 2004, and negatively affected the gross margin rate by approximately three percentage points during fiscal 2003. The changes between periods reflected lower provisions for slow-moving and obsolete inventories, including inventories associated with customers experiencing financial difficulties; costs associated with supplier and customer contract settlements; adjustments to long-term contracts; costs associated with warranty; and certain customer obligations and product performance issues.

Sales volume favorably impacted the gross margin rate by approximately one percentage point, because the fixed costs were spread over higher revenue levels.

Lower intellectual property licensing revenues and higher short- and long-term employee incentive awards each unfavorably impacted the gross margin rate by approximately one percentage point.

Cost reductions and the impact of product and geographic mix accounted for eight percentage points of improvement in the gross margin rate. Cost reductions were realized primarily from supply chain rationalization and efficiency gains, as well as product redesign. We also realized savings from employee workforce reductions primarily in the Services segment in fiscal 2004. Increased sales of certain U.S. Mobility products with higher gross margin contributed to the gross margin rate improvement. Historically, our Mobility gross margin rate was higher than the INS and Services gross margin rates. Our gross margin rate was also higher in the U.S. compared to non-U.S. regions. These trends are expected to continue in fiscal 2005.

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 issues 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.

We recognized $26 million in reversals and $64 million in charges during fiscal 2003 and 2002, 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 favorable product mix, including a higher proportion of intellectual property licensing revenues to total revenues.

Operating Expenses

	Years ended September 30,		
(in millions)	2004	2003	2002
Selling, general and administrative ("SG&A") expenses, excluding the following two items:	$ 1,523	$ 1,717	$ 2,466
Provision for (recovery of) bad debts and customer financings	(230)	(223)	1,253
Amortization of goodwill and other acquired intangibles	3	15	250
SG&A	1,296	1,509	3,969
Research and development ("R&D")	1,270	1,488	2,310
In-process research and development ("IPR&D")	14	-	-
Goodwill impairment	-	35	826
Business restructuring	(20)	(158)	1,426
Operating expenses	$ 2,560	$ 2,874	$ 8,531

The most significant cost included in operating expenses is salaries and related employee benefits associated with selling, general and product development functions. These employee related expenses are usually more fixed in nature and do not fluctuate significantly with short-term changes in revenue levels, unless there are changes in staffing levels to align employee resources with market conditions. However, employee related expenses may change as a result of salary increases or changes in related benefits, including those related to pension or health care for active employees and retirees. Salary increases are usually provided to employees on an annual basis and historically have been between 3% and 4%. Changes in the funding levels of short- and long-term employee incentive awards may also impact trends between various periods. To a lesser extent, third party consulting fees and certain other overhead items such as IT and facility related costs are also included in operating expenses. Most of the SG&A expenses are included in our global sales organization and shared services, such as general corporate functions. In contrast, most of the R&D expenses are directly associated with research and product development of our wireline and wireless products and included in our reportable segments.

SG&A expenses

Fiscal 2004 vs. 2003

Excluding bad debts and customer financings and amortization of other acquired intangibles, SG&A expenses decreased by $194 million or 11% during fiscal 2004. The decrease was primarily a result of employee workforce reductions under our restructuring program and other cost saving initiatives that limited discretionary spending. Our restructuring program is complete and is not expected to further reduce SG&A expense levels during fiscal 2005.

SG&A included approximately $100 million of higher accruals for short- and long-term employee incentive awards during fiscal 2004. The comparability of SG&A levels was also impacted by additional depreciation and other related charges of $108 million recognized during fiscal 2003 due to the shortening of the estimated useful lives of several properties that were in the process of being sold at the time.

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 $749 million or 30% during fiscal 2003. The decrease was primarily a result of employee workforce 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 discussed above. Most of the SG&A reductions resulted from lower spending in our global sales organization, shared services such as general corporate functions and INS.

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. We may provide or commit to additional customer financings on a limited basis. Significant recoveries were realized during fiscal 2004 and 2003. Further recoveries or charges may occur in the future.

Fiscal 2004 and 2003

We had net recoveries of bad debts and customer financings of $230 million and $223 million, during fiscal 2004 and 2003, respectively. These recoveries included charges for bad debts and customer financings of $24 million and $100 million during fiscal 2004 and 2003, respectively. Recoveries were realized from the favorable settlement of certain fully reserved notes receivable and accounts receivable, significantly lower bad debt and customer financing exposure and the expiration of certain customer financing guarantees. Settlements generally occur through debt workout procedures, including consummation of bankruptcy proceedings.

Fiscal 2002

The significant provisions reflected in fiscal 2002 were net of recoveries of $44 million. These provisions were realized due to the deterioration in the creditworthiness of certain customers as a result of the decline in the telecommunications market.

Amortization of goodwill and other acquired intangibles

We adopted FAS 142 during the first quarter of fiscal 2003. As a result, we no longer amortize goodwill but test for impairment annually or more often if an event or circumstance indicates that an impairment may have occurred. Our goodwill was $373 million as of September 30, 2004.

Amortization of other acquired intangibles was $3 million, $15 million and $42 million during fiscal 2004, 2003 and 2002, respectively. We expect the annual amortization of other acquired intangible assets to increase by approximately $13 million during fiscal 2005 as a result of higher amortization for intangible assets acquired in the Telica acquisition in the fourth quarter of fiscal 2004.

R&D

Our continuing R&D investment is focused on enhancing and expanding our broad portfolio of leading edge technologies. In Mobility, our R&D investment is focused primarily on CDMA and UMTS next-generation technologies and includes expenses associated with UMTS product trials with certain customers. This investment continues to support our leadership position in spread-spectrum technology and our development of high-speed mobile data solutions. Our INS R&D investment supports a broad array of current and next-generation technologies, including VoIP, metro optical and broadband

networking solutions. Together, Mobility and INS share R&D investment in a unified softswitch platform to support both wireless and wireline applications. Our R&D investment also supports reshaping our product portfolio to capture convergence opportunities and Bell Labs long-term research programs in such areas as computer science, materials science and bioengineering. We believe our current R&D spending levels and plans are aligned with current and expected market opportunities.

R&D costs are charged to expense as incurred. However, the costs incurred for the development of computer software that will be sold, leased or otherwise marketed are capitalized when technological feasibility has been established. The amortization of these costs was reflected as a cost component in determining our gross margin. Unamortized software development costs determined to be in excess of the net realizable value of the product are expensed immediately and reflected in R&D if such determination is made prior to when the product is available for general release to the customer.

Costs capitalized for the development of computer software that will be sold, leased or otherwise marketed were $258 million, $313 million and $485 million during fiscal 2004, 2003 and 2002, respectively. The amortization of these costs was reflected as a cost component in determining gross margin and amounted to $281 million, $291 million and $365 million during fiscal 2004, 2003 and 2002, respectively.

Fiscal 2004 vs. 2003

R&D expenses decreased by $218 million or 15% in fiscal 2004, primarily due to employee workforce reductions and product rationalizations under our restructuring program. Our restructuring program is complete and not expected to further reduce R&D expenses during fiscal 2005. R&D expenses included approximately $175 million of higher accruals for short- and long-term employee incentive awards during fiscal 2004 and a $50 million UMTS impairment charge during fiscal 2003.

Fiscal 2003 vs. 2002

R&D expenses decreased by $822 million or 36% in fiscal 2003 primarily due to employee reductions and product rationalizations. Approximately 84% of the reduction for fiscal 2003 was reflected in INS, due to the greater number of INS product rationalizations. In addition, R&D expense included impairment charges of $50 million and $250 million during fiscal 2003 and 2002, respectively.

In-Process Research and Development (IPR&D)

IPR&D charges of $14 million resulted from the acquisition of Telica. Refer to Note 3 to our consolidated financial statements for information regarding the purchase price allocation.

Goodwill impairment

Fiscal 2003

Our 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 carrying amount of the reporting unit's goodwill over its implied fair value was recognized as a $35 million impairment charge.

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. The excess of the carrying amount over the estimated fair value of the goodwill previously recognized in connection with the acquisition of Spring Tide was recognized as an $826 million impairment charge.

Business restructuring

(in millions)	Years ended September 30, 2004	2003	2002
Employee separations	$ (14)	$ (47)	$ 799
Contract settlements	(15)	(16)	(93)
Facility closings	12	17	301
Other	(3)	(18)	16
Restructuring costs (reversals)	(20)	(64)	1,023
Asset write-downs	1	(120)	458
Net gains on sales	(1)	-	(140)
Impairment of goodwill	-	35	826
Impairment of other intangible assets	-	-	149
Net charge (reversal)	$ (20)	$ (149)	$ 2,316
Included in:			
Costs	$ -	$ (26)	$ 64
Operating expenses	(20)	(158)	1,426
Goodwill impairment	-	35	826
Total	$ (20)	$ (149)	$ 2,316

During the second quarter of fiscal 2001, we committed to and began implementing a restructuring program to realign resources to market conditions and focus on the large service providers. We assessed our product portfolio and associated R&D, and then streamlined the rest of our operations to support those reassessments. We eliminated some marginally profitable or non-strategic product lines, merged certain technology platforms, consolidated development activities, eliminated management positions and many duplications in marketing functions and programs, centralized our sales support functions and 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 the employee workforce on a global basis.

Since the inception of the restructuring program, we reduced our employee workforce by approximately 74,200 employees, to approximately 31,800 employees as of September 30, 2004 (including the impact of attrition and other employee workforce reductions in the ordinary course of business). In addition, the restructuring plans included the exit of a significant number of owned and leased facilities, totaling approximately 15.9 million square feet. All of these sites were exited as of September 30, 2003.

We have completed the restructuring actions but continue to evaluate the remaining restructuring reserves at the end of each reporting period. Additional charges or reversals may be required if the expected amount of sublease rental income changes in the future or if other circumstances change.

Refer to Note 2 to our consolidated financial statements for additional details on our business restructuring program.

Fiscal 2004

The net reversals were primarily related to employee separations and net contract settlements for amounts lower than originally estimated. Net facility-closing charges were due to changes in estimated costs and reductions in expected sublease rental income.

Fiscal 2003

The net reversals were primarily related to actual termination benefits and curtailment costs for employee separations that were lower than the estimated amounts due to certain differences in actual versus assumed demographics, including age, service lives and salaries of the separated employees. In addition, net contract settlement reversals were related to the settlement of certain contractual obligations and purchase commitments for amounts lower than originally estimated. 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

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.

Fiscal 2002

The net charges primarily related to additional employee workforce reductions; revisions to facility closings as a result of changes in estimates for 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 on sales were related to business dispositions including the enterprise professional services business and the billing and customer care business.

Pension, Postretirement and Postemployment Benefits

(in millions)	Years ended September 30, 2004	2003	2002
Pension benefit credit	$ (1,111)	$ (1,097)	$ (575)
Postretirement benefit cost	243	351	290
Postemployment benefit cost (credit)	40	(93)	(17)
Net pension, postretirement and postemployment benefit credit	$ (828)	$ (839)	$ (302)
Included in:			
Business restructuring	$ -	$ (118)	$ 544
Other costs and expenses	(828)	(721)	(955)
Discontinued operations	-	-	109
Net credit	$ (828)	$ (839)	$ (302)

We maintain defined benefit pension plans covering the majority of employees and retirees, as well as postretirement benefit plans for U.S. retirees that include health care, dental benefits and life insurance coverage. Additionally, we offer various postemployment benefits to certain employees after employment but before retirement, including disability benefits, severance pay and workers' compensation. Refer to Note 9 to the consolidated financial statements for further information.

Excluding the amounts reflected in business restructuring and discontinued operations, approximately two-thirds of the net credit is reflected in operating expenses, with the balance in costs used to determine our gross margin.

The changes in the net credit during fiscal 2004 compared to fiscal 2003 were due to the net impact of the following items:

- Revised estimates of termination benefits and curtailments during fiscal 2003 that related to restructuring actions.
- Elimination of certain pension death benefits and reductions in certain retiree health care benefits.
- Reduction in the discount rate from 6.5% to 5.75%.
- Reduction in the market-related value of plan assets due to the impact of actual losses incurred on plan assets during fiscal 2002 and 2001.
- Accelerated gain amortization related to postemployment benefits during fiscal 2003.
- Initial recognition of the prescription drug benefit under Medicare Part D of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Act") and expected reduction in plan participation rates as a result of recent experience and the Act.

The changes in the net credit during fiscal 2003 compared to fiscal 2002 were due to the net impact of the following items:

- Significant termination benefits and curtailments related to restructuring actions during fiscal 2002.
- Employee workforce reductions associated with our restructuring actions.
- Reduction in the discount rate from 7.0% to 6.5%.
- Reduction in the market related value of plan assets and a reduction in the expected rate of return on plan assets from 9.0% to 8.75%.
- Accelerated gain amortization related to postemployment benefits during fiscal 2003.

We expect the net credit will decrease by approximately $200 million during fiscal 2005, primarily due to negative asset returns during fiscal 2001 and 2002 which continue to reduce the market related value of plan assets, the reduction in the expected rate of return on pension plan assets from 8.75% to 8.5%, and the impact of the tentative collective bargaining agreement, if ratified.

Other Income (Expense), Net and Interest Expense

	Years ended September 30,		
(in millions)	2004	2003	2002
Legal settlements	$ (84)	$ (401)	$ (212)
SEC settlement	(25)	-	-
Debt conversion cost and gain on extinguishments, net	(7)	(97)	-
Gain on sales of businesses, net	-	49	725
Gain (loss) on sale of investments	75	(10)	4
Interest income	89	86	114
Interest income on tax settlements	135	16	73
Gain (loss) on foreign currency transactions	(10)	10	(46)
Other-than-temporary write-down of investments	(22)	(63)	(209)
Other, net	89	(18)	(157)
Other income (expense), net	$ 240	$ (428)	$ 292
Interest expense	$ 396	$ 353	$ 382

Other income (expense)

Fiscal 2004

We recognized charges of $56 million related to the shareowner lawsuit settlement, including $91 million related to changes in the estimated fair value of the warrants that are expected to be issued. These changes are primarily caused by the market price of our common stock and are likely to continue until the warrants are issued. We also recovered $40 million from fiduciary insurance carriers and recognized a $5 million charge related to changes in the fair value of our common stock that was deposited into escrow and subsequently sold. The remaining legal settlement charges of $28 million were primarily related to Y2K claims under our separation agreement with Avaya and the prior period sale of our consumer products business. Refer to Note 13 to our consolidated financial statements for more information on legal settlements.

We reached an agreement with the SEC and paid a $25 million fine in connection with the SEC's investigation into our revenue recognition issues previously identified in November and December of 2000. The final judgment and consent decree to settle the investigation with the SEC was entered into during May 2004.

The gain on sale of an investment was primarily related to the maturity of a forward contract for the sale of Corning common stock we owned. We obtained the shares of Corning in connection with the sale of certain joint ventures associated with OFS in fiscal 2002.

Interest income on tax settlements was due primarily to the favorable resolution of certain prior year federal income tax audits and the recognition of a federal net operating loss carryback claim under tax sharing agreements with AT&T, Avaya and Agere. Refer to Note 7 to our consolidated financial statements for further information on these tax matters.

Fiscal 2003

Legal settlements 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 during fiscal 2003 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.

The debt conversion cost and gain on extinguishments was a result of the exchange of a portion of 7.75% trust preferred securities and certain other debt obligations for shares of our common stock and cash. Refer to Note 8 to our consolidated financial statements for more information on these exchanges, including the number of securities exchanged.

The other-than-temporary write-down of investments was 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 gain 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 $187 million, including $73 million related to the favorable resolution of federal income tax audits. This was partially offset by a legal settlement of $162 million related to our former consumer products 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 an investment in Commscope.

Interest Expense

Fiscal 2004 vs. 2003

Interest expense increased by $43 million during fiscal 2004, primarily due to the exchange of our 8.00% redeemable convertible preferred stock for 8.00% subordinated debentures in November 2003. The impact of additional interest on the 2.75% convertible securities that were issued in the third quarter of fiscal 2003 was largely offset by our debt recapitalization efforts.

Fiscal 2003 vs. 2002

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

Income Taxes

Fiscal 2004

The tax benefit of $939 million during fiscal 2004 included the impact of maintaining a valuation allowance on substantially all of our net deferred tax assets. As a result, federal and certain state and non-U.S. income taxes attributable to pre-tax income were not provided. Refer to the "Application of Critical Accounting Estimates" included in this MD&A and Note 7 to our consolidated financial statements for more detail regarding income taxes.

The tax benefit also included current tax expense related to certain non-U.S. operations and discrete items. The discrete items included the recognition of an $816 million net operating loss carryback claim and $142 million primarily related to the net favorable resolution of income tax audits for years 1990 through 1998. We also recognized interest income of $135 million related to these items.

The United States Congress passed the American Jobs Creation Act of 2004 (the "Jobs Creation Act"), which the President signed into law on October 22, 2004. Key provisions of the Jobs Creation Act include a temporary incentive for United States multinational corporations to repatriate foreign earnings, a domestic manufacturing deduction and international tax reforms designed to improve the global competitiveness of United States businesses. Our review of the Jobs Creation Act's provisions and our tax positions indicates that it will not have a material effect on our financial condition or results of operations during fiscal 2005.

Fiscal 2003

The tax benefit of $233 million during fiscal 2003 included the impact of maintaining 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. Federal and certain state and non-U.S. income tax benefits attributable to pre-tax losses were not provided. The 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 of $4.8 billion 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 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, federal and certain state and non-U.S. income tax benefits attributable to pre-tax losses were not provided.

RESULTS OF OPERATIONS BY SEGMENT

INS

(in millions)	Years ended September 30, 2004	2003	Change	2002	Change
Voice networking	$ 1,336	$ 1,560	(14%)	$ 2,122	(26%)
Data and network management	933	1,034	(10%)	1,132	(9%)
Optical networking	715	706	1%	1,345	(48%)
Total revenues	$ 2,984	$ 3,300	(10%)	$ 4,599	(28%)
U.S.	$ 1,490	$ 1,754	(15%)	$ 2,444	(28%)
Non-U.S.	1,494	1,546	(3%)	2,155	(28%)
Total revenues	$ 2,984	$ 3,300	(10%)	$ 4,599	(28%)
Gross margin %	35%	27%	8 pts	(1%)	28 pts
Segment income (loss)	$ 345	$ 102	$ 243	$ (1,693)	$ 1,795
Return on sales	12%	3%	9 pts	(37%)	40 pts

Fiscal 2004 vs. 2003

INS revenues declined by $316 million due primarily to a significant reduction in sales to AT&T as it completed certain capital spending programs in prior periods and reduced its annual spending during fiscal 2004. Five customers accounted for approximately 39% and 40% of INS revenues during fiscal 2004 and 2003, respectively. Lower non-U.S. sales were primarily in APAC, including China, as a result of competitive pricing pressures and the timing of completing certain project deployments. The decreases in APAC sales were primarily prevalent in the data and network management and optical product lines.

Voice networking revenues declined by $224 million due to lower circuit switching product sales. Traditional circuit switching product sales are currently declining at a faster rate than the growth in next generation technologies. The decline is also more prevalent in the U.S., where certain customers are shifting their spending to other areas, such as broadband access (DSL). Circuit switching represented approximately 42% and 52% of voice networking revenues during fiscal 2004 and 2003, respectively. Beginning in fiscal 2004, INS voice networking revenues include an allocation of revenue earned from switching equipment common platform sales to Mobility customers. This attribution is intended to better match revenue from these common platforms with the underlying R&D investment. The revenue impact to voice networking results for fiscal 2004 was $85 million. Data and network management revenues declined $101 million due primarily to lower revenues from multi-service switching products. Optical networking revenues increased by $9 million as higher sales of metro-optical products in the U.S. and EMEA, offset lower revenues from legacy optical products. We believe that we have transitioned most of our optical product contracts with key customers to next generation optical products.

Although customer-spending levels for INS products are not expected to change significantly in the aggregate, the mix of what they purchase is likely to continue to change or fluctuate. Our future revenues will be impacted by our success in offering a product portfolio that effectively addresses customer needs. Quarterly revenues declined sequentially each quarter except in the fourth quarter and ranged from $715 million to $790 million during fiscal 2004. We expect that our quarterly revenue levels will remain volatile as customers carefully consider alternatives in transitioning to next generation networks.

Segment income improved by $243 million. This improvement was driven by a $143 million increase in gross margin and a $100 million decrease in operating expenses. The higher gross margin was due to an eight-percentage point increase in the gross margin rate, which more than offset the impact of lower revenues. The increase in the gross margin rate primarily resulted from certain items, including lower inventory- and warranty-related charges that accounted for four percentage points of the improvement and continued cost reductions. R&D and SG&A expenses declined due to the impact of restructuring actions during fiscal 2003. However, segment operating expenses included charges of $23 million related to the Telica acquisition for IPR&D, employee compensation expense and amortization of intangible assets during fiscal 2004.

Fiscal 2003 vs. 2002

INS revenues declined by $1.3 billion. The $690 million decline in the U.S. was due to reductions and delays in capital spending by large telecommunications service providers. The $609 million decline in the non-U.S. regions was particularly concentrated in EMEA and APAC. In EMEA, revenues decreased by $303 million 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 the timing of revenues associated with several projects in China.

Voice networking revenues declined by $562 million due to lower circuit switching product sales. Data and network management revenues declined by $98 million due to a decrease in access networking revenues. Optical networking revenues declined by $639 million, primarily related to lower sales of long-haul products, as service providers in Europe and the U.S. responded to excess network capacity.

Segment income improved by $1.8 billion. This improvement was driven by a $961 million increase in gross margin, despite lower sales volume, and an $834 million decrease in operating expenses. The gross margin rate increased by 28 percentage points primarily due to lower inventory-related charges, that accounted for 12 percentage points of the improvement, and continued cost reductions from supply chain rationalization and efficiency gains. The remaining improvement in the gross margin rate was due to a more favorable product mix. The lower operating expenses were due to the restructuring program and less discretionary spending, of which over 80% was from lower R&D spending resulting from product rationalizations.

Mobility

	Years ended September 30,				
(in millions)	2004	2003	Change	2002	Change
U.S.	$ 2,843	$ 2,116	34%	$ 3,578	(41%)
Non-U.S.	1,164	964	21%	866	11%
Total revenues	$ 4,007	$ 3,080	30%	$ 4,444	(31%)
Gross margin %	51%	40%	11 pts	28%	12 pts
Segment income	$ 1,240	$ 173	$ 1,067	$ 2	$ 171
Return on sales	31%	6%	25 pts	0%	6 pts

Fiscal 2004 vs. 2003

Mobility revenues increased $927 million. U.S. revenues increased $727 million due primarily to higher CDMA sales to Verizon Wireless and Sprint as they continued to upgrade their wireless networks and deploy additional capacity to support subscriber growth. These two customers accounted for 61% and 52% of total Mobility revenues during fiscal 2004 and fiscal 2003, respectively. Including these two customers, five customers accounted for approximately 80% and 74% of Mobility revenues during fiscal 2004 and 2003, respectively. The $200 million increase in the non-U.S. regions was primarily due to higher UMTS data card sales in EMEA and higher CDMA sales in APAC and other Americas as certain customers continued to expand their networks.

Quarterly revenues ranged from $951 million to $1.1 billion during fiscal 2004. Although the quarterly revenues during fiscal 2004 have been more stable than in prior years, future quarterly revenue trends remain volatile as a result of the high concentration of revenue among a limited number of customers and shifts in their spending patterns, as well as the timing of revenue recognition related to long-term contracts.

Approximately 91% of the fiscal 2004 wireless product revenue was derived from CDMA technology. We continue to conduct third-generation UMTS / W-CDMA trials in the U.S. and China. We expect certain customers to continue to increase investments in mobile high-speed data equipment during fiscal 2005.

Segment income improved by $1.1 billion. This improvement was driven by an $820 million increase in gross margin and a $247 million decrease in operating expenses. Gross margin increased due to higher sales volume and an 11 percentage point increase in the gross margin rate. The increase in the gross margin rate was driven by favorable product and geographic mix, continued cost reductions, lower inventory and warranty charges and better absorption of fixed costs due to the higher revenues. R&D and SG&A expenses declined primarily due to the impact of restructuring actions and relocating certain activities to areas with lower cost structures. We also recognized a $50 million impairment charge for UMTS capitalized software during fiscal 2003. UMTS software development costs continued to be expensed as incurred. Lower R&D expenses accounted for 85% of the decrease in operating expenses.

Fiscal 2003 vs. 2002

Mobility revenues decreased $1.4 billion. The decrease resulted from reductions in capital spending, primarily in the U.S., as large service providers continued to preserve capital resources. The decline in U.S. revenues were also attributable to two large service providers, AT&T Wireless and Cingular, which selected alternatives to our TDMA technologies. Revenues from these two customers represented 7% and 21% of Mobility sales during fiscal 2003 and 2002, respectively, and the decline in revenues attributable to these two customers represented 51% of the Mobility revenue decline in the U.S. during fiscal 2003. Non-U.S. revenues increased by $98 million during fiscal 2003, primarily as a result of large CDMA network build-outs in the APAC region, primarily in China and India. Quarterly revenues ranged from $624 million to nearly $1.1 billion during fiscal 2003. Approximately 85% of our wireless product revenue was derived from CDMA technology.

Segment income improved by $171 million. The improvement was due to a $177 million decrease in operating expenses, partially offset by a $6 million decline in gross margin. Despite the decline in revenues, gross margin was consistent with the fiscal 2002 level. The gross margin rate increased by 12 percentage points in fiscal 2003. The higher gross margin rate was due to lower inventory-related charges, that accounted for eight percentage points of the improvement, supply chain rationalization and efficiency gains, and, to a lesser extent, favorable product mix. The lower operating expenses reflected a $160 million decline in R&D expenses. This decline included a $100 million net impact of UMTS asset impairment charges of $50 million and $250 million during fiscal 2003 and 2002, respectively, as well as expensing 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 lower discretionary spending.

Services

(in millions)	Years ended September 30, 2004	2003	Change	2002	Change
U.S.	$ 1,063	$ 1,006	6%	$ 1,754	(43%)
Non-U.S.	869	834	4%	1,007	(17%)
Total revenues	$ 1,932	$ 1,840	5%	$ 2,761	(33%)
Gross margin %	25%	19%	6 pts	14%	5 pts
Segment income	$ 282	$ 225	$ 57	$ 227	$ (2)
Return on sales	15%	12%	3 pts	8%	4 pts

Fiscal 2004 vs. 2003

Services revenues increased by $92 million. Revenues increased in the U.S. by $57 million and in the non-U.S. regions by $35 million. Five customers accounted for approximately 38% and 36% of Services revenues during fiscal 2004 and 2003, respectively. Quarterly revenues ranged from $466 million to $514 million during fiscal 2004.

The increase in revenues was due to higher maintenance and professional services. Professional services increased primarily due to new government contracts. Our traditional installation services decreased as a result of competitive pricing pressures, more customer self-installation, and lower wireline product sales. Deployment services related to researching, selecting and preparing sites for placement of our customers' wireless equipment have partially offset the decrease in traditional installation services.

Segment income increased by $57 million. This improvement was due to a $139 million increase in gross margin, partially offset by an $82 million increase in operating expenses. The higher gross margin resulted from an increase in the gross margin rate and to a lesser extent higher revenues. The gross margin rate increased by six-percentage points as a result of employee workforce reductions. Operating expenses increased due to higher sales and marketing expenses in order to expand worldwide service offerings.

Fiscal 2003 vs. 2002

Services revenues declined by $921 million. Revenues declined in all regions except APAC, due to a large project in China. The decline in U.S. revenues was primarily due to lower deployment services for large service providers.

Deployment services accounted for approximately 85% of the total Services decline. These services declined primarily due to lower sales of wireline equipment requiring installation. Competitive pricing pressures have also adversely affected deployment services.

Segment income decreased by $2 million. This decline was due to a $27 million decline in gross margin, partially offset by a $25 million decrease in operating expenses. The services gross margin rate increased by five-percentage points 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. The operating expense decrease was primarily due to employee workforce reductions under our restructuring program and lower discretionary spending.

LIQUIDITY AND CAPITAL RESOURCES

Cash flow overview

Cash, cash equivalents and marketable securities increased $366 million during fiscal 2004 to $4.9 billion, primarily from $634 million of cash provided by operating activities and $276 million of proceeds from common stock issued for certain employee benefit plans, partially offset by the repayment of certain debt obligations and convertible securities of $500 million.

Operating activities

Operating activities provided $634 million of cash during fiscal 2004. This primarily resulted from net income of $1.4 billion (adjusted for non-cash items of $587 million) offset by changes in other operating assets and liabilities of $799 million. The changes in other operating assets and liabilities included an increase in other current assets related to an $861 million income tax refund that is expected to be received during fiscal 2005 and cash outlays for our restructuring program of $227 million and capitalized software of $258 million that were partially offset by the impact of certain insurance and customer settlements and customer financing recoveries of approximately $600 million. Cash flow from operating activities also included net proceeds from tax refunds of $118 million (including related interest). Operating activities used approximately $1.0 billion of cash during fiscal 2003. The improvement in cash flow from operating activities during fiscal 2004 as compared with fiscal 2003 was primarily due to improved financial results driven by cost reductions, higher settlements and recoveries, and lower cash outlays for business restructuring.

Changes in working capital requirements (receivables, inventories and contracts in process, accounts payable and deferred revenue) provided $18 million of cash during fiscal 2004. We periodically sell certain non-U.S. receivables with extended payment terms where it is cost effective to do so. We sold $468 million of receivables during fiscal 2004, of which $263 million was due after September 30, 2004. This impact is reflected in the change in receivables. We also commit to extended billing terms on a limited basis, of which $232 million was outstanding as of September 30, 2004. Our days sales outstanding was 51 days and inventory turnover was 6.9 as of September 30, 2004.

Generally, working capital requirements will increase or decrease with changes in quarterly revenue levels. Our working capital requirements have also been reduced through more favorable billing terms, collection efforts and streamlined supply chain operations. In addition to changes in working capital, the timing of certain payments will also impact our quarterly cash flow. For example, while employee incentive awards are accrued throughout the fiscal year, they are usually paid during the first quarter of the subsequent fiscal year. The fiscal 2004 annual incentive awards of approximately $600 million are expected to be paid during the first quarter of fiscal 2005.

Operating activities used $948 million of cash during fiscal 2003. This primarily resulted from a net loss of $566 million (adjusted for non-cash items of $204 million) and changes in other operating assets and liabilities of $931 million. This was partially offset by a reduction in working capital requirements of $549 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. The changes in other operating assets and liabilities include cash outlays for our restructuring program of $629 million and capitalized software of $313 million.

Operating activities used $756 million of cash during fiscal 2002. This primarily resulted from a loss from continuing operations of $2.9 billion (adjusted for non-cash items of $8.9 billion) and changes in other operating assets and liabilities of $1.6 billion, offset in part by a reduction in working capital requirements of $3.7 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 employee workforce. Federal and state income tax refunds amounted to approximately $1.0 billion, including $616 million received in connection with changes in tax legislation.

Investing activities

Investing activities used $869 million of cash during fiscal 2004. These activities included net purchases of marketable securities of $821 million and capital expenditures of $157 million, of which $54 million was for internal use software. Partially offsetting these cash outflows were cash proceeds of $63 million from the sale of certain manufacturing and real estate facilities in the United States and China. We do not expect to receive any significant cash proceeds from business or asset dispositions in the near future. We may continue to purchase marketable securities in an attempt to improve our investment returns.

Investing activities provided $758 million of cash during fiscal 2003. This was primarily due to net maturities of marketable securities 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, we purchased the remaining 10% minority interest in AG Communication Systems for $23 million.

Investing activities provided $757 million of cash during fiscal 2002. This 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 marketable securities and $449 million of capital expenditures. Cash proceeds from dispositions primarily included the $2.1 billion received from the sale of our OFS business, $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.

Financing activities

Financing activities used $239 million of cash during fiscal 2004. We used $500 million of cash to repay or repurchase certain debt obligations and convertible securities, including $249 million under our recapitalization program and $216 million of variable interest notes related to our Insured Special Purpose Trust. We also received net proceeds of $276 million from the issuance of 91 million common shares for certain employee benefit plans.

Financing activities provided $1.1 billion of cash during fiscal 2003. This was primarily from the issuance of 2.75% Series A and Series B convertible senior debentures for a net amount of $1.6 billion. A portion of these proceeds were used to repay or retire certain debt obligations and convertible securities, all of which had higher interest or dividend rates than the debentures issued (the remainder of the proceeds were 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 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 paid our 8% redeemable convertible preferred stock dividend requirement of $91 million with 46 million shares of our common stock and $6 million of cash.

Financing activities provided $468 million of cash during fiscal 2002. This 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 credit facilities and other short-term borrowings and $149 million for preferred stock dividends.

Recapitalization program

We are currently authorized by our board of directors to issue shares of our common stock or use cash in exchange for our convertible securities and certain other debt obligations. Since the fourth quarter of fiscal 2002, we retired approximately $2.5 billion of our convertible securities and certain other debt obligations in exchange for approximately 643 million shares of our common stock and $736 million in cash in separate, multiple and privately negotiated transactions. Most of these transactions reduced future obligations at a discount and reduced annual fixed charges such as interest and dividend requirements. We may use cash or issue more of our common shares in similar transactions in the future. If our common stock is issued, it would result in additional dilution to our common shareowners. Subsequent to September 30, 2004, and through December 3, 2004, we retired $20 million of our debt obligations for approximately $21 million of cash.

We exchanged all of our outstanding 8% redeemable convertible preferred stock for 8% convertible subordinated debentures on November 24, 2003. This action increased our flexibility to settle this obligation by eliminating certain legal requirements related to available capital surplus as defined by Delaware law.

Our 8% convertible subordinated debentures are redeemable at the option of the holders on various dates. The next available redemption date at the option of the holder is August 2, 2007. We have the right to redeem the debentures beginning August 15, 2006. We have the option to satisfy the redemption with cash, shares of our common stock or a combination of both. The principal amount of these debentures was $817 million as of September 30, 2004.

Cash management

Achieving optimal returns on our cash balance involves concentrating domestic cash in a primary account with our lead bank in order to make efficient investment decisions in various instruments and maturities. Short-term domestic cash is invested daily in money market funds and other short-term instruments such as U.S. commercial paper and discount agency bills. Strategic long-term domestic cash is outsourced to various fund managers and the portfolio consists of investment grade quality debt securities such as treasury notes, corporate bonds, high quality asset-backed securities and government agency bonds with various maturities. International cash is invested in international money market funds, time deposits and other bank accounts. Approximately 80% of our cash and marketable securities was held domestically as of September 30, 2004.

Future capital requirements and funding sources

We do not expect our operations will generate cash on a sustainable basis until our pre-tax income exceeds the amount of net non-cash income items, which have been driven primarily by our pension credit. Our pension credit was $1.1 billion during fiscal 2004. Our cash requirements during the next few years are primarily related to funding our operations, capital expenditures, debt obligations and other matters discussed below and in our contractual obligations table. We believe our cash and cash equivalents of $3.4 billion and marketable securities of $1.5 billion as of September 30, 2004, are sufficient to fund our cash requirements for fiscal 2005 as well as the following few years. 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.

On November 8, 2004, we received written confirmation from the IRS that the Joint Committee approved our tentative agreement with the IRS that allowed for a tax refund of approximately $816 million (plus statutory interest to the date of payment). We expect to receive the refund during fiscal 2005, following completion of the IRS's audit of our 2001 federal income tax return. The refund will be paid by the IRS to AT&T and, under our tax sharing agreements with AT&T, would then be payable by AT&T to us. We do not believe there are any other matters that would impact the refund claim.

The cash requirements of our restructuring program are $2.6 billion, of which $2.4 billion had been paid through September 30, 2004. The remaining cash requirement is expected to be paid over the next 11 years, including approximately $100 million during fiscal 2005. This cash requirement is primarily for lease obligations, which are net of expected sublease rental income of approximately $137 million. Our cash requirements could increase in the future years if we do not receive this expected income.

We do not expect to make contributions to our qualified U.S. pension plans in fiscal 2005 and fiscal 2006. Annual contributions to our non-qualified and non-U.S. pension plans are expected to be approximately $50 million over the next several years. Legislative and regulatory changes were passed that alter the manner in which liabilities are determined for the purpose of calculating required pension contributions. The funding requirements for our pension plans are not expected to be significantly affected through fiscal 2006 as a result of these changes. We are unable to provide an estimate of future funding requirements beyond fiscal 2006 for U.S. pension plans. However, based on our actuarial projections, we believe it is unlikely that any required contributions would have a material effect on our liquidity during fiscal 2007 through fiscal 2009.

We currently provide retiree health care benefits for our retirees in the United States. These benefits are provided under a single plan covering 48,000 management retirees and 71,000 formerly represented retirees as well as an additional 81,000 dependents of retirees. The plans for management and formerly represented retirees are accounted for separately. Historically, retiree health care benefits were funded through plan assets set aside in trusts and transfers of excess pension assets. There are currently no plan assets available in these trusts to fund the obligations of the management retirees. There are approximately $600 million of assets in the trust that is available to fund the obligations of the formerly represented retirees, and approximately $400 million of plan assets in a welfare benefits trust that can be made available upon authorization from our senior management.

We are permitted to transfer pension plan assets that are in excess of 125% of pension plan obligations under Section 420 of the Internal Revenue Code to fund retiree health care benefits. The funding levels were below the required thresholds that would allow for Section 420 transfers in either of our U.S. pension plans as of the January 1, 2004 valuation date. The next valuation date is January 1, 2005. Our cumulative Section 420 transfers during the past several years were $1.9 billion, although no transfers were made within the management retiree plan since fiscal 2002 or within the formerly represented retiree plan since fiscal 2003. If a Section 420 transfer is made, we are required to maintain a certain level of cost per participant for a period of five years beginning with the year of transfer. As a result, although these excess pension asset transfers can help fund retiree health care benefits, they limit the ability to implement effective cost reductions in the future. We expect to seek legislative changes to allow more flexibility regarding this aspect of cost maintenance, together with our unions. If we are successful in obtaining the legislative changes, we believe that a majority of the Company's funding requirements for formerly represented retirees could be addressed through Section 420 transfers based on current actuarial assumptions. However, no assurances can be given that we will be successful in these efforts. If the legislative changes are not obtained by September 1, 2006, the Company's obligation to fund $400 million to a trust, as described below, terminates, and the Company can change the level of its subsidy at its sole discretion beginning January 1, 2007.

The retiree health care benefit payments were approximately $500 million for formerly represented retirees and approximately $275 million for management retirees during fiscal 2004 after plan participant

contributions of $80 million. The benefits for formerly represented retirees were funded through the assets that were available in the trusts. The benefits for management retirees were funded through Company contributions of $225 million and the remaining trust assets. We received $212 million from our welfare benefits trust in October 2004 as a reimbursement for management retiree health care contributions that we made during fiscal 2004. The Company's expected funding requirements for retiree health care benefits are expected to be $201 million, $426 million, $534 million, $494 million and $465 million during fiscal 2005 and the next four consecutive fiscal years, respectively. These amounts exclude potential Section 420 transfers, $400 million that we agreed to contribute to a trust through September 30, 2012, in accordance with the tentative agreement with our unions, and approximately $400 million of plan assets in a welfare benefits trust that can be made available upon authorization from our senior management. However, expected annual Medicare Part D subsidies of approximately $60 million are included beginning in fiscal 2007. These expected funding requirements are subject to change.

As discussed in more detail in Note 13 to our consolidated financial statements, we may fund up to $315 million of our shareowner litigation settlement with cash, common stock or a combination of both, at our option. On December 24, 2003, we deposited 33 million shares of our common stock into escrow, representing the initial $100 million payment of the settlement amount. The appeals process has ended and the claims administration process is almost complete. We expect the final distribution to occur during the first or second quarter of fiscal 2005.

We expect to file a shelf registration statement to register 200 million shares of our common stock that may be issued upon the exercise of the warrants we will be issuing as part of the settlement proceeds for our shareowner litigation.

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.

Contractual obligations and other commercial commitments and contingencies

Our contractual obligations as defined by the SEC's rules and regulations are presented in the table below. However, our expected cash flow cannot be entirely assessed based on such obligations since they are subject to changes based on future events. Many of our outsourced manufacturing agreements are linked to future sales forecasts and will vary based on customer demands. Furthermore, we have other cash requirements that are not included in the table. These requirements are related to our normal operations that are not based on "commitments", such as purchases of services on an "as needed" basis, employee compensation, and other items. The most significant factor affecting our future cash flows is our ability to earn and collect cash from our customers.

Contractual obligations

		Payments due in periods			
(in millions)	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt (a)	$ 6,003	$ 1	$ 1,267	$ 291	$ 4,444
Interest on long-term debt	4,338	345	656	503	2,834
Operating leases (b)	1,001	180	237	161	423
Unconditional purchase obligations (c)	856	783	65	8	-
Total (d) (e)	$12,198	$ 1,309	$ 2,225	$ 963	$ 7,701

(a) The long-term debt principle amounts exclude $13 million of fair value basis adjustments and unamortized discounts. Refer to Note 8 to our consolidated financial statements for additional information related to long-term debt and convertible securities, including early redemption features.

(b) The contractual obligations under operating leases exclude approximately $275 million of potential lease obligations that were assigned to Avaya, Agere and other entities for which we remain secondarily liable. The operating lease obligations for facilities reserved under our restructuring program of approximately $240 million are included in the table.

(c) Unconditional purchase obligations include all commitments to purchase goods or services that are noncancelable or would impose a penalty if the agreements were cancelled prior to expiration. In these situations, the amount of the penalty was included in the "Less than 1 Year" column in the table above. Amounts exclude obligations included in accounts payable as of September 30, 2004.

(d) Certain other long-term liabilities of $1.0 billion are excluded in the above table because they do not represent contractual obligations as defined by the SEC's rules. These liabilities are contingencies related to tax, litigation and insurance matters, long-term employee compensation and non-cash items, such as minority interests and deferred income. The estimated future cash payments for these items are expected to be $409 million in 2006 through 2007, $179 million in 2008 through 2009, and $134 million thereafter. Other long-term liabilities related to facility reserves in connection with our restructuring plans are included in the operating leases caption.

(e) Obligations related to pensions, postretirement health and welfare benefits and post-employment benefit obligations are excluded from the table. Refer to Note 9 to our consolidated financial statements and the above discussion for a summary of our expected contributions to these plans.

Other commercial commitments

	Amounts expiring in periods				
(in millions)	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Letters of credit	$ 353	$ 317	$ 26	$ 4	$ 6
Undrawn customer commitments	11	-	1	3	7
Total	$ 364	$ 317	$ 27	$ 7	$ 13

Letters of credit

Letters of credit are obtained to ensure the performance or payment to third parties in accordance with specified terms and conditions. Secured and unsecured outstanding letters of credit were $353 million and $588 million as of September 30, 2004 and 2003, respectively. The estimated fair value of these letters of credit was $8 million and $14 million as of September 30, 2004 and 2003, respectively. On October 1, 2004, we amended and restated our two primary agreements. The first agreement provides for the issuance of up to $215 million of new letters of credit until September 30, 2006. The second agreement permits us to request renewal of $199 million of letters of credit until September 30, 2006. Under these revised agreements, we are no longer required to meet specified levels of quarterly consolidated minimum operating income or to provide cash collateral for letters of credit issued. However, we are required to maintain a minimum amount of unrestricted cash and short-term investments in the U.S. as defined in the agreements.

On October 1, 2004, we also amended our Guarantee and Collateral Agreement and Collateral Sharing Agreement. Under these agreements, certain of our U.S. subsidiaries guaranteed certain of our obligations, and these subsidiaries pledged significant portions of their assets as collateral. These agreements secure certain obligations, including letters of credit, specified hedging arrangements, guarantees to lenders for vendor financing, lines of credit, cash management and other bank operating arrangements. These outstanding obligations amounted to $261 million as of September 30, 2004.

Customer financing commitments

(in millions)	September 30, 2004 Total loans and guarantees	Loans	Guarantees	September 30, 2003 Total loans and guarantees	Loans	Guarantees
Drawn commitments	$ 139	$ 125	$ 14	$ 442	$ 354	$ 88
Available but not drawn	11	3	8	49	6	43
Not available	-	-	-	14	14	-
Total commitments	$ 150	$ 128	$ 22	$ 505	$ 374	$ 131
Reserves	$ 135			$ 415		

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 each individual request for customer financing. 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 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, we remain exposed to the extent of drawn amounts. Our customer financing commitments were reduced during fiscal 2004, 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 3, 2004, are as follows:

Rating Agency	Long-term debt	8% convertible securities	Liability to subsidiary trust issuing preferred securities	Last change
Standard & Poor's (a)	B	CCC+	CCC	March 10, 2004
Moody's (a)	B2	Caa1	Caa1	September 10, 2004
Fitch (a)	B	CCC+	CCC+	July 21, 2004

(a) Ratings outlook is positive.

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 risk from changing exchange rates and interest rates 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 either by forward or option contracts, swap derivatives, or terms embedded into certain contracts that affect the ultimate amount of cash flows under the contract. The gains and losses on these exposures are generally offset by reciprocal changes in the value of the hedging instruments when used because there is a high correlation between the hedging instruments and the underlying exposures. We use derivative financial instruments as risk management tools and not for trading or speculative purposes. Generally, price risk on equity holdings is not hedged.

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 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 or at the corporate level. The corresponding net cash flow exposure is appropriately hedged. To the extent that the forecasted 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, 2004 and 2003 included the euro, Chinese yuan, Japanese yen and British pound. The fair value of foreign exchange contracts is subject to changes in foreign currency exchange rates. For the purpose of assessing this risk, 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, 2004 and 2003, 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 $32 million and $12 million, respectively. 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.

In fiscal 2004 we began using a value-at-risk (“VAR”) model to estimate and monitor our exposure to financial market risks because we believe it to be a better statistical measure of risk. We use the Monte Carlo simulation model to calculate VAR. This model estimates the potential loss in fair value of foreign currency forwards and options over a defined period of time within a certain confidence level by randomly generating different foreign currency exchange rates repeatedly and then applying those exchange rates to our outstanding forwards and options. As a result of our foreign currency VAR calculations, we estimate with 95 percent confidence that the fair value of our foreign currency derivatives would not decline by more than $12 million over a quarterly period. Consistent with the nature of the economic hedge, any changes in the value of the forwards and options would be offset by reciprocal changes in the underlying exposure.

Interest rate risk

We are exposed to various forms of interest rate risk. The fair value of our fixed-rate available-for-sale marketable securities and the interest income earned on our cash and cash equivalents may fluctuate as interest rates change. In addition, if interest rates remain low, we may forgo the opportunity to obtain more favorable interest rates on borrowings due to our fixed rate debt obligations. Our objective is to mitigate the variability of cash inflows and outflows resulting from interest rate fluctuations by maintaining a balanced mix of fixed and floating-rate debt and investments. We mitigate our interest rate risk by entering into interest rate swaps on a portion of our debt obligations to make them variable-rate debt instruments and by including fixed-rate assets in our investment portfolio. We also expect that these transactions will reduce our overall cost of borrowing and increase investment returns.

As of September 30, 2004, we had interest rate swaps where we received fixed interest rates (5.5% and 7.25%) and paid floating rates based upon the three and six-month LIBOR rates plus agreed upon spreads (ranging from 1.72% to 2.89%) on notional amounts aggregating $600 million. As of September 30, 2004, the three and six-month LIBOR rates were 2.02% and 2.20%, respectively. 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 shift in interest rates are as follows:

(in millions)	Fair value as of September 30, 2004	Hypothetical decrease in fair value as of September 30, 2004	Fair value as of September 30, 2003	Hypothetical decrease in fair value as of September 30, 2003
Assets:				
Short-term marketable securities	$ 858	$ 3	$ 686	$ 4
Long-term marketable securities	636	9	-	-
Interest rate swaps	17	10	28	10
Liabilities:				
Long-term debt (including liability to subsidiary trust issuing preferred securities)	6,325	318	4,597	230

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 Note 8 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. The carrying values of our available-for-sale equity securities and privately held securities were $2 million and $75 million as of September 30, 2004, respectively. The carrying values of our available-for-sale equity securities and privately held securities were $5 million and $131 million as of September 30, 2003, 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. An adverse movement in equity prices on our available-for-sale equity securities would not have a material

impact due to their immaterial carrying values as of September 30, 2004 and 2003. An adverse movement in equity prices on 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.

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. Investment impairment charges were $22 million, $63 million and $209 million during fiscal 2004, 2003 and 2002, respectively. Similar charges may be required in the future if declines in the fair value of investments are determined to be other-than-temporary.

We entered into prepaid forward sales agreements for all of our Corning shares during fiscal 2003. As a result, we received proceeds of $113 million and locked in $64 million of unrealized appreciation. This gain was recognized during fiscal 2004.

FIVE-YEAR SUMMARY OF SELECTED FINANCIAL DATA
(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)

	Years ended September 30,				
	2004	2003	2002	2001	2000
RESULTS OF OPERATIONS					
Revenues	$ 9,045	$ 8,470	$ 12,321	$ 21,294	$ 28,904
Business restructuring	(20)	(184)	1,490	7,567	-
Goodwill impairment	-	35	826	3,849	-
Income taxes	(939)	(233)	4,757	(5,734)	924
Income (loss) from continuing operations	2,002	(770)	(11,826)	(14,170)	1,433
Earnings (loss) per common share from continuing operations:					
Basic	0.47	(0.29)	(3.51)	(4.18)	0.44
Diluted	0.42	(0.29)	(3.51)	(4.18)	0.43
Dividends per common share	-	-	-	0.06	0.08
FINANCIAL POSITION					
Cash, cash equivalents and marketable securities	$ 4,873	$ 4,507	$ 4,420	$ 2,390	$ 1,467
Assets	16,963	15,911	17,791	33,664	47,512
Debt	5,990	5,980	5,106	4,409	6,498
8.00% redeemable convertible preferred stock	-	868	1,680	1,834	-
Shareowners' (deficit) equity	(1,379)	(4,239)	(4,734)	11,023	26,172

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 registered public accounting firm, to audit the consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States), 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 REGISTERED PUBLIC ACCOUNTING FIRM

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, changes in shareowners' (deficit) equity and cash flows present fairly, in all material respects, the financial position of Lucent Technologies Inc. and its subsidiaries (the "Company") as of September 30, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2004, 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.



Florham Park, New Jersey
October 20, 2004,
except for Note 7 and the second and eleventh paragraphs of Note 13,
as to which the date is November 9, 2004.

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

	Years ended September 30,		
	2004	2003	2002
Revenues:			
Products	$ 7,113	$ 6,630	$ 9,560
Services	1,932	1,840	2,761
Total revenues	9,045	8,470	12,321
Costs:			
Products	3,824	4,329	8,386
Services	1,442	1,489	2,383
Total costs	5,266	5,818	10,769
Gross margin	3,779	2,652	1,552
Operating expenses:			
Selling, general and administrative	1,296	1,509	3,969
Research and development	1,270	1,488	2,310
In-process research and development	14	-	-
Goodwill impairment	-	35	826
Business restructuring	(20)	(158)	1,426
Total operating expenses	2,560	2,874	8,531
Operating income (loss)	1,219	(222)	(6,979)
Other income (expense), net	240	(428)	292
Interest expense	396	353	382
Income (loss) from continuing operations before income taxes	1,063	(1,003)	(7,069)
Income taxes	(939)	(233)	4,757
Income (loss) from continuing operations	2,002	(770)	(11,826)
Income from discontinued operations	-	-	73
Net income (loss)	2,002	(770)	(11,753)
Conversion and redemption cost – 8% preferred stock	(1)	(287)	(29)
Preferred stock dividends and accretion	12	(103)	(167)
Net income (loss) applicable to common shareowners	$ 2,013	$ (1,160)	$ (11,949)
Income (loss) from continuing operations:			
Basic	$ 0.47	$ (0.29)	$ (3.51)
Diluted	$ 0.42	$ (0.29)	$ (3.51)
Net income (loss) applicable to common shareowners:			
Basic	$ 0.47	$ (0.29)	$ (3.49)
Diluted	$ 0.42	$ (0.29)	$ (3.49)
Weighted average number of common shares outstanding:			
Basic	4,258	3,950	3,427
Diluted	5,313	3,950	3,427

See Notes to Consolidated Financial Statements.

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

	September 30, 2004	September 30, 2003
ASSETS		
Cash and cash equivalents	$ 3,379	$ 3,821
Marketable securities	858	686
Receivables	1,359	1,511
Inventories	822	632
Other current assets	1,813	1,213
Total current assets	8,231	7,863
Marketable securities	636	-
Property, plant and equipment, net	1,376	1,593
Prepaid pension costs	5,358	4,659
Goodwill and other acquired intangibles, net	434	188
Other assets	928	1,608
Total assets	$ 16,963	$ 15,911
LIABILITIES		
Accounts payable	$ 872	$ 1,072
Payroll and benefit-related liabilities	1,232	1,080
Debt maturing within one year	1	389
Other current liabilities	2,361	2,393
Total current liabilities	4,466	4,934
Postretirement and postemployment benefit liabilities	4,881	4,669
Pension liabilities	1,874	2,494
Long-term debt	4,837	4,439
Liability to subsidiary trust issuing preferred securities	1,152	1,152
Other liabilities	1,132	1,594
Total liabilities	18,342	19,282
Commitments and contingencies		
8.00% redeemable convertible preferred stock	-	868
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; 4,396 issued and 4,395 outstanding shares as of September 30, 2004, and 4,170 issued and 4,169 outstanding shares as of September 30, 2003	44	42
Additional paid-in capital	23,005	22,252
Accumulated deficit	(20,793)	(22,795)
Accumulated other comprehensive loss	(3,635)	(3,738)
Total shareowners' deficit	(1,379)	(4,239)
Total liabilities, redeemable convertible preferred stock and shareowners' deficit	$ 16,963	$ 15,911

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	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareowners' (Deficit) Equity
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
Issuance of common stock related to employee benefit plans	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
Issuance of common stock related to employee benefit plans	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)
Net income				2,002		2,002
Minimum pension liability adjustment					150	150
Reclassification adjustment for realized gains on investments					(75)	(75)
Foreign currency translation adjustments					34	34
Unrealized holding losses on investments					(6)	(6)
Comprehensive income						2,105
Issuance of common stock in connection with the exchange of certain debt obligations	22		92			92
Issuance of common stock related to employee benefit plans	93	1	291			292
Issuance of common stock in connection with settlement of shareowner lawsuit	33		105			105
Issuance of common stock related to Telica acquisition	78	1	253			254
Preferred stock dividends and accretion			12			12
Balance as of September 30, 2004	4,395	$ 44	$ 23,005	$ (20,793)	$ (3,635)	$ (1,379)

See Notes to Consolidated Financial Statements.

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

	Years ended September 30, 2004	2003	2002
Operating activities:			
Net income (loss)	$ 2,002	$ (770)	$ (11,753)
Less: Income from discontinued operations	-	-	73
Income (loss) from continuing operations	2,002	(770)	(11,826)
Adjustments to reconcile net income (loss) from continuing operations to net cash provided by (used in) operating activities, net of effects of acquisitions and dispositions of businesses and manufacturing operations:			
Non-cash portion of business restructuring	1	(205)	827
Impairment of goodwill	-	35	826
Depreciation and amortization	693	978	1,470
Provision for (recovery of) bad debts and customer financings	(230)	(223)	1,253
Deferred income taxes	(19)	-	5,268
Pension credit	(1,111)	(1,018)	(1,220)
Gains on sales of businesses	-	(49)	(725)
Other adjustments for non-cash items	79	686	1,240
Changes in operating assets and liabilities:			
Decrease in receivables	200	205	2,493
(Increase) decrease in inventories and contracts in process	(59)	747	2,552
Decrease in accounts payable	(203)	(257)	(539)
Increase (decrease) in deferred revenue	80	(146)	(791)
Changes in other operating assets and liabilities	(799)	(931)	(1,584)
Net cash provided by (used in) operating activities	634	(948)	(756)
Investing activities:			
Capital expenditures	(157)	(291)	(449)
Dispositions of businesses and manufacturing operations	-	9	2,576
Purchases of marketable securities	(2,091)	(684)	(1,518)
Maturities of marketable securities	918	1,529	-
Sales of marketable securities	352	-	-
Proceeds from the sale or disposal of property, plant and equipment	63	158	194
Other investing activities	46	37	(46)
Net cash (used in) provided by investing activities	(869)	758	757
Financing activities:			
Issuance of convertible senior debt	-	1,631	-
Issuance of 7.75% trust preferred securities	-	-	1,750
Repayments of credit facilities	-	-	(1,000)
Net proceeds (repayments) of other short-term borrowings	2	46	(104)
Repayments of long-term debt	(479)	(535)	(47)
Issuance of common stock	276	38	64
Repayments of preferred stock	(21)	(69)	-
Dividends paid on preferred stock	-	(6)	(149)
Other financing activities	(17)	(54)	(46)
Net cash (used in) provided by financing activities	(239)	1,051	468
Effect of exchange rate changes on cash and cash equivalents	32	66	35
Net (decrease) increase in cash and cash equivalents	(442)	927	504
Cash and cash equivalents at beginning of year	3,821	2,894	2,390
Cash and cash equivalents at end of year	$ 3,379	$ 3,821	$ 2,894
Income tax refunds, net	$ 52	$ 109	$ 804
Interest payments	$ 371	$ 336	$ 349

See Notes to Consolidated Financial Statements.