1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Consolidation

The consolidated financial statements include all majority-owned subsidiaries over which we exercise control. Investments where we exercise significant influence but do not control (generally a 20% to 50% ownership interest), are accounted for under the equity method of accounting. All material intercompany transactions and balances have been eliminated. Except as otherwise noted, all amounts and disclosures only include continuing operations.

Use of Estimates

We are required to make estimates and assumptions that affect amounts reported in the financial statements and footnotes. Actual results could be different from 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. Estimates and assumptions are periodically reviewed, and the effects of any material revisions are reflected in the period that they are determined to be necessary.

Foreign Currency Translation and Transactions

Results of operations and cash flows are translated at average exchange rates and assets and liabilities are translated at end-of-period exchange rates for operations outside the United States that prepare financial statements in currencies other than the U.S. dollar. Translation adjustments are included as a separate component of accumulated other comprehensive income (loss) in shareowners' deficit. Gains and losses from foreign currency transactions are reflected in other income (expense), net.

Revenue Recognition

Revenue is recognized when persuasive evidence of an agreement exists, delivery has occurred, the amount is fixed or determinable, and collection of the resulting receivable, including receivables of customers to which we have provided customer financing, is probable.

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. Revenue is generally recognized when title passes to the customer, which usually is upon delivery of the equipment, provided our installation requirements are expected to be completed within 90 days from equipment delivery and all other revenue recognition criteria is met. Revenue is generally recognized for products sold through multiple distribution channels when the reseller or distributor sells the product to the end user. Services revenue is generally recognized at the time of performance.

We apply software revenue recognition rules when we sell software on a standalone basis, or when software is embedded with our hardware and the software is considered more than incidental. We determine that software is more than incidental when it is apparent that it is a significant factor in the customer's purchasing decision such as when a transaction also includes software upgrades or enhancements. In multiple element arrangements where software is considered more than incidental, fair

value of an undelivered element is determined using vendor specific objective evidence (VSOE). If VSOE cannot be determined or any undelivered element is essential to the functionality of the delivered element, revenue is deferred until such criteria are met or until the last element is delivered.

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. The units-of-delivery method or units-of-work performed method is used to measure progress on each contract. Revenue and cost estimates are revised periodically based on changes in circumstances. Any expected losses on contracts are recognized immediately upon contract signing or as soon thereafter as identified.

The assessment of collectibility is critical in determining whether revenue should be recognized. As part of the revenue recognition process, we determine whether trade and notes receivables are reasonably assured of collection based on various factors. 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.

Research and Development and Software Development Costs

Research and development costs are charged to expense as incurred. However, the direct labor and related overhead costs incurred for the development of computer software that will be sold ("marketed software") are capitalized when technological feasibility is established. Technological feasibility is established upon completion of all of the planning, designing, coding and testing activities that are necessary in order to establish that the product can be produced to meet its design specifications, including functions, features and technical performance requirements. These capitalized costs are subject to an ongoing assessment of recoverability based on anticipated future revenues and changes in hardware and software technologies.

Capitalization ceases and amortization of marketed software development costs begins when the product is available for general release to customers. Amortization is recognized as costs included in our gross margin on a product-by-product basis, generally using the straight-line method over a 12 to 18-month period. Unamortized marketed software development costs determined to be in excess of the net realizable value of the product are charged to Research and Development expense prior to the general release to the customer, or to Costs thereafter.

Internal Use Software

Direct labor and related overhead costs incurred during the application development stage and the implementation stage for developing, purchasing or otherwise acquiring software for internal use are capitalized. These costs are amortized over the estimated useful lives of the software, generally three years. Costs incurred during the preliminary project stage are expensed as incurred.

Stock-Based Compensation

We follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", for our stock-based compensation plans and do not recognize expense for stock option grants if the exercise price is at least equal to the market value of the common stock at the date of grant. Stock-based compensation expense reflected in the as reported net income (loss) includes expense for restricted stock unit awards and option modifications and the amortization of certain acquisition-related deferred compensation expense.

In accordance with Statement of Financial Accounting Standards ("SFAS") 123, "Accounting for Stock-Based Compensation", as amended by SFAS 148, the following table summarizes the pro forma effect of stock-based compensation as if the fair value method of accounting for stock options had been applied in measuring compensation cost. No tax benefits were attributed to the stock-based employee compensation expense during fiscal 2004 and 2003 because we maintained a valuation allowance on substantially all of our net deferred tax assets.

(in millions, except per share amounts)	Years ended September 30, 2004	2003	2002
Net income (loss), as reported	$ 2,002	$ (770)	$ (11,753)
Add: Stock-based employee compensation expense included in as reported net income (loss), including tax expense of $13 during fiscal 2002	16	17	50
Deduct: Total stock-based employee compensation expense determined under the fair value based method, including tax expense of $1,408 during fiscal 2002	(338)	(285)	(2,562)
Pro forma net income (loss)	$ 1,680	$ (1,038)	$ (14,265)
Income (loss) per share applicable to common shareowners:			
Basic – as reported	$ 0.47	$ (0.29)	$ (3.49)
Diluted – as reported	0.42	(0.29)	(3.49)
Basic – pro forma	0.40	(0.36)	(4.22)
Diluted – pro forma	0.36	(0.36)	(4.22)

The fair value of stock options used to compute the pro forma disclosures is estimated using the Black-Scholes option-pricing model. This model requires the input of subjective assumptions, including the expected price volatility of the underlying stock. Projected data related to the expected volatility and expected life of stock options is based upon historical and other information. Changes in these subjective assumptions can materially affect the fair value estimates. The following table summarizes the assumptions used to compute the weighted average fair value of stock option grants.

	2004	2003	2002
Dividend yield	0.0%	0.0%	0.0%
Expected volatility	90.2%	95.1%	78.9%
Risk-free interest rate	2.6%	2.2%	3.6%
Expected holding period (in years)	3.2	3.0	2.5
Weighted average fair value of options granted	$ 1.83	$ 0.87	$ 2.11

Refer to Note 10 for further information regarding our stock-based compensation plans.

Cash and Cash Equivalents

All highly liquid investments with original maturities of three months or less are considered cash equivalents. These primarily consist of money market funds and to a lesser extent, certificates of deposit and commercial paper. Cash held as collateral or escrowed for contingent liabilities is included in other current and non-current assets based on the expected release of the underlying obligation.

Marketable Securities

Our marketable securities consist of debt securities that are designated as available-for-sale and recorded at fair value. Unrealized holding gains or losses are reported as a component of accumulated other comprehensive income (loss). Realized gains or losses resulting from the sale of these securities are determined based on the specific identification of the securities sold. Marketable securities with maturities greater than three months and less than one year are classified as short-term, otherwise they are classified as long-term.

An impairment charge is recognized when the decline in the fair value of a security below the amortized cost basis is determined to be other-than-temporary. We consider various factors in determining whether to recognize an impairment charge, including the duration of time and the severity to which the fair value has been less than our amortized cost basis, any adverse changes in the investees' financial condition and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Inventories

Inventories are stated at the lower of standard cost (which approximates cost determined on a first-in, first-out basis) or market. Excess and obsolete inventory reserves are generally determined by future demand forecasts. Inventories associated with deferred revenue and where title and risk of loss was transferred to the customer were $166 million and $158 million as of September 30, 2004 and 2003, respectively.

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is determined using accelerated and straight-line methods over the estimated useful lives of the various asset classes. Useful lives for buildings and building improvements, furniture and fixtures, and machinery and equipment principally range from five to fifty years, five to ten years and two to ten years, respectively.

Acquisition costs and substantial improvements to property, plant and equipment are capitalized. The cost of normal maintenance and repairs are expensed as incurred.

Goodwill and Other Intangible Assets

We adopted SFAS 142, "Goodwill and Other Intangible Assets", in the first quarter of fiscal 2003. As a result, goodwill is no longer amortized but is tested for impairment in the fourth quarter of each fiscal year or more often if an event or circumstance indicates that an impairment loss has been incurred. An impairment charge is recognized if a reporting unit's goodwill carrying amount exceeds its implied fair value. We experienced no transitional impairment loss upon adoption of SFAS 142. Prior to adoption, goodwill and identifiable intangible assets were amortized on a straight-line basis over their estimated useful lives. Other acquired intangible assets continue to be amortized on a straight-line basis over the periods benefited, primarily over four years. The following table summarizes the changes in the carrying value of goodwill and other acquired intangible assets.

	Goodwill					Other Acquired Intangible
(in millions)	INS	Mobility	Services	Other	Total	Assets
As of September 30, 2002	$ 151	$ 11	$ 38	$ 9	$ 209	$ 15
Acquisition/contingencies	5	5	-	-	10	3
Impairment/amortization	(35)	-	-	-	(35)	(15)
Other	10	-	-	(9)	1	-
As of September 30, 2003	131	16	38	-	185	3
Acquisition/contingencies	127	11	53	-	191	60
Impairment/amortization	-	-	-	-	-	(3)
Other	(1)	(2)	-	-	(3)	1
As of September 30, 2004	$ 257	$ 25	$ 91	$ -	$ 373	$ 61

Other acquired intangible assets were net of accumulated amortization of $48 million and $45 million as of September 30, 2004 and 2003, respectively. The following table presents the net loss for fiscal 2002, adjusted to exclude goodwill amortization of $208 million.

(in millions, except per share amounts)	Year ended September 30, 2002
Net loss:	
As reported	$ (11,753)
Adjusted	(11,545)
Basic and diluted loss per share:	
As reported	$ (3.49)
Adjusted	(3.43)

The following table summarizes the estimated future amortization expense of other acquired intangible assets.

(in millions) Fiscal Year:	Amount
2005	$ 16
2006	16
2007	15
2008	14
Total	$ 61

Impairment of Other Long-Lived Assets

Other long-lived assets, including property, plant and equipment, capitalized software and other acquired 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. An impairment loss is recognized when the carrying amount of a long-lived asset exceeds the sum of the undiscounted cash flows expected to result from the asset's use and eventual disposition. An impairment loss is measured as the amount by which the carrying amount exceeds its fair value, which is typically calculated using discounted expected future cash flows. The discount rate applied to these cash flows is based on our weighted average cost of capital, which represents the blended after-tax costs of debt and equity.

Reclassifications

Certain amounts have been reclassified to conform to our current period presentation.

2. BUSINESS RESTRUCTURING

During the second quarter of fiscal 2001, we committed to and began implementing a restructuring program to realign resources to focus on the large telecommunications service provider market. 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.

All reportable segments, sales and marketing, and general corporate functions participated in these actions, however the charges or subsequent reversals to the reserves were excluded from their results and were reported separately. The following table summarizes the net charges or reversals under our restructuring program.

	Years ended September 30,			
	2004	2003	2002	2001
(in millions)				
Restructuring costs	$ (20)	$ (64)	$ 1,023	$ 4,767
Asset write-downs	1	(120)	458	2,800
Business dispositions	(1)	-	(140)	-
Impairment of goodwill and other acquired intangible assets	-	35	975	3,849
Net charges (reversals)	$ (20)	$ (149)	$ 2,316	$ 11,416
Reflected in:				
Costs	$ -	$ (26)	$ 64	$ 1,259
Operating expenses	(20)	(158)	1,426	6,308
Impairment of goodwill	-	35	826	3,849
Net charges (reversals)	$ (20)	$ (149)	$ 2,316	$ 11,416

Restructuring Costs

Restructuring costs consisted of employee separations of $3.4 billion, contract settlements of $944 million, facility closings of $304 million, and other charges of $79 million during fiscal 2001. The following table summarizes the components of restructuring costs and related reserve activity.

	Employee Separations	Contract Settlements	Facility Closings	Other	Total
(in millions)					
Restructuring reserve as of September 30, 2001	$ 588	$ 610	$ 296	$ 125	$ 1,619
Charges related to current year plans	944	90	210	34	1,278
Charges related to prior year plans	5	18	116	2	141
Reversals related to prior year plans	(150)	(201)	(25)	(20)	(396)
Total restructuring costs for fiscal 2002	799	(93)	301	16	1,023
Utilization of reserves	(1,020)	(367)	(114)	(72)	(1,573)
Restructuring reserve as of September 30, 2002	367	150	483	69	1,069
Charges related to current year plans	18	17	-	1	36
Charges related to prior year plans	163	27	54	5	249
Reversals related to prior year plans	(228)	(60)	(37)	(24)	(349)
Total restructuring costs for fiscal 2003	(47)	(16)	17	(18)	(64)
Utilization of reserves	(258)	(100)	(133)	(47)	(538)
Restructuring reserve as of September 30, 2003	62	34	367	4	467
Charges related to prior year plans	-	-	44	-	44
Reversals related to prior year plans	(14)	(15)	(32)	(3)	(64)
Total restructuring costs for fiscal 2004	(14)	(15)	12	(3)	(20)
Utilization of reserves	(38)	(11)	(177)	(1)	(227)
Restructuring reserve as of September 30, 2004	$ 10	$ 8	$ 202	$ -	$ 220

Employee Separations

There were approximately 53,600 voluntary and involuntary employee separations associated with employee separation charges from fiscal 2001 through fiscal 2003. Substantially all of the employee separations were completed as of September 30, 2003. The employee separations affected all business groups and geographic regions. Management represented approximately 70% of the total employee separations. In addition, involuntary separations represented approximately 70% of the total employee separations.

The fiscal 2003 charges for new plans were for approximately 200 employee separations associated with the discontinuance of the TMX Multi-Service Switching and Spring Tide product lines in the INS segment. The fiscal 2002 charges for new plans were for approximately 17,300 employee separations and included charges for pension termination benefits for certain former U.S. employees funded through our pension assets, pension and postretirement curtailment charges and postemployment benefit curtailment credits.

The fiscal 2004 and 2003 revisions to prior year plans were due to actual termination benefits and curtailment costs being lower than the estimated amounts as a result of certain differences in assumed demographics, including the age, service lives and salaries of the separated employees. Fiscal 2003 also included a reversal of approximately 900 employee separations due to higher than expected attrition rates. Components of the fiscal 2003 net reversal included non-cash reversals for pension and postretirement termination benefits to certain former U.S. employees funded through our pension assets, and pension, postretirement and postemployment benefit curtailments. The fiscal 2002 revisions to prior year plans were due to higher than expected attrition rates that resulted in a reduction of 2,200 expected employee terminations. Also, the actual severance cost per person was lower than the original estimates after execution of the various plans in many countries.

Contract Settlements

Contract settlement charges were primarily incurred for settlements of purchase commitments with suppliers and contract renegotiations or cancellations of contracts with customers, all of which resulted from the discontinuance of various product lines. Revisions to prior year plans were due primarily to the negotiated settlement of obligations and commitments for amounts lower than originally estimated.

Facility Closings

The planned exit of certain owned and leased facilities consisting of approximately 15.9 million square feet were included in the restructuring program. All of these sites were exited as of September 30, 2003. Charges were recognized for the expected remaining future cash outlays associated with trailing lease liabilities, lease termination payments and expected restoration costs in connection with the plans. The trailing lease liabilities were reduced by expected sublease rental income.

Revisions to prior year plans were due to the impact of changes in estimated facility closing costs, including additional space consolidation, expected sublease rental income on certain properties resulting from changes in the commercial real estate market and early termination of certain lease obligations.

The facility closings charges were net of expected sublease rental income of $136 million and $241 million during fiscal 2002 and 2001, respectively. This expected sublease rental income was subsequently reduced by $105 million, $55 million and $63 million during fiscal 2004, 2003 and 2002, respectively. The remaining reserve as of September 30, 2004 of $202 million is expected to be paid over the remaining lease terms ranging from several months to 11 years and is reflected net of expected sublease income of $137 million. We have received commitments for approximately $30 million of this expected sublease rental income as of September 30, 2004. Additional charges may be required in the future if the expected sublease income is not realized.

Utilization of business restructuring reserves

(in millions)	Years ended September 30, 2004	2003	2002
Cash payments	$ (227)	$ (629)	$ (1,022)
Net pension and postretirement termination benefits to certain former U.S. employees to be funded through our pension assets	-	33	(205)
Net pension and postretirement benefit curtailments	-	44	(337)
Net postemployment benefit curtailments	-	41	34
Other	-	(27)	(43)
Utilization of reserves	$ (227)	$ (538)	$ (1,573)

Asset write-downs

The following table summarizes the components of asset write-downs.

(in millions)	Inventory	Property, plant and equipment	Capitalized software	Other	Total
Fiscal 2001 asset write-downs	$ 1,259	$ 425	$ 362	$ 754	$ 2,800
Charges related to current year plans	$ 129	$ 304	$ 72	$ 31	$ 536
Charges related to prior year plans	97	51	-	-	148
Reversals related to prior year plans	(162)	(35)	-	(29)	(226)
Fiscal 2002 asset write-downs	$ 64	$ 320	$ 72	$ 2	$ 458
Charges related to current year plans	$ 3	$ 2	$ -	$ -	$ 5
Charges related to prior year plans	26	24	-	-	50
Reversals related to prior year plans	(55)	(113)	-	(7)	(175)
Fiscal 2003 asset write-downs	$ (26)	$ (87)	$ -	$ (7)	$ (120)
Fiscal 2004 asset write-downs	$ -	$ -	$ -	$ 1	$ 1

Significant asset write-downs were required as a result of our restructuring actions, including the elimination of product lines, the sale or lease of certain manufacturing operations, the exit of certain facilities and the elimination of certain management positions. The realizability of each asset affected by the restructuring actions was assessed and written down to a new cost basis if required, based on estimated future cash flows.

Inventory charges included an estimate of amounts related to products rationalized or discontinued that were not required to fulfill existing customer obligations. Additional inventory charges or reserve reductions were recognized if the fulfillment of those customer obligations were different from amounts estimated. In addition, reversals related to property, plant and equipment were recognized due to changes in the original plans for certain owned facility closings.

Business dispositions

The fiscal 2002 net gain of $140 million related to business dispositions contemplated as part of our overall restructuring program, including a $188 million gain related to the sale of the billing and customer care business and a $38 million loss related to the sale of the enterprise professional services business.

Impairment of goodwill and other acquired intangible assets

Business decisions during fiscal 2003 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 the INS segment. 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 goodwill's carrying value over its implied fair value was recognized as an impairment charge in the amount of $35 million.

The continued and sharper decline in the telecommunications market prompted an assessment during fiscal 2002 of all key assumptions underlying goodwill valuation judgments, including those relating to short- and long-term growth rates. It was determined that the carrying amounts of goodwill and other intangible assets, primarily related to the September 2000 acquisition of Spring Tide, were greater than the forecasted undiscounted cash flows. As a result, impairment charges of $826 million for goodwill and $149 million for other acquired intangibles were recognized based on the difference between the estimated fair values and corresponding carrying amounts. Fair values were determined on the basis of discounted cash flows.

3. BUSINESS ACQUISITIONS AND DIVESTITURES

Acquisitions

On August 20, 2004, we acquired 100 percent of the outstanding equity of Telica. Telica provides VoIP communications switching equipment that enables service providers to deliver enhanced and traditional voice services over Internet Protocol and legacy networks. The operating results of Telica were included in our consolidated results since the date of acquisition. Pro forma results were not presented because the effect of the acquisition was not material.

The aggregate purchase price of $262 million included approximately 80 million shares of our common stock valued at $258 million and options to purchase shares of our common stock. The value of the common shares was determined based on the average market price of our common shares over the 2-day period before and after the date of the acquisition agreement. The purchase price includes $9 million that was recognized as a current liability because certain Telica shares were not presented for exchange as of September 30, 2004. An additional nine million shares of our common stock, valued at $29 million, is held in an escrow account for potential general indemnification matters through February 2006. Goodwill will be increased if these common shares are released.

In addition to the consideration referenced above, a $7 million cash bonus was paid to Telica's employees. An additional $7 million cash bonus will be provided to employees if certain product development milestones are achieved during the next two years. We have begun to accrue this cost over the milestone period because we expect that they will be achieved.

The purchase price in excess of the estimated fair value of tangible assets acquired was allocated to goodwill ($178 million), identifiable intangible assets ($60 million) and in-process research and development (IPR&D) ($14 million). The identifiable intangible assets were attributed to developed technology that is amortized over its expected useful life of four years. IPR&D represents technology that has not reached technological feasibility and has no alternate future use. The value allocated to IPR&D was determined using an income approach that included an excess earnings analysis reflecting the appropriate cost of capital for each project. These estimated future cash flows considered estimates of revenue, gross margin, operating expenses and income taxes and were consistent with historical pricing, cost and expense levels for similar products. A 33% discount rate was utilized to discount the cash flows based on consideration of our weighted average cost of capital, as well as other factors including the estimated useful life of each project, the anticipated profitability of each project, the uncertainty of technology advances that were known at the time and the stage of completion of each project.

On February 3, 2003, we purchased the remaining 10% minority interest in AG Communications Systems Corporation for $23 million. This transaction resulted in $3 million of goodwill and $3 million of other acquired intangible assets that related to developed technology.

Dispositions

On September 30, 2002, we sold two of our China-based joint ventures to Corning Incorporated. These joint ventures were part of the optical fiber solutions business ("OFS"). The total purchase price of $200 million included a cash payment of $123 million, shares of Corning common stock valued at $50 million and a note receivable of $27 million. The note receivable was collected during fiscal 2003. A gain of $100 million was recognized and included in other income during fiscal 2002.

On May 31, 2002, we sold certain manufacturing equipment and inventory for $96 million and commenced a three-year supply agreement with Solectron Corporation for certain optical networking products. Due to continuing market uncertainties, we terminated the agreements, purchased certain assets back from Solectron and paid $50 million to Solectron in November 2002. The contract manufacturing work for the optical networking products was transitioned to other suppliers during the first half of fiscal 2003. These events did not significantly impact our results of operations.

On February 28, 2002, we sold our billing and customer care business to CSG Systems International, Inc. for $250 million. After the settlement of certain post-closing purchase price adjustments, a gain of $188 million was recognized and included in business restructuring during fiscal 2002.

On November 16, 2001, we sold OFS to The Furukawa Electric Co., Ltd. for approximately $2.3 billion, including shares of CommScope, Inc.'s common stock valued at $173 million. A gain of $564 million was recognized and included in other income during fiscal 2002. The favorable resolution of certain contingencies resulted in an additional gain of $41 million during fiscal 2003.

Discontinued Operations

On June 1, 2002, we completed the spin-off of Agere Systems Inc. ("Agere"), our former microelectronics business, by distributing our 57.8% interest in Agere common stock, consisting of 37.0 million shares of Agere Class A common stock and 908.1 million shares of Agere Class B common stock, to our common shareowners of record on May 3, 2002. Each of our shareowners received one share of Agere Class A common stock for every 92.768991 shares of our common stock held and one share of Agere Class B common stock for every 3.779818 shares of our common stock held. The historical carrying amount of the net assets transferred to Agere of approximately $1.2 billion was charged to shareowners' deficit during fiscal 2002. Our results of operations included $73 million of income on disposal of Agere, including tax expense of $34 million during fiscal 2002. This income included subsequent adjustments to the related loss reserve for our share of Agere's net losses from the initial measurement date through the spin-off date, including pension termination benefit charges of $102 million related to business restructuring actions taken by Agere prior to the spin-off.

During fiscal 2002 and through the spin-off date, Agere's net cash used by operating activities was $521 million, net cash provided by investing activities was $279 million and net cash used by financing activities was $1.7 billion.

4. SUPPLEMENTARY FINANCIAL INFORMATION

(in millions)	Years ended September 30, 2004	2003	2002
Supplementary Statement of Operations Information:			
Depreciation of property, plant and equipment	$ 284	$ 559	$ 718
Amortization of software development costs	376	393	469
Amortization of other acquired intangible assets	3	15	42
Amortization of goodwill	-	-	208
Other amortization	30	11	33
Depreciation and amortization	$ 693	$ 978	$ 1,470
Legal settlements	$ (84)	$ (401)	$ (212)
SEC settlement	(25)	-	-
Debt conversion cost and gain on extinguishments, net	(7)	(97)	-
Gain on sale 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

(in millions)	September 30, 2004	2003
Supplementary Balance Sheet Information:		
Completed goods	$ 604	$ 465
Work in process	49	43
Raw materials	169	124
Inventories	$ 822	$ 632
Contracts in process, gross	$ 3,696	$ 7,053
Less: progress billings	3,798	7,020
Contracts in process	$ (102)	$ 33
Costs and recognized income not yet billed	$ 106	$ 251
Billings in excess of costs and recognized income	(208)	(218)
Contracts in process	$ (102)	$ 33
Retainage receivables (included in other assets)	$ 16	$ 207
Land and improvements	$ 76	$ 86
Buildings and improvements	1,505	1,645
Machinery, electronic and other equipment	2,223	2,350
Property, plant and equipment, gross	3,804	4,081
Less: accumulated depreciation	2,428	2,488
Property, plant and equipment, net	$ 1,376	$ 1,593
Income tax receivables, including related interest	$ 868	$ 134
Non-trade receivables	360	198
Deferred income taxes	197	146
Prepaid expenses	187	217
Restricted cash	148	140
Forward contracts receivable	24	322
Contracts in process	-	33
Other	29	23
Other current assets	$ 1,813	$ 1,213

	September 30, 2004	2003
Marketed software	$ 284	$ 323
Internal use software	142	183
Restricted cash	125	116
Non-trade receivables	78	582
Investments	77	136
Other	222	268
Other assets	$ 928	$ 1,608
Deferred revenue	$ 593	$ 507
Shareholder lawsuit settlement	572	481
Warranty reserve	221	244
Contracts in process	102	-
Restructuring	88	115
Other	785	1,046
Other current liabilities	$ 2,361	$ 2,393
Deferred income taxes	$ 178	$ 146
Deferred compensation	155	90
Restructuring	122	290
Environmental	83	93
Warranty	76	86
Minority interests	35	58
Other, including contingencies	483	831
Other liabilities	$ 1,132	$ 1,594

(in millions)	Years ended September 30, 2004	2003	2002
Valuation and Qualifying Accounts			
Allowance for uncollectible accounts receivable:			
Allowance at beginning of year	$ 246	$ 325	$ 634
Provision for (recovery of) bad debts	(42)	(67)	488
Transfers to (from) other accounts	7	134	-
Write-offs	(101)	(146)	(797)
Allowance at end of year	$ 110	$ 246	$ 325
Inventory valuation reserves:			
Reserve at beginning of year	$ 980	$ 1,490	$ 1,814
Charged to costs	17	56	621
Transfers to (from) other accounts	(26)	109	334
Write-offs	(251)	(675)	(1,279)
Reserve at end of year	$ 720	$ 980	$ 1,490

5. EARNINGS (LOSS) PER COMMON SHARE

Basic EPS is calculated by dividing the net income (loss) applicable to common shareowners by the weighted average number of common shares outstanding during the period. Diluted EPS is calculated by dividing net income (loss) applicable to common shareowners, adjusted to exclude preferred dividends and accretion, conversion costs, redemption costs and interest expense related to the potentially dilutive securities, by the weighted average number of common shares outstanding during the period, plus any additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period.

The following table summarizes the computation of basic and diluted EPS. Due to the net loss incurred in fiscal 2003 and 2002, the diluted loss per share was the same as basic because any potentially dilutive securities would have reduced the loss per share.

(in millions, except per share amounts)	Years ended September 30, 2004	2003	2002
Net income (loss)	$ 2,002	$ (770)	$ (11,753)
Conversion and redemption cost – 8.00% convertible securities	(1)	(287)	(29)
Preferred stock dividends and accretion	12	(103)	(167)
Net income (loss) applicable to common shareowners – basic	2,013	(1,160)	(11,949)
Adjustment for dilutive securities on net income (loss):			
Interest expense related to convertible securities	200	-	-
Net income (loss) applicable to common shareowners – diluted	$ 2,213	$ (1,160)	$ (11,949)
Weighted average shares outstanding – basic	4,258	3,950	3,427
Effect of dilutive securities:			
Stock options	72	-	-
2.75% convertible securities	496	-	-
8.00% convertible securities	249	-	-
7.75% convertible securities	238	-	-
Weighted average shares outstanding – diluted	5,313	3,950	3,427
EPS:			
Basic	$ 0.47	$(0.29)	$(3.49)
Diluted	0.42	(0.29)	(3.49)

The loss from continuing operations applicable to common shareowners was approximately $12.0 billion or $3.51 per share during fiscal 2002. Income from discontinued operations was $73 million or $0.02 per share during fiscal 2002.

The following table summarizes the potential shares of common stock that were excluded from the diluted per share calculation, because the effect of including these potential shares was antidilutive.

(in millions)	Years ended September 30, 2004	2003	2002
8% convertible securities	3	685	519
7.75% convertible securities	-	273	193
2.75% convertible securities	-	326	-
Stock options	-	14	4
Other	-	-	2
Potentially dilutive shares	3	1,298	718
Stock options excluded from the diluted per share calculation because the exercise price was greater than the average market price of the common shares	252	300	471

The calculation of dilutive or potentially dilutive common shares related to our convertible securities considers the conversion features or redemption features, whichever is more dilutive. Redemption features are only considered if we have the right to settle redemption requests through the issuance of our common stock as in the case of our 2.75% and 8.00% convertible securities. In this case, the "if redeemed" calculations are based upon the 12-month average price of our common stock and the weighted average number of the respective securities outstanding during the periods presented. The conversion features related to our 2.75% convertible securities are only considered if certain conditions are met, otherwise the “if redeemed” calculations are used. The dilutive effect of our convertible securities may fluctuate from period to period as a result of the as reported net income levels and the average market price of our common stock.

In September 2004, the FASB’s Emerging Issues Task Force (EITF) finalized EITF Issue No. 04-8, “The Effect of Contingently Convertible Instruments on Diluted Earnings per Share”. As a result, beginning in the first quarter of fiscal 2005, the conversion features related to our 2.75% convertible securities will

always be considered in the diluted EPS calculation and will be used unless the "if redeemed" calculation is more dilutive. The impact of EITF 04-8 is not expected to materially effect our future diluted EPS calculations and would not have changed our quarterly and annual fiscal 2004 diluted EPS.

6. ACCUMULATED OTHER COMPREHENSIVE LOSS

The components of accumulated other comprehensive loss are summarized below. Foreign currency translation adjustments are generally not adjusted for income taxes as they relate to indefinite investments in non-U.S. subsidiaries.

(in millions)	Foreign currency translation adjustment	Change in net unrealized holding gains / losses on investments	Minimum pension liability adjustment	Total accumulated other comprehensive loss
Balance as of October 1, 2001	$ (467)	$ 40	$ (14)	$ (441)
Current-period change	60	(36)	(2,927)	(2,903)
Amounts transferred to Agere	(6)	-	-	(6)
Balance as of September 30, 2002	(413)	4	(2,941)	(3,350)
Current-period change	135	71	(594)	(388)
Balance as of September 30, 2003	(278)	75	(3,535)	(3,738)
Current-period change	34	(81)	150	103
Balance as of September 30, 2004	$ (244)	$ (6)	$ (3,385)	$ (3,635)

7. INCOME TAXES

The following table summarizes the U.S. and non-U.S. components of income (loss) from continuing operations before income taxes and the provision (benefit) for income taxes.

	Years ended September 30,		
(in millions)	2004	2003	2002
Income (loss) from continuing operations before income taxes:			
U.S.	$ 985	$ (1,048)	$ (7,076)
Non-U.S.	78	45	7
Income (loss) from continuing operations before income taxes	$ 1,063	$ (1,003)	$ (7,069)
Provision (benefit) for income taxes:			
Current:			
Federal	$ (967)	$ (309)	$ (611)
State and local	(10)	4	-
Non-U.S.	57	72	100
Subtotal	(920)	(233)	(511)
Deferred:			
Federal	-	-	4,242
State and local	-	-	837
Non-U.S.	(19)	-	189
Subtotal	(19)	-	5,268
Provision (benefit) for income taxes	$ (939)	$ (233)	$ 4,757

The following table summarizes the principal reasons for the difference between the effective tax (benefit) rate on continuing operations and the U.S. federal statutory income tax (benefit) rate.

	Years ended September 30,		
	2004	2003	2002
U.S. federal statutory income tax (benefit) rate	35.0%	(35.0)%	(35.0)%
State and local income tax (benefit) rate, net of federal income tax effect	3.1	(3.6)	(3.3)
Foreign earnings taxed at different rates	(2.3)	8.4	0.2
Research credits	-	(0.9)	(0.7)
IPR&D, goodwill amortization and impairments	0.5	1.2	5.0
Disposition of OFS business	-	-	(7.3)
Conversions of 7.75% trust preferred securities	-	4.5	-
Tax audit-related adjustments	(13.4)	(7.7)	(1.2)
Other differences, net	0.5	(3.0)	(1.7)
Change in valuation allowance	(111.8)	12.9	111.3
Effective income tax (benefit) rate	(88.4)%	(23.2)%	67.3%

The following table summarizes the change in the valuation allowance.

	September 30,		
(in millions)	2004	2003	2002
Valuation allowance at beginning of year	$ 9,934	$ 9,989	$ 742
Charged (credited) to expense	(1,188)	129	7,868
Charged (credited) to other comprehensive loss	(29)	205	1,472
Write-off of carryforwards	(756)	(389)	(93)
Acquisitions and other	(21)	-	-
Valuation allowance at end of year	$ 7,940	$ 9,934	$ 9,989

The following table summarizes the components of deferred income tax assets and liabilities.

	September 30,	
(in millions)	2004	2003
Bad debt and customer financing reserves	$ 98	$ 259
Inventory reserves	216	304
Business restructuring reserves	86	183
Other operating reserves	479	541
Postretirement and other benefits	2,358	2,149
Net operating loss/credit carryforwards	6,053	6,882
Other	223	748
Valuation allowance	(7,940)	(9,934)
Deferred tax assets	$ 1,573	$ 1,132
Pension	$ 1,367	$ 842
Other	187	290
Deferred tax liabilities	$ 1,554	$ 1,132
Net deferred tax assets	$ 19	$ -
Included in:		
Other current assets	$ 197	$ 146
Other liabilities	178	146
Total	$ 19	$ -

The following table summarizes carryforwards of losses (tax-effected) and tax credits.

(in millions)	Amount	Expiration
Federal net operating losses	$ 2,881	2022 to 2024
State net operating losses	792	2006 to 2024
Capital losses	430	2007 to 2008
Foreign net operating losses/credits	495	2005 to indefinite
Foreign tax credits	252	2010
Research credits	958	2017 to 2022
State credits (various)	245	2007 to 2018
Total as of September 30, 2004	$ 6,053	

The write-off of carryforwards includes the impact of the expiration of certain net operating loss and tax credit carryforwards, the repatriation of non-U.S. earnings to the U.S. and audit-related and other adjustments that reduced the net operating loss carryforwards during the respective 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. A review of all available positive and negative evidence needs to be considered, including a company's current and past performance, the market environment in which the company operates, the utilization of past tax credits, length of carryback and carryforward periods and existing contracts or sales backlog that will result in future profits.

Forming a conclusion that a valuation allowance is not needed is difficult when there is negative objective evidence such as cumulative losses in recent years. Cumulative losses weigh heavily in the overall assessment. We determine cumulative losses on a rolling twelve-quarter basis. Accordingly, as of June 30, 2002, we concluded that it was appropriate to establish a full valuation allowance for our net deferred tax assets. Subsequent to June 30, 2002, we have maintained a valuation allowance on substantially all of our net deferred tax assets. We expect to continue to maintain a full valuation allowance until an appropriate level of profitability is sustained or we are able to develop tax strategies that would enable us to conclude that it is more likely than not that a portion of our deferred tax assets would be realizable.

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 due to the realization of deferred tax assets 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.

During fiscal year 2004, $908 million of undistributed earnings of various non-U.S. subsidiaries were repatriated to the U.S. The income taxes on these distributions are not expected to be significant as a result of our U.S. net operating loss carryforwards and valuation allowance. These tax efficient one time distributions were made to reset the operating cash needs in certain foreign jurisdictions and reflect recent changes in our business and business model as well as various other contributing factors. We have not provided for U.S. deferred income taxes or foreign withholding taxes on the remaining

undistributed earnings of $1.9 billion of our non-U.S. subsidiaries since these earnings are intended to be reinvested indefinitely. As a result of our U.S. net operating loss carryforwards and valuation allowance, the amount of additional taxes that might be payable on such undistributed earnings is not expected to be significant. However, if significant changes to our net operating loss carryforwards and valuation allowance occur in the future, the amount of additional taxes on undistributed earnings could be significant. As a result, it is not practical to estimate the amount of additional taxes that might be payable on such undistributed earnings.

We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we may record incremental tax expense based upon the probable outcomes of such matters. In addition, we adjust the previously reported tax expense to reflect the expected results of these examinations. The net income tax benefit recognized as a result of the expected favorable resolution of certain tax audit matters were $142 million, $77 million and $82 million during fiscal 2004, 2003 and 2002, respectively.

8. DEBT OBLIGATIONS AND EARLY EXTINGUISHMENT OF DEBT

The following table summarizes components of long-term debt obligations.

(in millions)	September 30, 2004	2003
Variable interest notes due November 21, 2007 (5.75% as of September 30, 2003)	$ -	$ 216
7.25% notes due July 15, 2006	450	561
11.755% notes due July 1, 2006	-	34
8% convertible securities redeemable on August 2, 2007	817	-
5.50% notes due November 15, 2008	291	409
2.75% Series A debentures due June 15, 2023	750	750
2.75% Series B debentures due June 15, 2025	881	881
6.50% debentures due January 15, 2028	300	300
6.45% debentures due March 15, 2029	1,360	1,360
Unamortized discount	(30)	(33)
Fair value basis adjustment attributable to hedged debt obligations	17	28
Other	2	47
Subtotal long-term debt	4,838	4,553
Amounts maturing within one year	(1)	(114)
Long-term debt	$ 4,837	$ 4,439
Liability to subsidiary trust issuing preferred securities	$ 1,152	$ 1,152

Variable interest notes were repaid during fiscal 2004 as a result of settling a dispute with an unaffiliated insurer relating to our Insured Special Purpose Trust.

Debt maturing within one year included $275 million classified as a secured borrowing attributed to a prepaid forward sales agreement as of September 20, 2003. The agreement matured during fiscal 2004.

The 8% convertible securities were classified as preferred stock on September 30, 2003. On November 24, 2003, we exchanged all of our outstanding 8% redeemable convertible preferred stock for 8% convertible subordinated debentures.

The weighted average interest rate on long-term debt outstanding, including the liability to subsidiary trust issuing preferred securities, was 5.9% and 5.8% as of September 30, 2004 and 2003, respectively.

The maturities of long-term debt and liability to subsidiary trust issuing preferred securities as of September 30, 2004 for the next successive five fiscal years and thereafter were $1 million in 2005, $450 million in 2006, $817 million in 2007, $0 in 2008, $291 million in 2009, and $4.4 billion thereafter.

2.75% series A and B debentures

During the third quarter of fiscal 2003, we sold 2.75% Series A Convertible Senior Debentures and 2.75% Series B Convertible Senior Debentures for an aggregate amount of $1.6 billion, net of the underwriters discount and related fees and expenses of $46 million. The debentures were issued at a price of $1,000 per debenture and were issued under our universal shelf registration statement. The debentures rank equal in priority with all of the existing and future unsecured and unsubordinated indebtedness and senior in right of payment to all of the existing and future subordinated indebtedness. The terms governing the debentures limit our ability to create liens, secure certain indebtedness and merge with or sell substantially all of our assets to another entity.

The debentures are convertible into shares of common stock only if (1) the sale price of our common stock for at least twenty trading days during the period of thirty consecutive trading days ending on the last trading day of the previous calendar quarter is greater than or equal to 120% of the applicable conversion price, (2) the trading price of the debentures is less than 97% of the product of the sale price of our common stock and the conversion rate during any five consecutive trading-day period, (3) the debentures have been called for redemption by us or (4) certain specified corporate actions occur.

At our option, the debentures are redeemable for cash after certain dates ("optional redemption periods") at 100% of the principal amount plus any accrued and unpaid interest. In addition, at our option, the debentures are redeemable earlier ("provisional redemption periods") if the sale price of the common stock exceeds 130% of the applicable conversion price. Under these circumstances, the redemption price would also include a make-whole payment equal to the present value of all remaining scheduled interest payments through the beginning of the optional redemption periods.

At the option of the holder, the debentures are redeemable on certain dates at 100% of the principal amount plus any accrued and unpaid interest. In these circumstances, we may pay the purchase price with cash, common stock (with the common stock to be valued at a 5% discount from the then current market price) or a combination of both.

The following table summarizes the specific terms of these securities.

	Series A	Series B
Amount	$ 750,000,000	$ 881,000,000
Conversion ratio of common share per debenture	299.4012	320.5128
Initial conversion price	$ 3.34	$ 3.12
Redemption periods at our option:		
Provisional redemption periods	June 20, 2008 thru June 19, 2010	June 20, 2009 thru June 19, 2013
Optional redemption periods	After June 19, 2010	After June 19, 2013
Redemption dates at the option of the holder	June 15, 2010, 2015 and 2020	June 15, 2013 and 2019
Maturity dates	June 15, 2023	June 15, 2025

Liability to subsidiary trust issuing preferred securities (7.75% convertible securities)

During fiscal 2002, Lucent Technologies Capital Trust I (“the Trust”) sold 7.75% cumulative convertible trust preferred securities for an aggregate amount of $1.75 billion. We own all of the common securities of the Trust and as a result had previously consolidated the Trust. The Trust used the proceeds to purchase our 7.75% convertible subordinated debentures due March 15, 2017, which represent all of the Trust’s assets. The terms of the trust preferred securities are substantially the same as the terms of the debentures.

In December 2003, the FASB issued a revision to FIN No. 46, “Consolidation of Variable Interest Entities” (“FIN 46(R)”). The revision clarified certain provisions of what constitutes a variable interest and addressed substantive ownership provisions related to consolidation. We adopted FIN 46(R) during the second quarter of fiscal 2004.

We determined that the holders of the trust preferred securities were the primary beneficiaries of the Trust upon review of the provisions of FIN 46(R). As a result, we de-consolidated the Trust and reflected our obligation to the Trust under the caption "liability to subsidiary trust issuing preferred securities." We renamed the related balance as of September 30, 2003 to conform with the current period presentation. The effect of this change had no effect on our reported liabilities or results of operations. We continue to be obligated to repay the debentures held by the Trust and guarantee repayment of the preferred securities issued by the Trust.

We may redeem the debentures, in whole or in part, for cash at premiums ranging from 103.88% beginning March 20, 2007, to 100.00% on March 20, 2012, and thereafter. To the extent we redeem debentures, the Trust is required to redeem a corresponding amount of trust preferred securities. We have irrevocably and unconditionally guaranteed, on a subordinated basis, the payments due on the trust preferred securities to the extent we make payments on the debentures to the Trust.

The ability of the Trust to pay dividends depends on the receipt of interest payments on the debentures. We have the right to defer payments of interest on the debentures for up to 20 consecutive quarters. If payment of interest on the debentures is deferred, the Trust will defer the quarterly distributions on the trust preferred securities for a corresponding period. Deferred interest accrues at an annual rate of 9.25%. At the option of the holder, each trust preferred security is convertible into shares of our common stock, subject to an additional adjustment under certain circumstances. The following table summarizes the terms of this security.

Conversion ratio of common shares per security	206.6116
Conversion price	$ 4.84
Redemption period at our option	After March 19, 2007
Maturity date	March 15, 2017

8% convertible securities

The following table summarizes the terms of this security.

Conversion ratio of common shares per security	168.3502
Conversion price	$ 5.94
Liquidation preference per share	$1,000 plus accreted unpaid dividends
Redemption period at our option	After August 15, 2006
Redemption dates at the option of the holder	On August 2, 2007, 2010 and 2016
Mandatory redemption date	August 1, 2031

On November 24, 2003, we exchanged all of our outstanding 8% redeemable convertible preferred stock for 8% convertible subordinated debentures. This exchange was made pursuant to rights we had under the terms of the preferred stock to exchange the stock for the convertible subordinated debentures. These debentures have an interest rate of 8%, the same as the dividend rate on the preferred stock, and have the same payment and record dates as the preferred stock dividends, but the interest on the debentures must be paid in cash. The subordinated debentures have terms substantially the same as the preferred stock with respect to put rights, redemptions and conversion into common stock. Securities tendered to us pursuant to the August 2004 redemption feature were less than $1 million.

Early extinguishment of convertible securities and debt obligations

The following table summarizes the impact of convertible securities and certain debt obligations retired through exchanges of our common stock and cash.

(in millions)	Years ended September 30, 2004	2003	2002
8% convertible securities	$ 58	$ 835	$ 175
7.75% convertible securities	-	598	-
Total convertible securities	58	1,433	175
Other debt obligations	274	519	-
Total convertible securities and debt extinguished	$ 332	$ 1,952	$ 175
Shares of our common stock exchanged	22	563	58
Cash used for early extinguishments	$ 249	$ 487	$ -
8% convertible securities – conversion/ redemption costs	$ (4)	$ (287)	$ (29)
7.75% convertible securities – conversion costs	-	(129)	-
Debt obligations – gains (losses)	(4)	32	-
Impact on net income (loss) applicable to common shareowners	$ (8)	$ (384)	$ (29)

Conversion costs were recognized in amounts equal to the fair value of the additional common shares issued to the holders of each respective preferred security to prompt the exchange over the number of shares of common stock obligated to be issued pursuant to the original conversion terms of the respective security.

9. EMPLOYEE BENEFIT PLANS

We maintain defined benefit pension plans covering the majority of employees and retirees, and postretirement benefit plans for U.S. retirees that include health care, dental benefits and life insurance coverage. The pension plans feature a traditional service-based program as well as a cash balance program. The cash balance program was added to our defined benefit pension plan for U.S. management employees hired after December 31, 1998. No employees were transitioned from our traditional program to our cash balance program. Additionally, employees covered by the cash balance program are not eligible to receive company-paid postretirement health and group life coverage. We are not obligated to pay for postretirement group life and health care benefits for U.S. management employees with less than 15 years of service as of June 30, 2001.

The following tables summarize changes in the benefit obligation, the plan assets and the funded status of our pension and postretirement benefit plans as well as the components of net periodic benefit costs, including key assumptions. The measurement dates for plan assets and obligations were September 30, 2004 and 2003.

(in millions)	Pension benefits September 30, 2004	Pension benefits September 30, 2003	Postretirement benefits September 30, 2004	Postretirement benefits September 30, 2003
Change in benefit obligation:				
Benefit obligation at beginning of year	$ 31,235	$ 30,312	$ 8,511	$ 9,845
Service cost	150	155	8	8
Interest cost	1,716	1,859	434	583
Actuarial (gains) losses	832	2,502	(1,489)	112
Amendments	(11)	(464)	(110)	(1,148)
Benefits paid	(2,671)	(2,984)	(967)	(985)
Plan participant contributions	3	4	100	65
Settlements	(5)	(27)	-	-
Termination benefits	-	(21)	-	5
Curtailments	(1)	(200)	-	17
Exchange rate changes	53	99	-	-
Benefit obligation assumed by Agere and OFS	-	-	-	9
Benefit obligation at end of year	$ 31,301	$ 31,235	$ 6,487	$ 8,511
Change in plan assets:				
Fair value of plan assets at beginning of year	$ 30,148	$ 28,598	$ 2,327	$ 2,445
Actual return on plan assets	4,507	4,848	162	377
Benefits paid	(2,671)	(2,984)	(967)	(985)
Plan participant contributions	3	4	100	65
Company contributions	57	69	27	87
Exchange rate changes	48	96	-	-
Other (including transfer of assets from pension to postretirement plans)	(19)	(483)	(19)	338
Fair value of plan assets at end of year	$ 32,073	$ 30,148	$ 1,630	$ 2,327
Funded status of the plan	$ 772	$ (1,087)	$ (4,857)	$ (6,184)
Unrecognized prior service cost (credit)	85	169	(1,282)	(1,268)
Unrecognized transition obligation	1	1	-	-
Unrecognized net loss	6,017	6,628	1,263	2,802
Net asset (liability) recognized	$ 6,875	$ 5,711	$ (4,876)	$ (4,650)
Amounts recognized in the consolidated balance sheets:				
Prepaid pension costs	$ 5,358	$ 4,659	$ -	$ -
Other assets	11	16	-	-
Payroll and benefit-related liabilities	(5)	(5)	(258)	(310)
Postretirement and postemployment benefit liabilities	-	-	(4,618)	(4,340)
Pension liabilities	(1,874)	(2,494)	-	-
Accumulated other comprehensive loss	3,385	3,535	-	-
Net asset (liability) recognized	$ 6,875	$ 5,711	$ (4,876)	$ (4,650)

Additional Information:

(in millions)	Pension benefits September 30, 2004	Pension benefits September 30, 2003	Postretirement benefits September 30, 2004	Postretirement benefits September 30, 2003
Benefit obligation by major plans:				
U.S. management	$ 17,684	$ 17,714	$ -	$ -
U.S. occupational	12,459	12,686	-	-
Non-U.S. and supplemental	1,158	835	-	-
Non-represented health	-	-	1,503	2,771
Formerly represented health	-	-	3,369	4,232
Group Life and other	-	-	1,615	1,508
Benefit obligation at end of year	$ 31,301	$ 31,235	$ 6,487	$ 8,511
Plan assets by major plans:				
U.S. management	$ 15,974	$ 15,134	$ -	$ -
U.S. occupational	15,354	14,367	-	-
Non-U.S. and supplemental	745	647	-	-
Non-represented health	-	-	-	35
Formerly represented health	-	-	612	1,111
Group Life and other	-	-	1,018	1,181
Fair value of plan assets at end of year	$ 32,073	$ 30,148	$ 1,630	$ 2,327
Accumulated benefit obligation	$ 30,953	$ 30,863	n/a	n/a
Plans with under-funded or non-funded benefit obligation:				
Aggregate benefit obligation	18,287	18,058	6,487	8,511
Aggregate fair value of plan assets	16,090	15,225	1,630	2,327
Plans with under-funded or non-funded accumulated benefit obligation:				
Aggregate accumulated benefit obligation	17,957	17,700	n/a	n/a
Aggregate fair value of plan assets	16,086	15,206	n/a	n/a

Components of Net Periodic Benefit Cost:

(in millions)	Years ended September 30, 2004	2003	2002
Pension credit:			
Service cost	$ 150	$ 155	$ 238
Interest cost on benefit obligation	1,716	1,859	1,981
Expected return on plan assets	(3,059)	(3,137)	(3,384)
Amortization of unrecognized prior service costs	70	94	236
Amortization of transition asset	-	(9)	(92)
Amortization of net loss (gain)	6	1	(189)
Subtotal	(1,117)	(1,037)	(1,210)
Termination benefits	-	(21)	340
Curtailments	1	(48)	305
Settlements	5	9	(10)
Pension credit	$ (1,111)	$ (1,097)	$ (575)
Distribution of pension credit:			
Continuing operations:			
Business restructuring	$ -	$ (79)	$ 543
Other costs and expenses	(1,111)	(1,018)	(1,220)
Subtotal	(1,111)	(1,097)	(677)
Discontinued operations	-	-	102
Pension credit	$ (1,111)	$ (1,097)	$ (575)

(in millions)	Years ended September 30, 2004	2003	2002
Postretirement benefit cost:			
Service cost	$ 8	$ 8	$ 18
Interest cost on benefit obligation	434	583	622
Expected return on plan assets	(161)	(280)	(361)
Amortization of unrecognized prior service costs	(97)	(51)	-
Amortization of net loss (gain)	59	91	(24)
Subtotal	243	351	255
Termination benefits	-	6	-
Curtailments	-	(6)	35
Postretirement benefit cost	$ 243	$ 351	$ 290
Distribution of net postretirement benefit cost:			
Continuing operations:			
Business restructuring	$ -	$ 2	$ 35
Other costs and expenses	243	349	248
Subtotal	243	351	283
Discontinued operations	-	-	7
Postretirement benefit cost	$ 243	$ 351	$ 290

Key assumptions:

Weighted-average assumptions used to determine:			
Benefit obligations:			
Discount rate – pension	5.50%	5.75%	6.50%
Discount rate – postretirement	5.25%	5.75%	6.50%
Rate of compensation increase	4.00%	3.50%	3.50%
Net cost or credit:			
Discount rate	5.75%	6.50%	7.00%
Expected return on plan assets – pension	8.75%	8.75%	9.00%
Expected return on plan assets – postretirement	5.53%	7.93%	9.00%
Rate of compensation increase	3.50%	3.50%	4.50%

The weighted average expected rate of return on plan assets that will be used to determine the fiscal 2005 net periodic benefit cost is 8.50% for pension and 5.72% for postretirement benefits.

	September 30, 2004	2003
Assumed health care cost trend rates:		
Health care cost trend rate assumed for next year	11.1 %	10.4%
Health care cost trend rate assumed for next year (excluding postretirement dental benefits)	11.4 %	10.6%
Rate that the cost trend rate gradually declines to	5.0 %	5.0%
Year that the rate reaches the rate it is assumed to remain at	2010	2009

The assumed health care cost trend rate has a significant effect on the amounts reported. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

(in millions)	1 percentage point Increase	Decrease
Effect on total of service and interest cost components	$ 13	$ (12)
Effect on postretirement benefit obligation	255	(227)

We considered the available yields on high-quality fixed-income investments with maturities corresponding to our benefit obligations to determine our discount rates at each measurement date. Although we considered yields and changes in yields of several funds, the primary fund we considered is the Moody's Aa long-term corporate yield fund. The average duration of our primary pension obligations and postretirement health care obligations were 11 years and 7 years, respectively as of September 30, 2004.

We considered several factors in developing our expected rate of return on plan assets based on input from our external advisors. Individual asset class return forecasts were developed based upon current market conditions, for example, price-earnings levels and yields and long-term growth expectations. Historical returns were used to test for reasonableness. The expected long-term rate of return is the weighted average of the target asset allocation of each individual asset class. Our long-term expected rate of return on plan assets included approximately 0.5% for an anticipated premium over market returns from our active investment managers. Our actual 10-year annual rate of return on pension plan assets were 11.0%, 9.9% and 9.5% during fiscal 2004, 2003 and 2002, respectively.

The expected return on plan assets was determined using the expected rate of return and a calculated value of assets referred to as the "market-related value." The aggregate market-related value of pension and postretirement plan assets was $37.7 billion and $39.6 billion as of September 30, 2004 and 2003, respectively, which exceeded the fair value of plan assets by $4.0 billion and $7.1 billion. Differences between the assumed and actual returns are amortized to the market-related value on a straight-line basis over a five-year period. The amortization of these differences, including those resulting from the actual losses incurred during fiscal 2002 and 2001, will continue to reduce both the market-related value and our pension credit.

Gains and losses resulting from changes in actuarial assumptions and from differences between assumed and actual experience (except those differences being amortized to the market-related value) are amortized over the expected remaining service periods of active plan participants for the management pension plan and over the average remaining life expectancy of the inactive participants for all other plans to the extent they exceed 10% of the higher of the market-related value or the projected benefit obligation of each respective plan.

On December 8, 2003, the President of the United States signed the Medicare Prescription Drug Improvement and Modernization Act of 2003. This Act introduced a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefits plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. We currently sponsor retiree health care plans that provide prescription drug benefits to our U.S. retirees.

We elected to prospectively recognize the effects of the Act during the fourth quarter of fiscal 2004, which reduced the accumulated benefit obligation by approximately $600 million. The impact of the Act is expected to reduce the annual expense of providing the prescription drug benefit by approximately $90 million, including lower participation rates. Approximately 25% of this impact was recognized during the fourth quarter of fiscal 2004. This included an estimated impact for retirees who may determine the addition of Part D makes the complete reliance on Medicare more financially attractive than remaining a participant in our retiree medical plans. While the accounting treatment has been addressed, other detailed regulations necessary to implement the Act have not yet been promulgated. These regulations will need to specify how actuarial equivalency must be determined and demonstrated to the Secretary of Health and Human Services and specify the reimbursement mechanism for the subsidy. These final regulations may change the estimated impact of the Act.

Plan Assets

The following table summarizes the target asset allocation ranges of our pension and postretirement trusts by asset category.

		Percentage of pension plan assets as of September 30,			Percentage of postretirement plan assets as of September 30,	
Asset category:	Pension target allocation range as of September 30, 2004	2004	2003	Postretirement target allocation as of September 30, 2004	2004	2003
Equity securities	52% - 70%	62%	63%	50%	51%	41%
Fixed income securities	20% - 28%	24	24	50%	48	57
Real estate	5% - 9%	6	5		-	-
Private equity and other	6% - 10%	8	8		1	2
Total		100%	100%		100%	100%

The majority of the pension plan assets are held in a master pension trust. Postretirement plan assets are held in three separate trusts. Plan assets are managed by independent investment advisors with the objective of maximizing returns with a prudent level of risk. We periodically complete asset-liability studies to assure that the optimal asset allocation is maintained in order to meet future benefit obligations. The pension target allocation ranges summarized above were approved by our Board of Directors during fiscal 2003, upon completion of a study by our external advisors. There were no changes from our previous target allocations. Investment advisors managing plan assets may use derivative financial instruments including futures contracts, forward contracts, options and interest rate swaps to manage market exposure and foreign currency and interest-rate risk.

Pension plan assets included $12 million and $7 million of our common stock as of September 30, 2004 and 2003, respectively. Postretirement plan assets included $40 million and $47 million of our common stock as of September 30, 2004 and 2003, respectively.

Contributions

We contribute to our pension and postretirement benefit plans to make benefit payments to plan participants and to pre-fund some benefits by means of trust funds. For our U.S. pension plans, the funding policy is to contribute amounts to the trusts sufficient to meet minimum funding requirements as set forth in employee benefit and tax laws plus such additional amounts as we may determine to be appropriate. Contributions are made to benefit plans for the sole benefit of plan participants.

In addition, we received $212 million from our welfare benefits trust during October 2004 as reimbursement for retiree health care contributions that were made during fiscal 2004. The Company's contributions for postretirement benefits of $27 million are reflected net of this amount during fiscal 2004.

The following table summarizes expected contributions to our various pension and postretirement plans through fiscal 2014. We do not expect to make contributions to our qualified U.S. pension plans during fiscal 2005 or 2006. We are unable to estimate the expected contributions to our qualified U.S. pension plans beyond fiscal 2006. Actual contributions may differ from expected contributions.

	Pension	Postretirement		
(in millions)	Non -qualified and non-U.S. pension plans	Formerly represented retiree health plans	Non-represented retiree health plans	Other benefit plans
2005	$ 53	$ -	$ 201	$ 11
2006	51	237	189	11
2007	52	367	167	12
2008	54	342	152	11
2009	53	323	142	11
2010-14	270	1,315	570	55

Benefit Payments

The following table summarizes expected benefit payments from our various pension and postretirement plans through fiscal 2014. Actual benefit payments may differ from expected benefit payments. These amounts are reflected net of expected plan participant contributions and the annual Medicare Part D subsidy of approximately $60 million beginning in fiscal 2007.

	Pension		Postretirement		
(in millions)	Qualified U.S. pension plans	Non-qualified and non-U.S. pension plans	Formerly represented retiree health plans	Non-represented retiree health plans	Other benefit plans
2005	$ 2,453	$ 71	$ 453	$ 201	$ 86
2006	2,421	53	407	189	89
2007	2,385	54	367	167	93
2008	2,351	57	342	152	95
2009	2,312	57	323	142	97
2010-14	10,974	302	1,315	570	515

Savings Plans

Our savings plans allow employees to contribute a portion of their compensation on a pre-tax and/or after-tax basis in accordance with specified guidelines. We match a percentage of the employee contributions up to certain limits, in cash, in accordance with participants' investment elections. Savings plan expense charged to continuing operations was $97 million, $75 million and $71 million for fiscal 2004, 2003 and 2002, respectively.

Postemployment Benefits

We offer various postemployment benefits to certain employees after employment but before retirement. These benefits are paid in accordance with our established postemployment benefit practices and policies. Postemployment benefits include disability benefits, severance pay and workers' compensation benefits. We accrue for these future postemployment benefits, which are funded on a pay-as-you-go basis. The expense (credit) under these plans was $40 million, $(93) million and $(17) million during fiscal 2004, 2003 and 2002, respectively, including $41 million and $34 million of credits related to our restructuring actions. The accrued postemployment liability was $310 million and $417 million as of September 30, 2004 and 2003, respectively. These amounts include $47 million and $88 million in payroll and benefit related liabilities as of September 30, 2004 and 2003, respectively.

10. STOCK COMPENSATION PLANS

We have stock-based compensation plans under which directors, officers and other eligible employees receive stock options and other equity-based awards. The plans provide for the grant of stock options, stock appreciation rights, performance awards, restricted stock awards and other stock unit awards.

Stock options generally are granted with an exercise price equal to 100% of the market value of a share of common stock on the date of grant, have terms of five to 10 years and vest within four years from the date of grant. Subject to customary antidilution adjustments and certain exceptions, the total number of shares of common stock authorized for option and other equity grants under the plans was 563 million shares as of September 30, 2004.

On April 22, 2002, we commenced a voluntary offer to eligible employees to exchange certain outstanding stock options to purchase shares of common stock, including all stock options issued during the six-month period ended April 22, 2002, for our promise to grant a new stock option on or about November 25, 2002. In response to this offer, employees tendered stock options to purchase an aggregate of 214 million shares of our common stock in exchange for promises to grant new stock options to purchase up to an aggregate of 123 million shares of our common stock. On November 25, 2002, 111 million new stock options were granted in connection with the exchange with an exercise price of $1.78 per share, which was the fair market value of our common stock on the date of the grant. The 214 million stock options tendered by employees in the exchange were cancelled.

Under the terms of the Employee Stock Purchase Plan ("2001 ESPP"), eligible employees may have up to 10% of eligible compensation deducted from their pay to purchase shares of common stock, subject to plan limits, at a discount of 15% of the market value at either the purchase date or at certain earlier dates defined in the plan. During fiscal 2004, 2003 and 2002, 18 million, 12 million and 10 million shares of common stock were purchased, respectively. As of September 30, 2004, 210 million shares were available for issuance under the 2001 ESPP.

During fiscal 2002, four million restricted stock units were awarded at a weighted average market value of $6.74.

The following table summarizes stock option activity.

	Shares (in millions)	Weighted average exercise price per share
Outstanding as of September 30, 2001	683	$ 26.43
Granted	13	6.37
Exercised	(7)	1.50
Forfeited/expired	(101)	26.85
Cancelled due to exchange offer	(213)	30.22
Outstanding as of May 31, 2002	375	23.96
Outstanding as of June 1, 2002, after spin-off adjustments (a)	363	21.04
Granted	1	2.09
Exercised	-	0.41
Forfeited/expired	(77)	36.85
Outstanding as of September 30, 2002	287	16.73
Granted	162	1.67
Exercised	(1)	1.40
Forfeited/expired	(60)	8.79
Outstanding as of September 30, 2003	388	11.70
Granted / assumed	55	3.05
Exercised	(9)	1.67
Forfeited/expired	(31)	10.46
Outstanding as of September 30, 2004	403	10.84

(a) Effective with the spin-off of Agere on June 1, 2002, Lucent stock options held by Agere employees were converted to Agere stock options. For the remaining unexercised stock options, the number of stock options and the exercise price were adjusted to preserve the intrinsic value of the stock options that existed prior to the spin-off.

The following table summarizes information about stock options.

	Stock options outstanding			Stock options exercisable	
Range of exercise prices per share	Shares (in millions)	Weighted average remaining contractual life (years)	Weighted average exercise price per share	Shares (in millions)	Weighted average exercise price per share
$ 0.02 to $ 2.25	124	4.0	$ 1.63	56	$ 1.70
$ 2.26 to $ 3.50	48	6.2	3.20	-	2.80
$ 3.51 to $ 6.26	61	2.2	6.11	56	6.16
$ 6.27 to $ 9.99	35	2.1	9.44	35	9.45
$10.00 to $ 16.03	79	2.1	12.24	79	12.23
$16.04 to $ 77.10	56	4.4	42.08	56	42.08
Amounts as of September 30, 2004	403		$ 10.84	282	$ 14.47
Amounts as of September 30, 2003	388		$ 11.70	246	$ 16.54
Amounts as of September 30, 2002	287		$ 16.73	219	$ 18.40

11. OPERATING SEGMENTS

We design and deliver networks for the world's largest communications service providers. The accounting policies of the reportable segments are the same as those applied in the consolidated financial statements. 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 is a worldwide organization that provides deployment, maintenance, professional and managed services in support of both our product offerings as well as multivendor networks. Performance measurement and resource allocation for the reportable segments are based on many factors. Total assets by reportable segment are not included in the measures of each segment reviewed by the chief operating decision maker. The primary financial measures include the revenues, costs and expenses directly controlled by each reportable segment and excludes the following:

- Business restructuring.
- Global sales organization expenses.
- Bad debt and customer financing expenses and recoveries.
- Certain personnel costs and benefits, including most of the impacts related to pension, postretirement and postemployment benefits, differences between the actual and budgeted benefit rates and differences between actual and budgeted employee incentive awards.
- Certain costs related to shared services, such as general corporate functions, which are managed on a common basis in order to realize economies of scale and efficient use of resources.
- Revenues and expenses associated with licensing and protecting intellectual property rights.
- Results of the optical fiber business.
- Certain other general and miscellaneous costs and expenses not directly used in assessing the performance of the operating segments, including impairment or amortization of goodwill and other acquired intangible assets related to acquisitions completed prior to fiscal 2004.

(in millions)	Years ended September 30, 2004	2003	2002
Revenues:			
INS	$ 2,984	$ 3,300	$ 4,599
Mobility	4,007	3,080	4,444
Services	1,932	1,840	2,761
Reportable segments	8,923	8,220	11,804
Optical fiber business	-	-	114
Other (a)	122	250	403
Revenues	$ 9,045	$ 8,470	$ 12,321
Operating income (loss):			
INS	$ 345	$ 102	$ (1,693)
Mobility	1,240	173	2
Services	282	225	227
Reportable segments	1,867	500	(1,464)
Business restructuring	20	184	(1,490)
Global sales organization	(515)	(527)	(924)
Bad debts and customer financings	230	223	(1,253)
Goodwill and other acquired intangible asset amortization	(1)	(15)	(250)
Goodwill impairment	-	(35)	(826)
Optical fiber business	-	-	(68)
Unallocated personnel costs and benefits	859	1,207	1,718
Shared services such as general corporate functions	(1,162)	(1,499)	(1,756)
Other	(79)	(260)	(666)
Operating income (loss)	$ 1,219	$ (222)	$ (6,979)

Supplemental Segment Information

(in millions)	Years ended September 30, 2004	2003	2002
Depreciation and amortization:			
INS	$ 171	$ 231	$ 429
Mobility	181	177	230
Services	26	41	64
Reportable segments	378	449	723
Non-segment	315	529	747
Depreciation and amortization	$ 693	$ 978	$ 1,470

Products and Services Revenues

(in millions)	Years ended September 30, 2004	2003	2002
Wireless	$ 4,007	$ 3,080	$ 4,444
Voice networking	1,336	1,560	2,122
Data and network management	933	1,034	1,132
Optical networking	715	706	1,345
Services	1,932	1,840	2,761
Optical fiber	-	-	114
Other (a)	122	250	403
Totals	$ 9,045	$ 8,470	$ 12,321

(a) Includes intellectual property licensing revenues.

Geographic Information

(in millions)	Revenues (a) Years ended September 30, 2004	2003	2002	Long- lived assets (b) September 30, 2004	2003	2002
U.S.	$ 5,517	$ 5,149	$ 8,150	$ 1,567	$ 1,397	$ 1,540
Non-U.S.	3,528	3,321	4,171	243	384	661
Totals	$ 9,045	$ 8,470	$ 12,321	$ 1,810	$ 1,781	$ 2,201

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

(b) Includes property, plant and equipment and goodwill and other acquired intangible assets.

Concentrations

Historically, we have relied on a limited number of customers for a substantial portion of our total revenues. Revenues from Verizon, including Verizon Wireless, accounted for 27%, 22% and 19% of consolidated revenues in fiscal 2004, 2003 and 2002, respectively. Revenues from Sprint accounted for 11% in consolidated revenue in fiscal 2004. Revenues from customers located in China accounted for 10% and 11% of consolidated revenues in fiscal 2004 and 2003, respectively. We expect a significant amount of our future revenues will continue to be generated by a limited number of customers. The loss of any of these customers or any substantial reduction in orders by any of these customers could adversely affect our operating results. Refer to Note 13 for a discussion of our contract manufacturing concentration.

12. FINANCIAL INSTRUMENTS

Fair Values

The following table summarizes the carrying values and estimated fair values of financial instruments, based on quoted market prices. The carrying values of cash and cash equivalents, receivables, payables and debt maturing within one year approximate fair value.

(in millions)	Years ended September 30, 2004 Carrying value	2004 Fair value	2003 Carrying value	2003 Fair value
Long-term debt	$ 4,837	$ 5,048	$ 4,439	$ 3,777
Liability to subsidiary trust issuing preferred securities	1,152	1,277	1,152	956
8% redeemable convertible preferred stock	-	-	868	901

The following table summarizes our available-for-sale debt securities.

(in millions)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
U.S. Treasury and government agency debt securities	$ 979	$ -	$ (3)	$ 976
Corporate bonds	340	1	(1)	340
Asset-backed securities	179	-	(1)	178
Total as of September 30, 2004	$ 1,498	$ 1	$ (5)	$ 1,494
Classified as:				
Current	$ 859	$ -	$ (1)	$ 858
Non-current	639	1	(4)	636
Total	$ 1,498	$ 1	$ (5)	$ 1,494
U.S. Treasury and government agency debt securities – classified as current as of September 30, 2003	$ 686	$ -	$ -	$ 686

Gross unrealized losses of $5 million were primarily related to U.S. Treasury and government agency debt securities that were in a continuous loss position for less than one year. These unrealized losses were primarily caused by increases in interest rates. We do not consider these investments to be other-than-temporarily impaired because we have the ability and intent to hold these investments until maturity or until the fair value is recovered.

Proceeds from the sale of marketable debt securities were $352 million during fiscal 2004. The realized gains and losses on these sales were $1 million and $2 million for fiscal 2004, respectively. There were no sales of marketable debt securities during fiscal 2003 and 2002.

The following table summarizes the contractual maturities of our available-for-sale debt securities.

(in millions)	Amortized cost	Estimated fair value
2005	$ 859	$ 858
2006 – 2010	555	552
2011 – 2015	11	11
2016 and thereafter	73	73

The following table summarizes the carrying value of our non-consolidated equity investments.

(in millions)	September 30, 2004	2003
Available-for-sale	$ 2	$ 5
Cost-method	70	98
Equity-method	5	33
Non-consolidated equity investments	$ 77	$ 136

Proceeds from the sale of available-for-sale equity securities were $178 million during fiscal 2003. During fiscal 2003, we entered into prepaid forward sales agreements for all of our Corning shares, under which we received proceeds $113 million and locked in $64 million of unrealized appreciation. This gain was recognized during fiscal 2004. Proceeds from the sale of available-for-sale equity securities were not material during fiscal 2004 and 2002. Gross unrealized losses on available-for-sale equity securities were not material during fiscal 2004 and 2003 and were $150 million during fiscal 2002.

All investments are periodically reviewed to determine if declines in fair value below cost basis are other-than-temporary. This review considers among other factors, significant and sustained decreases in quoted market prices, a series of historical and projected operating losses, changes in the market demand for technology and our intent to provide future funding. If the decline in fair value has been

determined to be other-than-temporary, an impairment loss is recognized, and a new cost basis is established. We recognized $22 million, $63 million and $209 million of other-than-temporary impairment losses related to our non-consolidated equity investments during fiscal 2004, 2003 and 2002, respectively.

Credit Risk

All financial instruments involve credit risk for non-performance by counterparties. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments.

Our maximum exposure to credit loss in the event of non-performance by the other party to the financial instruments for commitments to extend credit and financial guarantees is limited to the amount drawn and outstanding on those instruments. Exposure to credit risk is controlled through credit approvals, credit limits and continuous monitoring procedures. Reserves for losses are established based upon collectibility assessments.

Derivative Financial Instruments and Market Risk

All financial instruments inherently expose the holders to market risk, including changes in currency and interest rates and equity prices. We manage our exposure to these market risks through our regular operating and financing activities, including the use of derivative financial instruments.

Foreign currency risk

Our business is conducted using different foreign currencies. The objective of our foreign currency risk management policy is to preserve the value of cash flows in non-functional currencies. Our policy is to hedge all significant booked and firmly committed cash flows identified as creating foreign currency exposure on a rolling 12-month basis. In addition, we typically hedge a portion of our exposure resulting from identified anticipated cash flows, providing the flexibility to mitigate the variability of longer-term forecasts as well as changing market conditions.

Foreign exchange forward and option contracts are used to manage our foreign currency risk. We have hedged foreign exchange risk in certain sales and purchase contracts by embedding terms in the contracts that affect the ultimate amount of cash flows under the contract. Our primary net foreign currency exposures included the euro, Chinese yuan, Japanese yen, and British pound as of September 30, 2004 and 2003.

The following table provides a summary of the total net notional amounts of foreign exchange forward and option contracts.

	September 30,	
(in millions)	2004	2003
Purchase contracts	$ 208	$ 257
Sale contracts	532	134

The fair value of our hedged contracts and the notional amounts and fair values of embedded derivatives were not material as of September 30, 2004 and 2003.

We hedge all types of foreign currency risk to preserve our cash flows in accordance with corporate risk management policies but generally do not designate related derivative instruments as hedges under SFAS 133, for cost/benefit reasons. Accordingly, the changes in fair value of these undesignated freestanding foreign currency derivative instruments are recorded in other income (expense) in the period of change and have not been material because of the short maturities of these instruments.

Our foreign currency embedded derivatives consist of sales and purchase contracts with cash flows indexed to changes in or denominated in a currency that neither party to the contract uses as its functional currency. Changes in the fair value of these embedded derivatives were not significant during fiscal 2004 and 2003.

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.

Equity price risk

We hold 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 equity investments are exposed to price fluctuations and are generally concentrated in the high-technology industries. 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. We had no outstanding hedging instruments for our equity price risk as of September 30, 2004.

Customer Financing Commitments

Requests for providing commitments to extend credit and financial guarantees are reviewed and subject to approval by senior management. We regularly review all outstanding commitments, letters of credit and financial guarantees to assess the adequacy of our reserves for possible credit and guarantee losses.

The following table summarizes our customer financing commitments for amounts drawn, available but not drawn and not available to be drawn. These commitments may expire without being drawn upon. The amounts drawn on these commitments are generally collateralized by substantially all of the assets of the respective creditors.

	September 30, 2004			September 30, 2003		
(in millions)	Total loans and guarantees	Loans	Guarantees	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	$ 150	$ 128	$ 22	$ 505	$ 374	$ 131

The following table summarizes the change in the customer financing reserves.

(in millions)	Years ended September 30, 2004	2003	2002
Reserve at beginning of year	$ 415	$ 951	$ 2,109
Provision for (recovery of) customer financing	(188)	(156)	765
Transfers from (to) other accounts, net	(29)	116	-
Write offs	(63)	(496)	(1,923)
Reserve at end of year	$ 135	$ 415	$ 951

Commitments to Extend Credit

Commitments to extend credit to third parties are conditional agreements generally having fixed expiration or termination dates and specific interest rates and purposes. In certain situations, credit may not be available for drawdown until certain conditions are met.

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 were $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.

Transfers of Financial Instruments

We have agreements that allow us to sell accounts receivable from selected customers at a discount to various financial institutions on a non-recourse basis. We sold approximately $468 million and $339 million of accounts receivable under these agreements during fiscal 2004 and 2003, respectively. These transactions were accounted for as a sale. Discounting fees were $5 million and $3 million during 2004 and 2003, respectively. Sales and transfers that do not meet the criteria for surrender of control are accounted for as secured borrowings. There were no secured borrowings as of September 30, 2004.

13. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

We are subject to legal proceedings, lawsuits, and other claims, including proceedings by government authorities. In addition, we may be subject to liabilities of some of our former affiliates under separation agreements with them. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Consequently, unless otherwise indicated, we are unable to estimate the ultimate aggregate amounts of monetary liability or financial impact with respect to these matters as of September 30, 2004. As described below, we have received final court approval for the settlement of our securities and related litigation. The impact of other pending litigation matters that we agreed to settle during the year were not material individually or in the aggregate to our results of operations or financial condition. We believe that the remainder of the cases will not have a material financial impact on our results of operations or financial condition after final disposition. However, because of the uncertainties of legal proceedings, one or more of these proceedings could ultimately result in a material obligation.

Securities and Related Cases

On March 27, 2003, we announced that we reached an agreement to settle assorted securities, ERISA and derivative class action and other related lawsuits against us and certain of our current and former directors, officers and employees. The settlement covers all claims generally relating to the purchase of Lucent securities during different class periods. The primary class period is October 26, 1999 through December 20, 2000. We did not admit nor deny any wrongdoing as part of the settlement. We received final approval of the settlement from the U.S. District Court in Newark, New Jersey, on December 12, 2003. All appeals of this order are resolved, and on November 9, 2004, the court approved the plaintiffs' plan of distribution. The distribution is scheduled to occur during the first or second quarter of fiscal 2005.

The agreement is a global settlement of 53 separate lawsuits, including a consolidated shareowner class action lawsuit in the U.S. District Court of New Jersey, and related ERISA, bondholder, derivative, and other state securities cases. Under the settlement agreement, we will pay $315 million in common stock, cash 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. These shares were subsequently sold in the market by the escrow agent for $105 million during the second quarter of fiscal 2004 and the net proceeds remain in escrow.

We will also issue warrants to purchase 200 million shares of our common stock at an exercise price of $2.75 per share with an expiration date three years from the date of issuance. The estimated fair value of these warrants was $252 million, based upon the Black-Scholes option-pricing model as of September 30, 2004. We also paid $5 million for the cost of settlement administration. We will also pay for certain other costs involved in the issuance of securities.

In addition to our contributions, certain of our insurance carriers agreed to pay their available policy limits of $148 million into the settlement fund. Our former affiliate, Avaya Inc., contributed shares of its common stock valued at $24 million to the settlement during September 2004. We continue to pursue a partial recovery of the settlement from our fiduciary insurance carriers under certain insurance policies. We filed a lawsuit against them to recover these amounts. We settled with two of the carriers for $40 million and are continuing to pursue our claim against a third carrier that provided additional coverage up to $20 million.

The charge for the global settlement will be revised in future quarters to reflect any additional recoveries, as well as to reflect additional changes in the fair value of the warrants until the warrants are issued. The estimated fair value of the warrants may continue to change as a result of fluctuations in the share price of our common stock.

We will defend any lawsuits that may be brought by parties that have opted out of the settlement. We and certain of our current and former officers and directors are defendants in two such actions in the U.S. District Court in New Jersey, *Staro Asset Management, LLC v. Lucent Technologies Inc. et al., and Florida State Board of Administration v. Lucent Technologies Inc. et al.,* alleging violations of federal securities laws. These cases were originally part of the global settlement referred to above. However, the plaintiffs opted out of the settlement and are pursuing their claims separately against Lucent and the other defendants. Other cases have been and may continue to be brought by individual investors opting out of the settlement.

Government Investigations

During November and December 2000, we identified certain revenue recognition issues that we publicly disclosed and brought to the attention of the SEC. A final judgment and consent decree with the SEC was entered for this matter in May 2004. Under the terms of the consent decree, we paid a $25 million civil penalty in the third quarter of fiscal 2004 and were not required to restate our financial statements. Without admitting or denying any wrongdoing, we consented to the settlement enjoining us from future violations of specific provisions of the federal securities laws.

During August 2003, the U.S. Department of Justice (the "DOJ") and the SEC informed us that they had each commenced an investigation into possible violations of the Foreign Corrupt Practices Act ("FCPA"). These investigations followed allegations made by National Group for Communications and Computers

Ltd. (“NGC”) in an action filed against us on August 8, 2003, which is described below. In April 2004, we reported to the DOJ and the SEC that a FCPA compliance audit and an outside counsel investigation found incidents and internal control deficiencies in our operations in China that potentially involve FCPA violations. We are cooperating with those agencies. We believe these incidents and deficiencies did not have a material effect on our results of operations. However, we cannot determine whether this matter will affect our future business operations in China.

As disclosed in an 8-K filing on November 8, 2004, our former Chairman and Chief Executive Officer, Richard McGinn, the former head of our Saudi Arabia operations, John Heindel, and a third former employee received “Wells” notices from the SEC. These Wells notices state that the staff of the SEC is considering recommending that civil actions be taken against these three former employees for FCPA violations. The allegations against these individuals include violations of the anti-bribery provisions of the FCPA and aiding and abetting the Company’s alleged violations of requirements under the FCPA to keep accurate books and records and to maintain a proper system of internal accounting controls. We have not received a Wells notice at this time, but the investigation is continuing.

Other Matters

We are involved in commercial disputes with customers, suppliers, subcontractors and other parties. These matters generally involve claims for monetary damages for breach of contract or breach of warranty or similar claims in the normal course of business. While many of these disputes are settled amicably without litigation, some of these matters have resulted in lawsuits being filed against us. The condition of the telecommunications market in the past three years and the insolvency or failure of numerous service providers has led to more claims and disputes resulting in litigation. In addition, our restructuring has resulted in the termination of tens of thousands of employees and changes in benefits for current and former employees. These actions have led to additional claims against us. The following is a description of significant pending litigation.

A lawsuit involving investors in Actel Integrated Communications was filed against us for unspecified damages, claiming we misled them as to certain technology, which influenced their decision to invest in Actel. This case, *Sandler Capital Partners IV, L.P. et al. v. Lucent Technologies*, filed in New York State Court, is in its early stages. During fiscal 2004, we settled cases filed against us by Actel. In addition, two other cases were filed against us alleging that we failed to deliver working products related to this technology. Those cases, *Maxcess, Inc. v. Lucent Technologies Inc. et al.*, filed in the U.S. District Court for the Middle District of Florida, and *Official Plan Committee of Omniflex, Inc. v. Lucent Technologies Inc.*, filed in Missouri State Court, are in the early stages of the litigation process.

We are a defendant in an adversary proceeding filed in U.S. Bankruptcy Court in Delaware by Winstar and Winstar Wireless, Inc. in connection with the bankruptcy of Winstar and various related entities. The complaint asserts claims for breach of contract and other claims against us and seeks compensatory damages, as well as costs and expenses associated with litigation. Many of these claims against us have been dismissed. The complaint also seeks recovery of a payment to us of approximately $190 million in December 2000.

On August 8, 2003, NGC filed an action in the U.S. District Court for the Southern District of New York against us, our subsidiary Lucent Technologies International Inc. and an unaffiliated company, alleging violations of the Racketeer Influenced Corrupt Organizations Act (“RICO”) and other improper activities. These allegations relate to activities in Saudi Arabia in connection with certain telecommunications contracts between us, the Kingdom of Saudi Arabia and other entities. The complaint seeks damages in excess of $63 million, which could be tripled under RICO. The allegations in this complaint appear to arise out of certain contractual disputes between NGC and Lucent, that are the subject of a separate case that NGC previously filed against us in U.S. District Court in New Jersey. This case is in its early stages.

In the case of *Pf.Net Supply Corp. v. Lucent Technologies*, pending in the U.S. District Court in New Jersey, the plaintiff claims that we breached an alleged $100 million purchase commitment and seeks to compel us to meet this purchase commitment or pay damages. Both parties have filed motions for summary judgement, which are currently pending.

A purported class action lawsuit, *Foss v. Lucent Technologies*, was filed against us in U.S. District Court in New Jersey during October 2003 in connection with the elimination of the death benefit from our U.S. management pension plan in early 2003. The elimination of these benefits reduced the future pension obligations by approximately $450 million. The benefit was paid out of the pension plan assets to certain qualified surviving dependents, such as spouses or dependent children of management retirees who retired before 1998. The case alleges that we wrongfully terminated this death benefit and requests that it be reinstated, along with other remedies. This case is in the early stages. Three other cases of a similar nature have recently been filed: *Berendt, et al. v. Lucent Technologies Inc., et al*. and *Lucas, et al. v. Lucent Technologies, et al*., both filed in the U.S. District Court in New Jersey; and *Chastain, et al. v. AT&T,* filed in the U.S. District Court in the Western District of Oklahoma.

The Equal Employment Opportunity Commission (EEOC) filed a purported class action lawsuit against us, *EEOC v. Lucent Technologies Inc*., in the U.S District Court in California. The case alleges gender discrimination in connection with the provision of service credit to a class of present and former Lucent employees who were out of work because of maternity prior to 1980 and seeks the restoration of lost service credit prior to April 29, 1979, together with retroactive pension payment adjustments; corrections of service records; back pay, other damages and attorneys fees and costs.

Separation Agreements

We are party to various agreements that were entered into in connection with the separation of Lucent and former affiliates, including AT&T, Avaya, Agere Systems and NCR Corporation. Pursuant to these agreements, we and the former affiliates have agreed to allocate certain liabilities related to each other's business, and have agreed to share liabilities based on certain allocations and thresholds. For example, AT&T, Avaya and NCR each assumed a portion of the settlement liability related to our former consumer products leasing business, which settled in August 2002. The plaintiffs' counsel in this case has filed a motion to reconsider the disposition of certain settlement proceeds, so this matter may not be completely resolved. We are not aware of any material liabilities to our former affiliates as a result of the separation agreements that are not otherwise reflected in our unaudited consolidated financial statements. Nevertheless, it is possible that potential liabilities for which the former affiliates bear primary responsibility may lead to contributions by us.

Avaya has informed us that they settled three separate purported class action lawsuits that are based on claims that we, as predecessor to Avaya's business, sold products that were not Year 2000 compliant. In addition, NCR has disclosed that it is responsible for remediation costs related to the discharge of contaminants into the Fox River in Wisconsin. NCR has informed us that these costs are expected to exceed threshold limits under the separation agreement among NCR, AT&T and us. We have reserves for the amounts we currently expect to pay Avaya and NCR under the separation agreements for these matters. The impact of these matters was not material to our results of operations or financial condition.

Other Commitments

We agreed to purchase 90% of our requirements for products we currently purchase from Agere and 60% of our requirements for other products that Agere can supply through September 30, 2006, provided Agere is competitive with other potential suppliers as to price, lead time and technological merit. We have also agreed to proceed first with Agere on all joint product development projects where Agere meets our criteria.

We exited most of our manufacturing operations and increased our use of contract manufacturers. A sole-source supplier is currently used for a majority of the switching and wireless product lines. Purchases from this supplier were approximately $750 million, $695 million and $1.5 billion during fiscal 2004, 2003 and 2002, respectively. Four other contract manufacturers supplied the majority of our other product lines. Purchases from these suppliers were approximately $880 million, $825 million and $1.0 billion during fiscal 2004, 2003 and 2002, respectively. We are generally not committed to unconditional

purchase obligations in these contract-manufacturing relationships. However, there is exposure to short-term purchase commitments when they occur within the contract manufacturers' lead-time for specific products or raw materials. These commitments were $691 million as of September 30, 2004. As a result, any sudden and significant changes in forecasted demand requirements within the lead-time of those products or raw materials could adversely affect our results of operations and cash flows.

Guarantees and Indemnification Agreements

We divested certain businesses and assets through sales to third-party purchasers and spin-offs to our common shareowners. In connection with these transactions, certain direct or indirect indemnifications are provided to the buyers or other third parties doing business with the divested entities. These indemnifications include secondary liability for certain leases of real property and equipment assigned to the divested entity and certain specific indemnifications for certain legal and environmental contingencies, as well as vendor supply commitments. The time durations of such indemnifications vary but are standard for transactions of this nature.

We remain secondarily liable for approximately $275 million of lease obligations as of September 30, 2004, that were assigned to Avaya, Agere and purchasers of other businesses. The remaining terms of these assigned leases and our corresponding guarantees range from one month to 15 years. The primary obligor under assigned leases may terminate or restructure the lease obligation before its original maturity and thereby relieve us of our secondary liability. We generally have the right to receive indemnity or reimbursement from the assignees and have not reserved for losses on this form of guarantee.

We are party to a tax-sharing agreement to indemnify AT&T and are liable for tax adjustments that are attributable to our lines of business, as well as a portion of certain other shared tax adjustments during the years prior to our separation from AT&T. We have similar agreements with Avaya and Agere. In addition to the fiscal year 2001 federal net operating loss carryback claim discussed in Note 7, certain tax adjustments have been proposed or assessed subject to these tax-sharing agreements. Certain tax issues, including potential adjustments and refunds related to the years 1990 through 1998 were recently resolved with the Internal Revenue Service and our former affiliates. The resolution of these matters resulted in a benefit of $234 million, including interest of $90 million, to our results of operations during fiscal 2004. The outcome of all remaining matters is not expected to have a material adverse effect on our consolidated results of operations, consolidated financial position or near-term liquidity.

We license to our customers software and rights to use intellectual property that might provide the licensees with an indemnification against any liability arising from third-party claims of patent, copyright or trademark infringement. We cannot determine the maximum amount of losses that we could incur under this type of indemnification, because we often may not have enough information about the nature and scope of an infringement claim until it has been submitted to us.

We indemnify our directors and certain of our current and former officers for third-party claims alleging certain breaches of their fiduciary duties as directors or officers. Certain costs incurred for providing such indemnification may be recovered under various insurance policies.

We are unable to reasonably estimate the maximum amount that could be payable under certain of our arrangements since these exposures are not capped and due to the conditional nature of our obligations and the unique facts and circumstances involved in each agreement. Historically, payments made under these agreements have not had a material effect on our business, financial condition or results of operations.

Warranty reserves are established for costs that are expected to be incurred after the sale and delivery of a product or service for deficiencies under specific product or service warranty provisions. These reserves are established when it is probable that customers will make claims and when a reasonable estimate of costs can be made. The reserves are determined as a percentage of revenues based on the actual trend of historical charges incurred over various periods, excluding any significant or infrequent issues that are specifically identified and reserved. The following table summarizes the activity related to warranty reserves:

(in millions)	Years ended September 30, 2004	2003
Reserve at beginning of year	$ 330	$ 440
Accruals for warranties, net	61	136
Payments	(94)	(229)
Optical Fiber business adjustment	-	(17)
Reserve at end of year	$ 297	$ 330

Environmental Matters

Our current and historical operations are subject to a wide range of environmental laws. In the United States, these laws often require parties to fund remedial action regardless of fault. We have remedial and investigatory activities underway at numerous current and former facilities.

Environmental reserves of $118 million have been established for environmental liabilities that can be reasonably estimated as of September 30, 2004. These reserves are not discounted to present value. We have receivables of $31 million with respect to environmental matters due from third-party indemnitors as of September 30, 2004. Receivables are recorded only if the indemnitors have agreed to pay the claims and management believes collection of the receivables is reasonably assured. Environmental matters did not have a significant impact on our consolidated financial condition, results of operations, or cash flows during the year ended September 30, 2004. Charges related to environmental matters were $15 million, $25 million and $26 million during fiscal 2004, 2003 and 2002, respectively and were included in costs.

Reserves for estimated losses from environmental remediation are, depending on the site, based on analyses of many interrelated factors, including:

- The extent and degree of contamination and the nature of required remedial actions.
- The timing and various types of environmental expenditures, such as investigatory, remedial, capital and operations, and maintenance costs.
- Applicable legal requirements defining remedial goals and methods.
- Progress and stage of existing remedial programs in achieving remedial goals.
- Innovations in remedial technology and expected trends in environmental costs and legal requirements.
- The number, participation level and financial viability of other potentially responsible parties.
- The timing and likelihood of potential recoveries or contributions from other third parties.
- Historical experience.
- The degree of certainty and reliability of all the factors considered.

It is often difficult to estimate the future impact of environmental matters, including potential liabilities, due to the above factors and the lengthy time periods involved in resolving them (which may be up to 30 years or longer). Although we believe that our reserves are currently adequate, there can be no assurance that the amount of capital expenditures and other expenses which will be required relating to remedial actions and compliance with applicable environmental laws will not exceed the amounts reflected in reserves or will not have a material adverse effect on our consolidated financial condition, results of operations or cash flows. Any possible loss or range of possible loss that may be incurred in excess of amounts provided for as of September 30, 2004 cannot be reasonably estimated.

Lease Commitments

We lease land, buildings and equipment under agreements that expire in various years through 2020. Rental expense under operating leases was $230 million, $267 million and $325 million, net of sublease rental income of $38 million, $53 million and $96 million, for fiscal 2004, 2003 and 2002, respectively. Future minimum lease payments due under non-cancelable operating leases (including leases that are part of our restructuring actions) as of September 30, 2004 were $180 million in 2005, $136 million in 2006, $101 million in 2007, $86 million in 2008, $75 million in 2009 and $423 million thereafter. These future minimum lease payments do not include future sublease rental income of $27 million in 2005, $18 million in 2006, $16 million in 2007, $14 million in 2008, $12 million in 2009 and $125 million thereafter.

14. QUARTERLY INFORMATION (UNAUDITED)

(in millions, except per share amounts)	First	Second	Third	Fourth	Total
Year ended September 30, 2004					
Revenues	$ 2,259	$ 2,194	$ 2,190	$ 2,402	$ 9,045
Gross margin	919	938	947	975	3,779
Recovery of bad debts and customer financings	(14)	(99)	(90)	(27)	(230)
Business restructuring charges (reversals), net	29	(17)	(27)	(5)	(20)
Other income (expense), net	79	(172)	128	205	240
Income taxes	(101)	(22)	(4)	(812)	(939)
Net income	338	68	387	1,209	2,002
Conversion / redemption cost - 8% preferred stock	(1)	-	-	-	(1)
Preferred stock dividends and accretion	12	-	-	-	12
Net income applicable to common shareowners	349	68	387	1,209	2,013
Income per common share:					
Net income applicable to common shareowners - basic	0.08	0.02	0.09	0.28	0.47
Net income applicable to common shareowners - diluted	0.07	0.02	0.08	0.23	0.42
Year ended September 30, 2003					
Revenues	$ 2,075	$ 2,403	$ 1,965	$ 2,027	$ 8,470
Gross margin	454	762	573	863	2,652
Provision for (recovery of) bad debts and customer financings	(91)	24	(32)	(124)	(223)
Goodwill impairment	-	-	35	-	35
Business restructuring charges (reversals), net (including amounts affecting gross margin)	(14)	(142)	14	(42)	(184)
Other income (expense), net	22	(489)	31	8	(428)
Income taxes	(120)	(197)	(69)	153	(233)
Net (loss) income	(264)	(351)	(254)	99	(770)
Conversion / redemption cost - 8% preferred stock	(100)	(166)	(20)	(1)	(287)
Preferred stock dividends and accretion	(25)	(36)	(21)	(21)	(103)
Net income (loss) applicable to common shareowners	(389)	(553)	(295)	77	(1,160)
(Loss) income per common share - basic and diluted:					
Net income (loss) applicable to common shareowners	(0.11)	(0.14)	(0.07)	0.02	(0.29)

As reflected above, our quarterly results were impacted by charges, recoveries or reversals related to bad debts and customer financing, restructuring actions and retirements of convertible securities and certain debt obligations among other items. There were no dividends per common share for any of the periods presented. The impact of significant items incurred during the first three interim periods of each fiscal year are discussed in more detail and disclosed in our quarterly reports on Form 10-Q. Additional items affecting our quarterly results were as follows:

- During the second quarter of fiscal 2003, we recognized a $415 million charge in other income (expense) related to the settlement of our shareowner class action lawsuits for alleged securities violations. Additional charges (benefits), primarily to adjust the fair value of the warrants that are expected to be issued in connection with the legal settlement, were $54 million, $212 million, ($72) million and ($98) million for the four quarters of fiscal 2004 and $33 million in both the third and fourth quarters of fiscal 2003.
- The results for the four quarters of fiscal 2004 included the impact of certain discrete tax items related to the reversal of valuation allowances and the favorable settlement of certain prior year federal and state tax audit matters. Tax related benefits recognized for the four quarters of fiscal 2004 were $123 million, $37 million, $15 million and $828 million, including the recognition of an $816 million net operating loss carryback claim. We also recognized $68 million, $18 million, $4 million and $45 million of interest income related to these settlements during the four quarters of fiscal 2004. During each of the first three quarters of fiscal 2003, the income tax benefit reflected the expected utilization of a portion of the current period's operating losses as a result of certain equity transactions, including a $135 million tax benefit from exchanges of 7.75% convertible securities for shares of our common stock, and a $30 million tax benefit from unrealized investment holding gains. These income tax benefits were reversed during the fourth quarter of fiscal 2003 as a result of changes in the minimum pension liability that was reflected in other comprehensive income.