

BELLSOUTH[®]

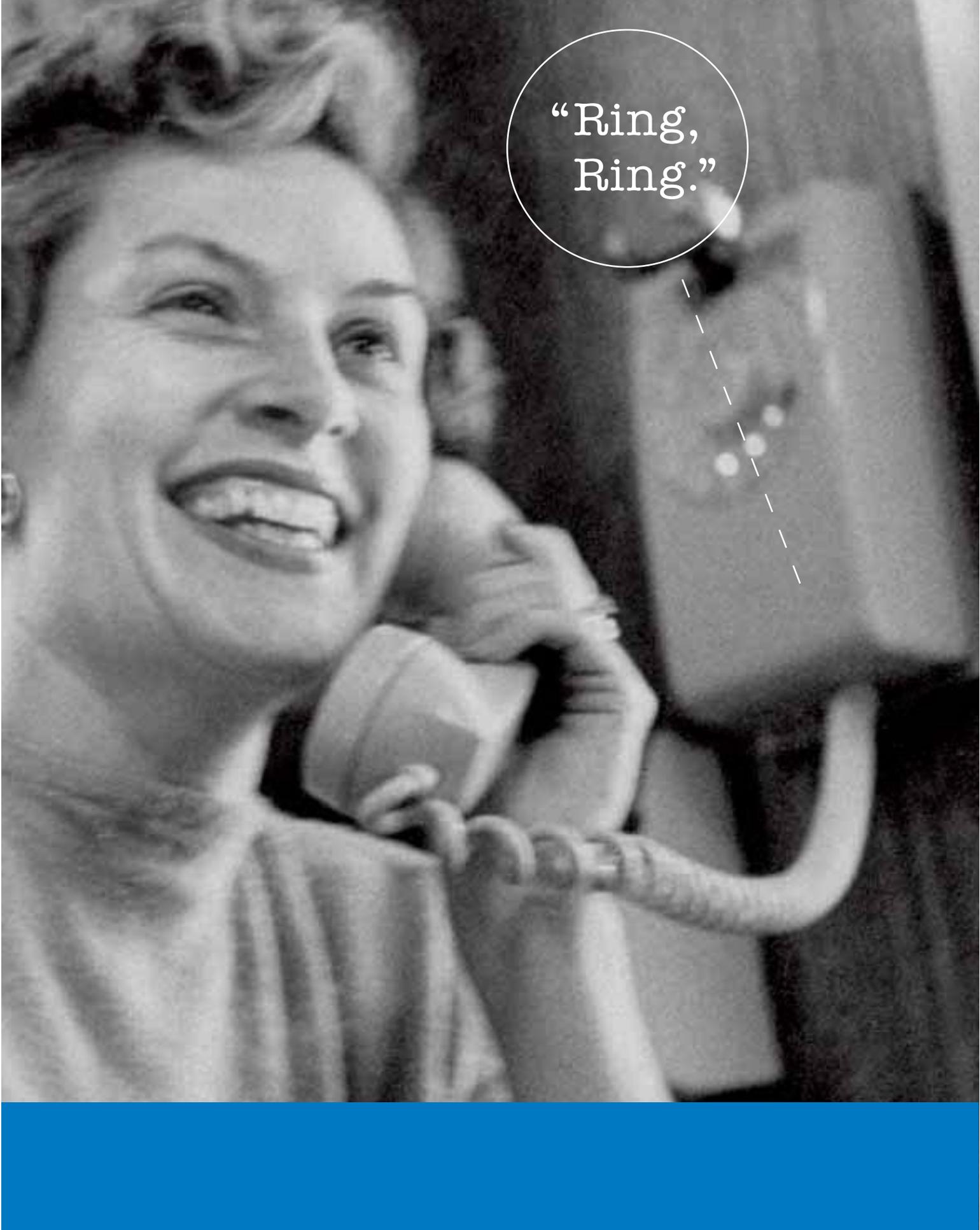
2004 Annual Report

A photograph of a woman and a young boy looking at a computer monitor together. The woman is on the right, wearing a grey blazer and a white shirt, smiling as she looks at the screen. The boy is on the left, wearing a blue shirt and a blue tie, also smiling and looking at the screen. The background shows a white brick wall with a framed picture and green curtains.

***Improving people's
lives with the power
of communications.***



***Telecommunications
used to be just about
the telephone.***



“Ring,
Ring.”

*Today, communications
is so much more ...*

[Vibrate].

*beep,
beep.*



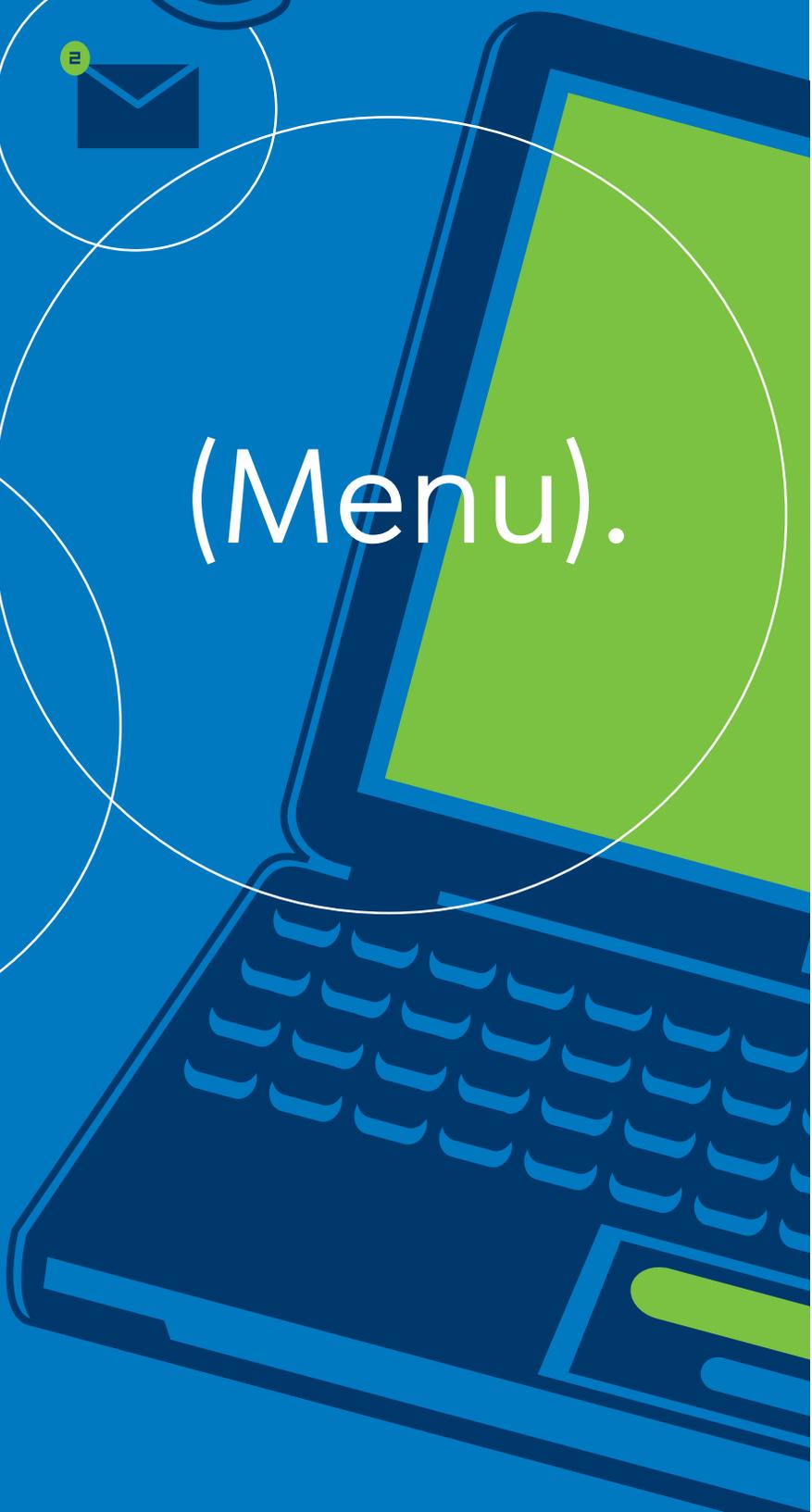


Chirp, Chirp.



(Menu).

Surf.



***It's what we're all
about at BellSouth.***



wireless handsets

Cingular works exclusively with the best manufacturers to bring customers the latest in wireless technology, like the new MOTO RAZR V3.



high-speed Internet access

With BellSouth® FastAccess® DSL, customers can talk on the phone and surf on the Internet at the same time, download photos and music, play games and stream video.



wireless voice

Cingular Nation® plans have Unlimited Night and Weekend Minutes, Anytime Rollover Minutes and no long distance or roaming charges. Cingular's Family plans let customers add phones and share minutes.



video entertainment

A variety of DIRECTV® programming delivers access to over 225 digital-quality channels of news, sports and movies – plus commercial-free audio music channels.



wireless data

Cingular data packages provide wireless Internet access, instant/text messaging and multimedia messaging. Customers can also download ringtones, games, customized graphics and much more.



business solutions

Local and long distance voice and secure, reliable data networking solutions keep businesses of any size connected and competitive.



any distance voice

Call anywhere in the United States anytime for one monthly rate with the BellSouth® Unlimited plan and the Complete Choice® plan, a premium set of calling features.



bundles and packages

BellSouth Answers® provide all the services customers need – local and long distance voice, Cingular Wireless, digital television and Internet access – all in one package. The more services selected, the more money saved.



online and print directories

The Real Yellow Pages® and RealPages.com® give businesses the advertising tools to connect to potential customers before they make buying decisions.

Financial Highlights

BellSouth Corporation

| <i>(Dollars in millions, except per share data)</i> | 2002 | 2003 | 2004 |
|--|-----------|-----------|------------------|
| Operating Revenues | \$ 20,207 | \$ 20,341 | \$ 20,300 |
| Operating Expenses | \$ 15,753 | \$ 14,784 | \$ 15,011 |
| Net Income from Continuing Operations | \$ 3,475 | \$ 3,488 | \$ 3,394 |
| Net Income | \$ 1,323 | \$ 3,904 | \$ 4,758 |
| Diluted Earnings Per Share from Continuing Operations | \$ 1.85 | \$ 1.88 | \$ 1.85 |
| Diluted Earnings Per Share | \$ 0.71 | \$ 2.11 | \$ 2.59 |
| Weighted Average Shares Outstanding – Diluted (millions) | 1,876 | 1,852 | 1,836 |
| Declared Dividends Per Share | \$ 0.79 | \$ 0.92 | \$ 1.06 |
| Total Assets ⁽¹⁾ | \$ 49,479 | \$ 49,702 | \$ 59,496 |
| Capital Expenditures | \$ 3,536 | \$ 2,926 | \$ 3,193 |
| Debt Ratio ⁽¹⁾ | 49.2% | 43.1% | 47.1% |
| DSL Customers (000) ⁽¹⁾ | 1,021 | 1,462 | 2,096 |
| Long Distance Customers (000) ⁽¹⁾ | 1,002 | 3,960 | 6,130 |
| Cingular Wireless Customers (000) ⁽¹⁾ | 21,925 | 24,027 | 49,109 |
| Access Lines (000) ⁽¹⁾ | 23,005 | 22,263 | 21,356 |
| Employees ⁽¹⁾ | 77,020 | 75,743 | 62,564 |
| Closing Stock Price ⁽¹⁾ | \$ 25.87 | \$ 28.30 | \$ 27.79 |

⁽¹⁾ At end of year

Dear Shareholders:

Communications used to be about the telephone. We dialed, and our voices flowed over vast networks. Today, communications is still about that voice on the phone, but it's also about data – sending pictures, downloading music and watching videos. We click, we email, we surf, we download and we text message each other.

And we can do so on any number of wired and wireless devices running on high-speed, broadband networks. For our customers and shareholders, communications is so much more than it used to be. At BellSouth, we are in the business of harnessing the power of communications to improve our customers' lives and businesses every day.

In 2004, BellSouth celebrated 20 years of meeting the changing communications needs of our customers while at the same time delivering value for our shareholders.

This milestone year was marked by both tradition and transformation. We made significant strategic changes in our Company – we sold our Latin America division to Telefónica, and we made a significant cash contribution to Cingular's purchase of AT&T Wireless. In spite of the near-term disruptive effects of these changes, our total shareholder return was 2 percent. We maintained a strong balance sheet and cash flows. We increased our declared dividends per share by 15.2 percent, improving our dividend yield to 3.9 percent at year-end. To keep pace with our customers' communications needs, BellSouth is transforming the business to focus on the growth areas of wireless

Duane Ackerman

Chairman and Chief Executive Officer



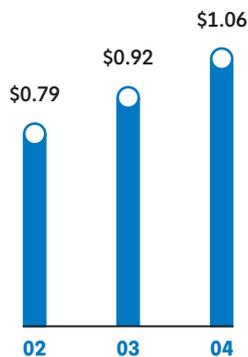
and broadband. We believe that this transformation positions us well in the shifting communications marketplace, and will enable us to uphold our tradition of focusing on the financial fundamentals.

Industry Transformation

Your Company will continue to see more transformation over the next several years. The communications landscape is fundamentally changing, with shifts in technology and consolidation of competitors. Our customers and our services are shifting from wireline to wireless and from narrowband voice to broadband services. With next-generation technology, voice, video and data can run simultaneously on a broadband network. Customers can see and hear all these services on home phones, wireless phones, personal computers and television set-top boxes. Convergence has finally happened. Also over the last 12 months, the communications landscape has seen consolidation – Cingular acquired AT&T Wireless and pending mergers were announced for AT&T, MCI and Nextel.

Declared Dividends per Share

dollars per share



All these changes in technology and corporate structures have profound implications for everyone. Today, competition to be the communications provider of choice for homes and offices is intense. Tomorrow, while there may be fewer competitors, there remain many risks in the communications environment. The companies that will succeed are the ones who transform their businesses with balance and financial discipline. That's why BellSouth has positioned our assets for growth, while delivering value for our investors today.

Positioned for Tomorrow

We have realigned our assets in four different areas of our business to focus on domestic growth opportunities in the communications industry.

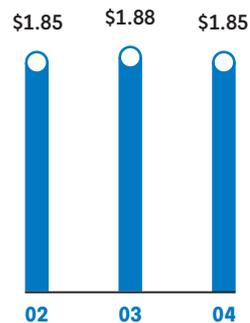
Cingular Wireless completed the acquisition of AT&T Wireless, creating the nation's largest wireless company with a mobile-to-mobile calling community of more than 49 million customers. The new Cingular offers the nation's largest digital and voice network, better call quality, more geographic and global coverage, and next-generation data services for both consumer and business customers.

Now that the merger with AT&T Wireless is closed, we are focused on integrating the two companies. Cingular demonstrated a fast start out of the gate by adding a record 1.8 million pro forma new customers in the fourth quarter of 2004.

Over the next few years, Cingular will build the best network, deliver great customer service, create unmatched distribution and develop compelling products and services. With these plans in place, Cingular is poised to achieve market-leading performance. By 2007, Cingular has set a goal to be the fastest growing wireless company, to be the most profitable wireless company and to be the company with the best reputation around its customers and its network.

Diluted Earnings per Share from Continuing Operations

dollars per share



Cingular is well positioned to participate in a growing segment of the U.S. communications market. For BellSouth, approximately 40 percent of our normalized company revenue now comes from domestic wireless communications services and, as Cingular adds customers and products, its revenue growth will enhance our financial performance in the future.

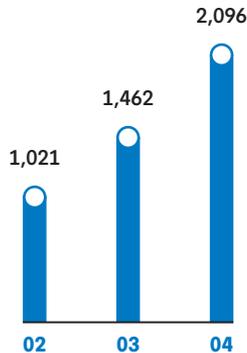
In January 2005, we successfully completed the sale of our 10 Latin America operations to Telefónica Móviles, the wireless affiliate of Telefónica, S.A.

To position our Advertising and Yellow Pages asset for growth in the Internet search business, we formed an Internet Yellow Pages joint venture with SBC that acquired YellowPages.com, Inc. in November 2004.

In our wireline business, traditional access line voice services are being replaced by broadband and wireless services. We are transforming our wireline business to provide broadband services, and we have made significant progress on that journey. We have been the leader in deploying fiber in our network for 20 years, steadily increasing the broadband capacity of our network by pushing fiber to the outer edges. Today, we are already passing more than 1 million homes with fiber and adding to this number every year. In 2004, BellSouth generated more than \$4.5 billion in network data revenue from broadband services to both consumers and businesses. In the future, communications services will rely more and more on broadband and fiber-based networks.

We now have more than 2 million DSL subscribers, and we are aggressively competing to grow that number. Cable companies are offering communications packages that include voice and high-speed Internet services in addition to their traditional video services. To compete, BellSouth today offers a "triple play" bundle of voice and data, and video services from DIRECTV. Our combined unlimited voice, high-speed data and satellite entertainment package is very

DSL Customers in thousands



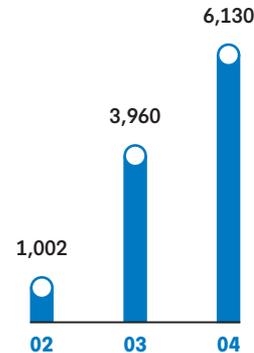
competitive on both price and quality of service. We also believe that with careful investing, we can provide speeds fast enough to make high-bandwidth services, including video, over our own network a reality.

BellSouth serves more than 1 million business customers ranging in size from single location small businesses to global Fortune 500 corporations. We provide voice and data networking solutions to all these customers over our fiber-rich network. Since May 2002, more than half our small business customers have switched their long distance service to BellSouth. And with our long distance capabilities, we are successfully providing more complete voice and data solutions to our large business customers. We are committed to offering our business customers the leading-edge services they need to grow and expand their operations and to take advantage of the productivity and cost benefits of the Internet.

In 2005, BellSouth will continue to pursue regulatory reform. The FCC made progress in 2004 by easing regulation around fiber-based broadband services and regulatory pricing schemes. But we need updated legislation to bring about market-based competition. The way people communicate has changed, but the laws governing the telecommunications industry have not kept pace.

That's why BellSouth, along with other local phone companies, will support legislation to reform federal telecom law so that we can freely compete with cable, wireless and other communications platforms in the marketplace. Through the *Future...Faster* coalition, we are working with like-minded industry constituents who believe that competition and consumer choice will do a far better job of driving telecom to its full potential for our nation than heavy government regulation. I encourage you to please join with your fellow shareholders and our employees by filling out and returning the enclosed postcard on page 24 of this report or signing up at www.thefuturefaster.com/bellsouth.

Long Distance Customers in thousands



Delivering for Today

Throughout this year of transformation, BellSouth has remained committed to the traditional fundamentals of our business: value for our shareholders and service for our customers.

We continue to foster a strong ethical climate at BellSouth. We take great care to operate our business with integrity and in compliance with the law. As required by the Sarbanes-Oxley Act, we conducted a time-consuming and thorough assessment of the Company's internal controls over financial reporting. We are pleased to confirm that these internal controls were effective at year-end.

We upheld our tradition of service during the worst hurricane season in more than a century. Our markets were hit hard by four hurricanes in six weeks. To ensure the reliability of our network, we deployed massive amounts of equipment and resources. Thanks to the tireless efforts and dedication of our employees, we did not have a single central office fail, and our technicians were able to restore service to our customers quickly and efficiently.

2005 will once again be a year of challenges and change in our industry. I believe the future belongs to those who balance vision with fundamentals, financial discipline with investment and the promise of new technology with improving the lives of customers.

In a rapidly changing environment, BellSouth is committed to striking that balance. That's who we are. We will stand firm on that foundation – and we are committed to working hard for our shareholders and our customers today and in the future.

Duane Ackerman
Chairman and Chief Executive Officer

***We deliver what
our customers want.***



For more than 20 years, BellSouth has been improving our customers' lives and businesses with the power of communications. We are committed to providing the **simple, reliable services** that customers need to operate more efficiently and effectively at work and to connect more quickly and easily at home. We simply deliver what our customers want. We do this by staying on the forefront of technology. Today, BellSouth has one of the **most advanced wireline networks** in the industry. We have deployed fiber to the outer edges of our network, allowing us to evolve from a narrowband voice company to a **broadband services** company.

By diligently investing in **wireless technology**, we are launching a next-generation network that carries voice and data. Now that the purchase of AT&T Wireless is complete, Cingular serves more than 49 million customers with the nation's largest digital voice and data network. We are rapidly moving toward a future where technology convergence will allow us to offer customers a continuum of integrated **voice, data and video solutions over both wireline and wireless devices**. In the pages that follow, you will see that BellSouth is positioned to meet our customers' demands for speed, convenience and efficiency.



Diane

Diane's one-woman business is now much more efficient.

The need for broader bandwidth to transfer more data at faster speeds is a rapidly growing trend – and one that BellSouth has responded to with our DSL service. Diane's home-based business is part of this trend, and she found a high-speed DSL option that best meets her needs as a manufacturer's representative. Her BellSouth® FastAccess® DSL service offers the right capacity for quickly downloading graphics, manuals and technical material as well as receiving emails from customers.

BellSouth has the network capabilities to deliver broadband DSL service at increasingly greater speeds. BellSouth has continued to penetrate the high-speed Internet access market and by the end of 2004, we served more than 2 million DSL subscribers with broadband access.

As we continue to grow our broadband market share, we are focused on offering a portfolio that features a variety of speeds and prices to attract a broad base of customers. For businesses, BellSouth's DSL offers include faster upload speeds, web pages, multiple email boxes and a back-up dial account. DSL also provides an easier way for people to be productive at home by connecting them more quickly to their company's networks, email servers and the Internet. In the future, these customers will demand faster broadband services and packages. In anticipation of these needs, BellSouth is testing next-generation broadband services so that technology can continue to make our customers' daily lives and businesses more efficient.

Diane Shagott runs Dinamic Sales & Marketing from her home office with help from BellSouth. She chose BellSouth® FastAccess® DSL because of her need for quick, reliable email service and speedy downloads. BellSouth's call transfer and toll-free long distance services also help her stay in touch with her customers and the headquarters of the company she represents. "These services offer an efficient, cost-effective way for me to do business."





The Petersons have been BellSouth customers since 1986. In addition to local and long distance phone service, they have BellSouth® FastAccess® DSL and a Cingular® Family plan. They added DIRECTV® service before the holidays and are pleased with how easy it is to use. Mary's mom, Karen, noted, "We've had great success with BellSouth in all of the services we use, and you just can't beat the convenience of getting all your communications services from one company."

Mary

Mary and her family can have it all.

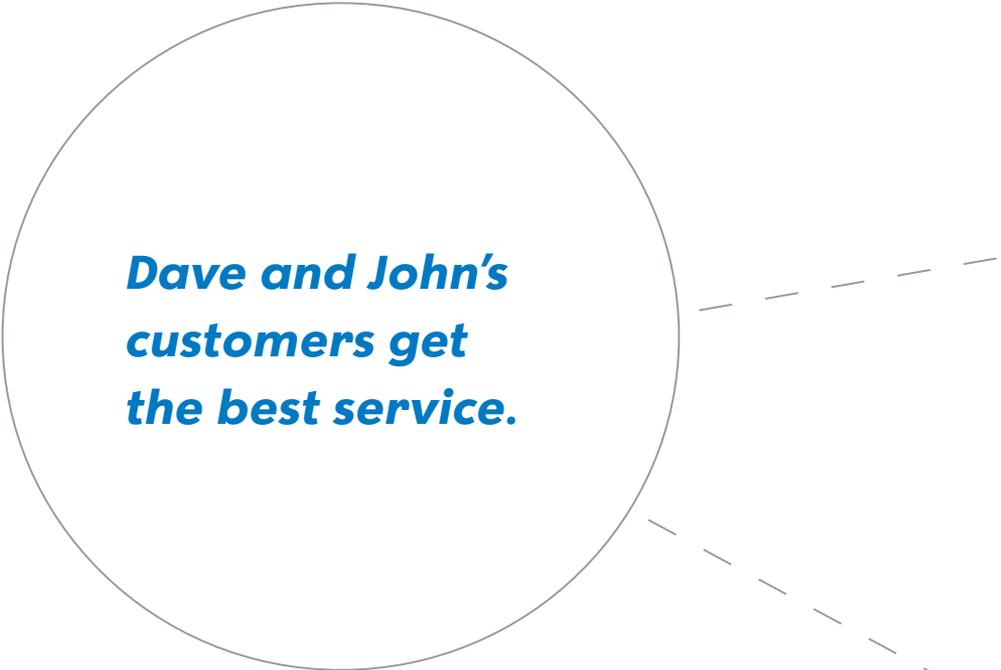
BellSouth's bundled offers are the answer for families like the Petersons, who want access to local, long distance, high-speed Internet access, wireless and video services in packages that are simple and convenient.

Mary and her brothers, Mark and David, take full advantage of these bundled services. They use BellSouth's DSL service to access the Internet for homework assignments and to instant message their friends. They also enjoy talking on the phone and watching satellite television. Recently, the family took advantage of a Cingular® Family plan and added a wireless phone for Mark. Most of all, the Petersons appreciate having one company responsible for all their communications services.

Bundling our products and services in BellSouth Answers® packages is one of the many ways we attract and retain customers. Customers can choose the right BellSouth services to meet their needs.

Families appreciate BellSouth's DSL add-on products: home-networking that connects multiple computers to DSL, parental Internet controls and email spam blockers. And many people enjoy the BellSouth® Unlimited Long Distance plan, which allows customers to call local and long distance for one monthly price, regardless of how much time they spend on the phone. By including popular services, such as DIRECTV® satellite television service, we have further enhanced the BellSouth Answers® consumer bundle. In fact, in our first six months of offering this service, more than 200,000 customers made DIRECTV® service part of their communications bundles. Currently, we have approximately 4.4 million BellSouth Answers® bundle customers, and the number is steadily growing. BellSouth customers can have it all – convenience, simplicity and a positive service experience end-to-end.

Dave and John



**Dave and John's
customers get
the best service.**

Regions Financial Corporation and other large, data-intensive businesses require secure, reliable networks to support their information technology operations and to serve their customers effectively. BellSouth's advanced network delivers the capabilities these companies need to get the job done right.

We offer a variety of products and services so that companies like Regions can do more. For example, with BellSouth's local and long distance voice and data network, Regions – one of the top 15 financial services companies in the nation – can grow and expand its call centers to provide enhanced customer service. BellSouth® SMARTRing® service offers a data network built on redundant, self-healing fiber that can reroute high volumes of voice, data

and video traffic in the event of network downtime. With the BellSouth® Virtual Private Network (VPN), companies can use one platform to manage all of their networks, connect branches or satellite offices, and provide employees working from home with access to the company network over DSL.

Looking to the future, we are expanding our voice over Internet protocol (VoIP) capabilities, deploying more sophisticated and faster network connections and further integrating wireless and wireline communications. By providing our solutions to large business customers like Regions, we will continue to meet their needs and build on our long-term relationships.



Regions Financial Corporation has been a BellSouth customer for 20 years. As Regions has grown, BellSouth has helped the company keep pace with changing technology. David C. "Dave" Gordon, executive vice president – operations, and John R. Dick, chief information officer, rely on BellSouth for a secure, reliable network that enables connectivity for Regions' banking, brokerage and ATM activity within BellSouth's markets. This reliable network helps Regions serve more than 5 million customers in 15 states across the South, Midwest and Texas.





Anna and Raymond

The Hsus like being part of the largest digital wireless network.

For customers like the Hsus, 2004 was the year BellSouth helped raise the bar on wireless communications, with the merger of Cingular Wireless and AT&T Wireless. Through our Cingular joint venture, we now have the largest digital voice and data network in the nation, providing coverage to millions of consumers and businesses across the United States. And, beyond our borders, Cingular's GSM technology is dominant globally, allowing us to provide coverage in 100 international countries.

The merger improved Cingular's reach and gave it the competitive advantage of spectrum depth. The result is better network performance, and the ability to implement advanced technology that will combine voice and high-speed data on a single platform.

Today, Cingular is focused on integrating the two companies. And, while this is clearly a multi-year journey, we are encouraged by what the company has already accomplished:

- A new marketing and advertising campaign that successfully promoted the new Cingular
- Overnight conversion of more than 1,000 AT&T Wireless stores and more than 10,000 agent locations
- 2 million training hours completed for thousands of employees and agents
- Record customer growth of 1.8 million pro forma subscribers in the fourth quarter of 2004

By building the best network, delivering great customer service, creating broad distribution and developing new, compelling products and services, Cingular is poised to be a market leader by 2007.

Anna and Raymond Hsu depend on their Cingular® Wireless service to run their three Atlanta restaurants – Silk, Hsu's and Pacific Rim Bistro. With eight cell phones distributed among their family and business partners, the Hsus are never out of contact. Raymond Hsu said, "Our Cingular service is better than ever now. That's important for our business."

Robert and Sharolyn

Robert and Sharolyn go the extra mile to help our customers.

At BellSouth, going the extra mile is a fundamental component of everything we do. Our commitment to our customers and their communities was never more evident than in the weeks after four devastating hurricanes pounded our markets in 2004. Hundreds of employees traveled to the affected states to restore service and rebuild the network infrastructure. Working around the clock, we repaired nearly 20,000 damaged cable spans and nearly 6,500 poles. In addition, we delivered equipment, ice, water and fuel, and helped schools re-open. Our employees and retirees also served meals at shelters, recruited volunteers, covered damaged roofs, spearheaded drives for supplies and sometimes just listened to distraught customers.

Meeting customers' needs is also the driving force behind BellSouth's research and development efforts. We are focused

on implementing the next generation of our broadband network, which will increase capacity to customers' homes and enable them to take greater advantage of services requiring larger bandwidth. These include enhanced voice and data services over the Internet; home-networking multiple computers; Internet control of electronics, appliances and security systems; and on-demand television. In an effort to more fully integrate wireless and wireline technology, we are testing cell phones that operate on Cingular's cellular network outside the home and on BellSouth's wireline network inside the home. We are also participating in a trial with Microsoft, testing high-definition Internet protocol (IP) television. Our goal is to increase our ability to serve our customers and to provide products that they value.



Photo by Fred Sauers

Above, Robert Fenner, BellSouth services technician in Pensacola, Florida, reports damage in Hurricane Ivan's wake. Below, Sharolyn Farmer, research director in BellSouth's Architecture and Emerging Technology Group, evaluates products and services that will enable BellSouth to remain competitive. "My job is directly related to customer service – seeking innovative ways that technology can provide value and create the highest level of customer satisfaction," Sharolyn said.



Board of Directors



F. Duane Ackerman, 62

Chairman of the Board,
President and Chief
Executive Officer,
BellSouth Corporation
Atlanta, GA
Director since 1993.



Kathleen F. Feldstein, 64

President,
Economic Studies, Inc.
Belmont, MA
– economics
consulting firm
Director since 1998.



Reuben V. Anderson, 62

Partner,
Phelps Dunbar, LLP
Jackson, MS
– law firm
Director since 1994.



James P. Kelly, 61

Retired Chairman of
the Board and Chief
Executive Officer,
United Parcel Service, Inc.
Atlanta, GA
Director since 2000.



James H. Blanchard, 63

Chief Executive Officer,
Synovus Financial
Corporation
Columbus, GA
– bank holding company
Director since 1994.



Leo F. Mullin, 62

Retired Chairman of
the Board and Chief
Executive Officer,
Delta Air Lines, Inc.
Atlanta, GA
Director since 1998.



J. Hyatt Brown, 67

Chairman of the Board and
Chief Executive Officer,
Brown & Brown, Inc.
Daytona Beach, FL
– insurance services
company
Director since 1994.



Robin B. Smith, 65

Chairman of the Board,
Publishers Clearing House
Port Washington, NY
– direct marketing
company
Director since 1994.



Armando M. Codina, 58

Chairman of the Board
and Chief Executive Officer,
Codina Group Inc.
Coral Gables, FL
– real estate development
company
Director since 1992.



**William S.
Stavropoulos, 65**

Chairman of the Board,
The Dow Chemical
Company
Midland, MI
Director since 1997.

Corporate Governance

BellSouth has held fast to a tradition of strong corporate governance. The Board has adopted Corporate Governance Principles, which set forth the guidelines for the operation of the Board and its Committees. Over the last three years, the Board has conducted reviews of the Company's governance practices and procedures, evaluating them against corporate governance best practices. As a result of these reviews, the Board adopted various changes to its Corporate Governance Principles that are designed to enhance shareholder confidence. These Principles are available on the Company's website at www.bellsouth.com/corporate_governance, and are attached to the Proxy Statement. The Board will continue to monitor this evolving area and make additional changes as appropriate.

BellSouth Management

F. Duane Ackerman

Chairman of the Board,
President and
Chief Executive Officer

Richard A. Anderson

Vice Chairman –
Planning and Administration

Mark L. Feidler

Chief Operating Officer

Marc Gary

General Counsel

Isaiah Harris, Jr.

President –
Advertising & Publishing

Herschel L. Abbott, Jr.

Vice President –
Governmental Affairs

Ronald E. Frieson

Vice President –
Transition and Strategy

William C. Pate

Vice President –
Advertising and
Public Relations

Rex M. Adams

President –
Interconnection Services

Jan H. Funderburg

President –
Consumer Services

Eddy C. Roberts, Jr.

State President –
Kentucky

Valencia I. Adams

Vice President –
Chief Diversity Officer

Margaret H. Greene

President –
Regulatory and External Affairs

David W. Scobey, Jr.

President –
Small Business Services

Paulino R. Barros, Jr.

Vice President –
Product Development and
Management

Don G. Hallacy

Chief Information Officer –
Domestic Operations

Fredrick K. Shaftman

President –
BellSouth Business

Barry L. Boniface

Vice President –
Planning and Development

Thomas L. Hamby

State President –
Alabama

W. Patrick Shannon

Senior Vice President –
Finance and Controller

Richard E. Burns

Vice President –
Centers and
Operations Support

Phil S. Jacobs

State President –
Georgia

Richard D. Sibbersen

Vice President –
Human Resources

Keith O. Cowan

President –
Marketing and Product
Development

Joseph P. Lacher

State President –
Florida

Elmer L. Smith ⁽¹⁾

President –
Advertising & Publishing

Marty G. Dickens

State President –
Tennessee

Donna A. Lee

Chief Marketing Officer

William L. Smith

Chief Technology Officer

Francis A. Dramis, Jr.

Chief Information,
eCommerce and
Security Officer

Harry M. Lightsey, III

State President –
South Carolina

Krista S. Tillman

State President –
North Carolina

Mark E. Droege

Vice President and Treasurer

John M. McCullouch

State President –
Mississippi

Lynn A. Wentworth

Vice President and
Chief Financial Officer –
Communications Group

Rebecca M. Dunn

Senior Vice President –
Corporate Compliance and
Corporate Secretary

Roderick D. Odom, Jr.

President –
Network Services

Mauricio E. Wior ⁽¹⁾

Regional Vice President –
Latin America

William A. Oliver

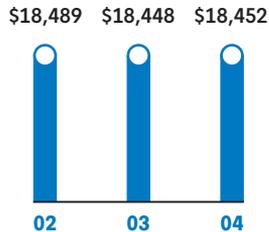
State President –
Louisiana

⁽¹⁾ Retiring in 2005

BellSouth At-a-Glance

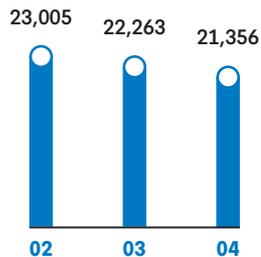
Communications Group Revenue

in millions



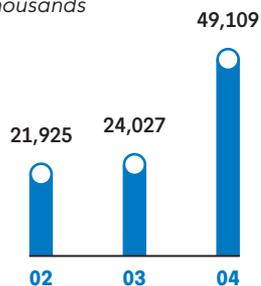
Access Lines

in thousands



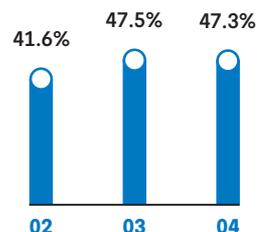
Cingular Customers

in thousands



Advertising & Publishing Segment Operating Margin

in percentages



Communications Group

BellSouth's Communications Group offers voice and data communications services to a wide array of customers, including consumers, small and large businesses and wholesale. Consumer and small business customers can bundle their local and long distance service with dial-up and high-speed DSL Internet access and satellite television. For large businesses, BellSouth provides secure, reliable local and long distance voice and data networking solutions.

Competition and technology substitution have pressured revenues from traditional access line services. Revenue in the segment has remained flat over the last three years as revenue growth from DSL and long distance offset the revenue lost from declining access lines.

Domestic Wireless

BellSouth owns a 40 percent interest in Cingular Wireless, a joint venture that provides nationwide wireless services. Our Domestic Wireless segment is based on our 40 percent proportionate share of Cingular's financial results.

On October 26, 2004, Cingular completed the acquisition of AT&T Wireless, creating the nation's largest wireless company with 49 million customers. Cingular has the largest digital voice and data network in the nation, owns spectrum licenses covering a total population of 290 million and serves all of the nation's top 100 metropolitan areas.

Advertising & Publishing Group

BellSouth's Advertising & Publishing Group publishes, prints and sells advertising in telephone directories and online services as The Real Yellow Pages® and BellSouth® RealPages.com®. This segment is one of the leading publishers of telephone directories in the United States, publishing more than 500 directories and distributing approximately 63 million copies to residences, businesses and government agencies annually.

In November 2004, BellSouth and SBC created an online Internet Yellow Pages joint venture that acquired the online directory publisher YellowPages.com, Inc. This venture is expected to expand our national advertising base and create an industry leader in online Yellow Pages and local Internet search.

Yes! *I want to join other concerned shareholders in taking action on critical issues that affect BellSouth!*

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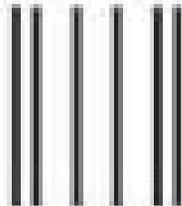
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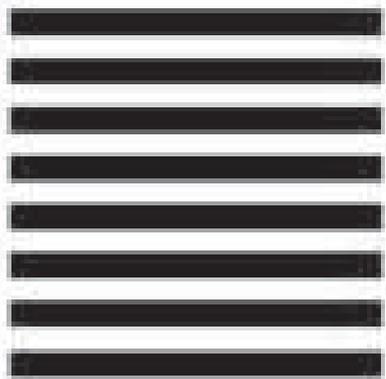
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2004 FINANCIAL INFORMATION

BELLSOUTH CORPORATION

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MARKET FOR REGISTRANT’S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The principal market for trading in BellSouth common stock is the New York Stock Exchange, Inc. (NYSE). BellSouth common stock is also listed on the London, Frankfurt, Amsterdam and Swiss exchanges. The ticker symbol for BellSouth common stock is BLS. At January 31, 2005, there were 688,379 holders of record of BellSouth common stock. Market price data was obtained from the NYSE Composite Tape, which encompasses trading on the principal United States stock exchanges as well as off-board trading. High and low prices represent the highest and lowest sales prices for the periods indicated.

| | Market Prices | | Per Share Dividends Declared | | Market Prices | | Per Share Dividends Declared |
|----------------|---------------|---------|------------------------------|-----------------------|----------------|----------------|------------------------------|
| | High | Low | | | High | Low | |
| 2003 | | | | 2004 | | | |
| First Quarter | \$30.00 | \$19.79 | \$.21 | First Quarter | \$31.00 | \$26.13 | \$.25 |
| Second Quarter | 27.98 | 21.00 | .23 | Second Quarter | 27.86 | 24.46 | .27 |
| Third Quarter | 27.92 | 23.15 | .23 | Third Quarter | 27.94 | 25.08 | .27 |
| Fourth Quarter | 28.37 | 22.19 | .25 | Fourth Quarter | 28.96 | 25.65 | .27 |

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

No change in accountants or disagreements on the adoption of appropriate accounting standards or financial disclosure has occurred during the periods included in this report.

CEO AND CFO CERTIFICATIONS

In 2004, as required by the listing standards of the New York Stock Exchange (NYSE), BellSouth’s chief executive officer (CEO) provided a certificate to the NYSE certifying that he is not aware of any violation by the Company of the New York Stock Exchange’s corporate governance listing standards. In addition, BellSouth’s CEO and chief financial officer filed with the Securities and Exchange Commission all required certifications regarding the quality of BellSouth’s public disclosures in its reports for 2004.

SELECTED FINANCIAL AND OPERATING DATA

DOLLARS ARE IN MILLIONS, EXCEPT PER SHARE AMOUNTS

The comparability of the following Selected Financial and Operating Data is significantly impacted by various changes in accounting principle and merger, acquisition and disposition activity. The more significant items include the formation of Cingular in October 2000, which resulted in a reduction in revenues and expenses caused by the contribution of our wireless operations to Cingular; the adoption of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets", effective January 1, 2002, which resulted in the cessation of amortization of goodwill; and the adoption of SFAS No. 143, "Accounting for Asset Retirement Obligations", effective January 1, 2003, which resulted in a reduction in depreciation expense.

| At December 31 or for the year ended | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|----------|----------|----------|----------|-----------------|
| Income Statement Data: | | | | | |
| Operating revenues | \$23,245 | \$21,211 | \$20,207 | \$20,341 | \$20,300 |
| Operating expenses | 16,663 | 15,339 | 15,753 | 14,784 | 15,011 |
| Operating income | 6,582 | 5,872 | 4,454 | 5,557 | 5,289 |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | 4,236 | 2,786 | 3,475 | 3,488 | 3,394 |
| Income (loss) from discontinued operations, net of tax | (118) | (339) | (867) | 101 | 1,364 |
| Income before cumulative effect of changes in accounting principle | 4,118 | 2,447 | 2,608 | 3,589 | 4,758 |
| Cumulative effect of changes in accounting principle, net of tax | - | - | (1,285) | 315 | - |
| Net income | 4,118 | 2,447 | 1,323 | 3,904 | 4,758 |
| Operating income margin | 28.3% | 27.7% | 22.0% | 27.3% | 26.1% |
| Diluted earnings per share of common stock: | | | | | |
| Income before discontinued operations and cumulative effect of changes in accounting principle | \$ 2.24 | \$ 1.48 | \$ 1.85 | \$ 1.88 | \$ 1.85 |
| Income before cumulative effect of changes in accounting principle | \$ 2.18 | \$ 1.30 | \$ 1.39 | \$ 1.94 | \$ 2.59 |
| Net income | \$ 2.18 | \$ 1.30 | \$ 0.71 | \$ 2.11 | \$ 2.59 |
| Other Financial Data: | | | | | |
| Diluted weighted-average shares of common stock outstanding (millions) | 1,893 | 1,888 | 1,876 | 1,852 | 1,836 |
| Dividends declared per share of common stock | \$ 0.76 | \$ 0.76 | \$ 0.79 | \$ 0.92 | \$ 1.06 |
| Total assets | \$50,925 | \$52,046 | \$49,479 | \$49,702 | \$59,496 |
| Long-term debt | 12,463 | 15,014 | 12,283 | 11,489 | 15,108 |
| Shareholders' equity | 16,993 | 18,758 | 17,906 | 19,712 | 23,066 |
| Construction and capital expenditures | \$ 6,169 | \$ 5,495 | \$ 3,536 | \$ 2,926 | \$ 3,193 |
| Book value per common share | \$ 9.08 | \$ 9.99 | \$ 9.63 | \$ 10.77 | \$ 12.60 |
| Ratio of earnings to fixed charges | 5.36 | 3.98 | 5.03 | 5.68 | 6.00 |
| Debt ratio | 54.0 | 51.7 | 49.2 | 43.1 | 47.1 |
| Operating Data: | | | | | |
| Access lines in service (in thousands) | 24,546 | 23,824 | 23,005 | 22,263 | 21,356 |
| Retail long distance customers (in thousands) | — | — | 1,002 | 3,960 | 6,130 |
| DSL customers (in thousands) | 215 | 621 | 1,021 | 1,462 | 2,096 |
| Cingular Wireless customers (in thousands) | 18,555 | 21,596 | 21,925 | 24,027 | 49,109 |
| Number of employees | 103,916 | 87,875 | 77,020 | 75,743 | 62,564 |

See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Consolidated Results of Operations" for a discussion of unusual items affecting the results for 2002, 2003 and 2004.

Overview

We are a Fortune 100 company with annual revenues of over \$20 billion. Our core business is wireline communications and our largest customer segment is the retail consumer. We have interests in wireless communications through our ownership of approximately 40% of Cingular Wireless (Cingular), the nation's largest wireless company based on number of customers. We also operate one of the largest directory advertising businesses in the United States. The great majority of our revenues are generated based on monthly recurring services.

We operate much of our business in one of the country's strongest regional economies, where the population is increasing, real income growth is outpacing the national average and a diverse mix of businesses require advanced information and communication technology solutions. The Southeast is a positive net migration region, with net migration averaging almost 500 thousand annually. The region's real income is expected to grow 10% to 15% faster than the national average in the next five years.

INDUSTRY DYNAMICS

The communications industry has experienced a very difficult period of contraction brought on by over-investment in the late 1990s that created significant excess capacity with many companies competing for the same business. Demand in the traditional voice business has been negatively impacted by the proliferation of wireless services led by one-rate pricing plans that include a large bucket of minutes and free roaming and long-distance, the popularity of e-mail and instant messaging, technological advances such as cable and DSL, that obviate the need for additional telephone lines, and stagnant job growth. After a period of significant growth in the 1990s, access lines, a key driver of our business, have declined steadily since 2001.

Based on comparisons to penetration rates in other parts of the world, there is still significant growth potential in the wireless market in the United States. There are currently five national wireless companies engaging in aggressive competition in a growing market. The intense competition has driven down pricing, increased costs due to customer churn and increased wireless usage as companies attempt to differentiate their service plans. Meanwhile, significant capital is being invested in networks to meet increasing demand and to upgrade capabilities in anticipation of the development of new data applications.

REGULATION AND COMPETITION

Our wireless and wireline business are subject to vigorous competition. In addition, both are subject to regulation.

Because of changes to federal law in the early 1990s, our wireless business is now subject to somewhat more rational regulation than our wireline business. The legal

changes generally preempted states from exercising any entry or rate regulation on commercial mobile services, while allowing states to regulate other terms and conditions. Our wireline business is subject to dual state and federal regulation. The Telecommunication Act of 1996 produced additional regulation of our wireline business. Since its passage, the FCC has pursued a course of sharing (unbundling) of our network with competitors, and has prescribed a pricing policy (TELRIC) that does not permit fair cost recovery. The unbundling rules have been invalidated by the courts on three separate occasions, but not before the unbundling required by its invalid policies had been generally implemented in our contracts with competitors.

We expect the FCC's recent decision to end the unbundled network elements platform (UNE-P) to restore some rationality to the wireline mass market. Other parts of the FCC decision governing the unbundling of high capacity loops and transport that competitors use to provide services to business customers provide relief in a small number of locations, but do not recognize the substantial competition we face for business customers in many other areas. Our states generally continue to exercise economic regulation over most of the revenue generated by intra-state telecommunications services. In recent years, we have achieved some success in rebalancing state telecommunication rates and in gaining some freedom from state regulation of our broadband services.

We also obtained some broadband freedom through a recent FCC decision not to require unbundling of installations that bring fiber optic technology within 500 feet of a customer's premises. We equipped more than 100,000 homes with this technology in 2004, and expect to continue deployments in 2005.

Despite these successes, our wireline business remains more regulated than competing businesses that use cable or wireless technologies. We will accordingly continue to encourage regulatory reform in every appropriate forum.

ACQUISITIONS AND DISPOSITIONS

On October 26, 2004, Cingular completed its previously announced acquisition of AT&T Wireless. With the close of the transaction, Cingular management moved immediately to begin integrating the two companies. Key focus areas included customer communications, immediate training for all sales and service personnel, relaunch of the Cingular brand, transitioning to a common order system, and beginning the work that over time will integrate support systems and network functions. This acquisition will substantially increase BellSouth's participation in the domestic wireless industry.

On March 5, 2004, we signed an agreement with Telefónica Móviles, S.A., the wireless affiliate of Telefónica, S.A., to sell all our interests in our Latin American operations. During October 2004, we closed on the sale of 8 of the 10 properties: Venezuela, Colombia, Ecuador, Peru, Guatemala, Nicaragua, Uruguay and Panama. During

January 2005, we closed on the sale of the remaining properties in Argentina and Chile.

HIGHLIGHTS AND OUTLOOK

Consolidated revenues for 2004 were down slightly compared to 2003 reflecting top line pressures caused by the loss of 1.2 million retail access lines to UNE-P competitors and technology substitution, primarily wireless. Revenue contraction due to line loss and pricing pressures was substantially offset by revenue growth from long distance and DSL services. During 2004 we added approximately 2.2 million long distance customers to total 6.1 million at December 31, 2004, while net new DSL subscriber additions of 634 thousand brought our total to 2.1 million. We anticipate a continuation of these trends in 2005.

Our cost structure is heavily weighted towards labor and fixed asset related costs. In order to sustain margins, we have to adjust our workforce as market share of access lines shifts. Since the beginning of 2001, we have reduced our domestic workforce by almost 18,000 employees, or 22%. In 2004, we announced additional force reductions of nearly 1,400 employees reflecting continued pressures on access lines. Maintaining current operating margin levels going forward will be challenging as competition intensifies and we are forced to achieve continued increases in productivity. This challenge was evident during 2004 as margins were down from 2003. While there have been some encouraging developments on the regulatory front,

there will be other events such as healthcare costs, continued losses of lines to wireless substitution and the roll-out of Voice over Internet Protocol (VoIP) telephony by cable providers that are likely to continue to put pressure on margins.

BellSouth differentiates itself from its competition through its commitment to customer service. Our customers depend on us, especially when disaster strikes. In the fall of 2004, BellSouth's customer service met the challenges presented by the most active and destructive Atlantic hurricane season in years. During 2004, we incurred approximately \$164 of incremental labor and material costs related to service restoration and network repairs due to the four major hurricanes that hit during the third quarter.

In September 2004, the Communications Workers of America (CWA) ratified BellSouth's new contracts. The agreements, which cover approximately 42,000 BellSouth employees and expire August 8, 2009, are expected to continue to give us the workforce planning flexibility needed to respond to changing marketplace conditions.

Operating free cash flow from continuing operations (cash flow from operating activities less capital expenditures) of \$3.6 billion for 2004 is down compared to 2003 primarily due to higher income tax payments. In the next few years, operating cash flow will continue to be negatively impacted by higher cash taxes as we see a reversal of the benefit derived in recent years associated with legislated tax incentives that provided for accelerated depreciation deductions that expired at the end of 2004.

Consolidated Results of Operations

Key financial and operating data for the three years ended December 31, 2002, 2003 and 2004 are set forth below. All references to earnings per share are on a diluted basis. The following consolidated Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with results by segment directly following this section.

Following generally accepted accounting principles (GAAP), our financial statements reflect results for the Latin American operations as Discontinued Operations. The operational results and other activity associated with the Latin American segment have been presented on one line item in the income statement separate from Continuing Operations.

| | 2002 | 2003 | 2004 | Percent Change | |
|---|----------|----------|----------|----------------|---------------|
| | | | | 2003 vs. 2002 | 2004 vs. 2003 |
| Results of operations: | | | | | |
| Operating revenues | \$20,207 | \$20,341 | \$20,300 | 0.7 | (0.2) |
| Operating expenses | | | | | |
| Cost of services and products | 6,670 | 6,991 | 7,520 | 4.8 | 7.6 |
| Selling, general, and administrative expenses | 3,891 | 3,777 | 3,816 | (2.9) | 1.0 |
| Depreciation and amortization | 4,202 | 3,811 | 3,636 | (9.3) | (4.6) |
| Provision for restructuring and asset impairments | 990 | 205 | 39 | (79.3) | (81.0) |
| Total operating expenses | 15,753 | 14,784 | 15,011 | (6.2) | 1.5 |
| Operating income | 4,454 | 5,557 | 5,289 | 24.8 | (4.8) |
| Interest expense | 1,066 | 947 | 916 | (11.2) | (3.3) |
| Net (losses) earnings of equity affiliates | 542 | 452 | 68 | (16.6) | (85.0) |
| Gain on sale of operations | 1,335 | - | 462 | * | * |
| Other income (expense), net | 102 | 362 | 283 | 254.9 | (21.8) |
| Income from continuing operations before income taxes, discontinued operations and cumulative effect of changes in accounting principle, net of tax | 5,367 | 5,424 | 5,186 | 1.1 | (4.4) |
| Provision for income taxes | 1,892 | 1,936 | 1,792 | 2.3 | (7.4) |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | 3,475 | 3,488 | 3,394 | 0.4 | (2.7) |
| Income (loss) from discontinued operations, net of tax | (867) | 101 | 1,364 | 111.6 | * |
| Income before cumulative effect of changes in accounting principle | 2,608 | 3,589 | 4,758 | 37.6 | 32.6 |
| Cumulative effect of changes in accounting principle, net of tax | (1,285) | 315 | — | 124.5 | * |
| Net income | \$ 1,323 | \$ 3,904 | \$ 4,758 | 195.1 | 21.9 |

Summary results of discontinued operations:

| | | | | | |
|--|-------|-------|-------|-------|------|
| Operating revenues | 2,233 | 2,294 | 2,459 | 2.7 | 7.2 |
| Operating Income | 292 | 349 | 647 | 19.5 | 85.4 |
| Income (loss) from discontinued operations | (867) | 101 | 1,364 | 111.6 | * |

* Not meaningful

2004 compared to 2003

OPERATING REVENUES

Consolidated revenues declined \$41 in 2004 as compared to 2003. Communications group revenues decreased \$16 compared to 2003 reflecting the impact of revenue declines associated with competitive line losses and related pricing pressures substantially offset by growth in DSL and long distance products. Revenues from DSL and long distance combined increased \$893 in 2004 compared to

2003. In addition, 2004 was negatively affected by a \$50 customer refund accrual associated with a settlement agreement with the South Carolina Consumer Advocate. A decline in revenue for the exit of the payphone business was offset by higher revenues from the sale of wholesale long distance. Advertising & Publishing group revenues were down \$28 in 2004 compared to 2003 because of a reduction in print revenues due to lower overall spending by our advertisers. Revenue trends are discussed in more detail in the Communications group and Advertising & Publishing group segment results sections.

OPERATING EXPENSES

Total operating expenses increased \$227 in 2004 as compared to the prior year. The most significant expense change driver was increased labor costs of \$464, which includes incremental overtime related to service restoration and network repairs due to the four major hurricanes that hit during the third quarter of 2004, higher expense associated with pension and postretirement benefit plans (pension and retiree medical costs) driven by changes associated with the recent contract agreement with the CWA. The most significant changes were the change in the calculation of the obligation for non-management retiree medical costs as if there were no caps and lower contractual limits on life insurance coverage, increases in annual salary and wage rates, higher incentive compensation and adjustments to workers compensation and long-term disability accruals partially offset by lower average employees due to continued workforce reductions. In addition to higher labor costs, costs of goods sold increased \$213 primarily for the provision of long distance services associated with the growth in subscribers and information technology expenses and contract services increased \$63 in connection with more project-related spending.

These increases were partially offset by lower depreciation and amortization expense of \$175 attributable to lower depreciation rates, lower uncollectible expense of \$139 driven by improved economic conditions and improved collection processes and lower access fees of \$95 driven by CLEC interconnect volume declines. The \$166 decline in restructuring charges and asset impairments is attributable to incrementally smaller workforce reductions and a \$52 asset impairment charge related to an abandoned software project in 2003.

INTEREST EXPENSE

| | For the Year Ended December 31, | | |
|--------------------------------------|------------------------------------|---------------|----------------|
| | 2003 | 2004 | Change |
| Interest expense – debt | \$ 836 | \$ 864 | \$ 28 |
| Interest expense – other | 111 | 52 | (59) |
| Total interest | \$ 947 | \$ 916 | \$ (31) |
| Average debt balances ⁽¹⁾ | \$14,193 | \$15,458 | \$1,265 |
| Effective rate | 5.9% | 5.6% | (30) bps |

(1) Average debt balances exclude amounts related to discontinued operations.

Interest expense decreased \$31 in 2004 compared to 2003. Interest expense associated with interest-bearing debt was up \$28 for 2004 compared to 2003 reflecting higher average debt balances impacted by higher incremental borrowings associated with our equity contributions to Cingular to fund its acquisition of AT&T Wireless. The lower effective interest rate is due to our interest rate swap

program and refinancing higher-rate debt with lower-rate debt, offset partially by an increase in commercial paper rates. The change in interest expense-other relates primarily to the reversal of interest accruals related to tax contingencies based on audit settlements.

NET EARNINGS (LOSSES) OF EQUITY AFFILIATES

| | For the Year Ended December 31, | | |
|------------------------|------------------------------------|--------------|-----------------|
| | 2003 | 2004 | Change |
| Cingular | \$ 408 | \$ 24 | \$ (384) |
| Other equity investees | 44 | 44 | - |
| Total | \$ 452 | \$ 68 | \$ (384) |

Earnings from Cingular in the 2004 periods were lower compared to the same periods in 2003 primarily due to impacts of the AT&T Wireless acquisition, which included integration costs and higher depreciation expense associated with increased capital investments and a reduction in the useful life of TDMA assets.

GAIN (LOSS) ON SALE OF OPERATIONS

The gain on sale of operations in 2004 relates to the sale of our interest in Danish wireless provider, Sonofon, for 3.68 billion Danish Kroner to Telenor ASA. As a result of the sale, we recorded a gain of \$462, or \$295 net of tax, which included the recognition of cumulative foreign currency translation gains of \$13.

OTHER INCOME (EXPENSE), NET

| | For the Year Ended December 31, | | |
|---|------------------------------------|---------------|----------------|
| | 2003 | 2004 | Change |
| Interest Income | \$ 316 | \$ 300 | \$ (16) |
| Foreign currency transaction gains (losses) | 39 | (1) | (40) |
| Loss on early extinguishment of debt | (18) | (14) | 4 |
| Other, net | 25 | (2) | (27) |
| Total Other Income (Expense), net | \$ 362 | \$ 283 | \$ (79) |

The decrease in interest income reflects a lower rate on our advance to Cingular and to a lesser extent the loss of income on an advance to Dutch telecommunications provider Royal KPN N.V. (KPN) due to early repayment in 2003. Foreign currency transaction gains in 2003 relate primarily to the advance to KPN.

During 2003, we recognized \$33 in gains related to the sale of our interests in two real estate partnerships and the sale of a building. In addition, we recognized a \$9 loss on the sales and impairments of cost-method investments.

PROVISION FOR INCOME TAXES

| | For the Year Ended December 31, | | |
|----------------------------|------------------------------------|----------------|-----------|
| | 2003 | 2004 | Change |
| Provision for income taxes | \$1,936 | \$1,792 | \$ (144) |
| Effective tax rate | 35.7% | 34.6% | (110) bps |

The effective tax rates in 2004 were reduced by a favorable permanent difference for the Medicare Part D subsidy and an adjustment to taxes payable associated with divested operations.

INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX

Income (loss) from discontinued operations, net of tax, increased \$1,263 in 2004 compared to the same period in 2003 primarily due to the sale of eight of the ten Latin American properties, which resulted in a \$850 gain, net of tax. Other net income increases include a \$336 tax benefit related to excess tax basis over book basis in our Latin America investments, \$177 for the cessation of depreciation beginning in the second quarter of 2004, a \$234 loss on the sale of our interests in two Brazilian wireless companies in 2003, and higher revenues. Partially offsetting the increases to net income were the \$190 charge related to the settlement of arbitration in Venezuela, foreign exchange gain decreases of \$99, and a \$33 loss in the second quarter of 2004 related to the purchase of additional ownership share in Argentina.

From an operational perspective, the Latin America business generated strong growth in both customers and revenue. Despite the October 2004 sale of eight properties, which resulted in only ten months of revenues in 2004 for these properties, operating revenue in the Latin America operations for 2004 increased \$165, or 7.2%, over 2003 due to growth in customers and traffic throughout the portfolio. Excluding the decrease in operating expenses for the cessation of depreciation beginning in the second quarter of 2004, operating income was \$76 higher than the prior year.

CUMULATIVE EFFECT OF CHANGES IN ACCOUNTING PRINCIPLE

Asset retirement obligations

Effective January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). In connection with the adoption of this standard, we recorded the cumulative effect of accounting change that increased 2003 net income by \$816.

Revenue recognition for publishing revenues

Effective January 1, 2003, we changed our method for recognizing revenues and expenses related to our direc-

tory publishing business from the publication and delivery method to the deferral method. The cumulative effect of the change in accounting method is reflected in the income statement as a decrease to 2003 net income of \$501.

2003 compared to 2002

OPERATING REVENUES

Consolidated revenues increased \$134 in 2003 as compared to 2002. The increase in total operating revenues is attributable to revenue growth in long distance and DSL, which together generated nearly \$800 in new revenue in 2003. Growth from these new products was substantially offset by lower voice revenues caused by the loss of 1.5 million retail access lines to UNE-P competitors and technology substitution. Voice revenues were also impacted by pricing strategies in our effort to remain competitive. Revenues from the sale of wholesale data transport services, including long distance and Competitive Local Exchange Carriers, declined 7.8% in 2003 primarily due to reductions in leased circuits by large inter-exchange carriers as they rationalized their capacity needs in relation to current demand. The exit from our payphone business and the elimination of certain products within the wholesale long distance portfolio also negatively impacted year-over-year comparisons.

Although Advertising & Publishing Group revenues were up nearly 6%, the year-over-year comparison was significantly impacted by a one-time reduction of \$163 in 2002 for the correction of an error.

OPERATING EXPENSES

Operating expenses declined by nearly \$1 billion in 2003 driven by:

- \$785 in lower charges related to restructuring and asset impairments as we rationalized our business in 2002;
- \$391 of lower depreciation expense associated with the declines in capital expenditures and a change in accounting for plant retirements;
- \$272 of improvements in uncollectibles expense due to a steadily improving economy, lower bankruptcy rates and operational improvements;
- \$86 of lower cost of goods related to equipment sales in the Communications Group due to a change in the presentation for drop shipments from gross to net, which had no impact on operating margin, and paging and equipment costs decreased \$53 driven by lower volumes; and
- \$121 in lower labor related costs in the Communications Group due to a nearly 12% reduction in our workforce since the beginning of 2002 driven by weak demand and increased productivity.

These decreases were partially offset by:

- \$379 of incremental expense associated with pension and postretirement benefits plans (pension and retiree medical costs) driven by rising health care costs, unfavorable returns on pension assets due to weak capital markets over the past few years, changes to plan assumptions regarding expected asset returns, and a lower discount rate used to calculate service and interest cost;
- \$350 of customer acquisition costs related to competitive response in the Communications Group; and
- \$108 of variable cost of goods for the provision of long distance service in the Communications Group.

We have made adjustments to our business model to address changes in our economic, regulatory, and competitive environment, and as a result we have incurred charges in each of the years presented. The provision for restructuring and asset impairments of \$205 in 2003 includes \$153 of charges associated with workforce reductions (including \$47 of pension settlement losses) and a \$52 charge for an abandoned software project. The provision of \$990 in 2002 includes \$635 of charges associated with workforce reductions (including \$167 of pension settlement losses) and a \$221 charge for the impairment of MMDS spectrum license and charges of \$134 associated with the elimination of certain services including wholesale long distance and e-business services.

INTEREST EXPENSE

| | For the Year Ended December 31, | | |
|--------------------------------------|------------------------------------|----------|-----------|
| | 2002 | 2003 | Change |
| Interest expense – debt | \$ 953 | \$ 836 | \$ (117) |
| Interest expense – other | 113 | 111 | (2) |
| Total interest | \$ 1,066 | \$ 947 | \$ (119) |
| Average debt balances ⁽¹⁾ | \$16,525 | \$14,193 | \$(2,332) |
| Effective rate | 5.8% | 5.9% | 10 bps |

(1) Average debt balances exclude amounts related to discontinued operations.

Interest expense declined \$119 in comparison to the prior year, reflecting reductions in average debt of approximately \$2.4 billion, as rates were relatively stable.

GAIN ON SALE OF OPERATIONS

The gain in 2002 of \$1,335 related to the sale of our investment in E-Plus, a German wireless carrier.

NET EARNINGS (LOSSES) OF EQUITY AFFILIATES

| | For the Year Ended December 31, | | |
|------------------------|------------------------------------|-------|--------|
| | 2002 | 2003 | Change |
| Equity in Earnings | | | |
| Cingular | \$497 | \$408 | \$(89) |
| Other equity investees | 45 | 44 | (1) |
| Total | \$542 | \$452 | \$(90) |

Earnings from Cingular in 2003 declined compared to 2002 primarily due to significant growth in customers and the costs related to that growth and due to slightly lower average revenue per customer. See "Managements Discussion and Analysis of Financial Condition and Results of Operations – Results by Segment – Domestic Wireless" for further discussion of Cingular results.

OTHER INCOME (EXPENSE), NET

| | For the Year Ended December 31, | | |
|--|------------------------------------|-------|--------|
| | 2002 | 2003 | Change |
| Gain (loss) on sales and impairments of cost method investments: | | | |
| Qwest | \$(336) | \$ – | \$ 336 |
| Other | – | (9) | (9) |
| Subtotal | (336) | (9) | 327 |
| Interest Income | 460 | 316 | (144) |
| Loss on early extinguishment of debt | (40) | (18) | 22 |
| Foreign currency gain/loss | 16 | 39 | 23 |
| Other | 2 | 34 | 32 |
| Total Other Income (Expense), net | \$ 102 | \$362 | \$ 260 |

During 2002 we recorded other than temporary impairments to reduce the carrying value of our Qwest investment driven by continued weak market conditions, particularly in technology and communications stocks. We also incurred losses on sales of our Qwest investment. As of December 31, 2003, we no longer hold any interest in Qwest.

Interest income declined as compared to 2002 due to lower rates on our advance to Cingular and the loss of income on an advance to Dutch telecommunications provider Royal KPN N.V. (KPN) due to early repayment.

During 2003, we recognized \$33 in gains related to the sale of our interests in two real estate partnerships and the sale of a building.

PROVISION FOR INCOME TAXES

| | For the Year Ended December 31, | | |
|----------------------------|------------------------------------|---------|--------|
| | 2002 | 2003 | Change |
| Provision for income taxes | \$1,892 | \$1,936 | \$ 44 |
| Effective tax rate | 35.3% | 35.7% | 40 bps |

The effective tax rate increased slightly to 35.7% in 2003 from 35.3% in 2002, primarily driven by state income tax activity. A reconciliation of the statutory federal income

tax rate to the effective income tax rate for each period is included in Note J to our consolidated financial statements.

INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX

Income (loss) from discontinued operations, net of tax, improved \$968 in comparison to the prior year principally driven by foreign currency transaction activity and a \$263 after-tax loss recorded in 2002 related to the recognition of other-than-temporary impairments related to our Brazilian

wireless affiliate. Currency gains were recorded in 2003 for the improvement in the Argentine Peso and the Chilean Peso. For 2002, the devaluation of the Argentine Peso resulted in losses of \$584. During 2003, we recognized a loss of \$234 on the sale of our interests in two Brazilian wireless companies. During 2002, we recognized a loss of \$51 on the sale of Listel, our Brazilian advertising and publishing company. Additionally, Latin America experienced a nearly 3% growth in revenue in 2003 driven by the addition of over 1.5 million net customers and steady average revenue per customer. Operating expenses remained flat.

Results by Segment

Our reportable segments reflect strategic business units that offer similar products and services and/or serve similar customers. We have three reportable operating segments:

- Communications Group;
- Domestic Wireless; and
- Advertising & Publishing Group.

Management evaluates the performance of each business unit based on net income, exclusive of internal charges for use of intellectual property and adjustments for unusual items that may arise. Unusual items are transactions or events that are included in reported consolidated results but are excluded from segment results due to their nonrecurring or nonoperational nature. In addition, when changes in our business affect the comparability of current versus historical results, we adjust historical operating information to reflect the current business structure. See Note P to our consolidated financial statements for a reconciliation of segment results to the consolidated financial information.

The following discussion highlights our performance in the context of these segments. For a more complete understanding of our industry, the drivers of our business, and our current period results, you should read this discussion in conjunction with our consolidated financial statements, including the related notes.

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

DOLLARS ARE IN MILLIONS, EXCEPT PER SHARE AMOUNTS AND AS OTHERWISE INDICATED

BELLSOUTH CORPORATION

COMMUNICATIONS GROUP

The Communications Group includes our core domestic businesses including: all domestic wireline voice, data, broadband, e-commerce, long distance, Internet services and advanced voice features. The group provides these services to an array of customers, including residential, business and wholesale.

During 2003 and 2004, the Communications Group emphasized interLATA long distance and BellSouth® FastAccess® DSL, encouraging customers to purchase packages containing multiple communications services. We continue to experience retail access line market share loss due to competition and technology substitution, and we expect these trends to continue into 2005.

| | 2002 | 2003 | 2004 | Percent Change | |
|---|----------|----------|-----------------|------------------|------------------|
| | | | | 2003 vs. 2002 | 2004 vs. 2003 |
| Segment operating revenues: | | | | | |
| Voice | \$12,559 | \$12,702 | \$12,609 | 1.1 | (0.7) |
| Data | 4,269 | 4,353 | 4,518 | 2.0 | 3.8 |
| Other | 1,661 | 1,393 | 1,325 | (16.1) | (4.9) |
| Total segment operating revenues | 18,489 | 18,448 | 18,452 | (0.2) | 0.0 |
| Segment operating expenses: | | | | | |
| Cost of services and products | 6,464 | 6,755 | 7,108 | 4.5 | 5.2 |
| Selling, general, and administrative expenses | 2,948 | 3,079 | 3,123 | 4.4 | 1.4 |
| Depreciation and amortization | 4,161 | 3,771 | 3,593 | (9.4) | (4.7) |
| Total segment operating expenses | 13,573 | 13,605 | 13,824 | 0.2 | 1.6 |
| Segment operating income | 4,916 | 4,843 | 4,628 | (1.5) | (4.4) |
| Segment net income | \$ 2,751 | \$ 2,829 | \$ 2,727 | 2.8 | (3.6) |
| Segment net income including unusual items | \$ 2,237 | \$ 3,505 | \$ 2,567 | 56.7 | (26.8) |
| Key Indicators:(000s except where noted) | | | | | |
| Switched Access lines: | | | | | |
| Residence retail: | | | | | |
| Primary | 13,242 | 12,466 | 11,771 | (5.9) | (5.6) |
| Additional | 1,926 | 1,601 | 1,346 | (16.9) | (15.9) |
| Total Retail Residence | 15,168 | 14,067 | 13,117 | (7.3) | (6.8) |
| Residential wholesale: | | | | | |
| Resale | 342 | 177 | 116 | (48.2) | (34.5) |
| UNE-P | 934 | 1,696 | 1,972 | 81.6 | 16.3 |
| Total Wholesale Residence | 1,276 | 1,873 | 2,088 | 46.8 | 11.5 |
| Total residence | 16,444 | 15,940 | 15,205 | (3.1) | (4.6) |
| Business retail | 5,687 | 5,417 | 5,245 | (4.7) | (3.2) |
| Business wholesale: | | | | | |
| Resale | 85 | 73 | 58 | (14.1) | (20.5) |
| UNE-P | 607 | 686 | 750 | 13.0 | 9.3 |
| Total wholesale business | 692 | 759 | 808 | 9.7 | 6.5 |
| Total business | 6,379 | 6,176 | 6,053 | (3.2) | (2.0) |
| Other retail/wholesale lines (primarily public) | 182 | 147 | 98 | (19.2) | (33.3) |
| Total switched access lines | 23,005 | 22,263 | 21,356 | (3.2) | (4.1) |
| ISDN line equivalents | | | | | |
| Residence | 18 | 13 | 9 | (27.8) | (30.8) |
| Business | 1,580 | 1,453 | 1,459 | (8.0) | 0.4 |
| Total ISDN Adjusted Access Lines in Service | 24,603 | 23,729 | 22,824 | (3.6) | (3.8) |
| DSL customers (retail and wholesale) | 1,021 | 1,462 | 2,096 | 43.2 | 43.4 |
| Retail long distance customers | 1,002 | 3,960 | 6,130 | 295.2 | 54.8 |
| Switched access and local minutes of use (millions) | 96,755 | 82,101 | 70,061 | (15.1) | (14.7) |
| Retail long distance minutes of use | 1,816 | 10,039 | 21,109 | * | 110.3 |
| Total access minutes of use (millions) | 98,571 | 92,141 | 91,170 | (6.5) | (1.1) |
| Capital expenditures | \$ 3,337 | \$ 2,824 | \$ 3,018 | (15.4) | 6.9 |

* Not meaningful

2004 compared to 2003

SEGMENT OPERATING REVENUES

Voice

Voice revenues decreased \$93 during 2004 compared to 2003 driven primarily by continued access line loss offset by the growth in interLATA long distance. Total switched access lines declined 907,000, or 4.1%, for the period with retail line losses being slightly offset by increases in wholesale lines. The access line decline was the result of continued share loss and technology substitution, primarily wireless.

Wholesale lines, which consist primarily of unbundled network element – platform (UNE-P) lines, totaled almost 3.0 million at December 31, 2004, up 276,000 lines year over year. The vast majority of the UNE-P additions were residential. When lines over which we provide retail services are converted to UNE-P, we lose revenue and margin. On average, the revenue from our provision of UNE-P does not permit us to recover the fully allocated costs we incur to provide it. To mitigate this loss, we have been actively seeking reform of the pricing rules that regulators use to set UNE-P prices. As previously discussed under the heading “Overview,” a judicial decision that became effective in June 2004 invalidated certain FCC rules that governed the provision of wholesale access to our network by local service competitors. We believe this change in the regulatory environment influenced the loss in UNE-P lines that we experienced in the second half of 2004.

In efforts to combat share loss, we continue to grow our package services. BellSouth Answers® is our signature residential package offering, which combines various wireline, wireless, Internet services and/or DIRECTV® digital satellite television services. The package combines the Complete Choice calling plan of local service and multiple convenience calling features with BellSouth Long Distance, BellSouth® FastAccess® DSL or dial-up Internet, and Cingular Wireless services. During 2004, we began offering DIRECTV® digital satellite television service through all sales channels as part of the BellSouth Answers® portfolio. This agency relationship with DIRECTV® provides us with a key competitive product with insignificant cost or capital requirements. With the addition of video, the BellSouth Answers® package is one of the most comprehensive and competitively priced bundles in our markets today. We ended 2004 with almost 4.4 million residential packages, representing a 37% penetration of our retail primary line residence base. Almost 84% of Answers customers have long distance in their package and almost 45% have either DSL or BellSouth dial-up Internet.

Long distance voice revenue increased \$578 in 2004 when compared to 2003, driven primarily by growth in interLATA and wireless long distance. InterLATA revenues increased \$640 reflecting continued large market share gains driven by marketing efforts and the BellSouth Unlimited Long Distance Plans. At December 31, 2004, we had 6.1 million retail long distance customers and a mass-

market penetration rate of approximately 48% of our customer base. We also continued to grow our long distance offerings in complex business. We recorded \$209 in complex long distance revenue in 2004 compared to \$71 in 2003. Through December 31, 2004, the complex long distance backlog stands at \$624. This backlog represents an estimated value of the complex long distance business sold but not yet booked as revenue. Revenue from wholesale long distance services provided to Cingular increased \$55 when compared to 2003. This increase was caused by higher volumes associated with the proliferation of wireless package plans that include long distance partially offset by slightly lower rates.

Switched access revenues declined \$62 in 2004 when compared to 2003 due to volume and rate decreases. Our entry into interLATA long distance shifted switched access minutes from other carriers to our service resulting in a transfer from wholesale switched access revenues to retail long distance revenue. Switched access and local minutes of use decreased 14.7% compared to 2003. The decrease is due to the impact of our entry into interLATA long distance, access line losses including the shift to UNE-P lines and alternative communications services, primarily wireless and e-mail. Switched access rates were slightly lower in 2004 due to the July 1, 2003 rate reduction of the CALLs program, an FCC access reform initiative. The decline in rates, however, is substantially offset by higher subscriber line charges that are also included in voice revenues.

Data

Data revenues increased \$165 in 2004 when compared to 2003. Data revenues were driven by strong growth from the sale of BellSouth® FastAccess® DSL service partially offset by decreases in revenue from other data products. Combined wholesale and retail DSL revenues were up \$241 in 2004 when compared to 2003 due primarily to a larger customer base. As of December 31, 2004, we had almost 2.1 million DSL customers, an increase of 634 thousand customers compared to December 31, 2003.

Retail data services grew 11.5% in 2004 when compared to 2003 driven primarily by the growth from the sale of FastAccess DSL service. During 2004, we added 653 thousand net retail customers. We offer three broadband downstream connection speeds to meet the varying needs of our mass-market customers. The original version – BellSouth FastAccess DSL Ultra – runs at downstream connection speeds of up to 1.5 megabits. Since mid-2003, we have offered a lower speed version – BellSouth FastAccess DSL Lite – running at downstream connection speeds of up to 256 kilobits. FastAccess DSL Lite accounted for approximately one-fourth of DSL customers as of December 31, 2004. In April 2004, we began offering FastAccess DSL Xtreme, delivering downstream connection speeds of up to 3.0 megabits and upstream connection speeds of up to 384 kilobits. We believe our broadband offers are among the most competitively priced in our markets. In late September 2004, we launched additional incentives and introduced new pricing for FastAccess DSL Ultra service

designed to increase long-term market penetration. Retail FastAccess customer additions were offset somewhat by wholesale DSL disconnects as we continue to see a shift in customer mix to retail. Revenue from other retail data products was flat for 2004 when compared to 2003.

Revenues from the sale of wholesale data transport services and wholesale DSL to other communications providers, including long distance companies and CLECs, declined 4.3% in 2004 when compared to 2003, primarily due to the lingering impacts of soft enterprise market segment demand and continued network grooming and consolidation by large inter-exchange carriers.

Other

Other revenues decreased \$68 in 2004 when compared to 2003. This decrease reflects decreases in revenues from the payphone business of \$77 and billing and late payment fees of \$29, partially offset by increases in equipment revenues of \$33 and increases in wholesale long distance revenues of \$12. Increases in equipment revenues reflect increased demand due to improved economic conditions and customer upgrades to newer technology.

SEGMENT OPERATING EXPENSES

Cost of services and products

Cost of services and products of \$7,108 in 2004 increased \$353 from 2003. The cost of services increase was impacted by: increases of \$213 in costs of goods sold principally driven by increases in the provision of long distance service volumes; increases of \$104 in labor costs impacted by pay increases driven by union contract raises and higher costs from retiree and medical benefits slightly offset by lower average workforce; increases of \$39 in contract services related to network planning projects and equipment installations; and increases in materials and supplies of \$39 associated with increased utilities usage, partially offset by decreases of \$95 in access fees due to volume declines, settlements and significant reductions in charges associated with access to other carriers customer name databases; and by decreases in rent of \$22 related to real estate consolidation.

Selling, general, and administrative expenses

Selling, general, and administrative expenses of \$3,123 in 2004 increased \$44 from 2003. The selling, general, and administrative expense reflected represents an increase of \$133 in labor costs driven by higher costs from retiree and medical benefits, incentive awards, reduced use of contractors and pay increases partially offset by lower headcount. Also included in the labor increase was a \$38 increase in an annual adjustment to the workers compensation and long-term disability accruals. In addition to labor increases, information technology costs increased \$24 during 2004 compared to 2003.

This increase was partially offset by a decrease in uncollectibles expense of \$90 driven by continued improvements in the collection process and improved economic conditions, and decreases of \$23 in outside sales commissions, fees and other various expenditures.

Depreciation and amortization

Depreciation and amortization expense decreased \$178 during 2004 when compared to 2003. The primary driver of the decline in depreciation expense relates to lower depreciation rates under the group life method of depreciation. The lower depreciation rates were precipitated primarily by the reductions in capital expenditures over the past several years. Amortization expense increased due to higher levels of capitalized software.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items that were excluded from this segment's net income consisted of the following: for 2004, unusual items of \$(160) for the South Carolina regulatory settlement, lease termination fees, severance and hurricane-related costs; for 2003, unusual items of \$676 for the cumulative effect of change in accounting principle related to the adoption of FAS 143 offset by restructuring charges, costs associated with the early extinguishment of debt, and an asset impairment.

2003 compared to 2002

SEGMENT OPERATING REVENUES

Voice

Voice revenues increased \$143 driven by significant growth in interLATA long distance substantially offset by continued access line share loss and conversion to wholesale lines. Total switched access lines declined 3.6% with retail line losses being partially offset by increases in wholesale lines. The access line decline was the result of share loss, technology substitution and a continued weak economy.

Wholesale lines consist primarily of unbundled network element – platform (UNE-P) lines. The UNE-P lines totaled approximately 2.4 million at December 31, 2003, up 864,000 lines from the prior year. The vast majority of the UNE-P additions were residential. Business UNE-P line adds of 79,000 fell slightly from the prior year while other wholesale UNE-P lines, primarily payphone, increased by 23,000 in 2003.

As of the end of 2003, we had more than 3 million residential packages designated as Answers customers, which represents a 24.1% penetration of our retail primary line residence base. As of December 31, 2003, over 75% of Answers customers had long distance in their package and over 40% had either DSL or BellSouth dial-up Internet.

InterLATA long distance voice revenues increased \$573 compared to 2002. Substantial interLATA growth reflects our receipt of regulatory relief to provide interLATA services

in the nine southeastern states we serve. At December 31, 2003, we had nearly 4 million long distance customers, a penetration rate of 28% of primary residential access lines and 39% of mass-market small business accounts. Earlier in 2003, we began offering unlimited long distance to reduce competitive churn and increase retention and reacquisition of residential customers. We recorded \$71 in complex long distance revenue in 2003 compared to \$3 in 2002. Revenue from wholesale long-distance services provided to Cingular increased \$47 in 2003. This increase was caused by higher volumes associated with the proliferation of wireless long distance plans.

Switched access revenues declined \$195 in 2003 when compared to 2002 due to volume and rate decreases. Our entry into interLATA long distance shifted switched access minutes from other carriers to our service resulting in a transfer from wholesale switched access revenues to retail long distance revenue. Switched access and local minutes of use declined 15.1% compared to 2002. The decrease is due to the impact of our entry into interLATA long distance, access line losses including the shift to UNE-P lines and alternative communications services, primarily wireless and email. Switched access rates were lower in 2003 due to effects of the CALLS program, an FCC access charge reform initiative. The decline in rates, however, is substantially offset by higher subscriber line charges that are also included in voice revenues.

Data

Data revenues increased \$84 in 2003. The overall growth was driven by revenues from the sale of BellSouth® FastAccess® DSL service. Combined wholesale and retail DSL revenues were up \$248 in 2003 due to a larger customer base. As of December 31, 2003, we had over 1.46 million DSL customers, an increase of 441,000 customers compared to December 31, 2002.

Retail data services, which represent roughly half of data revenues, grew 14.1% in 2003 driven primarily by growth from the sale of FastAccess DSL service. Early in the third quarter 2003, we introduced FastAccess® DSL Lite, creating a tiered approach to broadband that allows customers to choose the connection speed and price best suited to their Internet use. Other retail data products, primarily DS1 lines (dedicated high capacity lines) were lower driven by decreases in demand and special access rate reductions effective July 2002.

Revenues from the sale of wholesale data transport services to other communications providers, including long distance companies and Competitive Local Exchange Carriers, declined 7.8% in 2003 primarily due to reductions in leased circuits by large inter-exchange carriers as they rationalized their capacity needs in relation to current demand. The decline was also attributable to the lingering impacts of a soft economy and the renegotiation of an access contract with a bankrupt wholesale customer.

Other

Other communications revenue decreased \$268 primarily due to a decline of \$123 in sales to second and third tier long distance carriers due to our decision to eliminate certain products within the wholesale long distance portfolio and due to the continuing phase-out of our payphone business which created a decline of \$59. We completed our exit of the payphone business as of December 31, 2003. Other revenues decreased \$86 due to a change in the presentation for drop shipments of equipment from gross to net, which lowered both revenues and expenses.

SEGMENT OPERATING EXPENSES

Cost of services and products

Cost of services and products increased \$291 compared to the same periods in 2002. The increase reflects higher pension and retiree medical costs of \$315. Costs of service associated with providing retail interLATA long distance increased \$183 driven by higher volumes related to more customers while costs associated with the provision of long distance services to Cingular increased \$34 driven by higher volumes. In addition, installation and activation expense increased \$239 as compared to the prior period reflecting lower expense deferrals related to lower installation and activation service revenue.

These cost increases were partially offset by work force reductions, primarily as a result of reduced business volumes, that resulted in decreased salary and wage related expenses of \$116. Wholesale long distance cost of services decreased \$100 reflecting a de-emphasis in these services. Costs of goods related to equipment sales decreased \$86 due to a change in the presentation for drop shipments from gross to net, which had no impact on operating margin. In addition, page and equipment costs decreased \$53 driven by lower volumes. Information technology infrastructure costs decreased \$60, reflecting cost containment efforts.

Selling, general, and administrative expenses

Selling, general, and administrative expenses increased \$131 in 2003 compared to 2002. The periods presented were impacted by increases in advertising of \$111 associated with higher spending related to a more competitive environment and increases in outside sales commissions of \$55 primarily related to the long distance launch. The periods presented were also impacted by increased pension and retiree medical costs of \$33.

These increases were partially offset by decreases in uncollectible expenses of \$116. Prior year periods included the impact of higher bankruptcies and non-pay accounts driving the decrease in 2003.

Depreciation and amortization

Depreciation and amortization expense decreased \$390. The primary driver of the year-over-year decline in depreciation expense relates to lower depreciation rates under the group life method of depreciation. The lower rates were caused primarily by the significant reductions in capital expenditures over the past several years. In addition, depreciation expense was lower due to the adoption of SFAS No. 143. In connection with the adoption of this standard, we no longer accrue for net cost of removal in our depreciation rates causing lower depreciation expense. Amortization expense increased slightly due to higher levels of capitalized software.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items which were excluded from this segment's results consisted of the following: in 2003, \$676 for the cumulative effect of a change in accounting principle related to the adoption of FAS 143 offset by restructuring charges, costs associated with the early extinguishment of debt, and an asset impairment; in 2002, \$(514) related to restructuring costs, including pension settlements, costs associated with the early extinguishment of debt, costs associated with service curtailments and asset impairments and refund of customer late fees in Florida.

Domestic Wireless

We own an approximate 40% economic interest in Cingular, a joint venture with SBC. Because we exercise influence over the financial and operating policies of Cingular, we use the equity method of accounting for this investment. Under the equity method of accounting, we record our proportionate share of Cingular's earnings in our consolidated statements of income. These earnings are included in the caption "Net earnings (losses) of equity affiliates". For management purposes, we evaluate our Domestic Wireless segment based on our proportionate share of Cingular's results. Accordingly, results for our Domestic Wireless segment reflect the proportional consolidation of approximately 40% of Cingular's financial results.

On October 26, 2004, Cingular completed the acquisition of AT&T Wireless, creating the largest wireless carrier in the United States based on number of customers. Data revenue played an increasingly important role in revenue composition in 2003 and 2004 and those impacts are expected to increase in 2005. Further, competition continues to be intense, with up to five competitors in most of Cingular's significant markets.

| | 2002 | 2003 | 2004 | Percent Change | |
|---|----------|----------|----------|----------------|---------------|
| | | | | 2003 vs. 2002 | 2004 vs. 2003 |
| Segment operating revenues: | | | | | |
| Service revenues | \$ 5,569 | \$ 5,689 | \$ 6,989 | 2.2 | 22.9 |
| Equipment revenues | 392 | 504 | 785 | 28.6 | 55.8 |
| Total segment operating revenues | 5,961 | 6,193 | 7,774 | 3.9 | 25.5 |
| Segment operating expenses: | | | | | |
| Cost of services and products | 1,965 | 2,273 | 2,980 | 15.7 | 31.1 |
| Selling, general, and administrative expenses | 2,170 | 2,170 | 2,826 | 0.0 | 30.2 |
| Depreciation and amortization | 740 | 835 | 1,232 | 12.8 | 47.5 |
| Total segment operating expenses | 4,875 | 5,278 | 7,038 | 8.3 | 33.3 |
| Segment operating income | 1,086 | 915 | 736 | (15.7) | (19.6) |
| Segment net income | \$ 357 | \$ 261 | \$ 129 | (26.9) | (50.6) |
| Segment net income including unusual items | \$ 301 | \$ 261 | 20 | (13.3) | (92.3) |

Key Indicators (100% Cingular):

| | 2002 | 2003 | 2004 | 2003 vs. 2002 | 2004 vs. 2003 |
|---|----------|----------|----------|---------------|---------------|
| Cellular/PCS Customers (000s) | 21,925 | 24,027 | 49,109 | 9.6 | 104.4 |
| Wireless average monthly revenue per user - Cellular/PCS (whole dollars)(a) | \$ 52 | \$ 51 | \$ 49 | (1.9) | (3.9) |
| Capital Expenditures | \$ 3,085 | \$ 2,734 | \$ 3,449 | (11.4) | 26.2 |

(a) Management uses average revenue per user (ARPU) as an indicator of operating performance of the business. Wireless ARPU - Cellular/PCS is defined as Cellular/PCS service revenues during the period divided by average Cellular/PCS subscribers during the period. This metric is used to compare the recurring revenue amounts being generated on Cingular's network to prior periods and internal targets. We believe that this metric provides useful information concerning the performance of Cingular's initiatives to attract and retain high value customers and the use of its network.

2004 compared to 2003

SEGMENT OPERATING REVENUES

Cingular had 49.1 million cellular/PCS customers at December 31, 2004, representing growth of 25.1 million in its cellular/PCS customer base from a year ago. This growth was primarily due to a 21.7 million cellular/PCS customer base increase, related to Cingular's acquisition of AT&T Wireless in October 2004. Additionally, for 2004, Cingular's cellular/PCS customer net additions were 3.4 million, up from 2.1 million a year ago, with 1.7 million of the current year's cellular/PCS customer net additions occurring in the fourth quarter of the year. This fourth quarter increase represents the highest cellular/PCS customer net additions total ever when compared with the combined historical results of Cingular and AT&T Wireless. The strong performance in cellular/PCS customer net additions during the fourth quarter was driven by the re-launch of the Cingular brand, the offering of new common rate plans and the larger distribution network of the newly combined Cingular/AT&T Wireless company subsequent to the acquisition. Also favorably impacting customer net additions throughout 2004 were the promotion and success of Cingular's new GSM service offerings and the continued promotion of its FamilyTalk® service offering and its Rollover® rate plans. Excluding the impact to the prepaid customer base due to the AT&T Wireless acquisition, the prepaid customer count was reduced from the prior year, in part due to the successful promotion of the postpaid FamilyTalk® plan, which competes for customers at a similar price point but with enhanced services. The increase in reseller customer net additions compared with the prior year can be attributed to continued growth by Cingular's primary reseller.

The monthly cellular/PCS churn rate of 2.7% in 2004, which included the results of AT&T Wireless since its acquisition, was flat compared with the churn rate in the prior year as a lower churn rate in Cingular's postpaid customer base was offset by higher churn rates in the prepaid and reseller customer bases. During the fourth quarter of 2004, Cingular experienced a significant improvement in its postpaid customer base churn rate compared with prior periods, as customers responded positively to the launch of the new Cingular, its broad network coverage and its attractive GSM service offerings. Also, during the fourth quarter of 2004, conformity issues related to the calculation of churn for Cingular and AT&T Wireless reduced churn subsequent to the acquisition by 13 basis points. Beginning in the first quarter of 2005, Cingular will adopt a new reseller churn calculation methodology that is consistent with its primary competitor. Cingular currently includes gross reseller disconnects in the churn calculation. In the future, Cingular will base the calculations on total reseller net customer reductions. To date, Cingular does not believe that wireless local number portability has materially impacted the customer churn rate.

Total operating revenues, consisting of service revenue and equipment sales, increased \$1,581 in 2004. The primary driver behind the year over year increases in almost every component of total operating revenues was Cingular's acquisition of AT&T Wireless in late October 2004 and the inclusion of 67 days of AT&T Wireless operating results. Additionally, total operating revenues continue to be favorably impacted by growth in service revenue as a result of a higher average cellular/PCS customer base and the continued growth in data revenues. Equipment sales contributed \$281 to the increase in total operating revenues, driven by both strong customer growth and handset upgrade activity.

Service revenues

Service revenue, comprised of local voice and data services, roaming, long distance and other revenue, increased \$1,300 in 2004 compared to 2003. The local service component of total service revenue includes recurring monthly access charges, airtime usage, including prepaid service, and charges for optional features and services, such as voice mail, mobile-to-mobile calling, roadside assistance, caller ID, handset insurance and data services. It also includes billings to customers for the Universal Service Fund (USF) and other regulatory fees. The primary driver of the increase in local service revenue for 2004 was the inclusion of the former AT&T Wireless operating results as a result of Cingular's acquisition in late October 2004. Aside from this impact, increases in local service revenue are a function of the higher average customer base partially offset by the impact of a lower Average Revenue Per User (ARPU). Strong growth in data revenue, including the impact of the AT&T wireless acquisition, continues to favorably impact local service revenue driven primarily by increased data service penetration and usage of text messaging and other data services by cellular/PCS customers. Incollect and outcollect roaming revenues were essentially flat, when compared with the corresponding prior year. Roaming revenue continues to be unfavorably impacted by the bundling of "free" roaming minutes with all-inclusive regional and national rate plans and lower negotiated rates with Cingular's roaming partners. Prior to the acquisition, AT&T Wireless was Cingular's largest national roaming partner. Effective with the acquisition, Cingular's consolidated outcollect revenue reflects elimination of roaming revenue between the now combined Cingular and former AT&T Wireless properties along with a corresponding elimination of incollect roaming costs. Although net income neutral, this elimination will significantly reduce the new combined company outcollect revenue when compared to the combination of prior historical stand-alone results. The increase in long distance revenue compared with 2003 was primarily related to the incremental impact of the additional long distance revenue contributed as a result of the AT&T Wireless acquisition. Higher international long distance revenue in 2004 also contributed, to a lesser extent, to the overall increase compared with the prior year.

Cellular/PCS ARPU for 2004 was \$49.30, a decrease of \$2.02, or 3.9%, compared with \$51.32 for 2003. Although the contribution of a higher ARPU for the AT&T Wireless customer base for the last 67 days of 2004 had a slightly positive impact on overall 2004 ARPU when compared with 2003, the main drivers of the changes in ARPU remained consistent with prior periods. Continued increases in ARPU related to higher customer usage and increased data revenue and regulatory fee revenue were more than offset by the impact of a larger embedded customer base of postpaid customers on lower ARPU FamilyTalk® rate plans and on all-inclusive rate plans that include more "free" minutes, thereby reducing overages and other chargeable airtime. Also exerting downward pressure on ARPU compared with the prior year is a change in the mix of the cellular/PCS customer base to include a higher percentage of lower ARPU reseller customers and decreases in roaming revenue, largely as a result of the acquisition of AT&T Wireless. Additionally, as former AT&T Wireless customers migrate to the popular Rollover rate plans, Cingular expects higher revenue deferrals related to unused rollover minutes to have an unfavorable impact on reported ARPU. This effect may be partially offset by the addition of higher ARPU AT&T Wireless subscribers to the customer base.

Equipment revenues

For 2004, equipment sales increased \$281 in 2004 compared to 2003, primarily driven by overall higher handset sales including the impact of a significant increase in customer gross additions due to the acquisition of AT&T Wireless. Customer migrations to new Cingular rate plans as a result of the merger also favorably impacted handset upgrade revenue.

SEGMENT OPERATING EXPENSES

Cost of services and products

The cost of services and products increase of \$707 for 2004 compared to 2003 was due to increases in local network system costs and in third party system costs (*i.e.*, roaming and long distance costs). Over half of the increase in local network system costs can be attributed to the incremental costs related to the acquired AT&T Wireless network. Excluding this impact, the overall drivers of increased local network costs are primarily related to increased network system usage and associated network system expansion costs. Increased local network system costs in 2004 versus the prior year attributable to historical pre-merger Cingular activities included increased costs billed to its customers related to payments into the USF and certain other regulatory funds and higher costs related to its handset insurance program due to increased claims. For 2004, third party network system costs were lower as continued decreases in incollect roaming costs were partially offset by higher long distance costs. Lower incollect roaming costs were a result of lower negotiated roaming rates with Cingular's roaming partners, which more than offset in-

creased volumes of roaming minutes. Also, as a result of the AT&T Wireless acquisition, Cingular's consolidated incollect expenses reflect elimination of intra-company incollect roaming costs between the now combined Cingular and former AT&T Wireless properties along with a corresponding elimination of outcollect revenue. Although net income neutral, this elimination will significantly reduce the new combined company incollect roaming expenses when compared to the combination of prior historical stand-alone results. The increase in long distance costs was primarily volume driven, impacted by the inclusion of "free long distance" in many of Cingular's regional and national rate plan offerings. In addition, approximately one-third of the increase in long distance costs versus 2003 was related to the incremental long distance expenses incurred as a result of the AT&T Wireless acquisition. For 2004, the cost of equipment sales increased, primarily driven by overall higher handset sales including the impact of a significant increase in customer gross additions and customer migration to Cingular rate plans due to the acquisition of AT&T Wireless.

Selling, general, and administrative expenses

Selling, general, and administrative expenses for 2004 increased \$656 when compared with the prior year, primarily due to the incremental expense impact resulting from the addition of the AT&T Wireless selling, general, and administrative expenses during the fourth quarter of 2004. Selling, general, and administrative expenses in 2004 also included cost increases associated with increased customer gross additions and other customer service and support initiatives. Selling expenses, which include sales, marketing, advertising and commission expenses, increased for 2004 compared with the prior year primarily due to the addition of the incremental AT&T Wireless selling expenses during the fourth quarter of 2004. Higher sales, advertising and promotion costs and commissions expenses were also a function of the increased customer gross additions in 2004. Costs for maintaining and supporting the customer base also increased for 2004 compared with the prior year primarily due to the addition of the AT&T Wireless expenses in the fourth quarter. Costs for maintaining and supporting the customer base were also impacted by higher bad debt expense, customer service expenses to support on-going customer retention and other service improvement initiatives and higher commission expenses associated with handset upgrades. Bad debt expense increased primarily due to higher customer net write-offs as a result of prior relaxed credit policies in selected areas, which have been subsequently changed, as well as residual impacts related to the implementation of wireless local number portability in late 2003. Additionally, 2003 included a net recovery of prior MCI write-offs. Upgrade commission expenses were impacted by over one million customer migrations to new rate plans as a result of the merger.

Depreciation and amortization

Depreciation expense increased by \$249 in 2004, compared to 2003, and included an incremental \$130 related to assets acquired from AT&T Wireless. Other increases in depreciation expense were primarily due to on-going capital spending, including the GSM/GPRS/EDGE network overlay, in addition to increased depreciation on TDMA assets in 2004 as a result of a further review of estimated service lives. Amortization expense increased by \$148 in 2004 compared to 2003, and included an incremental \$166 in amortization expense as a result of the AT&T Wireless acquisition, primarily related to the amortization of the customer relationship intangible asset. This increase was partially offset by certain historical Cingular finite-lived intangible assets becoming fully amortized during 2004.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items which were excluded from this segment's results consisted of the following: in 2004, \$(109) related to wireless merger integration costs, fair value adjustment and lease accounting adjustments; in 2003, no unusual items were excluded.

2003 compared to 2002

SEGMENT OPERATING REVENUES

Cellular/PCS customers increased 9.6% during 2003. Net cellular/PCS additions in 2003 increased 1.8 million compared to 2002. Improvement in customer additions was attributable to several business initiatives Cingular implemented earlier in 2003: (1) reorganization of Cingular's marketing, sales and operations activities from a national to a regional basis to more effectively address local market needs; (2) introduction of a more meaningful brand message; (3) increased emphasis on Cingular's affiliation with its parents and co-branding and more effectively utilizing the parents' sales channels in those areas where Cingular's wireless markets overlap with the parents' wireline markets; and (4) more effective marketing execution such as the "Family Talk" rate plan offer introduced in the third quarter of 2003. Prepaid subscriber growth was impacted positively in 2003 by the KIC (Keep in Contact) prepaid plan launched in the fourth quarter of 2002. The reseller subscriber base was higher due to aggressive growth by Cingular's primary reseller during 2003 and to a loss of 371,000 MCI reseller customers in 2002, principally when MCI made the decision to exit the wireless reseller business in the second half of 2002. The cellular/PCS churn rate was 2.7% in 2003 compared with a 2.8% churn rate in 2002.

Total segment operating revenues increased \$232 during 2003. The growth in total operating revenues was a result of improved service revenues driven by a larger average cellular/PCS customer base, robust growth in

data revenues and increased regulatory fee revenues. Strong customer growth and a significant increase in handset upgrade activity in 2003 also contributed to increased equipment revenues.

Service revenues increased \$120 in 2003, driven by the 3.6% increase in the average subscriber base, a 14.4% increase in local minutes of use, and a \$64 increase over prior year of revenues related to billings to Cingular's customers for the USF and other regulatory fees. Other increases were a result of an increase in data revenues from 2002, reflective of higher penetration and usage of SMS short messaging data services with cellular/PCS customers as well as increased revenue per customer related to the Mobitex data business. Partially offsetting these increases were a decrease in wireless Average Revenue Per User (ARPU), declines in roaming and long distance revenues reflecting the migration of customers to regional and national rate plans and a reduction in roaming rates with major roaming partners to support all-inclusive rate plans. Additionally, the increase was offset partially by the effects of Emerging Issues Task Force Issue No. 00-21 (EITF 00-21), Revenue Arrangements with Multiple Deliverables, adopted July 1, 2003. Implementation of EITF 00-21 resulted in a reclassification of certain direct channel activation revenues from service revenues to equipment revenues on a prospective basis only. As a result, service revenue growth was reduced by approximately \$14 for the year.

ARPU for cellular/PCS customers declined 1.6% or \$0.82 to \$51.32 in 2003 from \$52.14 in 2002. Increased sales of lower ARPU "Family Talk" plans in the second half of the year, in combination with a higher percentage of lower ARPU reseller and prepaid customers in Cingular's 2003 customer base, negatively impacted its overall ARPU when compared with the prior year. Additionally, the impact of increased revenue deferrals associated with its "rollover" rate plans, which allow customers to carry over any unused "anytime" minutes from month to month for up to one year, plus the revenue reclassification as a result of the adoption of EITF 00-21 also had a negative impact on ARPU. Other unfavorable impacts include on-going competitive pricing pressures and the reductions in roaming and long distance revenues.

Equipment revenues increased \$112 in 2003 compared to 2002. An increase in handset revenues was primarily driven by higher unit sales reflecting the nearly 14% increase in cellular/PCS postpaid and prepaid gross customer additions and a significant increase in the sale of "upgrade" handsets compared with the prior year. The increased unit sales, particularly for upgrades, was a function of both Cingular's GSM conversions and focused efforts to increase the number of customers under contract in anticipation of wireless local number portability. These increases also included the impact of the implementation of EITF 00-21, which increased equipment revenues by approximately \$14.

SEGMENT OPERATING EXPENSES

Cost of services and products

Cost of services and products primarily includes expenses to monitor, maintain and service Cingular's network, landline facilities expense, incollect roaming charges from other carriers, cost of equipment sales, and long distance expense. Cost of services and products increased \$308 during 2003. The primary driver of the increase of cost of services was the increase in the cost of equipment sales of \$198. This increase was driven primarily by higher unit sales associated with the large increase in gross customer additions and upgrade unit sales. Overall, the increased cost of equipment sales was also impacted by higher per unit handset costs for upgrade units driven by a shift to more advanced handsets, such as the dual mode TDMA/GSM handsets in use during Cingular's GSM system conversion and newly introduced feature-rich GSM-only handsets. Other increases in cost of services include increases in local system costs of \$164, partially offset by decreases in third party system costs. Local systems costs continue to be driven by growth in system minutes of use, system expansion and the increased costs of redundant TDMA and GSM networks required during the current GSM system overlay. System minutes of use increased 19.1% in 2003. The increase in local system costs includes a \$64 increase in costs related to payments into the USF and other regulatory funds. The primary contributor to lower third party system costs was a decrease in incollect roaming costs, which decreased \$53 in 2003. These reductions were a result of lower negotiated roaming rates and cost reductions associated with the Mobile Telecommunications Sourcing Act.

Advertising & Publishing Group

Our Advertising & Publishing Group is comprised of companies in the US that publish, print, sell advertising in and perform related services concerning alphabetical and classified telephone directories and electronic product offerings. In November 2004, BellSouth and SBC created an online Internet yellow pages joint venture that acquired the online directory publisher www.yellowpages.com. This venture is expected to allow us to expand the national advertising base and expand traffic relationships.

As discussed more fully in Note C to our consolidated financial statements, effective January 1, 2003, we changed our method for recognizing revenues and expenses related to our directory publishing business from the publication and delivery method (issue basis) to the deferral method (deferral basis). For BellSouth's consolidated results, this change was treated as a prospective change and prior year consolidated results were not restated. However, to align internal reporting, the 2002 segment results for the Advertising & Publishing Group were recast to reflect the change. Under the issue basis, we recognized 100% of revenues and direct expenses at the time the directories were published and delivered. Under the deferral basis, we amortize, or recognize ratably, revenues and direct expenses over the life of the related print directory, generally 12 months. When compared to the issue-basis method, the deferral method causes trends in current-period operating results to be recognized in the income statement over a longer period of time and to cross fiscal years.

Selling, general, and administrative expenses

Selling, general, and administrative expenses remained flat in 2003. Increases in Cingular's selling expenses were offset by decreases in costs related to maintaining and supporting its customer base and other administrative costs. Higher commissions and advertising expenses were partially offset by reduced employee-related costs as a result of the sales operation reorganization in 2002.

Costs for maintaining and supporting the customer base decreased \$27 during 2003. Reduced costs included lower bad debt expenses and billing expenses, partially offset by increased residuals and upgrade commissions expenses related to the existing customer base. The lower billing expenses reflect cost reductions as a result of system conversions and related consolidations in 2002.

Depreciation and amortization

Depreciation and amortization increased \$95 in 2003. The increase in depreciation expense of \$106 was attributable to higher levels of gross property, plant and equipment plus accelerated depreciation on TDMA assets that began in 2003. Amortization expense declined \$11 due to certain finite-lived intangibles becoming fully amortized during 2002.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items which were excluded from this segment's results consisted of the following: in 2003, no unusual items were excluded; in 2002, \$(56) related to impairment losses.

In 2003 and early 2004, our Advertising & Publishing Group was negatively affected by weak economic conditions and competition. We expect an improving economy, combined with the execution of our business strategies, to result in moderate revenue growth in 2005.

| | 2002 | 2003 | 2004 | Percent Change | |
|---|---------|---------|--------------|----------------|---------------|
| | | | | 2003 vs. 2002 | 2004 vs. 2003 |
| Segment operating revenues | | | | | |
| Advertising & Publishing revenues | \$2,010 | \$1,906 | 1,878 | (5.2) | (1.5) |
| Commission revenues | 147 | 144 | 141 | (2.0) | (2.1) |
| Total segment operating revenues | 2,157 | 2,050 | 2,019 | (5.0) | (1.5) |
| Segment operating expenses: | | | | | |
| Cost of services and products | 351 | 345 | 353 | (1.7) | 2.3 |
| Selling, general, and administrative expenses | 879 | 706 | 684 | (19.7) | (3.1) |
| Depreciation and amortization | 29 | 26 | 28 | (10.3) | 7.7 |
| Total segment operating expenses | 1,259 | 1,077 | 1,065 | (14.5) | (1.1) |
| Segment operating income | 898 | 973 | 954 | 8.4 | (2.0) |
| Segment net income | \$ 545 | \$ 600 | 583 | 10.1 | (2.8) |
| Segment net income including unusual items | \$ 428 | \$ 96 | 583 | (77.6) | * |
| Capital Expenditures | \$ 29 | \$ 28 | 29 | (3.4) | 3.6 |

* Not meaningful

2004 compared to 2003

SEGMENT OPERATING REVENUES

Segment operating revenues decreased \$31 in 2004 compared to 2003. The decreases include a reduction in print revenues, partially offset by an increase in electronic media revenues. Sales agency commission revenues declined \$3 in 2004 compared to 2003.

The print revenue decline between periods was primarily driven by the amortization of revenues from directories issued in the latter half of 2003. The decline in revenues from 2003 directories was attributable to the lingering effects of weak economic conditions in 2003 that affected the directory advertising environment, and the continued impact of online and offline media competition. These factors also caused revenues from directories issued in the first half of 2004 to be flat when compared to their 2003 issues. Revenues from directories issued in the second half of 2004, however, achieved positive growth as a result of expanded product offerings, increased distribution, successful sales execution, growth in Internet sales, and an improving economy. Based on recent directory sales volumes, revenues from directories to be issued 2005 are also expected to show moderate positive growth over their previous issues.

The \$3 decline in sales agency commission revenues was the result of the discontinuance of a line of business, partially offset by growth in core sales.

SEGMENT OPERATING EXPENSES

Cost of services and products increased \$8 in 2004 compared to 2003 driven by the impact of increased distribution. Selling, general, and administrative expenses decreased \$22 in 2004 compared to 2003 driven primarily

by a \$49 decrease in uncollectible expense, the result of improved collection performance between periods. Variable costs associated with selling also decreased as a result of the reduction in revenues. Partially offsetting these decreases were increases in employee healthcare, pension and post-retirement medical costs, as well as increased spending for advertising in response to a more competitive environment. Depreciation and amortization expense increased \$2 during 2004 reflecting an increase in capitalized software.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items that were excluded from this segment's net income consisted of the following: in 2004 there were no unusual items; in 2003, unusual items of \$(504) included the cumulative effect of change in accounting principle and severance and pension costs.

2003 compared to 2002

SEGMENT OPERATING REVENUES

Segment operating revenues decreased \$107 from 2002 to 2003. The decrease included a reduction in print revenues due to lower overall spending by our advertisers. The decline in print revenue was partially offset by an increase in revenues from electronic media offerings, resulting from increased penetration of the print customer base. Sales agency commission revenues decreased slightly as the result of a discontinued line of business.

Because of the accounting convention used for publishing revenue, the revenue decline during 2003 was primarily driven by the amortization of revenues from directories issued in 2002, and to a lesser extent from those issued in 2003. Revenues from directories issued in 2003 also de-

clined when compared to their 2002 issues attributable to the factors discussed previously. Approximately 50% of the decline was recognized in the segment's 2003 income statement, with the remainder to be recognized in 2004.

SEGMENT OPERATING EXPENSES

Cost of services and products decreased \$6 in 2003, primarily reflecting the impact of manufacturing cost reduction efforts. Selling, general, and administrative expenses decreased \$173 in 2003. Uncollectible expense was the primary driver of the reductions, decreasing \$141. The decrease reflects the impact of improved collection per-

formance in 2003. In addition, variable costs associated with selling decreased as the result of the reduction in revenues. Depreciation and amortization expenses were relatively flat in 2003.

UNUSUAL ITEMS EXCLUDED FROM SEGMENT NET INCOME

Unusual items which were excluded from this segment's results consisted of the following: in 2003, \$(504) included the cumulative effect of a change in accounting principle and severance and pension costs; in 2002, \$(117) related to an unbilled receivable adjustment, severance costs and employee benefits related to workforce reduction.

Liquidity and Financial Condition

DESCRIPTION OF CASH FLOWS

| | 2002 | 2003 | 2004 | Percent Change | |
|---|----------|----------|----------|----------------|---------------|
| | | | | 2003 vs. 2002 | 2004 vs. 2003 |
| Net cash provided by (used for): | | | | | |
| Continuing Operations | | | | | |
| Operating activities | \$ 7,712 | \$ 7,883 | \$ 6,801 | 2.2 | (13.7) |
| Investing activities | (1,912) | (2,706) | (13,560) | * | * |
| Financing activities | (4,443) | (4,679) | 5,071 | (5.3) | * |
| Discontinued Operations | 72 | 428 | (579) | * | * |

* Not meaningful

Continuing Operations

NET CASH PROVIDED BY OPERATING ACTIVITIES

Cash generated by operations decreased \$1,082 in 2004 compared to the prior year due primarily to a \$601 increase in income tax payments in 2004, a previously accrued payment of approximately \$81 to MCI related to its bankruptcy settlement, a \$77 payment associated with the ratification of our contract with CWA, \$160 of cash expenses due to the hurricanes in 2004, and lower operating margins before depreciation and amortization in the Communications group. Operating income excluding depreciation and amortization in the Communications group decreased \$393 in 2004 compared to the prior year. Partially offsetting these increased payments were decreases over prior year of \$141 in other postretirement benefit funding and \$45 in severance payments.

Cash generated by operations increased \$171 during 2003 compared to the prior year. The increase was driven primarily by lower severance payments and better receivables collections. Severance payments of \$125 in 2003 declined \$369 as compared to \$494 of payments in 2002. During 2003, we enhanced our processes with respect to receivable collection management resulting in improved collections. Decreases in interest income, due to lower rates on our advance to Cingular and the loss of income on an advance to KPN were substantially offset by lower interest expense due to lower borrowings.

Operating cash flows in the next few years will be negatively impacted by higher federal income tax payments as the timing of accelerated tax depreciation in recent years begins to reverse.

NET CASH USED FOR INVESTING ACTIVITIES

Capital expenditures

Capital expenditures consist primarily of (a) gross additions to property, plant and equipment having an estimated service life of one year or more, plus the incidental costs of preparing the asset for its intended use, and (b) gross additions to capitalized software.

Our capital expenditures for continuing operations for 2000 through 2004 were as follows:

| | Millions | % of Revenue |
|-------------|----------------|--------------|
| 2000 | \$6,169 | 26.5 |
| 2001 | \$5,495 | 25.9 |
| 2002 | \$3,536 | 17.5 |
| 2003 | \$2,926 | 14.4 |
| 2004 | \$3,193 | 15.7 |

The trend in capital spending levels over the past five years reflects targeted capital deployment and better unit pricing due to technological advances. The trend in spending for capitalized software has increased over the period driven by system enhancements to increase efficiencies and introduce new products. While spending levels

are expected to remain relatively flat as a percent of revenue, we expect a slight shift in the mix of capital expenditures toward broadband and other next-generation technologies, such as fiber optics and DSL.

We expect expenditures for 2005 to be financed substantially through internal sources and, to the extent necessary, from external financing sources.

Other investing activities

During 2004, we contributed \$14,410 to Cingular to fund its acquisition of AT&T Wireless. In addition, we loaned Cingular \$666 under a revolving credit agreement to fund higher cash needs associated with the initial integration of AT&T Wireless. We received net proceeds of \$3,020 in connection with the sale of eight of our Latin American operations. The sale of our investment in Sonofon resulted in proceeds of \$634, including the repayment of a shareholder loan. Purchases and sales of short-term investments resulted in a cash inflow of \$1,593. Purchases and sales of equity securities, primarily in our grantor trust, resulted in a net cash outlay of \$492.

Other 2003 investing activities include net proceeds of \$1,458 resulting from an early repayment by KPN of the entire outstanding balance of the loan we had extended to them and the settlement of related currency swaps. In June 2003, we sold our entire interest in two real estate partnerships for net proceeds of \$26. In conjunction with the sale, we received proceeds of \$97 for the repayment of loans we had extended to the partnerships. During 2003, we purchased \$194 in debt and equity securities and made net short-term investment purchases of \$1,148.

Other 2002 investing activities include receipt of \$2,268 in proceeds from the sale of shares in Qwest and KPN as well as proceeds from a principal payment related to a loan to KPN. In addition, we contributed a total of \$210 to equity affiliates, including \$200 to Cingular. The \$200 contribution related to income tax benefits realized by BellSouth associated with our investment in Cingular. We also made net purchases of short-term investments of \$461.

NET CASH USED FOR FINANCING ACTIVITIES

Net borrowings of short-term and long-term debt of \$7,057 during 2004 increased \$9,337 over 2003, primarily due to financing our share of the purchase price of Cingular's acquisition of AT&T Wireless. Cash used for the purchase of treasury shares declined \$712 due to the expiration of the Company's stock repurchase program in December 2003. Dividend payments increased \$293 as compared to 2003 due to an increase in the annual dividend rate to \$1.04 per share from \$.87 per share in 2003. In December 2004, we called \$400 of debt, which was redeemed in January 2005.

Our debt to total capitalization ratio of 47.1% at December 31, 2004 increased from 43.1% at December 31,

2003, reflecting the net issuance of short-term and long-term debt, partially offset by a decrease in debt related to our discontinued operations and an increase in equity.

Cash used for financing activities increased \$236 during 2003 compared to 2002 due primarily to an increase in dividends paid of \$148 and an increase in purchases of treasury shares of \$267, partially offset by a reduction in debt pay downs of \$176. During 2003, we paid dividends of \$.87 per share totaling \$1,608 and purchased 35.0 million shares of our common stock for \$858. During 2002, we paid dividends of \$.78 per share totaling \$1,460 and purchased 22.3 million shares of our common stock for \$591.

We utilized cash in 2003 to pay down short-term borrowings by \$431 and long-term notes by \$1,849. Our debt to total capitalization ratio of 43.1% at December 31, 2003 decreased from 49.2% at December 31, 2002, reflecting both the \$2.4 billion debt pay down for both short-term and long-term notes as well as an increase in equity due to earnings partially offset by dividends declared.

Discontinued Operations

The following table includes cash flows from our discontinued operations:

| | 2002 | 2003 | 2004 |
|---|--------|--------|----------|
| Cash flows from operating activities | \$ 534 | \$ 646 | \$ 561 |
| Cash flows from investing activities | (256) | (140) | (997) |
| Cash flows from financing activities | (206) | (78) | (143) |
| Total cash flows from discontinued operations | \$ 72 | \$ 428 | \$ (579) |

Operating Activity — Cash flows from operations declined during 2004 impacted by working capital changes and to a lesser extent by foreign currency translation rate changes on cash balances. Cash flows from operations improved during 2003 reflecting improved margins compared to 2002 driven by growth in Ecuador, Colombia, and the currency recovery in Argentina.

Investing Activity — Capital expenditures from our discontinued operations were \$249 in 2002, \$274 in 2003 and \$225 in 2004. In addition to capital expenditures, 2004 investing activity included \$793 in expenditures related to the purchase of interests and other rights of minority partners in Argentina, Colombia, Ecuador, and Venezuela. Investing activity in 2003 includes proceeds of \$35 from the sale of our Colombian debt securities, \$70 for the sale of two Brazilian operations, and \$37 for the sale of equity securities. In addition to capital expenditures, 2002 investing activity includes a \$94 payment related to a guarantee payment on a Brazilian loan offset by \$90 of proceeds on sales of our investment in TCO.

Financing Activity — Payments on outstanding borrowings were \$158 in 2002, \$78 in 2003, and \$63 in 2004. Financing activity also included net payments to minority partners of \$48 in 2002 and \$80 in 2004.

ANTICIPATED SOURCES AND USES OF FUNDS

General

The Communications group and Advertising & Publishing group generate substantially all of our consolidated cash provided by operating activities. These segments generate sufficient cash flow to fund their investing and financing activities. Should other investing opportunities arise, we believe we are well positioned to raise capital in the public debt markets.

Our Board of Directors considers the cash dividend on a quarterly basis. Their objective is to maintain a competitive dividend balanced with an evaluation of projected free cash flow.

At December 31, 2004, our long-term debt rating was A2 from Moody's Investor Service and A from Standard and Poor's. Our short-term debt rating at December 31, 2004 was P-1 from Moody's and A-1 from Standard and Poor's. During 2004, Moody's reduced our long-term debt rating from A1 to A2. Moody's indicated the rating was reduced because of the loss of financial flexibility due to the significantly increased debt levels associated with Cingular's acquisition of AT&T Wireless, increasing competition that continues to erode profitability and the ability to generate free cash flow, and increasing capital expenditures associated with network upgrades which will negatively impact our ability to reduce debt over the near term. Moody's outlook on both our short and long-term ratings remains negative. The reasons cited were our expanded competitive challenges in the wireline business which could erode our ability to reduce debt levels as planned and the possibility of lower earnings and cash flow at Cingular if the AT&T Wireless integration is more expensive and time consuming than anticipated. Standard and Poor's also has a negative outlook on our long-term debt rating. The reasons given are increasing competition in our wireline business from the cable television companies, which could drive down pricing and squeeze operating margins, and near term pressures from the integration of AT&T Wireless.

Our authorized commercial paper program as of December 31, 2004 was \$10.5 billion, with \$3.2 billion outstanding. We believe that we have ready access to the commercial paper market in the event funding in excess of our operating cash flows is needed. We also have a registration statement on file with the SEC under which \$3.1 billion of long-term debt securities could be issued. Our sources of funds — primarily from operations and, to the extent necessary, from readily available external financing arrangements — are sufficient to meet all current obligations on a timely basis. We believe that these sources of funds will be sufficient to meet the operating needs of our business for at least the next twelve months.

Domestic wireless

The Domestic Wireless segment, which consists entirely of our equity investment in Cingular, historically has not relied on BellSouth for funding its operations and capital program

but has relied upon the debt capital markets. Effective August 1, 2004, BellSouth and SBC have agreed to finance our respective pro rata shares of Cingular's capital and operating cash requirements based upon Cingular's budget and forecasted cash needs. Cingular also terminated its bank credit facilities and ceased issuing commercial paper and long-term debt. As of December 31, 2004, we had outstanding advances under the line of credit of \$666 to fund cash needs associated with the initial integration of AT&T Wireless. During 2005, we expect Cingular to pay down this advance and to distribute additional cash to its parent companies.

Cash management

BellSouth's primary source of cash flow is dividends from its subsidiaries. Generally, we do not permit our subsidiaries to accumulate cash, requiring them to pay out either net income or cash flow available in the form of dividends. Any funding requirements for wholly owned domestic subsidiaries are fulfilled by BellSouth Corporation.

Debt instruments

PUBLICLY HELD INDEBTEDNESS

BellSouth and BellSouth Telecommunications currently have debt outstanding under various indentures that we have entered into over the past twelve years. None of these indentures contain any financial covenants. They do contain limitations that restrict the Company's (or the affiliate of the company that is a party to the indenture) ability to create liens on their properties or assets (but not the properties or assets of their subsidiaries) except in specified circumstances. None of these indentures contains any provisions that are tied to the ratings assigned to the company or its affiliates by an external debt rating agency. Further, none of these indentures contains cross-default provisions.

On October 4, 2004, we entered into a syndicated credit agreement that provides for lender commitments in the aggregate principal amount of \$9.0 billion. As of December 31, 2004, aggregate lender commitments under that agreement had been reduced to approximately \$2.0 billion. Of this amount, \$1.0 billion expires on April 29, 2005 and the remaining amount expires on October 3, 2005. The agreement acts as a backup facility for our commercial paper program. In addition, we have a syndicated line of credit (together with the credit agreement, the "credit facilities") in the amount of \$1.5 billion. If the line of credit is not drawn and the term conversion is not exercised, the line of credit will expire on April 29, 2005. We expect to enter into a new syndicated line of credit on substantially similar terms. We do not have any balances outstanding under the line of credit.

Except as described in this paragraph, the credit facilities contain no financial covenants or requirements for compensating balances. Further, the credit facilities do not contain any provisions that are tied to the ratings assigned

to us or our affiliates by an external debt rating agency. At our election, any outstanding borrowings may be converted to a one-year term loan, in which case the debt of the Company and its consolidated subsidiaries is not permitted to exceed 300% of consolidated earnings before interest, taxes, depreciation and amortization for the preceding four quarters. In addition, the credit facilities prohibit the Company and its significant subsidiaries from permitting liens to be placed on their properties or assets except in specified circumstances. If BellSouth or any of our subsidiaries defaults on any outstanding debt in excess of

\$200, an event of default will occur under the line of credit.

DISCONTINUED OPERATIONS

As of December 31, 2004, BellSouth Enterprises, a subsidiary of BellSouth, had guaranteed our Chilean operation's \$180 syndicated loan facility. This guarantee was terminated in January 2005 when we sold our Chilean operations to Telefónica Móviles.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

OFF-BALANCE SHEET ARRANGEMENTS

In most of our sale and divestiture transactions we indemnify the purchaser for various items including labor and general litigation as well as certain tax matters. Generally, the terms last one to five years for general and specific indemnities and for the statutory review periods for tax matters. The events or circumstances that would require us to perform under the indemnity are transaction and circumstance specific. We regularly evaluate the probability of having to incur costs associated with these indemnifications and have accrued for expected losses that are probable. In addition, in the normal course of business, we indemnify counter parties in certain agreements. The nature and terms of these indemnities vary by transaction. Historically, we have not incurred significant costs related to performance under these types of indemnities.

We do not have transactions, arrangements or relationships with "special purpose" entities, and we do not have any off-balance sheet debt.

CONTRACTUAL OBLIGATIONS

The following table discloses aggregate information about our contractual obligations as of December 31, 2004 and the periods in which payments are due:

| | Total | Payments Due by Period | | | |
|---|-----------------|------------------------|----------------|----------------|-----------------|
| | | Less than 1 year | 2006-2008 | 2009-2011 | After 2011 |
| Debt maturing within 1 year | \$ 5,475 | \$5,475 | \$ - | \$ - | \$ - |
| Long-term debt ⁽¹⁾ | 15,453 | - | 2,872 | 3,877 | 8,704 |
| Interest on long-term debt | 21,365 | 943 | 2,626 | 2,085 | 15,711 |
| Operating leases | 691 | 136 | 256 | 99 | 200 |
| Unconditional purchase obligations ⁽²⁾ | 3,102 | 723 | 1,599 | 780 | - |
| Interest rate swaps ⁽³⁾ | (2) | (8) | 2 | 4 | - |
| Total contractual cash obligations | \$46,084 | \$7,269 | \$7,355 | \$6,845 | \$24,615 |

(1) The long-term debt amount above excludes \$(77) of unamortized discounts and premiums included in long-term debt on the balance sheet as of December 31, 2004. Payments after the year 2011 include the final principal amount of \$500 for the Zero-to-Full Debentures due in 2095, which have a carrying value of \$232 as of December 31, 2004.

(2) The total unconditional purchase obligation includes \$472 related to agreements with Qwest and Accenture that do not stipulate annual minimum purchases. The agreement with Qwest expires in 2010 and the Accenture agreement expires in 2007. Of this amount, \$6 is included in the 2006 - 2008 column and \$466 is included in the 2009 - 2011 column.

(3) The amounts due for the interest rate swaps and forward contracts are based on market valuations at December 31, 2004. Actual payments, if any, may differ at settlement date.

Pensions and other retiree benefits

As of December 31, 2004, our defined benefit pension plans were fully funded. Therefore, we do not currently anticipate any cash funding needs to meet minimum required funding thresholds. Over the past three years, funding for other retiree benefits was \$493 in 2002, \$563 in

2003, and \$422 in 2004. We currently expect funding in 2005 to be in the range of \$450 to \$500.

OTHER POTENTIAL OBLIGATIONS

Several issues of long-term debt included in the table above contain embedded options which may require us to

repurchase the debt or which may alter the interest rate associated with that debt. Please refer to Note I to our consolidated financial statements for further information on these instruments. Those issues, their amounts and the date of the related options, are as follows:

| Issue | Amount | Date of Put Option |
|---------------------|---------|--------------------|
| 20-put-1 Securities | \$1,000 | Annually in April |
| Putable debentures | 281 | November 2006 |

RELATED PARTY TRANSACTIONS

We own an approximate 40% interest in Cingular. See Note E to our consolidated financial statements for a description of our relationship with Cingular.

Quantitative and Qualitative Disclosure About Market Risk

DESCRIPTION OF RISK

We are exposed to various types of market risk in the normal course of business, including the impact of interest rate changes, changes in equity investment prices and foreign currency exchange rate fluctuations. To manage this exposure, we employ risk management strategies including

the use of derivatives such as interest rate swap agreements, foreign currency forwards and currency swap agreements. We do not hold derivatives for trading purposes.

Interest rate risk

Our objective in managing interest rate risk is to maintain a balance of fixed and variable rate debt that will lower our overall borrowing costs within reasonable risk parameters. Interest rate swaps are used to convert a portion of our debt portfolio from a variable rate to a fixed rate or from a fixed rate to a variable rate.

Risk sensitivity

Our use of derivative financial instruments is designed to mitigate foreign currency and interest rate risks, although to some extent they expose us to credit risks. The credit risks associated with these instruments are controlled through the evaluation and continual monitoring of the creditworthiness of the counter parties. In the event that a counter party fails to meet the terms of a contract or agreement, our exposure is limited to the current value at that time of the currency rate or interest rate differential and not the full notional or contract amount. Such contracts and agreements have been executed with credit worthy financial institutions, and as such, we consider the risk of nonperformance to be remote.

The following table provides information, by maturity date, about our interest rate sensitive financial instruments, which consist of fixed and variable rate debt obligations and related interest rate derivatives. Fair values for the majority of our long-term debt obligations are based on quotes from dealers.

| | Expected Maturity Date | | | | | | Total | Fair Value |
|----------------------------------|------------------------|---------|-------|-------|---------|------------|----------|------------|
| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | | |
| Liabilities | | | | | | | | |
| Long-term debt: | | | | | | | | |
| Fixed Rate | \$1,867 | \$1,299 | \$ 19 | \$621 | \$1,872 | \$10,434 | \$16,112 | \$17,149 |
| Average interest rate | 3.1% | 5.2% | 6.3% | 5.7% | 4.5% | 6.4% | 5.7% | |
| Variable Rate | \$ 335 | \$ 410 | \$500 | - | - | - | \$ 1,245 | \$ 1,245 |
| Average interest rate | 2.7% | 2.9% | 3.7% | | | | 3.2% | |
| Interest Rate Derivatives | | | | | | | | |
| Interest Rate Swaps: | | | | | | | | |
| Variable to Fixed | \$1,000 | \$ - | \$ - | \$ - | \$ - | \$ - | \$ 1,000 | \$ (29) |
| Average pay rate | 5.9% | | | | | | 5.9% | |
| Average receive rate | 3.0% | | | | | | 3.0% | |
| Fixed to Variable | - | - | - | \$600 | \$ 800 | - | \$ 1,400 | \$ 5 |
| Average pay rate | | | | 5.5% | 4.8% | | 5.1% | |
| Average receive rate | | | | 5.8% | 4.8% | | 5.2% | |

PROPORTIONAL DEBT

We own an approximate 40% interest in Cingular Wireless, and share joint control of the venture with SBC and, therefore, do not consolidate these operations. Our proportional debt, including our share of the face value of

Cingular's non-affiliate debt and capitalized leases at December 31, 2004, is shown in the table below.

| | |
|----------------------------|----------|
| Consolidated debt | \$20,583 |
| Plus: 40% of Cingular debt | 5,099 |
| Proportional debt | \$25,682 |

Operating Environment

DOMESTIC ECONOMIC TRENDS

On average, the economy of our nine-state region tends to closely track the US economy. Real gross domestic product (GDP) grew at an average annual rate of 4.4 percent in 2004, compared with an increase of 3.0 percent in 2003. The improvement in the economy was marked by gains in personal consumption expenditures, residential construction, business investment in equipment and software, federal government spending, and exports. These gains were partly offset by an increase in imports. Nonagricultural employment increased 2.2 million during the year and the unemployment rate dipped to 5.4 percent in December from 5.7 percent a year earlier. The nation's economic growth is expected to slow in 2005 to near 3.5 percent. Employment gains are expected to again exceed 2 million with the unemployment rate receding further to 5.2 percent in 2005.

Nonagricultural employment in our nine-state region grew 1.4 percent during the year, and we anticipate a gain of 2.0 percent in 2005. Employment in the region has historically been closely correlated with various measures of BellSouth's business performance. Residential construction activity has been very strong in the region and the nation. Through the third quarter of 2004, housing starts were on pace to reach 588 thousand, exceeding the 533 thousand reached in 2003. We expect a more moderate pace of construction activity for 2005.

WIRELINE REGULATORY ENVIRONMENT

The FCC regulates rates and other aspects of our provision of interstate telecommunications services, including international rates and interstate access charges. State regulatory commissions have jurisdiction over our provision of intrastate telecommunications services, including local and long distance rates and network access services. Access charges are designed to compensate our wireline subsidiaries for the use of their networks by other carriers. Our future operations and financial results will be substantially influenced by developments in a number of federal and state regulatory proceedings. Adverse results in these proceedings could materially affect our revenues, expenses and ability to compete effectively against other telecommunications carriers.

Regulatory Reform

Because traditional telecommunications providers such as BellSouth are subject to significantly more regulatory requirements than our competitors, we will encourage reform efforts before legislatures and regulatory agencies. As competition increases, our need for regulatory requirements whose burdens more nearly equal those of our competitors increases. We have encouraged both state and federal legislators and regulators to adopt reforms that prevent greater rate and service quality

regulation of our services than is imposed on our competitors. In various dockets before the FCC, we have urged it to accord our broadband and Internet Protocol offerings a regulatory treatment more nearly like that it accords broadband offerings by the cable industry, and to forebear from old requirements, such as the Computer Inquiry requirements that require us to tariff and offer separately the telecommunications service portion of any information service we offer and that assume our telecommunications business is a monopoly.

We expect significant regulatory reform debate in the jurisdictions where we provide traditional telecommunications service. We cannot predict the outcome of reform efforts. The continued imposition of unequal regulatory burdens could have an adverse effect on the results of operations.

Federal Regulatory Matters

The FCC regulates rates and other aspects of our provision of interstate telecommunications services. In addition, pursuant to the Telecommunications Act of 1996, the FCC has authority to establish policies for pricing and terms of interconnection between local exchange carriers and incumbent local exchange carriers, such as BellSouth. Prior to 1996, this activity had been mostly the exclusive jurisdiction of the state regulatory commissions. The states now set the rates and establish terms for interconnection within the policy framework ordered by the FCC. We expect the FCC to continue policies that promote local service competition.

FCC INTERCONNECTION, UNBUNDLING AND PRICING RULES

Under the 1996 Act, the FCC is required to consider the extent to which we must make elements of our network available to other providers of local service. The FCC can require access to proprietary network elements only when "necessary". For non-proprietary network elements, the FCC can order access only when failure to do so will impair the ability of the requesting carrier to provide services. The elements provided under these requirements are known as unbundled network elements, or "UNEs". The FCC also establishes the pricing policy for elements. The policy currently in effect is TELRIC (an acronym for Total Element Long-Run Incremental Cost), which assumes a hypothetical, lowest costs, most efficient network for purposes of establishing prices for elements. The states have set prices for elements under this policy since 1996. The FCC's unbundling and pricing requirements have caused us to provide service to competitors at deeply discounted artificial prices, often below actual costs.

The FCC adopted UNE rules in 1996, 1999 and 2003. On each occasion, the rules required significant unbundling of our loop, switching and transmission facilities. Although we implemented the unbundling requirements as they were adopted, we also participated in appeals that challenged

their validity, and the courts generally invalidated the unbundling requirements on each occasion.

Because we implemented the rules before the courts found them invalid, we still have many contracts under which we continue to provide UNEs, including the unbundled network element platform, or UNE-P. As the rules were invalidated, we pursued the options provided by law and our contracts to reform our UNE offerings. In response to the most recent invalidation and in addition to pursuing legal options, we also have offered competitors commercial and tariffed services that would replace the services required by the invalidated rules. These offerings have market-based prices and require longer term commitments. We currently have approximately 45 commercial contracts with CLEC customers through which our former UNE-P service is replaced with a mutually acceptable commercial offering.

The most recent invalidation of the FCC rules became effective on June 16, 2004. The FCC in August issued an interim order that required incumbent local carriers such as BellSouth to continue operating under the terms of their interconnection contracts until new rules were adopted or March 2005, whichever occurs first. The FCC announced new rules in December 2004 and, in February 2005, released its order with the new rules. Its action effectively relieves us of the obligation to accept new UNE-P orders after March 10, 2005, and provides a 12-month transition period to phase out existing UNE-P service. The order also generally requires us to offer as UNEs certain high capacity loop and transport services that competitors use to serve business customers. The obligation to provide the services as UNEs does not apply if the wire centers we use to provide the service meet certain thresholds. However, only a very small percentage of BellSouth's wire centers meet these thresholds. The FCC's action also permits competitors to convert qualifying higher priced special access tariff services they currently use to the lower-priced UNE services. Depending on the extent to which competitors can and do choose to order these UNEs or convert existing tariff services to UNEs, we could experience a material adverse effect on operations.

We believe the action requiring unbundling of high-capacity loop and transport services is a violation of earlier court orders, and we, along with other incumbent carriers, have challenged the action in the D.C. Circuit Court of Appeals. The Court has not set a schedule for considering the case. Other parties may challenge other provisions of the order through appeal or requests for reconsideration. If the outcome of those actions requires us to increase the number or scope of UNEs we must provide or allows competitors greater ability to substitute UNEs for special access services, or contains other negative findings, we could experience a material adverse effect on revenues and results of operations.

In its 2003 unbundling decision, the FCC refused to require incumbents to unbundle the packet switching facilities used to provide broadband service, and also declined to require unbundling of newly constructed fiber loops that connect at the customer premises. In October,

in response to a BellSouth request, the FCC adopted a new rule that also frees certain "fiber to the curb" (FTTC) installations from unbundling requirements. Under the new rule, where BellSouth and other incumbent companies install fiber optic technology within 500 feet of a residential customer's premises, the installation is not subject to the FCC's unbundling rules.

The FCC has established a proceeding to consider modification of TELRIC. We are participating in the proceeding and encouraging the adoption of a methodology that allows appropriate recovery of the costs of operating an actual network. To the extent the rules resulting from the proceeding do not allow recovery of the costs of operating an actual network, we will continue to experience an adverse effect on revenues and results of operations.

On January 31, 2005, the FCC released a notice of proposed rulemaking addressing its special access pricing flexibility rules and criteria to obtain relief, as well as regulation of special access services under federal price cap regulation. Potential revenue loss from an adverse decision could be material.

PRICE REGULATION

The FCC regulates interstate prices using a price regulation plan, which limits aggregate price changes to the rate of inflation, minus a productivity offset, plus or minus other cost changes recognized by the FCC. The productivity factor can vary among services. Interstate prices have been decreasing over the last few years as a result of low inflation in the US economy.

ACCESS CHARGE REFORM

The FCC has favored access reform, through which the historical subsidy for residential local service contained in network access charges paid by long distance carriers is funded instead by the end-user, by universal service funds, or both. As a result of a May 2000 FCC order implementing access charge reform (referred to as the CALLS order), we have reduced the interstate network access charges paid by long distance carriers and increased interstate subscriber line charges paid by end-users. These rate changes better align our cost recovery with the way in which we incur costs.

We continue to participate in FCC examinations of further access reform. The FCC has undertaken a comprehensive examination of intercarrier compensation – the payments among telecommunications carriers resulting from use of their respective interconnecting networks. In general, there are two classes of intercarrier compensation: (1) reciprocal compensation that applies to local calls; and (2) access charges that apply to long distance calls. The objective of the FCC's comprehensive examination is to examine existing rules pertaining to intercarrier compensation and explore alternative forms of intercarrier compensation. This

examination could lead to permanent changes in the way carriers compensate one another and in the way carriers receive compensation from their end-user customer. In February, the FCC announced that it would consider seven policy models submitted by various commenters, each of which would significantly reform intercarrier compensation. We expect the FCC will also reconsider its methodology and rates for reciprocal compensation as part of this comprehensive intercarrier compensation reform. See “– Reciprocal Compensation” below.

There are other aspects of access charges and universal service fund contribution requirements that continue to be considered by state and federal commissions that could result in greater expense levels or reduced revenues.

UNIVERSAL SERVICE

In 1998, the FCC’s universal service order established funding mechanisms for high-cost and low-income service areas. Telecommunications companies are required to pay a specific percentage of their interstate and international revenues into the Universal Service Fund to support the four established programs. All long distance companies, local telephone companies, paging companies, payphone providers and wireless telephone companies must contribute to the Universal Service Fund. We began contributing to the new funds in 1998. During 2004, our wireline operations contributed \$307 to the Universal Service Fund. The FCC does not require contributing companies to recover their contributions directly from customers. Like many other companies, however, BellSouth has chosen to recover universal costs directly from end-users.

The FCC’s universal service mechanism for non-rural carriers serving high-cost, low-income areas is designed to ensure that customers in those areas receive telephone service at affordable rates. BellSouth is receiving high-cost support for service to residents in Alabama, Kentucky and Mississippi.

The universal service order also established significant discounts to be provided to eligible schools and libraries for all telecommunications services, internal connections and Internet access. Further, it established support for rural health care providers so that they may pay rates comparable to those that urban health care providers pay for similar services. Industry-wide annual costs of the entire universal service program, estimated at approximately \$6 billion, are to be funded out of the federal universal service fund.

RECIPROCAL COMPENSATION

Following the enactment of the 1996 Act, our telephone company subsidiary, BST, and various competitive local exchange carriers entered into interconnection agreements providing for, among other things, the payment of reciprocal compensation for local calls initiated by the customers of one carrier that are

completed on the network of the other carrier. These agreements were the subject of litigation before various regulatory commissions. After an FCC ruling in April 2001 prescribing new rates, BellSouth settled its claims with competitors for traffic occurring through mid-June 2001, and entered into agreements that contained the FCC rates for traffic occurring from mid-June 2001 forward. The District of Columbia Circuit Court of Appeals, in the second quarter of 2002, remanded the ruling to the FCC to implement a rate methodology consistent with the Court’s opinion. Although it has not issued an order responding to the Court’s 2002 opinion, the FCC, in October 2004, granted a request by a competitor to forbear from applying certain compensation caps and new market rules required by its April 2001 decision. We expect that the FCC will reconsider the rates and methodology for reciprocal compensation as part of its comprehensive evaluation of intercarrier compensation, and we do not currently expect any change in reciprocal compensation rates to have a material effect on results of operations.

BROADBAND REGULATION

The FCC has pending dockets in which it is considering the regulatory classification of broadband service. Specifically, it is looking at whether broadband service should be deemed a regulated telecommunications service or a non-regulated information service. The FCC and various state public service commissions are considering what rules and regulations should apply to voice over Internet protocol (VoIP) services. We are unable to predict the outcome of these proceedings. Because wireline telephony is transitioning toward broadband services, the materiality of the outcome of these proceedings to us is increasing over time.

SECTION 272 CLAIM

In December 2004, the FCC partially granted and otherwise dismissed July 2004 claims of AT&T that two optional discount special access tariffs violated various provisions of the Communications Act. The FCC held that one of the tariffs, the Transport Savings Plan, was unlawful under Section 272 of the Act, which governs dealings between BST and our long distance affiliate. That tariff, originally filed in 1999, provided an overlay discount for carriers that accepted its terms, which included a five year commitment, a commitment for a defined amount of spending on special access, and shortfall charges if commitments were not met. The FCC held that the discount structure in the tariff was insufficiently related to cost, and unduly favored a class of carriers (including our long distance affiliate) with relatively lower volume special access spending, and discriminated against carriers with relatively higher volumes. The FCC dismissed the other claims associated with the Transport Savings Plan, and dismissed all claims associated with the second tariff. We do not agree with the FCC’s finding, and appealed its decision to the D.C. Circuit Court of Appeals. We do not believe that AT&T has suffered any damages, and we

believe that any such claims would be barred in whole or in part by various provisions of law. At this time, however, neither the likely outcome of the appeal nor AT&T's potential damages claim can be predicted, and therefore no reasonable estimate of loss, if any, can be made.

State Regulatory Matters

We are subject to regulation of our local and intrastate long distance services by a state authority in each state where we provide intrastate telecommunications services. Such regulation covers prices, services, competition and other issues.

PRICE REGULATION

We currently operate under price regulation plans in all states in our wireline territory. Under these plans, the state regulatory commissions or state legislatures have established maximum prices that can be charged for certain telecommunications services. While such plans limit the amount of increases in prices for specific services, they enhance our ability to adjust prices and service options to respond more effectively to changing market conditions and competition. Price regulation also provides an opportunity to benefit more fully from productivity enhancements. The majority of these plans have limitations on raising prices for basic local exchange services during the early years with provisions for inflation-based price increases in later years.

While some plans are not subject to either review or renewal, other plans contain specified termination dates and/or review periods. Upon review or renewal, a regulatory commission could attempt to require substantial modifications to prices and other terms of these plans. During 2004, our plans in Alabama, Kentucky and Mississippi were updated without material modification. A review of our North Carolina plan is pending.

Beginning in 1996, we operated under a price regulation plan approved by the South Carolina Public Service Commission (PSC) under existing state laws. In April 1999, however, the South Carolina Supreme Court invalidated this price regulation plan. In July 1999, we elected to be regulated under a new state statute, adopted subsequent to the PSC's approval of the earlier plan. The new statute allows telephone companies in South Carolina to operate under price regulation without obtaining approval from the PSC. The election became effective during August 1999. The South Carolina Consumer Advocate petitioned the PSC seeking review of the level of our earnings during the 1996-1998 period when we operated under the subsequently invalidated price regulation plan. The PSC dismissed the petition in November 1999 and issued orders confirming the vote in February and June of 2000. In July 2000, the Consumer Advocate appealed the PSC's dismissal of the petition. In January 2004, the court hearing the appeal affirmed the PSC's decision. An appeal of this decision to the South Carolina Supreme Court was filed in March 2004. In April 2004, BellSouth entered into agreements that

completely terminated the litigation. Under the terms of the settlement, BellSouth refunded \$50 to its South Carolina end user customers in 2004. BellSouth agreed to settle the case to avoid further expensive litigation and uncertainty relating to the outcome of the litigation. The settlement is not an admission of liability.

OTHER STATE REGULATORY MATTERS

In each of our states, we are subject to performance measurement plans that measure our service performance to competitors against certain benchmarks and our own retail performance. When we do not meet the relevant standards, we make payments to the competitors or the State's treasury. In some states, if we continuously fail to meet certain criteria, we also would suspend our marketing and sale of long distance services. We made immaterial payments in all states in 2003 and 2004, and likely will make immaterial payments in 2005. The plans are reviewed regularly for necessary changes.

WIRELESS REGULATORY ENVIRONMENT

Overview

The FCC regulates the licensing, construction, operation, acquisition and transfer of wireless systems in the US pursuant to the Communications Act of 1934 (Communications Act) and its associated rules, regulations and policies.

To obtain the authority to have the exclusive use of radio frequency spectrum in an area within the US, wireless communications systems must be licensed by the FCC to operate the wireless network and wireless devices in assigned spectrum segments and must comply with the rules and policies governing the use of the spectrum as adopted by the FCC. These rules and policies, among other things:

- regulate Cingular's ability to acquire and hold radio spectrum licenses or to lease spectrum;
 - impose technical obligations on the operation of Cingular's network;
 - impose requirements on the ways Cingular provides service to and communicates with its customers;
 - regulate the interconnection of Cingular's network with the networks of other carriers;
 - obligate Cingular to permit resale of its services by resellers, if it offers resale opportunities, and to serve roaming customers of other wireless carriers; and
 - impose a variety of fees and charges on Cingular's business that are used to finance numerous regulatory programs and a substantial part of the FCC's budget.
- Licenses are issued for only a fixed period of time, typically 10 years. Consequently, Cingular must periodically seek renewal of those licenses. The FCC will award a renewal expectancy to a wireless licensee that has provided substantial service during its past license term and has substantially complied with applicable FCC rules and policies and the Communications Act. The FCC has routinely renewed wireless licenses in the past. However,

the Communications Act provides that licenses may be revoked for cause and license renewal applications denied if the FCC determines that a renewal would not serve the public interest. Violations of FCC rules may also result in monetary penalties or other sanctions. FCC rules provide that applications competing with a license renewal application may be considered in comparative hearings and establish the qualifications for competing applications and the standards to be applied in hearings.

Wireless systems are subject to Federal Aviation Administration and FCC regulations governing the location, lighting and construction of transmitter towers and antennas and are subject to regulation under federal environmental laws and the FCC's environmental regulations, including limits on radio frequency radiation from wireless handsets and towers. Zoning and land use regulations, including compliance with historic preservation requirements, also apply to tower siting and construction activities.

Recent Regulatory Developments

The FCC eliminated the rules limiting the amount of spectrum a wireless carrier can own in a market effective January 1, 2003. It has not yet replaced these spectrum limits with published rules or guidelines setting forth how the FCC will review carriers' spectrum aggregations. The FCC also eliminated the prohibition on ownership of both cellular licenses by a single entity except it will review on a case-by-case basis applications for authority to own both cellular licenses in a rural area. Certain acquisitions of spectrum would remain subject to approval of the US Department of Justice.

The FCC has imposed rules requiring carriers to provide emergency 911 services, including enhanced 911 services that provide to local public safety dispatch agencies the caller's communications number and approximate location. Providers are required to transmit the geographic coordinates of the customer's location within accuracy parameters set forth by the FCC, either by means of network-based or handset-based technologies. Providers may not demand cost recovery as a condition of doing so, although they are permitted to negotiate cost recovery if it is not mandated by the state or local governments. Because of the delayed availability of vendor equipment that could reasonably be relied upon to comply with the FCC's location accuracy rules, Cingular and other wireless carriers negotiated settlement arrangements with the FCC that modified compliance standards and deadlines.

The FCC has established federal universal service requirements that affect commercial mobile radio service operators. Under the FCC's rules, commercial mobile radio service providers are potentially eligible to receive universal service subsidies for the first time; however, they are also required to contribute to the federal universal service fund and may be required to contribute to state universal service funds. Contributions into the federal fund are based on the interstate and international revenues generated by the properties owned by a commercial mobile radio service provider. For 2004, Cingular had

payment obligations into the federal universal service fund of approximately \$415. Because the amount that Cingular is required to pay into the fund is based on revenues generated by its properties, we anticipate that this amount should continue to increase over time. Cingular recovers most of this expense from its customers. Many states also are moving forward to develop state universal service fund programs. A number of these state funds require contributions, varying greatly from state to state, from commercial mobile radio service providers. If these programs expand they will impose a correspondingly growing expense on Cingular's business. As mentioned, commercial mobile radio service providers are now eligible to receive universal service subsidies if federal and state conditions are met. Cingular is planning to pursue this funding in states where the corresponding regulatory burdens do not exceed the benefits of the subsidies.

In November 2003, the FCC's rules on wireless local number portability became operative, enabling wireless customers to keep their wireless number when switching to another carrier. These rules have increased competition, costs and customer churn across the industry.

The FCC has adopted rules requiring wireless providers to provide functions to facilitate electronic surveillance by law enforcement officials pursuant to the Communications Assistance for Law Enforcement Act of 1995. These obligations are likely to result in significant costs to Cingular for the purchase, installation and maintenance of network software and other equipment needed.

The Communications Act and the FCC's rules grant various rights and impose various obligations on commercial mobile radio service providers when they interconnect with the facilities of local exchange carriers. Generally, commercial mobile radio service providers are entitled to "reciprocal compensation" in connection with the termination of wireline-originated local traffic, in which they are entitled to collect the same charges for terminating wireline-to-wireless local traffic on their system similar to the charges that the local exchange carriers levy for terminating wireless-to-wireline local calls. Interconnection agreements are typically negotiated by carriers, but in the event of a dispute, state public utility commissions, courts and the FCC all have a role in enforcing the interconnection provisions of the Communications Act. Although Cingular has interconnection agreements in place with the major local exchange carriers in virtually all of its service areas, those agreements are subject to modification, expiration or termination in accordance with their terms. Moreover, Cingular is negotiating and must continue to negotiate interconnection agreements with a number of independent telephone companies in its service areas. Until these agreements are concluded, Cingular must accrue for contractual liabilities associated with the resulting unpaid invoices from those companies. Additionally, as Cingular expands its coverage footprint, Cingular will be required to negotiate interconnection arrangements with other wireline carriers.

State Regulation and Local Approvals

With the rapid growth and penetration of wireless services has come a commensurate surge of interest on the part of state legislatures and state public utility commissions and local governmental authorities in regulating the domestic wireless industry. This interest has taken the form of efforts to regulate customer billing, termination of service arrangements, advertising, filing of "informational" tariffs, certification of operation, use of handsets when driving, service quality, sales practices, and many other areas. We anticipate that this trend will continue. It will require Cingular to devote legal and other resources to working with the states to respond to their concerns while minimizing any new regulation that could increase Cingular's costs of doing business.

While the Communications Act generally preempts state and local governments from regulating entry of, or the rates charged by, wireless carriers, it also permits a state to petition the FCC to allow it to impose commercial mobile radio service rate regulation when market conditions fail adequately to protect customers and such service is a replacement for a substantial portion of the telephone wireline exchange service within a state. No state currently has such a petition on file. In addition, the Communications Act does not expressly preempt the states from regulating the "terms and conditions" of wireless service.

Several states have invoked this "terms and conditions" authority to impose or propose various consumer protection regulations on the wireless industry. California's recently enacted rules are potentially quite costly. States also may impose their own universal service support requirements on wireless and other communications carriers, similar to the requirements that have been established by the FCC. At the local level, wireless facilities typically are subject to zoning and land use regulation. Neither local nor state governments may categorically prohibit the construction of wireless facilities in any community or take actions, such as indefinite moratoria, which have the effect of prohibiting construction. Nonetheless, securing state and local government approvals for new tower sites has been and is likely to continue to be difficult, lengthy and costly.

In addition, state commissions continue their efforts to conserve telephone numbering resources. These efforts may impact wireless service providers disproportionately by imposing additional costs or limiting access to numbering resources. Examples of state conservation methods include number pooling, number rationing and code sharing. In many non-top 100 markets, the supply of new numbers is inadequate to meet growing customer demands, but states have been and continue to be reluctant to deploy new area codes.

Further, states have become more active in imposing new taxes on wireless carriers, such as gross receipts taxes, and fees for items such as the use of public rights of way. These taxes and fees are generally passed through to Cingular's customers and result in higher costs to its customers.

COMPETITION

There are many competitive forces that impact our businesses. The Telecommunications Act of 1996 removed the regulatory barriers to local service competition in the wireline market and required incumbent carriers such as us to open our networks to other carriers.

Competitors primarily utilize our local wireline network under two methods: resale and through the use of UNE platform. Lines provided on a resale basis include all of the components necessary for a wholesale customer to provide complete service delivery to an end-user. UNEs represent components of our network that wholesale customers may combine with components of their own networks, or with other UNEs purchased from us (referred to as a UNE platform or UNE-P) to allow complete service delivery to an end-user. Wholesale UNE prices are based on a forward-looking cost model and the premise of a most efficient, least cost network design. Because the pricing is not based on actual cost, certain costs that exist in today's network are not adequately addressed in the calculations. The impact of competitors' use of UNEs and the UNE platform on us is two-fold in that it results in lower revenue per access line and has a detrimental impact on our margins as we retain the actual level of costs to maintain and to service the access line. The impact is amplified due to the competitors' fashioning service bundles that target high revenue customers. Under the legacy framework of state PSC-mandated subsidies, business rates are artificially higher in order to subsidize lower residence and rural rates. In addition, revenues from non-UNE sources such as switching and calling features as well as complimentary services such as inside wire maintenance, operator services and directory assistance, are lost to UNE-P provisioned lines.

We plan to compete through aggressive marketing, competitive pricing, bundled services, technical innovation and customer service. We will offer consumers a full range of services-local, long distance, Internet access, wireless and more-while remaining committed to our high level of customer service and value.

Cingular's ability to compete successfully will depend, in part, on the quality of its network, customer service, and sales and distribution channels, as well as its marketing efforts and ability to anticipate and respond to various competitive factors affecting the industry. These factors include the introduction of new services and technologies, changes in consumer preferences, demographic trends, economic conditions, pricing strategies of competitors and its ability to take advantage of its wireless/wireline service area overlap with BellSouth and SBC. As a result of competition, Cingular has in the past and may in the future be required to:

- increase its spending to retain customers;
- restructure its service packages to include more compelling products and services;
- further upgrade its network infrastructure and the handsets Cingular offers; and

- increase its advertising, promotional spending, commissions and other customer acquisition costs.

TECHNOLOGY

We are continually upgrading our networks with digital and optical technologies, making them capable of delivering a full complement of voice and data services. This modernization of the network is critical to our success in providing the data connectivity demanded by customers and to compete with fiber networks being constructed or currently utilized by start-ups and cable companies. This continuing effort will require investment of significant amounts of capital in the future.

Digital wireless technology is rapidly evolving and the development of a common roaming platform for digital wireless technologies could result in more intense competition and have an adverse effect on our results of operations.

LEGAL MATTERS

We are involved in numerous legal proceedings associated with state and federal regulatory matters, the disposition of which could materially impact our operating results and prospects. See Note Q to our consolidated financial statements.

NEW ACCOUNTING PRONOUNCEMENTS

See Note B to our consolidated financial statements for a description of new accounting pronouncements.

Critical Accounting Policies

We consider an accounting estimate to be critical if: (1) the accounting estimate requires us to make assumptions about matters that were highly uncertain at the time the accounting estimate was made, and (2) changes in the estimate that are reasonably likely to occur from period to period, or use of different estimates that we reasonably could have used, would have a material impact on our financial condition or results of operations.

Senior management regularly discusses the development and selection of these critical accounting estimates with the Audit Committee of our Board of Directors and the Audit Committee has reviewed the disclosure set forth below.

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

See Note H to our consolidated financial statements for more information regarding costs and assumptions for property, plant and equipment.

Nature of estimates required

We use the group life method to depreciate the assets of our telephone subsidiary. Telephone plant acquired in a given year is grouped into similar categories and depreciated over the remaining estimated useful life of the group. Due to rapid changes in technology and new competitors, selecting the estimated economic life of telecommunications plant and equipment requires a significant amount of judgment. We periodically review data on expected utilization of new equipment, asset retirement activity and net salvage values to determine adjustments to our depreciation rates. We also utilize studies performed by outside consultants to assist us in our determination. We have not made any changes to the lives of assets resulting in a material impact in the three years presented.

Sensitivity analysis

The effect of a one year change in the useful lives of our telephone plant accounts is shown below:

| | 2005 Depreciation Expense Higher/(Lower) |
|---|---|
| Increasing economic life by one year | \$(290) |
| Decreasing economic life by one year | 360 |

PENSIONS

See Note L to our consolidated financial statements for more information regarding costs associated with employee retirement benefits.

Nature of estimates required

The measurement of our pension obligations, costs and liabilities is dependent on a variety of assumptions including estimates of the present value of projected future pension payments to plan participants, consideration of the likelihood of potential future events such as salary increases and demographic experience. These assumptions may have an effect on the amount and timing of future contributions, if any. Additionally, the plan trustee conducts an independent valuation of the fair value of pension plan assets.

Assumptions and approach used

The assumptions in developing the required estimates include the following key factors:

- Discount rates
- Inflation
- Salary growth
- Expected return on plan assets
- Retirement rates
- Mortality rates

The discount rate enables us to state expected future cash flows at a present value on the measurement date. We are required to select a rate that represents the market rate for high-quality fixed income investments and considers the timing and amounts of our expected future benefit payments. A lower discount rate increases the present value of benefit obligations and usually increases expense. However, the expense impact for our plans currently has an opposite impact (lower discount rate decreases expense). This impact occurs because our plan is currently within the specified corridor that under accounting rules does not require us to amortize the discount rate assumption change as it relates to the obligation but we do receive the benefit of lower interest rates in calculating the current period interest component of net periodic pension cost. Our inflation assumption is based on an evaluation of external market indicators. The salary growth assumptions reflect our long-term actual experience, the near-term outlook and assumed inflation. The expected return on plan assets reflects asset allocations, investment strategy and the views of investment managers and other large pension plan sponsors. For 2003, we reduced our estimated return on plan assets to 8.5% reflecting lower expected long-term market returns. Retirement and mortality rates are based primarily on actual plan experience. The effects of actual results differing from our assumptions are accumulated and amortized into the income statement in future periods in accordance with the pension accounting rules.

Sensitivity analysis

The effect of the change in the selected assumptions is shown below:

| Assumption | Percentage Point Change | December 31, 2004 Obligation Higher/(Lower) | 2005 Expense Higher/(Lower) |
|---------------------------|-------------------------|---|-----------------------------|
| Discount rate | +/- 0.5 pts. | \$(454)/\$472 | \$18/\$(21) |
| Expected return on assets | +/- 1.0 pts. | - | (151)/151 |

OTHER POSTRETIREMENT BENEFITS

See Note L to our consolidated financial statements for more information regarding costs associated with postretirement benefits.

Nature of estimates required

We provide certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrue actuarially determined postretirement benefit costs as active employees earn these benefits. For postretirement benefit plans, the benefit obligation is the "accumulated postretirement benefit obligation," the actuarial present value as of a date of all future benefits attributed under the terms of the postretirement benefit plan to employee service rendered to that date. The measurement of our obligations associated with

postretirement benefits (e.g., retiree health care) is dependent on a variety of assumptions. This includes estimating the present value of projected future payments to plan participants, net of projected government prescription drug subsidy receipts, and consideration of the likelihood of potential future events such as demographic experience. These assumptions may have an effect on the amount and timing of future payments. Additionally, the plan trustee conducts an independent valuation of the fair value of plan assets.

Assumptions and approach used

Our contract with the CWA provides for contractual limits on the company-funded portion of retiree medical costs (referred to as "caps"). We have waived the premiums in excess of the caps during the current and past contract periods and, therefore have not collected contributions from those non-management retirees in effect creating a substantive plan. Based on this past practice, we determine the future obligation based on this substantive plan. Accordingly, we calculate the obligation for non-management retiree medical costs as if there were no caps.

The assumptions used in developing the required estimates include the following key factors:

- Discount rates
- Health care cost trends
- Inflation
- Expected return on plan assets
- Retirement rates
- Mortality rates
- Actuarial equivalence for purposes of the Medicare Prescription Drug, Improvement and Modernization Act

The discount rate enables us to state expected future cash flows at a present value on the measurement date. We are required to select a rate that represents the market rate for high-quality fixed income investments and considers the timing and amounts of our expected future benefit payments. A lower discount rate increases the present value of benefit obligations and expense. Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook, and an assessment of likely long-term trends. Our inflation assumption is based on an evaluation of external market indicators. The expected return on plan assets reflects asset allocations, investment strategy and the views of investment managers and other large plan sponsors. Retirement and mortality rates are based primarily on actual plan experience. Actuarial equivalence was based on comparing the Medicare Part D standard drug coverage and premiums to BellSouth's retiree prescription drug coverage and premiums. We calculated the actuarial values based on our specific experience combined with published nationwide statistics. The effects of actual results differing from our assumptions are accumulated and amortized into the income statement in future periods in

accordance with the other postretirement benefits accounting rules.

Sensitivity analysis

The effect of the indicated increase/decrease in the selected assumptions is shown below:

| Assumption | Percentage Point Change | December 31, 2004 Obligation Higher/(Lower) | 2005 Expense Higher/(Lower) |
|------------------------|-------------------------|---|-----------------------------|
| Discount rate | +/- 0.5 pts. | \$(648)/\$693 | \$(42)/\$43 |
| Health care cost trend | +/- 1.0 pts. | 1,251/(1,030) | 187/(143) |

OTHER LOSS CONTINGENCIES

Other loss contingencies are recorded as liabilities when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Disclosure is required when there is a reasonable possibility that the ultimate loss will exceed the recorded provision. Contingent liabilities are often resolved over long time periods. Estimating probable losses requires analysis of multiple forecasts that often depend on judgments about potential actions by third parties such as regulators.

OTHER SIGNIFICANT ACCOUNTING POLICIES

Other significant accounting policies, not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. Policies related to revenue recognition, stock-based compensation, uncollectible reserves and tax valuation allowances require difficult judgments on complex matters that are often subject to multiple sources of authoritative guidance. Certain of these matters are among topics currently under re-examination by accounting standard setters and regulators. Although no specific conclusions reached by these standard setters appear likely to cause a material change in our accounting policies, outcomes cannot be predicted with confidence. Also see Note A to our consolidated financial statements, which discusses accounting policies that we have selected from acceptable alternatives.

Cautionary Language Concerning Forward-Looking Statements

In addition to historical information, this document contains forward-looking statements regarding events, financial trends and critical accounting policies that may affect our future operating results, financial position and cash flows. These statements are based on our assumptions and estimates and are subject to risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

While the below list of cautionary statements is not exhaustive, some factors, in addition to those contained throughout this document, that could affect future operating results, financial position and cash flows and could cause actual results to differ materially from those expressed in the forward-looking statements are:

- a change in economic conditions in the markets where we operate or have material investments which could affect demand for our services;
- the impact and the success of Cingular Wireless, our wireless joint venture with SBC, including marketing and product development efforts, technological changes and financial capacity;
- Cingular Wireless' failure to realize, in the amounts and within the timeframe contemplated, the capital and expense synergies and other financial benefits expected from its acquisition of AT&T Wireless as a result of technical, logistical, regulatory and other factors;
- changes in laws or regulations, or in their interpretations, which could result in the loss, or reduction in value, of our licenses, concessions or markets, or in an increase in competition, compliance costs or capital expenditures;
- continued pressures on the telecommunications industry from a financial, competitive and regulatory perspective;
- the intensity of competitive activity and its resulting impact on pricing strategies and new product offerings;
- changes in the federal and state regulations governing the terms on which we offer retail and wholesale services;
- continued successful penetration of the interLATA long distance market;
- the impact on our business of consolidation in the wireline and wireless industries in which we operate;
- the issuance by the Financial Accounting Standards Board or other accounting bodies of new accounting standards or changes to existing standards;
- changes in available technology that increase the impacts of technology substitution;
- higher than anticipated start-up costs or significant up-front investments associated with new business initiatives;
- the outcome of pending litigation; and
- unanticipated higher capital spending from, or delays in, the deployment of new technologies.

CONSOLIDATED STATEMENTS OF INCOME

BELLSOUTH CORPORATION

| <i>(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)</i> | For the years ended December 31, | | |
|---|----------------------------------|-----------------|-----------------|
| | 2002 | 2003 | 2004 |
| Operating Revenues: | | | |
| Communications Group | \$18,226 | \$18,255 | \$18,239 |
| Advertising & Publishing Group | 1,921 | 2,033 | 2,005 |
| All other | 60 | 53 | 56 |
| Total Operating Revenues | 20,207 | 20,341 | 20,300 |
| Operating Expenses: | | | |
| Cost of services and products (excludes depreciation and amortization shown separately below) | 6,670 | 6,991 | 7,520 |
| Selling, general, and administrative expenses | 3,891 | 3,777 | 3,816 |
| Depreciation and amortization | 4,202 | 3,811 | 3,636 |
| Provisions for restructuring and asset impairments | 990 | 205 | 39 |
| Total Operating Expenses | 15,753 | 14,784 | 15,011 |
| Operating income | 4,454 | 5,557 | 5,289 |
| Interest expense | 1,066 | 947 | 916 |
| Net earnings of equity affiliates | 542 | 452 | 68 |
| Gain (loss) on sale of operations | 1,335 | - | 462 |
| Other income (expense), net | 102 | 362 | 283 |
| Income from Continuing Operations Before Income Taxes, Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | 5,367 | 5,424 | 5,186 |
| Provision for Income Taxes | 1,892 | 1,936 | 1,792 |
| Income from Continuing Operations Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | 3,475 | 3,488 | 3,394 |
| Income (Loss) from Discontinued Operations, Net of Tax | (867) | 101 | 1,364 |
| Income Before Cumulative Effect of Changes in Accounting Principle | 2,608 | 3,589 | 4,758 |
| Cumulative Effect of Changes in Accounting Principle, Net of Tax | (1,285) | 315 | - |
| Net Income | \$ 1,323 | \$ 3,904 | \$ 4,758 |
| Weighted-Average Common Shares Outstanding: | | | |
| Basic | 1,870 | 1,848 | 1,832 |
| Diluted | 1,876 | 1,852 | 1,836 |
| Basic Earnings Per Share: | | | |
| Income from Continuing Operations Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | \$ 1.86 | \$ 1.89 | \$ 1.85 |
| Discontinued Operations, net of tax | \$ (.46) | \$.05 | \$.74 |
| Cumulative Effect of Accounting Changes, net of tax | \$ (.69) | \$.17 | \$ — |
| Net Income | \$.71 | \$ 2.11 | \$ 2.60 |
| Diluted Earnings Per Share: | | | |
| Income from Continuing Operations Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | \$ 1.85 | \$ 1.88 | \$ 1.85 |
| Discontinued Operations, net of tax | \$ (.46) | \$.05 | \$.74 |
| Cumulative Effect of Accounting Changes, net of tax | \$ (.68) | \$.17 | \$ — |
| Net Income* | \$.71 | \$ 2.11 | \$ 2.59 |
| Dividends Declared Per Common Share | \$.79 | \$.92 | \$ 1.06 |

* Net income per share may not sum due to rounding

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

BELLSOUTH CORPORATION

| (IN MILLIONS) | December 31, | |
|---|--------------|----------|
| | 2003 | 2004 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 2,947 | \$ 680 |
| Short-term investments | 1,609 | 16 |
| Accounts receivable, net of allowance for uncollectibles of \$496 and \$317 | 2,870 | 2,559 |
| Material and supplies | 375 | 321 |
| Other current assets | 1,048 | 1,055 |
| Assets of discontinued operations | - | 1,068 |
| Total current assets | 8,849 | 5,699 |
| Investments in and advances to Cingular | 7,679 | 22,771 |
| Property, plant and equipment, net | 23,807 | 22,039 |
| Other assets | 6,977 | 7,400 |
| Intangible assets, net | 2,297 | 1,587 |
| Goodwill | 93 | - |
| Total assets | \$49,702 | \$59,496 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Debt maturing within one year | \$ 3,491 | \$ 5,475 |
| Accounts payable | 1,339 | 1,047 |
| Other current liabilities | 3,628 | 3,018 |
| Liabilities of discontinued operations | - | 830 |
| Total current liabilities | 8,458 | 10,370 |
| Long-term debt | 11,489 | 15,108 |
| Noncurrent liabilities: | | |
| Deferred income taxes | 5,349 | 6,492 |
| Other noncurrent liabilities | 4,694 | 4,460 |
| Total noncurrent liabilities | 10,043 | 10,952 |
| Shareholders' equity: | | |
| Common stock, \$1 par value (8,650 shares authorized; 1,830 and 1,831 shares outstanding) | 2,020 | 2,020 |
| Paid-in capital | 7,729 | 7,840 |
| Retained earnings | 16,540 | 19,267 |
| Accumulated other comprehensive income (loss) | (585) | (157) |
| Shares held in trust and treasury | (5,992) | (5,904) |
| Total shareholders' equity | 19,712 | 23,066 |
| Total liabilities and shareholders' equity | \$49,702 | \$59,496 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

BELLSOUTH CORPORATION

| (IN MILLIONS) | For the years ended December 31, | | |
|---|----------------------------------|-----------------|-----------------|
| | 2002 | 2003 | 2004 |
| Cash Flows from Operating Activities: | | | |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | \$ 3,475 | \$ 3,488 | \$ 3,394 |
| Adjustments to reconcile income to cash provided by operating activities from continuing operations: | | | |
| Depreciation and amortization | 4,202 | 3,811 | 3,636 |
| Provision for uncollectibles | 795 | 523 | 384 |
| Net losses (earnings) of equity affiliates | (542) | (452) | (68) |
| Deferred income taxes and investment tax credits | 1,330 | 788 | 1,081 |
| Pension income | (825) | (534) | (484) |
| Pension settlement losses | 167 | 47 | - |
| Stock-based compensation expense | 161 | 124 | 116 |
| (Gain) loss on sale of operations | (1,335) | - | (462) |
| Net losses (gains) on sale or impairment of equity securities | 370 | 7 | 4 |
| Curtailment and termination benefit charges | 60 | - | - |
| Unbilled receivable adjustment | 163 | - | - |
| Asset impairments | 302 | 52 | - |
| Net change in: | | | |
| Accounts receivable and other current assets | (261) | (81) | (419) |
| Accounts payable and other current liabilities | (360) | 55 | (680) |
| Deferred charges and other assets | 46 | 299 | (79) |
| Other liabilities and deferred credits | 10 | (276) | 159 |
| Other reconciling items, net | (46) | 32 | 219 |
| Net cash provided by operating activities from continuing operations | 7,712 | 7,883 | 6,801 |
| Cash Flows from Investing Activities: | | | |
| Capital expenditures | (3,536) | (2,926) | (3,193) |
| Purchase of short-term investments | (1,302) | (3,439) | (3,770) |
| Proceeds from sale of short-term investments | 841 | 2,291 | 5,363 |
| Proceeds from sale of operations | - | - | 3,392 |
| Proceeds from sale of debt and equity securities | 1,383 | 27 | 286 |
| Investments in debt and equity securities | (36) | (194) | (632) |
| Proceeds from repayment of loans and advances | 885 | 1,899 | 129 |
| Net short term advances to Cingular | - | - | (666) |
| Settlement of derivatives on advances | 85 | (352) | (17) |
| Investments in and advances to equity affiliates | (210) | - | (14,445) |
| Other investing activities, net | (22) | (12) | (7) |
| Net cash used for investing activities from continuing operations | (1,912) | (2,706) | (13,560) |
| Cash Flows from Financing Activities: | | | |
| Net borrowings (repayments) of short-term debt | (1,307) | (431) | 1,738 |
| Proceeds from the issuance of long-term debt | - | - | 6,078 |
| Repayments of long-term debt | (1,149) | (1,849) | (759) |
| Dividends paid | (1,460) | (1,608) | (1,901) |
| Purchase of treasury shares | (591) | (858) | (146) |
| Other financing activities, net | 64 | 67 | 61 |
| Net cash used in financing activities from continuing operations | (4,443) | (4,679) | 5,071 |
| Net (decrease) increase in cash and cash equivalents from continuing operations | 1,357 | 498 | (1,688) |
| Net (decrease) increase in cash and cash equivalents from discontinued operations | 72 | 428 | (579) |
| Net (decrease) increase in cash and cash equivalents | 1,429 | 926 | (2,267) |
| Cash and cash equivalents at beginning of period | 592 | 2,021 | 2,947 |
| Cash and cash equivalents at end of period | \$ 2,021 | \$ 2,947 | \$ 680 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME

BELLSOUTH CORPORATION

| | Number of Shares | | Amount | | | | | | Total |
|---|------------------|--|----------------|-----------------|-------------------|--|--|------------------------|-----------------|
| | Common Stock | Shares Held in Trust and Treasury ^(a) | Common Stock | Paid-in Capital | Retained Earnings | Accum. Other Comprehensive Income (Loss) | Shares Held in Trust and Treasury ^(a) | Guarantee of ESOP Debt | |
| <i>(IN MILLIONS)</i> | | | | | | | | | |
| Balance at December 31, 2001 | 2,020 | (143) | \$2,020 | \$7,368 | \$14,805 | \$(294) | \$(4,996) | \$(145) | \$18,758 |
| Net Income | | | | | 1,323 | | | | 1,323 |
| Other comprehensive income, net of tax | | | | | | (446) | | | (446) |
| Total comprehensive income | | | | | | | | | 877 |
| Dividends declared | | | | | (1,477) | | | | (1,477) |
| Share issuances for employee benefit plans | | 5 | | (33) | (104) | | 197 | | 60 |
| Purchase of treasury stock | | (22) | | | | | (591) | | (591) |
| Purchase of stock by grantor trusts | | | | | (18) | | 18 | | - |
| Stock-based compensation | | | | 171 | | | | | 171 |
| Tax benefit related to stock options | | | | 40 | | | | | 40 |
| ESOP activities and related tax benefit | | | | | 2 | | | 66 | 68 |
| Balance at December 31, 2002 | 2,020 | (160) | \$2,020 | \$7,546 | \$14,531 | \$(740) | \$(5,372) | \$(79) | \$17,906 |
| Net Income | | | | | 3,904 | | | | 3,904 |
| Other comprehensive income, net of tax | | | | | | 155 | | | 155 |
| Total comprehensive income | | | | | | | | | 4,059 |
| Dividends declared | | | | | (1,696) | | | | (1,696) |
| Share issuances for employee benefit plans | | 5 | | (19) | (89) | | 169 | | 61 |
| Purchase of treasury stock | | (35) | | | | | (858) | | (858) |
| Purchases and sales of treasury stock with grantor trusts | | | | 43 | (112) | | 69 | | - |
| Stock-based compensation | | | | 137 | | | | | 137 |
| Tax benefit related to stock options | | | | 22 | | | | | 22 |
| ESOP activities and related tax benefit | | | | | 2 | | | 79 | 81 |
| Balance at December 31, 2003 | 2,020 | (190) | \$2,020 | \$7,729 | \$16,540 | \$(585) | \$(5,992) | \$- | 19,712 |
| Net Income | | | | | 4,758 | | | | 4,758 |
| Other comprehensive income, net of tax | | | | | | 428 | | | 428 |
| Total comprehensive income | | | | | | | | | 5,186 |
| Dividends declared | | | | | (1,934) | | | | (1,934) |
| Share issuances for employee benefit plans | | 7 | | (59) | (94) | | 236 | | 83 |
| Purchase of treasury stock | | (6) | | | | | (146) | | (146) |
| Purchases and sales of treasury stock with grantor trusts | | | | 2 | | | (2) | | - |
| Stock-based compensation | | | | 121 | | | | | 121 |
| Tax benefit related to stock options | | | | 39 | | | | | 39 |
| Other | | | | 8 | (3) | | | | 5 |
| Balance at December 31, 2004 | 2,020 | (189) | \$2,020 | \$7,840 | \$19,267 | \$(157) | \$(5,904) | \$- | \$23,066 |

(a) Trust and treasury shares are not considered to be outstanding for financial reporting purposes. As of December 31, 2004, there were approximately 26 shares held in trust and 163 shares held in treasury.

The accompanying notes are an integral part of these consolidated financial statements.

Note A – Accounting Policies

In this report, BellSouth Corporation and its subsidiaries are referred to as “we” or “BellSouth.”

ORGANIZATION

We are a communications company headquartered in Atlanta, Georgia. For management purposes, our operations are organized into three reportable segments: Communications Group; Domestic Wireless; and Advertising & Publishing Group.

BASIS OF PRESENTATION

The consolidated financial statements include the accounts of BellSouth’s wholly-owned subsidiaries and subsidiaries in which we have a controlling financial interest. Investments in businesses that we do not control, but have the ability to exercise significant influence over operations and financial policies, are accounted for using the equity method. We report our results on a calendar-year basis, except for our international operations that we report on a one-month lag basis to facilitate timely reporting of the consolidated results of BellSouth. All significant intercompany transactions and accounts have been eliminated. We own an approximate 40% economic interest in Cingular Wireless and we share control with SBC Communications (SBC). Accordingly, we account for this investment under the equity method. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year’s presentation.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets” (SFAS No. 144), we have classified the results of our Latin American segment as discontinued operations. The presentation of discontinued operations includes revenues and expenses of the Latin American operations as one line item on the income statement for all periods presented. All Latin America related balance sheet items at December 31, 2004 are presented in the assets and liabilities of Discontinued Operations line items. In accordance with SFAS No. 144 the December 31, 2003 balance sheet and related footnotes were not restated for discontinued operations. Unless explicitly noted all amounts disclosed and described in these accompanying notes to the consolidated financial statements exclude our two remaining Latin investments that were sold in January 2005. Beginning with the second quarter of 2004, long-lived assets of the Latin America group ceased to be depreciated (amortized) in accordance with SFAS No. 144.

USE OF ESTIMATES

Our consolidated financial statements have been prepared in accordance with Generally Accepted Accounting

Principles (US GAAP). We are required to make estimates and assumptions that affect amounts reported in our financial statements and the accompanying notes. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. Investments with an original maturity of over three months to one year are not considered cash equivalents and are included as other current assets in the consolidated balance sheets. Interest income on cash equivalents and temporary cash investments was \$95 for 2002, \$76 for 2003, and \$60 for 2004.

Included in the December 31, 2004 cash balance of \$696 are cash balances of \$148 held by our remaining discontinued operations in Latin America.

SHORT-TERM INVESTMENTS

Short-term investments represent auction rate securities which are highly liquid, variable-rate debt securities. While the underlying security has a long-term nominal maturity, the interest rate is reset through dutch auctions that are typically held every 7, 28 or 35 days, creating a short-term instrument. The securities trade at par and are callable at par on any interest payment date at the option of the issuer. Interest is paid at the end of each auction period.

MATERIAL AND SUPPLIES

New and reusable material held at our telephone subsidiary is carried in inventory, principally at average original cost, except that specific costs are used in the case of large individual items. Non-reusable material is carried at estimated salvage value. Inventories of our other subsidiaries are stated at the lower of cost or market, with cost determined principally on either an average cost or first-in, first-out basis.

PROPERTY, PLANT AND EQUIPMENT

The investment in property, plant and equipment is stated at original cost. For plant dedicated to providing regulated telecommunications services, depreciation is based on the group remaining life method of depreciation and straight-line rates determined on the basis of equal life groups of certain categories of telephone plant acquired in a given year. This method requires the periodic revision of depreciation rates. When depreciable telephone plant is disposed of, the original cost less any net salvage proceeds is charged to accumulated depreciation. We perform inventories of the telephone plant to verify the existence of these assets and reconcile these inventories to our property records. In addition, the inventory reconciliation results allow us to correct our records for investment moved from one location to another and to

account for delayed retirements. The cost of other property, plant and equipment is depreciated using either straight-line or accelerated methods over the estimated useful lives of the assets. Depreciation of property, plant and equipment in continuing operations was \$3,718 for 2002, \$3,257 for 2003, and \$3,039 for 2004.

Gains or losses on disposal of other depreciable property, plant and equipment are recognized in the year of disposition as an element of Other income (expense), net. The cost of maintenance and repairs of plant, including the cost of replacing minor items not resulting in substantial betterments, is charged to operating expenses. Interest expense and network engineering costs incurred during the construction phase of our networks are capitalized as part of property, plant and equipment until the projects are completed and placed into service.

VALUATION OF LONG-LIVED ASSETS

Long-lived assets, including property, plant and equipment and intangible assets with finite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The communications industry is rapidly evolving and therefore it is reasonably possible that our long-lived assets could become impaired as a result of technological or other industry changes. For assets we intend to hold for use, if the total of the expected future undiscounted cash flows is less than the carrying amount of the asset, we recognize a loss for the difference between the fair value and carrying value of the asset. For assets we intend to dispose of, we recognize a loss for the amount that the estimated fair value, less costs to sell, is less than the carrying value of the assets. We principally use the discounted cash flow method to estimate the fair value of long-lived assets.

We account for equity security investments in which we exercise significant influence under the equity method of accounting. In accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, we periodically review equity method investments for impairment. These reviews are performed to determine whether a decline in the fair value of an investment below its carrying value is deemed to be other than temporary.

FOREIGN CURRENCY

Assets and liabilities of foreign subsidiaries and equity investees with a functional currency other than US Dollars are translated into US Dollars at exchange rates in effect at the end of the reporting period. Foreign entity revenues and expenses are translated into US Dollars at the average rates that prevailed during the period. The resulting net translation gains and losses are reported as foreign currency translation adjustments in shareholders' equity as a component of accumulated other comprehensive income (loss). Operations in countries with

hyperinflationary economies consider the US Dollar the functional currency.

COST METHOD INVESTMENTS

We have investments in marketable securities, primarily common stocks, which are accounted for under the cost method. Securities classified as available-for-sale under, "Accounting for Certain Investments in Debt and Equity Securities," SFAS No. 115 are carried at fair value, with unrealized gains and losses, net of income taxes, recorded in accumulated other comprehensive income (loss) in the statement of changes in shareholders' equity and comprehensive income. The fair values of individual investments in marketable securities are determined based on market quotations. Gains or losses are calculated based on the original cost. We periodically review cost method investments for impairment. These reviews are performed to determine whether a decline in the fair value of an investment below its carrying value is deemed to be other than temporary. Equity securities that are restricted for more than one year or not publicly traded are recorded at cost.

DERIVATIVE FINANCIAL INSTRUMENTS

We generally enter into derivative financial instruments only for hedging purposes. In hedging the exposure to variable cash flows or foreign currency impacts on forecasted transactions, deferral accounting is applied when the derivative reduces the risk of the underlying hedged item effectively as a result of high inverse correlation with the value of the underlying exposure. If a derivative instrument either initially fails or later ceases to meet the criteria for deferral accounting, any subsequent gains or losses are recognized currently in income. In hedging the exposure to changes in the fair value of a recognized asset or liability, the change in fair value of both the derivative financial instrument and the hedged item are recognized currently in income. Cash flows resulting from derivative financial instruments are classified in the same category as the cash flows from the items being hedged.

REVENUE RECOGNITION

Revenues are recognized when earned. Certain revenues derived from local telephone services are billed monthly in advance and are recognized the following month when services are provided. Revenues derived from other telecommunications services, principally network access, long distance and wireless airtime usage, are recognized monthly as services are provided. Marketing incentives, including cash coupons, package discounts and free service are recognized as revenue reductions and are accrued in the period the service is provided. With respect to coupons, accruals are based on historical redemption experience. While cash is generally received at the time of sale, revenues from installation and activation activities are

deferred and recognized over the life of the customer relationship, which is generally four years. Print Advertising & Publishing revenues and related directory costs are recognized ratably over the life of the related directory, generally 12 months. Allowances for uncollectible accounts are determined based on analysis of history and future expectations. The provision for such uncollectible accounts in continuing operations was \$795 for 2002, \$523 for 2003, and \$384 for 2004.

DEFERRED ACTIVATION AND INSTALLATION EXPENSES

We defer certain expenses associated with installation and activation activities. Expense is only deferred to the extent associated revenues are deferred. Service costs in excess of revenues are recognized in the period incurred. The deferred costs are recognized over approximately 4 years.

ADVERTISING

We expense advertising costs as they are incurred. These expenses include production, media and other promotional and sponsorship costs. Our total advertising expense in continuing operations was \$258 for 2002, \$357 for 2003, and \$382 for 2004.

INCOME TAXES

The consolidated balance sheets reflect deferred tax balances associated with the anticipated tax impact of future income or deductions implicit in the consolidated balance sheets in the form of temporary differences. Temporary differences primarily result from the use of accelerated methods and shorter lives in computing depreciation for tax purposes.

EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average number of common shares outstanding during each year. Diluted earnings per share are based on the weighted-average number of common shares outstanding plus net incremental shares arising out of employee stock options and benefit plans. The earnings amounts used for per-share calculations are the same for both the basic and diluted methods. The following is a reconciliation of the weighted-average share amounts (in millions) used in calculating earnings per share:

| | 2002 | 2003 | 2004 |
|---|-------|-------|-------|
| Basic common shares outstanding | 1,870 | 1,848 | 1,832 |
| Incremental shares from stock options and benefit plans | 6 | 4 | 4 |
| Diluted common shares outstanding | 1,876 | 1,852 | 1,836 |
| Stock options excluded from the computation | 77 | 92 | 79 |

Options with an exercise price greater than the average market price of the common stock or that have an anti-

dilutive effect on the computation are excluded from the calculation of diluted earnings per share.

GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist primarily of capitalized software, wireless licenses and customer related intangibles. Goodwill represents the excess of consideration paid over the fair value of net assets acquired in purchase business combinations. Beginning January 1, 2002 we ceased amortization of goodwill and other indefinite-lived intangible assets in connection with the adoption of SFAS 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). Customer-related intangible assets represent values placed on customer lists, contracts and non-contractual relationships of acquired businesses and are amortized over periods up to eight years using the sum-of-the-years digits method. Capitalized software costs are being amortized ratably over periods of three to five years. Amortization of intangibles in continuing operations was \$484 for 2002, \$554 for 2003, and \$597 for 2004.

We test goodwill and other indefinite-lived intangible assets for impairment on an annual basis. Additionally, goodwill is tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of an entity below its carrying value. These events or circumstances would include a significant change in the business climate, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business or other factors. Other indefinite-lived intangible assets are tested between annual tests if events or changes in circumstances indicate that the asset might be impaired.

Note B – Recently Issued Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), "Share-Based Payment." This standard amends and clarifies the accounting for stock compensation plans under SFAS No. 123, "Accounting for Stock-Based Compensation," which we adopted effective January 1, 2003. We will adopt this revised statement for our quarter ending September 30, 2005. We do not expect the adoption of this statement to have a material impact on our results of operations, financial position or cash flows.

Note C – Changes in Accounting Principle

ASSET RETIREMENT OBLIGATIONS

Effective January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations" (SFAS No. 143). This statement provides the accounting for the cost of legal obligations associated with the retirement of

long-lived assets. SFAS No. 143 requires that companies recognize the fair value of a liability for asset retirement obligations in the period in which the obligations are incurred and capitalize that amount as part of the book value of the long-lived asset. SFAS No. 143 also precludes companies from accruing removal costs that exceed gross salvage in their depreciation rates and accumulated depreciation balances if there is no legal obligation to remove the long-lived assets. For our outside plant accounts, such as telephone poles and cable, estimated cost of removal does exceed gross salvage.

Although we have no legal obligation to remove assets, we have historically included in our group depreciation rates estimated net removal costs associated with these outside plant assets in which estimated cost of removal exceeds gross salvage. These costs have been reflected in the calculation of depreciation expense, which results in greater periodic depreciation expense and the recognition in accumulated depreciation of future removal costs for existing assets. When the assets are actually retired and removal costs are expended, the net removal costs are recorded as a reduction to accumulated depreciation.

In connection with the adoption of this standard, we removed existing accrued net costs of removal in excess of the related estimated salvage from our accumulated depreciation for those accounts. The adjustment was reflected in the 2003 income statement as a cumulative effect of accounting change adjustment and on the

balance sheet as an increase to net plant and equipment of \$1,334 and an increase to deferred income taxes of \$518. The cumulative effect of change increased net income by \$816 for the year ended December 31, 2003.

REVENUE RECOGNITION FOR PUBLISHING REVENUES

Effective January 1, 2003, we changed our method for recognizing revenues and expenses related to our directory publishing business from the publication and delivery method to the deferral method. Under the publication and delivery method, we recognized 100% of the revenues and direct expenses at the time the directories were published and delivered to end-users. Under the deferral method, revenues and direct expenses are recognized ratably over the life of the related directory, generally 12 months. The change in accounting method is reflected in the 2003 income statement as a cumulative effect of accounting change adjustment and on the balance sheet as a decrease to accounts receivable of \$845, increase to other current assets of \$166, increase to current liabilities of \$129, and a decrease to deferred income taxes of \$307. The cumulative effect of the change resulted in a decrease to net income of \$501 for 2003. Absent this one-time adjustment, the change in accounting did not materially affect our annual results.

PRO FORMA IMPACT OF ACCOUNTING CHANGES

The following table presents our 2002 results adjusted to reflect the changes in accounting for asset retirement obligations and revenue recognition for publishing revenues:

| | For the Year Ended December 31, | | | |
|--|---------------------------------|--------------------------------|--|----------------------------------|
| | 2002 (As reported) | SFAS No. 143 (Unaudited) | Directory Publishing (Unaudited) | 2002 Pro Forma (Unaudited) |
| Total Operating Revenue | \$ 20,207 | \$ - | \$ 49 | \$ 20,256 |
| Operating Expenses | | | | |
| Cost of services and products | 6,670 | 32 | 37 | 6,739 |
| Selling, general, and administrative expenses | 3,891 | - | 13 | 3,904 |
| Depreciation and amortization | 4,202 | (133) | - | 4,069 |
| Provision for restructuring and asset impairments | 990 | - | - | 990 |
| Total operating expenses | 15,753 | (101) | 50 | 15,702 |
| Operating income | 4,454 | 101 | (1) | 4,554 |
| Non-operating income (expense), net | 913 | - | - | 913 |
| Income from continuing operations before income taxes, discontinued operations, and cumulative effect of changes in accounting principle | 5,367 | 101 | (1) | 5,467 |
| Provision for income taxes | 1,892 | 39 | - | 1,931 |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | 3,475 | 62 | (1) | 3,536 |
| Income (Loss) from discontinued operations, net of tax | (867) | - | - | (867) |
| Income before cumulative effect of changes in accounting principle | 2,608 | 62 | (1) | 2,669 |
| Cumulative effect of changes in accounting principle, net of tax | (1,285) | - | - | (1,285) |
| Net Income | \$ 1,323 | \$ 62 | \$ (1) | \$ 1,384 |
| Basic earnings per share*: | | | | |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | \$ 1.86 | \$ 0.03 | \$ 0.00 | \$ 1.89 |
| Income before cumulative effect of changes in accounting principle | \$ 1.39 | \$ 0.03 | \$ 0.00 | \$ 1.43 |
| Net income | \$ 0.71 | \$ 0.03 | \$ 0.00 | \$ 0.74 |
| Diluted earnings per share*: | | | | |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | \$ 1.85 | \$ 0.03 | \$ 0.00 | \$ 1.88 |
| Income before cumulative effect of changes in accounting principle | \$ 1.39 | \$ 0.03 | \$ 0.00 | \$ 1.42 |
| Net income | \$ 0.71 | \$ 0.03 | \$ 0.00 | \$ 0.74 |

*Earnings per share amounts do not sum due to rounding.

Note D – Discontinued Operations

In March 2004, we signed an agreement with Telefónica Móviles, S.A., the wireless affiliate of Telefónica, S.A. (Telefónica), to sell all of our interests in Latin America. Total after-tax proceeds of the sale to Telefónica of the 10 properties, including shareholder loans, were \$5.1 billion. The net assets sold to Telefónica included \$1.2 billion of cash as part of the Latin American operations, resulting in a net cash inflow to BellSouth related to the Latin American divestitures of approximately \$3.9 billion. Based on the net book value of our investment, we recorded after-tax gains totalling approximately \$1.2 billion.

Under the agreement, Telefónica purchased all equity interests that we purchased from the minority shareholders in various Latin American operations. Following the deal announcement, we purchased debt and equity interests and other rights of minority partners in our Argentina, Ecuador, Nicaragua, Uruguay, and Venezuela operations for a combined total of \$757. In addition, we purchased \$125 of third party Argentine debt.

During October 2004, we closed on the sale of 8 of the 10 properties: Venezuela, Colombia, Ecuador, Peru, Guatemala, Nicaragua, Uruguay and Panama. During January 2005, we closed on the sale of the operations in the remaining two Latin American countries (Argentina and Chile).

SUMMARY OF SALE TRANSACTIONS

| | Gross Proceeds | After-Tax Gain |
|--|----------------|----------------|
| For the year ended December 31: | | |
| 2004 | \$4,037 | \$ 850 |
| 2005 | \$1,079 | \$ 391 |
| Total | \$5,116 | \$1,241 |

The 2004 gain includes the recognition of cumulative foreign currency translation losses of \$421 and the 2005 gain includes the recognition of cumulative foreign currency translation gains of \$77.

SUMMARY FINANCIAL INFORMATION

The assets and liabilities of our remaining Latin American operations (Argentina and Chile) are aggregated and presented as current assets and current liabilities in the consolidated balance sheet at December 31, 2004. Additional detail related to the assets and liabilities of our discontinued operations follows:

At December 31, 2004:

| | |
|--|----------------|
| Current assets (excluding cash of \$148) | \$ 403 |
| Property, plant and equipment, net | 387 |
| Investments and advances | 4 |
| Intangible assets, net | 269 |
| Other non-current assets | 5 |
| Total Assets | \$1,068 |
| Current liabilities | \$ 830 |
| Long-term debt | - |
| Other non-current liabilities | - |
| Total Liabilities | \$ 830 |

Summarized results for the discontinued operations are as follows:

| | For the Year Ended December 31, | | |
|--|---------------------------------|---------|----------------|
| | 2002 | 2003 | 2004 |
| Operating revenue | \$2,233 | \$2,294 | \$2,429 |
| Operating income | \$ 292 | \$ 349 | \$ 647 |
| Income (loss) before income taxes | \$ (951) | \$ 176 | \$1,525 |
| Provision (benefit) for income taxes | \$ (84) | \$ 75 | \$ 161 |
| Net income (loss) from discontinued operations | \$ (867) | \$ 101 | \$1,364 |

TAX OVER BOOK BASIS DIFFERENTIAL

No US tax benefit was previously recognized on losses generated by the Latin American operations due to the essentially permanent duration of those investments. During 2004, we recorded a \$336 tax benefit in accordance with SFAS No. 109, "Accounting for Income Taxes," relating to excess tax basis over book basis for our Latin American operations. In addition, a tax benefit of \$189 was recorded directly to equity related to the cumulative currency

translation balance associated with the discontinued operations. At December 31, 2004, our tax basis in the remaining Latin America investments exceeds the book basis by approximately \$520, resulting in a tax benefit of \$140 in net deferred tax liabilities and \$42 in equity. These balances reverse in the first quarter of 2005 with the sale of the final two Latin American properties (Argentina and Chile).

BUYOUT OF MINORITY PARTNERS

In March and April 2004, we purchased interests and other rights of minority partners in Argentina, Ecuador and Colombia. These purchases brought our ownership interests to 100% in Argentina and Ecuador and to 77.6% in Colombia. The aggregate purchase price for these acquisitions, including payment of minority shareholder loans, was \$177. The assignment of the purchase price to the estimated fair values of assets acquired and liabilities assumed resulted in an increase to intangible assets of \$55 and an increase to goodwill of \$81. In connection with the purchase of our minority partner in Argentina, the consideration paid exceeded the fair value by approximately \$33. Accordingly, this amount was recognized as a charge to income (loss) from discontinued operations in the second quarter 2004.

In October 2004, to facilitate the transfer of ownership to Telefónica, we purchased interests of minority partners in Nicaragua and Uruguay. These purchases brought our ownership interests to 100% in Nicaragua and 68% in Uruguay. The aggregate purchase price for these acquisitions was \$37, which approximated the proceeds received in the sale to Telefónica.

VENEZUELAN ARBITRATION AND SETTLEMENT

Prior to the sale of Telcel, our Venezuelan operation, to Telefónica on October 28, 2004, we owned a 78.2% interest in Telcel. Telcel's other major shareholder held an indirect 21.8% interest in Telcel. Under a Stock Purchase Agreement, that shareholder had the right to initiate a process that could require us to purchase (the puts), and we had the right to initiate a process that could require that shareholder to sell (the calls) to us, the shareholder's interest in Telcel.

In 2000, the shareholder initiated a process for appraising the value of approximately half of its interest in Telcel, but the process was not completed. The shareholder also sent a letter purporting to exercise the balance of the puts under the Stock Purchase Agreement. The matter was taken before an arbitration panel over alleged breaches by BellSouth and the shareholder of the Stock Purchase Agreement, including the timing of the valuation and whether the process was properly initiated in 2000. The shareholder was seeking damages and specific performance, and BellSouth was seeking, among other things, unspecified damages and a ruling that it had not breached the Stock Purchase Agreement in any respect. The arbitration also related to an alleged oral agreement to buy out the shareholder's entire interest in Telcel, which

agreement we argued did not exist. Hearings on these matters occurred in January and April 2004.

In a 2 to 1 decision issued on October 13, 2004, the arbitration panel ordered BellSouth to purchase an 11.1% interest in Telcel associated with the first put and directed the parties to negotiate a price for the second put. In addition, the arbitration panel ordered us to pay this shareholder approximately \$25 to satisfy its claims that we breached certain investment tax credit contracts. A provision for this \$25 payment had already been provided for in BellSouth's financial statements. The arbitration panel rejected the shareholder's claim that BellSouth breached an oral agreement to buy out the shareholder's entire interest in Telcel, and denied all other claims raised by the parties.

In response to the arbitration ruling, BellSouth purchased this shareholder's 21.8% interest in Telcel and settled all outstanding claims for an aggregate payment of \$616. The aggregate payment of \$616 included all the amounts that the arbitration panel ordered BellSouth to pay to this shareholder. Upon closing, BellSouth sold the interest to Telefónica for \$300. Because the settlement amount allocable to this interest exceeded the fair value, BellSouth recognized a pre-tax charge of approximately \$293 (\$190 after-tax) in income (loss) from discontinued operations in 2004.

VENEZUELA CURRENCY

Our results from discontinued operations reflect consolidation of the operations of Telcel in Venezuela in accordance with SFAS No. 94, "Consolidation of All Majority-Owned Subsidiaries." There are currency restrictions in place in Venezuela that limit the conversion of local currency to US Dollars. Due to the currency controls, there is no free market currency exchange rate. Therefore, in preparing our consolidated financial statements, we used the exchange rate established by the Venezuelan government of 1,920 Bolivars to the US Dollar to translate the local currency financial statements into our reporting currency, the US Dollar.

ARGENTINA CURRENCY

In January 2002, the Argentine government announced economic reforms, including a devaluation of its national currency, the Argentine Peso. The Argentine Peso lost over 71% of its value as compared to the US Dollar in 2002. Based on the net monetary position of CRM, we recorded foreign currency transaction losses of \$683 during 2002. We are recording a valuation allowance in 2004 on the net operating losses, deferring recognition of the tax benefits generated by these losses due to the potentially limited tax carry forward period in Argentina. The value of the Argentine Peso as compared to the US Dollar slightly recovered during 2003 resulting in the recognition of foreign currency transaction gains of \$104 during 2003. The value of the Argentine Peso remained stable in 2004.

Note E – Investments in and Advances to Cingular

| | 2003 | 2004 |
|------------|---------|----------|
| Investment | \$3,867 | \$18,311 |
| Advances | 3,812 | 4,460 |
| | \$7,679 | \$22,771 |

INVESTMENT

We own an approximate 40% economic interest in Cingular Wireless, and share joint control of the venture with SBC Communications, Inc. The following table presents 100% of Cingular's assets, liabilities, and results of operations as of and for the years ended December 31:

| | 2003 | 2004 |
|-----------------------------------|----------|----------|
| Balance Sheet Information: | | |
| Current assets | \$ 3,300 | \$ 5,570 |
| Noncurrent assets | \$22,230 | \$76,668 |
| Current liabilities | \$ 3,210 | \$ 7,983 |
| Noncurrent liabilities | \$13,328 | \$29,110 |
| Minority Interest | \$ 659 | \$ 609 |
| Members' capital | \$ 8,333 | \$44,536 |

| | 2002 | 2003 | 2004 |
|---|----------|----------|----------|
| Income Statement Information: | | | |
| Revenues | \$14,903 | \$15,483 | \$19,436 |
| Operating Income | \$ 2,496 | \$ 2,254 | \$ 1,528 |
| Income Before Cumulative Effect of Change in Accounting Principle | \$ 1,205 | \$ 977 | \$ 201 |
| Cumulative Effect of Change in Accounting Principle | \$ (32) | - | \$ - |
| Net Income | \$ 1,173 | \$ 977 | \$ 201 |

As of December 31, 2004 and 2003, our book investment exceeded our proportionate share of the net assets of Cingular by \$497 and \$534, respectively. As of December 31, 2004, \$1,377 of our consolidated retained earnings represented undistributed earnings from Cingular.

On October 26, 2004, Cingular completed its previously announced acquisition of AT&T Wireless, creating the largest wireless carrier in the United States based on the number of customers. Cingular's cash purchase price for AT&T Wireless shares totaled approximately \$41 billion. That amount was funded by equity contributions from Cingular's two owners in proportion to their equity ownership of Cingular — 60% for SBC and 40% for BellSouth — with the remainder provided from cash on hand at AT&T Wireless. BellSouth's portion of the funding, which was reflected as an increase in our investment in Cingular, was approximately \$14.4 billion.

ADVANCE

We have an advance to Cingular that was \$3,792 at December 31, 2004 and \$3,812 at December 31, 2003. Effective July 1, 2003, BellSouth and SBC agreed to amend the terms of our notes with Cingular. The amendment included reducing the fixed interest rate from 7.5% to 6.0% per annum and extending the maturity date from March 31, 2005 to June 30, 2008.

REVOLVING LINE OF CREDIT

Effective August 1, 2004, BellSouth and SBC have agreed to finance their respective pro rata shares of Cingular's capital and operating cash requirements based upon Cingular's budget and forecasted cash needs. Borrowings under this agreement bear interest at 1-Month LIBOR plus 0.05% payable monthly. Cingular also terminated its bank credit facilities and ceased issuing commercial paper and long-term debt. Available cash (as defined) generated by Cingular is applied on the first day of the succeeding month to the repayment of the advances from BellSouth and SBC. With regard to any interim loans Cingular makes to BellSouth from time to time, BellSouth pays Cingular interest on the excess cash at 1-Month LIBOR. The balance outstanding under the revolving credit line, including interest, was \$668 at December 31, 2004.

PROVISION OF SERVICES

We also generate revenues from Cingular in the ordinary course of business for the provision of local interconnection services, long distance services, sales agency fees and customer billing and collection fees.

INTEREST AND REVENUE EARNED FROM CINGULAR

| | For the Years Ended December 31, | | |
|-----------------------------|-------------------------------------|-------|--------------|
| | 2002 | 2003 | 2004 |
| Revenues | \$386 | \$426 | \$537 |
| Interest income on advances | \$284 | \$256 | \$230 |

Interest income on advances is offset by a like amount of interest expense recorded by Cingular and reported in our financial statements in the caption "Net earnings of equity affiliates."

Receivables and payables incurred in the ordinary course of business are recorded in our balance sheets as follows:

| | As of December 31, | |
|--------------------------|-----------------------|-------------|
| | 2003 | 2004 |
| Receivable from Cingular | \$57 | \$56 |
| Payable to Cingular | \$33 | \$44 |

Note F – Other Assets

Other assets at December 31 consist of the following:

| | 2003 | 2004 |
|---|---------|----------------|
| Deferred activation and installation expenses | \$1,614 | \$1,405 |
| Prepaid pension and postretirement benefits | 3,851 | 4,362 |
| Equity method investments other than Cingular | 370 | 277 |
| Cost method investments | 382 | 921 |
| Advance to Sonofon | 106 | – |
| Investments in debt securities | 244 | – |
| Other | 410 | 435 |
| Other assets | \$6,977 | \$7,400 |

DEFERRED ACTIVATION AND INSTALLATION EXPENSES

| | |
|--|----------|
| Deferred activation and installation expenses December 31, 2002 | \$ 1,800 |
| Amortization of previous deferrals | (864) |
| Current period deferrals | 678 |
| Deferred activation and installation expenses December 31, 2003 | 1,614 |
| Amortization of previous deferrals | (811) |
| Current period deferrals | 602 |
| Deferred activation and installation expenses December 21, 2004 | \$ 1,405 |

EQUITY METHOD INVESTMENTS OTHER THAN CINGULAR

Ownership in equity investments other than Cingular at December 31 is as follows:

| | 2003 | | 2004 | |
|------------------------------------|-------------------------|-----------------------|-------------------------|-----------------------|
| | Ownership Percentage | Investment Balance | Ownership Percentage | Investment Balance |
| Abiatar (Uruguay) | 46.0% | \$ 26 | – | \$ – |
| BellSouth Guatemala ⁽¹⁾ | 60.0% | 7 | – | – |
| BellSouth Panama | 43.7% | 86 | – | – |
| Cellcom (Israel) | 34.8% | 191 | 34.8% | 242 |
| Sonofon (Denmark) | 46.5% | 57 | – | – |
| Internet Yellow Pages | – | – | 34.0% | 33 |
| Other | – | 3 | – | 2 |
| | | \$370 | | \$277 |

(1) This investment is accounted for under the equity method due to the existence of significant minority rights that limit our ability to exercise unilateral control over the operation.

COST METHOD INVESTMENTS

We have investments in marketable securities, primarily common stocks, which are accounted for under the cost method. These investments are held in grantor trusts and our captive insurance subsidiary. In 2003 and 2004, the trusts

diversified their portfolio through the sale of BellSouth stock using the proceeds to reinvest in other equity securities.

ADVANCE TO SONOFON

On February 12, 2004, we closed on a previously announced agreement to sell our interest in Danish wireless provider, Sonofon, for 3.68 billion Danish Kroner to Telenor ASA. We received 3.05 billion Danish Kroner, or \$525, for our 46.5% equity stake and 630 million Danish Kroner, or \$109, for our shareholder loan and accrued interest, reduced by a settlement of \$17 associated with foreign currency swap contracts. As a result of these transactions, we recorded a gain of \$462, or \$295 net of tax, which included the recognition of cumulative foreign currency translation gains of \$13.

INVESTMENT IN DEBT SECURITIES

Investments in debt securities represented our loan participation agreements related to our Colombian operations. These securities were sold in conjunction with the sale of our Colombian operations.

Note G – Intangible Assets

Intangible assets are summarized as follows:

| | December 31, 2003 | | December 31, 2004 | |
|--|-------------------|--------------------------|-------------------|--------------------------|
| | Carrying Amount | Accumulated Amortization | Carrying Amount | Accumulated Amortization |
| Intangible assets subject to amortization: | | | | |
| Capitalized Software | \$2,893 | \$1,303 | \$2,930 | \$1,388 |
| Wireless Licenses | 764 | 294 | – | – |
| Customer related intangible assets | 330 | 288 | – | – |
| Other | 38 | 15 | 37 | 12 |
| Total | \$4,025 | \$1,900 | \$2,967 | \$1,400 |
| Intangible assets not subject to amortization: | | | | |
| Wireless Licenses | \$ 164 | \$ 12 | – | – |
| MMDS Licenses | 20 | – | 20 | – |
| Total | \$ 184 | \$ 12 | \$ 20 | – |
| Total Intangible Assets | \$4,209 | \$1,912 | \$2,987 | \$1,400 |

The following table presents current and expected amortization expense of the existing intangible assets as of December 31, 2004 for each of the following periods:

| | |
|--------------------------------------|-------|
| Aggregate amortization expense: | |
| For the year ended December 31, 2004 | \$597 |

Expected amortization expense:

| | |
|----------------------------------|-------|
| For the years ended December 31, | |
| 2005 | \$567 |
| 2006 | 421 |
| 2007 | 294 |
| 2008 | 175 |
| 2009 | 70 |

INTANGIBLE ASSET IMPAIRMENTS

We adopted SFAS No. 142 and recorded a cumulative effect of change in accounting principle on January 1, 2002.

As part of the adoption of SFAS No. 142, we were required to perform initial valuations to determine if any impairment of goodwill and indefinite-lived intangibles exists. We will continue to test embedded goodwill related to equity investments for impairment under accounting rules for equity investments, which are based on comparisons between fair value and carrying value.

During 2002, we completed the transitional impairment test required under SFAS No. 142. In accordance with SFAS No. 142, goodwill was tested for impairment by comparing the fair value of our reporting units to their carrying values. Fair values were determined by the assessment of future discounted cash flows. The fair values of our Latin America reporting units were less than the carrying value of these units. The allocation of fair values to identifiable tangible and intangible assets resulted in an implied valuation of the goodwill associated with these reporting units of \$118. As a result, we recorded an impairment loss of \$1,277, with no income tax benefit. Additionally, our equity investee, Cingular Wireless, completed its transitional impairment test in 2002 resulting in an impairment loss to BellSouth of \$8 after tax. These impairment losses are recorded as a cumulative effect of change in accounting principle in the statements of income as of January 1, 2002.

The changes in the carrying amount of goodwill for 2003 and 2004 are as follows:

| | |
|---|--------------|
| Balance at December 31, 2002 | \$ 98 |
| Other changes | (5) |
| Balance at December 31, 2003 | \$ 93 |
| Transfer of goodwill to discontinued operations | (93) |
| Balance at December 31, 2004 | \$ 0 |

During 2004 we reclassified goodwill balances associated with our Cingular investment to the Cingular investment line item in the consolidated balance sheet. We reclassified \$249 in the December 31, 2003 balance sheet to conform to the current period presentation. The table above reflects this reclassification in all periods presented.

OTHER IMPAIRMENTS OF INTANGIBLE ASSETS

In September 2003, a decision was reached to abandon a software project related to a network operations system. The project was terminated due to changes in the business since the initiation of the project and an assessment of the remaining costs to complete the project. As a result, we recorded an asset impairment charge of \$52 to write-off capitalized software associated with the project.

Note H – Supplemental Balance Sheet and Cash Flow Information

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is summarized as follows at December 31:

| | Estimated Depreciable Lives (In Years) | Average Remaining Life | 2003 | 2004 |
|------------------------------------|---|------------------------------|----------|-----------------|
| Central office equipment | 8–11 | 4.7 | \$26,066 | \$26,539 |
| Outside plant: | | | | |
| Copper cable | 15–16 | 6.8 | 19,975 | 20,440 |
| Fiber cable | 20 | 10.9 | 3,094 | 3,270 |
| Poles and conduit | 36–55 | 28.0 | 3,567 | 3,620 |
| Operating and other equipment | 5–15 | 3.3 | 4,419 | 1,691 |
| Building and building improvements | 25–45 | 28.0 | 4,780 | 4,597 |
| Furniture and fixtures | 10–15 | 8.4 | 2,478 | 2,429 |
| Station equipment | 6 | 3.0 | 763 | 542 |
| Land | – | – | 293 | 267 |
| Plant under construction | – | – | 280 | 206 |
| | | | 65,715 | 63,601 |
| Less: accumulated depreciation | | | 41,908 | 41,562 |
| Property, plant and equipment, net | | | \$23,807 | \$22,039 |

OTHER CURRENT LIABILITIES

Other current liabilities are summarized as follows at December 31:

| | 2003 | 2004 |
|--|---------|----------------|
| Advanced billing and customer deposits | \$ 863 | \$ 832 |
| Interest and rents accrued | 470 | 382 |
| Taxes payable | 632 | 222 |
| Dividends payable | 461 | 493 |
| Salaries and wages payable | 359 | 403 |
| Accrued compensated absences | 224 | 229 |
| Restructuring and severance accrual | 72 | 26 |
| Other | 547 | 332 |
| Other current liabilities | \$3,628 | \$2,919 |

OTHER NONCURRENT LIABILITIES

Other noncurrent liabilities are summarized as follows at December 31:

| | 2003 | 2004 |
|---|---------|----------------|
| Deferred installation and activation revenues | \$1,614 | \$1,405 |
| Accrued pension and postretirement benefits | 983 | 1,207 |
| Deferred credits | 724 | 652 |
| Compensation related accruals | 747 | 879 |
| Minority interests in consolidated subsidiaries | 209 | – |
| Postemployment benefits | 237 | 254 |
| Derivatives liability | 80 | 32 |
| Other | 100 | 31 |
| Other noncurrent liabilities | \$4,694 | \$4,460 |

SUPPLEMENTAL CASH FLOW FROM CONTINUING OPERATIONS INFORMATION

| | 2002 | 2003 | 2004 |
|----------------|--------|--------|----------------|
| Cash paid for: | | | |
| Income taxes | \$ 864 | \$ 678 | \$1,279 |
| Interest | \$ 993 | \$ 845 | \$ 863 |

Note I – Debt

DEBT MATURING WITHIN ONE YEAR

Debt maturing within one year is summarized as follows at December 31:

| | 2003 | 2004 |
|--------------------------------------|---------|----------------|
| Short-term notes payable: | | |
| Bank loans | \$ 167 | \$ – |
| Commercial paper | 1,470 | 3,248 |
| Current maturities of long-term debt | 1,854 | 2,227 |
| Debt maturing within one year | \$3,491 | \$5,475 |

Weighted-average interest rate at end of period:

| | 2003 | 2004 |
|------------------|-------|--------------|
| Bank loans | 5.25% | –% |
| Commercial paper | 1.04% | 2.26% |

| Credit lines at end of period: | 2003 | 2004 |
|--|---------|----------------|
| Available domestic committed credit lines | \$1,500 | \$3,523 |
| Borrowings under domestic credit lines | \$ – | \$ – |
| Available international uncommitted credit lines | \$ 118 | \$ – |
| Borrowings under international credit lines | \$ 12 | \$ – |

There are no significant commitment fees or requirements for compensating balances associated with any lines of credit.

LONG-TERM DEBT

Interest rates and maturities in the table below are for the amounts outstanding at December 31:

| | 2003 | 2004 |
|--|----------|----------|
| Issued by BellSouth Telecommunications, Inc. | | |
| 5.85%–5.88% 2009–2045 | \$ 437 | \$ 437 |
| 6.13%–7% 2004–2033 ⁽¹⁾ | 2,151 | 1,949 |
| 7.5%–7.63% 2033–2035 | 300 | 300 |
| 7% 2095 | 500 | 500 |
| 2.42%–2.47% Extendible Liquidity Securities due 2006 | 745 | 745 |
| 6.65% Zero-to-Full Debentures due 2095 | 217 | 232 |
| 6.3% Amortizing Debentures due 2015 | 277 | 261 |
| Issued by BellSouth Corporation | | |
| 2.42% 2007 | – | 500 |
| 4.2%–4.75% 2009–2012 ⁽¹⁾ | – | 2,299 |
| 5%–7.38% 2006–2039 ⁽¹⁾ | 3,852 | 6,631 |
| 7.75%–7.88% 2010–2030 | 2,000 | 2,000 |
| 7.12% 2097 | 500 | 500 |
| 4.11%–4.12% 20-put-1 Securities due 2021 | 1,000 | 1,000 |
| Issued by Foreign Operations | | |
| 3.30%–9.25% Argentina due 2003–2008 ⁽²⁾ | 350 | – |
| 1.72% Chile due 2004 | 180 | – |
| 2.95%–14.18% Colombia due 2005–2006 | 641 | – |
| 4.19%–4.59% Venezuela due 2004 | 23 | – |
| 1.79%–2.06% Peru due 2005 | 200 | – |
| Capital leases and other | 86 | 58 |
| Unamortized discount, net of premium | (116) | (77) |
| | 13,343 | 17,335 |
| Current maturities | (1,854) | (2,227) |
| Long-term debt | \$11,489 | \$15,108 |

(1) These debt maturities are affected by FAS 133 accounting requirements to mark hedged debt to fair value.

(2) CRM, our subsidiary in Argentina, was in default on \$490 of its US Dollar-denominated debt. The debt is classified as liabilities of discontinued operations in our consolidated December 31, 2004 balance sheet.

Several issues of long-term debt contain embedded options, which may require us to repurchase the debt or will alter the interest rate associated with that debt. Those issues, and their related options, are as follows:

| Issue | Date of Put Option |
|--|------------------------------------|
| 20-put-1 Securities due 2021 Putable debentures | Annually in April November 2006 |

If the holders of the put options on the 20-put-1 Securities do not require us to repurchase the securities, the interest rates for these securities will be reset based on current market conditions. Since the 20-put-1 Securities can be put to us annually, the balance is included in current

maturities of long-term debt in our balance sheet. Holders of our 6.04% bond maturing November 15, 2026, have a one-time ability to put the bond back to us on November 15, 2006.

The Amortizing Debentures pay against principal on a semi-annual basis and were issued with an original principal balance of \$375. The Zero-to-Full Debentures will accrete to a total principal balance of \$500 in 2015, at which time we will begin paying interest through the maturity in 2095.

Maturities of long-term debt outstanding, in principal amounts, at December 31, 2004 are summarized below. Maturities after the year 2009 include the final principal amount of \$500 for the Zero-to-Full Debentures due in 2095.

| Maturities | |
|------------|----------|
| 2005 | \$ 2,227 |
| 2006 | 1,722 |
| 2007 | 525 |
| 2008 | 625 |
| 2009 | 1,877 |
| Thereafter | 10,704 |
| Total | \$17,680 |

At December 31, 2004, we had a shelf registration statement on file with the Securities and Exchange Commission under which \$3,100 of debt securities could be publicly offered.

During 2004, we issued \$6,100 of debt and paid \$200 in maturing debt.

In addition, on August 1, 2004, we redeemed \$517 of 40-year, 7.375% quarterly interest bonds, due August 1, 2039. The redemption price was 100% of the principal amount, and resulted in recognition of a loss in Other income (expense) of \$14, or \$9 net of tax, associated with fully expensing remaining discount and deferred debt issuance costs.

Subsequent Event

In December 2004, we called \$400 of 40-year, 6.75% semi-annual interest bonds, due October 15, 2033, which we redeemed on January 18, 2005. The redemption price was 103.33% of the principal amount, and resulted in recognition of a loss of \$22, or \$14 net of tax, which includes \$9 associated with fully expensing remaining discount and deferred debt issuance costs.

Note J – Income Taxes

The consolidated balance sheets reflect the anticipated tax impact of future taxable income or deductions implicit in the consolidated balance sheets in the form of temporary differences. These temporary differences reflect the difference between the basis in assets and liabilities as measured in the consolidated financial statements and as measured by tax laws using enacted tax rates.

The provision for income taxes is summarized as follows:

| | 2002 | 2003 | 2004 |
|----------------------------------|---------|---------|---------|
| Current | | | |
| Federal | \$ 525 | \$1,020 | \$ 645 |
| State | 36 | 128 | 66 |
| | 561 | 1,148 | 711 |
| Deferred, net | | | |
| Federal | 1,245 | 730 | 1,010 |
| State | 113 | 85 | 71 |
| | 1,358 | 815 | 1,081 |
| Investment tax credits, net | | | |
| Federal | (27) | (27) | - |
| Total provision for income taxes | \$1,892 | \$1,936 | \$1,792 |

Temporary differences which gave rise to deferred tax assets and (liabilities) at December 31 were as follows:

| | 2003 | 2004 |
|---|-----------|-----------|
| Operating loss and tax credit carryforwards | \$ 718 | \$ 363 |
| Capital loss carryforwards | 781 | 658 |
| Allowance for uncollectibles | 183 | 125 |
| Other | 399 | 164 |
| | 2,081 | 1,310 |
| Valuation Allowance | (1,135) | (873) |
| Deferred tax assets | \$ 946 | \$ 437 |
| Tangible and intangible property | \$(4,009) | \$(4,667) |
| Equity investments | (1,647) | (1,640) |
| Compensation related | (169) | (131) |
| Other | (165) | (147) |
| Deferred tax liabilities | (5,990) | (6,585) |
| Net deferred tax liability | \$(5,044) | \$(6,148) |

The decrease in valuation allowance on deferred tax assets during 2004 relates primarily to operating loss carryforwards associated with sold Latin American operations. The remaining valuation allowance relates to excess US capital losses, state operating losses, and state credits that may not be utilized during the carryforward period. The carryforward periods for the excess capital losses expire in 2007 and 2008. The operating losses relate to state losses and credit carryforwards expiring in various years beginning in 2005.

At December 31, 2004, net deferred tax liabilities include a deferred tax asset of \$320 relating to compensation expense recognized under SFAS No. 123. Full realization of the deferred asset requires stock options to be exercised at a price equal to the sum of the exercise price plus the fair value at the grant date; any tax benefit realized in excess of the deferred asset is recorded as an increase to equity. A significant number of the options for which a deferred tax asset has been recognized have a combined exercise price and fair value at grant date in excess of \$45.00 per share. Accordingly, there is no assurance that the stock price of BellSouth will rise to levels

sufficient to realize the entire tax benefit currently reflected in our balance sheet. The provisions of SFAS No. 123 prohibit us from recording a valuation allowance on the deferred tax asset related to these options. If the full value of the deferred tax asset is not realized either at the exercise or expiration of the options, the deferred asset will reverse against equity to the extent of previously recognized excess tax benefits, otherwise against income tax expense. At December 31, 2004, accumulated excess tax benefits of \$72 have been recorded in equity.

The net deferred tax liability at December 31, 2004 included a current asset balance of \$344 and a noncurrent liability balance of \$6,492. The net deferred tax liability at December 31, 2003 included a current asset balance of \$305 and a noncurrent liability balance of \$5,349.

A reconciliation of the federal statutory income tax rate to our effective tax rate is as follows:

| | 2002 | 2003 | 2004 |
|---|-------|-------|-------|
| Federal statutory tax rate | 35.0% | 35.0% | 35.0% |
| State income taxes, net of federal income tax benefit | 1.9 | 2.6 | 1.7 |
| Net earnings (losses) of equity affiliates | (0.3) | (0.3) | (0.3) |
| Investment tax credits | (0.3) | (0.3) | - |
| Medicare drug subsidy | - | - | (0.6) |
| Other | (1.0) | (1.3) | (1.2) |
| Effective tax rate | 35.3% | 35.7% | 34.6% |

At December 31, 2004, we had approximately \$242 of cumulative unrepatriated earnings from an equity investment in an unconsolidated business. The deferred tax liability related to these unrepatriated earnings was excluded under SFAS No. 109 because such earnings are intended to be reinvested indefinitely. The potential income tax liability on these unrepatriated earnings is between \$85 and \$140.

Note K – Workforce Reduction and Restructuring

WORKFORCE REDUCTION CHARGES

Based on ongoing challenges in the telecom industry, continued economic pressures, the uncertainty resulting from regulatory rulings and productivity improvements, we have initiated workforce reductions and recorded charges related to approximately 8,700 employees in the last three years. These downsizings were implemented on a voluntary and non-voluntary basis. The positions were both management and non-management, primarily in network operations where the volume of work has substantially decreased. Charges to earnings have been recognized in accordance with provisions of SFAS No. 112, "Employer's Accounting for Postemployment Benefits" (SFAS No. 112), and consisted primarily of cash severance, outplacement

and payroll taxes under pre-existing separation pay plans. The following table summarizes the charges by year:

| | Employee separations | Related charge |
|------|----------------------|----------------|
| 2002 | 3,800 | \$430 |
| 2003 | 3,500 | \$132 |
| 2004 | 1,400 | \$51 |

ASSET IMPAIRMENTS

In 2002, we announced we were eliminating certain service offerings, including our own line of e-business services and some products within our wholesale long distance portfolio. We also discontinued operations at our multi-media Internet exchange in Miami. In connection with the previously announced exit of our public telephone operations, our periodic evaluation of the undiscounted cash flows indicated an impairment.

As a result of these combined events, we recorded a charge of \$134 in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" and Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity." This charge includes asset impairments, early termination penalties on contracts and leases, and severance for affected employees.

RESTRUCTURING LIABILITY

As of December 31, 2004, the aggregate liability related to the charges described above, excluding postretirement and pension impacts, was \$26. As of December 31, 2004 announced workforce reductions are expected to be substantially complete by the end of the first quarter 2005.

| | Type of Cost | | Total |
|-------------------------------------|----------------------|------------------|--------------|
| | Employee Separations | Other Exit Costs | |
| Balance at December 31, 2002 | \$ 84 | \$ 31 | \$ 115 |
| Accruals | 132 | 1 | 133 |
| Cash payments | (125) | (18) | (143) |
| Adjustments | (25) | (8) | (33) |
| Balance at December 31, 2003 | \$ 66 | \$ 6 | \$ 72 |
| Accruals | 51 | — | 51 |
| Cash payments | (80) | (1) | (81) |
| Adjustments | (12) | (4) | (16) |
| Balance at December 31, 2004 | \$ 25 | \$ 1 | \$ 26 |

Adjustments to the employee separations accrual are due to estimated demographics being different than actual demographics of employees that separated from the company. Deductions from the accrual for other exit costs consist primarily of changes to prior estimates.

Note L – Employee Benefit Plans

PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

Substantially all of our employees are covered by noncontributory defined benefit pension plans, as well as postretirement health and life insurance welfare plans (other benefits). The company uses a December 31 measurement date for its plans.

Pension Plans

For defined benefit pension plans, the benefit obligation is the projected benefit obligation, which represents the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered to that date. The pension plan covering management employees is a cash balance plan, which provides pension benefits determined by a combination of compensation-based service and additional credits and individual account-based interest credits. Due to past practice, the projected benefit obligations assume additional credits greater than the minimum levels specified in the written plan.

For non-management employees, pension benefits earned prior to 1999 are based on specified benefit amounts and years of service through 1998. Benefits earned in 1999 and subsequent years are calculated under a cash balance plan that is based on an initial cash balance amount, negotiated pension band increases and interest credits. Due to past practice, non-management pension obligations include the expectation of future pension band increases.

Other Benefits

We provide certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrue actuarially determined postretirement benefit costs as active employees earn these benefits. We maintain Voluntary Employee Beneficiary Association (VEBA) trusts to partially fund these postretirement benefits; however, there are no ERISA or other regulations requiring these postretirement benefit plans to be funded annually.

For postretirement benefit plans, the benefit obligation is the accumulated postretirement benefit obligation, which represents the actuarial present value as of a date of all future benefits attributed under the terms of the postretirement benefit plan to employee service rendered to that date.

In determining the accumulated postretirement benefit obligation of the management health care plan, we anticipate cost sharing adjustments for eligible employees who retire after December 31, 1994. The written plan provides for an annual dollar value cap for the purpose of determining contributions required from retirees. However, because of past practice, some level of cost sharing of

medical trend inflation above the caps is considered in the valuation.

Our non-management labor contract with the CWA contains contractual limits on the company-funded portion of retiree medical costs (also referred to as "caps"). We have waived the premiums in excess of the caps during the current and past contract periods and therefore have not collected contributions from those non-management retirees. We previously calculated the obligation for non-management retiree medical costs based on the terms of the written agreement with the CWA.

The 2004 agreement with the CWA includes an increase in the amount of the caps. We have determined that this increase in the caps combined with BellSouth's history of increasing the caps in prior agreements creates a substantive plan that is an uncapped plan, which differs from the written plan. Accordingly, we began calculating the obligation for non-management retiree medical costs as if there were no caps, effective with the ratification of the contract in the fourth quarter.

The change in the calculation resulted in an increase to the retiree medical accumulated postretirement benefit obligation of approximately \$3.5 billion, which will be recognized over the remaining years of future service to full eligibility of the active plan participants. As a result of this change, we remeasured the retiree medical obligation as of September 30, 2004. Net periodic benefit cost increased \$117 during the fourth quarter of 2004, or \$60 net of tax. The annual impact on net periodic benefit cost due to the remeasurement is approximately \$460, which will be partially offset by reductions in other retirement benefits.

Other benefit plan changes that resulted from the labor contract were not considered significant enough to perform an interim remeasurement but have been included in our annual valuation of the plans as of December 31, 2004.

Medicare Prescription Drug, Improvement and Modernization Act of 2003

In December 2003, the Medicare Prescription Drug Act was signed into law. The Act allows companies that provide certain prescription drug benefits for retirees to receive a federal subsidy beginning in 2006. We accounted for the government subsidy provided for in the Medicare Act as a plan amendment in the calculation of our 2003 retiree medical obligation, resulting in a reduction to the liability of \$575 as of December 31, 2003. Effective January 1, 2004 in accordance with final FASB guidance, we changed the method to treat the subsidy as an actuarial gain. The cumulative effect of the change in method was not material and did not affect the retiree medical obligation. Due to the change in the calculation of the obligation for non-management retiree medical costs as if there were no caps. The subsidy increased to approximately \$1.1 billion as of December 31, 2004. The total impact of the subsidy on net periodic benefit cost for 2004 was \$89.

A plan sponsor's eligibility for the federal subsidy depends on whether the plan's prescription drug benefit is at least actuarially equivalent to the Medicare Part D benefit. Actuarial equivalence was based on comparing the Medicare Part D standard drug coverage and premiums to BellSouth's retiree prescription drug coverage and premiums. We calculated the actuarial values based on our specific experience combined with nationwide statistics published in a standardized rating manual adjusted for historical utilization by our retirees. Our plans are projected to satisfy actuarial equivalence for substantially all participants in future years. Detailed regulations regarding the calculation of actuarial equivalence were issued on January 21, 2005. We do not expect our obligation or our assessment of actuarial equivalence to be materially affected by the regulations. We continue to study the regulations to determine whether any change to our analysis will be required for future valuations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

DOLLARS ARE IN MILLIONS, EXCEPT PER SHARE AMOUNTS AND AS OTHERWISE INDICATED

BELLSOUTH CORPORATION

The following tables summarize benefit costs, as well as the assumptions, benefit obligations, changes in plan assets and funded status at or for the years ended December 31:

| | Pension Benefits | | Other Benefits | |
|--|------------------|----------|----------------|-----------|
| | 2003 | 2004 | 2003 | 2004 |
| Change in benefit obligation: | | | | |
| Benefit obligation at the beginning of the year | \$11,386 | \$11,620 | \$ 7,387 | \$ 7,156 |
| Service cost | 181 | 177 | 50 | 66 |
| Interest cost | 742 | 696 | 478 | 472 |
| Amendments | - | 27 | (572) | 3,315 |
| Actuarial (gain) loss | 803 | 288 | 293 | 386 |
| Gross benefits and lump sums paid | (1,492) | (1,083) | (480) | (512) |
| Benefit obligation at the end of the year | \$11,620 | \$11,725 | \$ 7,156 | \$10,883 |
| Change in plan assets: | | | | |
| Fair value of plan assets at the beginning of the year | \$13,338 | \$14,605 | \$ 2,820 | \$ 3,693 |
| Actual return (loss) on plan assets | 2,759 | 2,090 | 761 | 556 |
| Employer contribution | - | - | 563 | 422 |
| Plan participants contributions | - | - | 29 | 39 |
| Benefits and lump sums paid | (1,492) | (1,083) | (480) | (512) |
| Fair value of plan assets at the end of year | \$14,605 | \$15,612 | \$ 3,693 | \$ 4,198 |
| Funded status: | | | | |
| As of the end of the year | \$ 2,985 | \$ 3,887 | \$(3,463) | \$(6,685) |
| Unrecognized prior service cost | (432) | (362) | (49) | 3,266 |
| Unrecognized net (gain) loss | 942 | 454 | 2,923 | 2,376 |
| Unrecognized net (asset) obligation | - | - | (38) | 219 |
| Prepaid (accrued) benefit cost | \$ 3,495 | \$ 3,979 | \$ (627) | \$ (824) |
| Amounts recognized in the consolidated balance sheets at December 31: | | | | |
| Prepaid benefit cost | \$ 3,572 | \$ 4,055 | \$ 279 | \$ 307 |
| Accrued benefit cost | (77) | (76) | (906) | (1,131) |
| Net amount recognized | \$ 3,495 | \$ 3,979 | \$ (627) | \$ (824) |

Weighted-average assumptions used to determine benefit obligations at December 31:

| | | | | |
|---|-------|-------|--------|--------|
| Discount rate | 6.25% | 5.25% | 6.25% | 5.50% |
| Rate of compensation increase | 5.10% | 4.50% | 4.80% | 4.50% |
| Health care cost trend rate assumed for the following year (Pre-age 65) | - | - | 9.00% | 8.33% |
| Health care cost trend rate assumed for the following year (Post-age 65) | - | - | 13.00% | 11.67% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | - | - | 5.00% | 5.00% |
| Year that the rate reaches the ultimate trend rate | - | - | 2010 | 2010 |

Discount rates are selected considering yields available on high-quality debt instruments at the measurement date. At December 31, 2004, in addition to reviewing standard bond market indices, we specifically considered the timing and amounts of expected future benefit payments and compared that with a yield curve developed to reflect yields available on high-quality bonds. The discount rates selected as of December 31, 2004, 5.25% for pension and 5.50% for other benefits, reflect the results of this yield curve analysis. The rates are lower than many published indices of long-maturity corporate bond rates. This difference is a reflection of the plans' demographics and benefit design, and the shape of the yield curve.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage point change in assumed health care

cost trend rates would have the following effects as of December 31, 2004:

| | 1-Percentage Point Increase | 1-Percentage Point Decrease |
|--|-----------------------------|-----------------------------|
| Effect on total service and interest cost components | \$ 53 | \$ (42) |
| Effect on other postretirement benefit obligation | \$1,251 | \$(1,030) |

In contrast to the projected benefit obligation, the accumulated benefit obligation represents the actuarial present value of benefits based on employee service and compensation as of a certain date and does not include an assumption about future compensation levels. The accumulated benefit obligation for the qualified defined benefit pension plans was \$11,164 and \$11,486 at December 31, 2003 and 2004, respectively.

The other benefits funded status above of \$(3,463) and \$(6,685) for the years ended December 31, 2003 and 2004, respectively, includes a plan with a positive funded status. For the remaining plans, the unfunded status was \$(3,754) and \$(7,146) for the years ended December 31,

2003 and 2004, respectively, which was comprised of a benefit obligation of \$6,709 and \$10,492 for the years ended December 31, 2003 and 2004, respectively, and a fair value of plan assets of \$2,955 and \$3,346 at December 31, 2003 and 2004, respectively.

| | Pension Benefits | | | Other Benefits | | |
|---|------------------|-----------------|-----------------|----------------|---------------|---------------|
| | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| Components of net periodic benefit cost: | | | | | | |
| Service cost | \$ 177 | \$ 181 | \$ 177 | \$ 51 | \$ 50 | \$ 66 |
| Interest cost | 809 | 742 | 696 | 453 | 478 | 472 |
| Expected return on plan assets | (1,598) | (1,386) | (1,319) | (323) | (315) | (321) |
| Amortization of prior service cost | (50) | (39) | (43) | 164 | 149 | 235 |
| Amortization of actuarial (gain) loss | (145) | (28) | 5 | 34 | 108 | 88 |
| Amortization of transition (asset) obligation | (19) | (5) | — | 75 | 66 | 80 |
| Net periodic benefit cost | \$ (826) | \$ (535) | \$ (484) | \$ 454 | \$ 536 | \$ 620 |
| Curtailment (gain) loss | (21) | — | — | 66 | — | — |
| Settlement (gain) loss | 181 | 49 | — | — | — | — |
| Special termination benefits | — | — | — | 13 | — | — |
| Net periodic benefit cost with adjustments | \$ (666) | \$ (486) | \$ (484) | \$ 533 | \$ 536 | \$ 620 |

Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:

| | | | | | | |
|---|-------|-------|-------|--------|--------|--------|
| Discount rate | 7.25% | 6.75% | 6.25% | 7.25% | 6.75% | 6.00% |
| Expected return on plan assets | 9.00% | 8.50% | 8.50% | 8.25% | 8.00% | 8.00% |
| Rate of compensation increase | 5.10% | 5.10% | 5.10% | 4.80% | 4.80% | 4.80% |
| Health care cost trend rate pre-age 65 | | | | 8.00% | 10.00% | 9.00% |
| Health care cost trend rate post-age 65 | | | | 10.50% | 12.00% | 13.00% |

Curtailments and Settlements

Work force reduction activity in 2002 resulted in a curtailment gain for pensions and curtailment and special termination benefits charges for other postretirement benefits.

In 2002 and 2003, lump-sum distributions from the pension plans exceeded the settlement threshold equal to the sum of the service cost and interest cost components of net periodic pension cost. Of the \$181 and \$49 in settlement charges noted above, \$167 (\$100 after tax) for 2002 and \$47 (\$29 after tax) for 2003 were recognized in operating results because a portion of the settlement charges were capitalized.

Expected Return on Assets Assumption

Our expected return on plan assets at December 31, 2004 of 8.5% reflects our long-term expectation of earnings on assets held in trusts. The expected return on plan assets reflects asset allocations, investments strategy and the views of investment managers and other large pension plan sponsors as well as historical returns. Our asset returns were approximately 22% in 2003 and 15% in 2004. As of December 2004, the 5-year average return on our pension assets was 4.7%, the 10-year average return was 10.8%, and the average return since inception was 10.9%. The postretirement benefits rate is slightly lower than the pension rate due to the use of a taxable postretirement benefits trust.

Plan Assets

BellSouth's weighted-average target allocations and actual asset allocations by asset category are:

| Asset Category | Target | Pension | | Other Benefits | | |
|-------------------|--------|----------------|-------------|----------------|-------------|-------------|
| | | At December 31 | | At December 31 | | |
| | | 2003 | 2004 | 2003 | 2004 | |
| Equity securities | 55-65% | 57% | 58% | 60-80% | 78% | 81% |
| Debt securities | 15-25 | 19 | 20 | 0-5 | 5 | 3 |
| Real estate | 10-15 | 10 | 10 | 5-15 | 4 | 4 |
| Other | 10-15 | 14 | 12 | 15-25 | 13 | 12 |
| Total | | 100% | 100% | 100% | 100% | 100% |

BellSouth has established and maintains separate investment policies for assets held in each employee benefit trust. Our investment strategies are of a long-term nature and are designed to meet the following objectives:

- ensure that funds are available to pay benefits as they become due;
- maximize the trusts total return subject to prudent risk taking; and
- preserve and/or improve the funded status of the trusts over time.

Investment policies and strategies are periodically reviewed to ensure the objectives of the trusts are met considering any changes in benefit plan design, market conditions or other material items.

Derivatives are permitted in the investment portfolio to gain investment exposure as a substitute for physical securities and to manage risk. Derivatives are not permitted for speculative or leverage purposes. Trust investments in BellSouth securities are immaterial.

Cash Flows

CONTRIBUTIONS

Due to the funded status of our pension plans, we do not expect to make contributions to these plans in 2005. Consistent with prior years, we expect to contribute cash to the VEBA trusts to fund other benefit payments. Contributions for 2005 are estimated to be in the range of \$450 to \$500.

ESTIMATED FUTURE BENEFIT PAYMENTS

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid over the next ten years:

| | Pension Benefits | Other Benefits Gross | Medicare Subsidy Receipts |
|-----------------|------------------|----------------------|---------------------------|
| 2005 | \$ 998 | \$ 557 | \$ - |
| 2006 | 1,007 | 598 | (32) |
| 2007 | 1,019 | 640 | (35) |
| 2008 | 1,043 | 679 | (39) |
| 2009 | 1,068 | 715 | (43) |
| Years 2010-2014 | 5,059 | 3,887 | (284) |

Cash-Balance Pension Plan

In July 2003, a Federal district court in Illinois ruled that the benefit formula used in International Business Machines Corporation's (IBM) cash balance pension plan violated the age discrimination provisions of ERISA. The IBM decision conflicts with decisions of at least two other district courts, including most recently a June 2004 decision of the federal district court in Maryland in a case involving ARINC, Inc. Proposed regulations validating the cash balance design have been withdrawn by the Treasury Department while Congress considers legislative action to clarify the legal status of cash balance plans under age discrimination rules. At this time, it is unclear what effect, if any, these court decisions or Congressional action may have on our tax-qualified cash balance pension plans or our financial condition.

Supplemental Executive Retirement Plan

The pension amounts reported above do not include the supplemental executive retirement plan (SERP), which is an unfunded nonqualified plan. The net periodic benefit cost associated with this plan was \$58 in 2002, \$53 in 2003 and \$53 in 2004. Additional information for the plan, which has an accumulated benefit obligation in excess of plan assets, is:

| | December 31 | |
|--|-------------|--------|
| | 2003 | 2004 |
| Project benefit obligation | \$ 473 | \$ 584 |
| Accumulated benefit obligation (net amount recognized pre-tax) | 429 | 515 |
| Fair value of plan assets | 0 | 0 |

Amounts recognized in the consolidated balance sheet at December 31:

| | | |
|---|-------|-------|
| Amount recognized as accrued benefit cost | (293) | (320) |
| Additional minimum liability recognized in other comprehensive income (pre-tax) | (136) | (195) |

DEFINED CONTRIBUTION PLANS

We maintain several contributory savings plans that cover substantially all employees. The BellSouth Retirement Savings Plan and the BellSouth Savings and Security Plan (collectively, the Savings Plans) are tax-qualified defined contribution plans. Assets of the plans are held by two trusts (the Trusts) which, in turn, are part of the BellSouth Master Savings Trust. We match a portion of employees' eligible contributions to the Savings Plans at rates determined annually by the Board of Directors. During 2004, our matching obligation was fulfilled with cash contributions to the Savings Plans, which were recorded as expenses of \$94.

The prior periods presented, 2002 and 2003, were the final two years of our leveraged Employee Stock Ownership Plan (ESOP) arrangement, which had been incorporated into the Savings Plans. In that arrangement, the Trusts used loan proceeds to purchase shares of BellSouth common stock, which were then held in suspense accounts in the Trusts. Our matching obligation was fulfilled with shares released from the suspense accounts semiannually for allocation to participants. During the term of the leveraged ESOP arrangement, we recognized expense using the shares allocated accounting method, which combined the cost of the shares allocated for the period plus interest

incurred, reduced by the dividends used to service the ESOP debt.

| | For the years Ended December 31, | | |
|---|-------------------------------------|-------|------|
| | 2002 | 2003 | 2004 |
| Compensation cost | \$ 38 | \$ 55 | (a) |
| Interest expense | \$ 9 | \$ 2 | |
| Actual interest on ESOP Notes | \$ 12 | \$ 2 | |
| Cash contributions, excluding dividends paid to the trusts | \$ 84 | \$ 86 | |
| Dividends paid to the trusts, used for debt service | \$ 34 | \$ 14 | |
| Shares allocated to participants (millions) | 58.6 | 63.5 | |
| Shares unallocated (millions) | 4.9 | — | |

(a) This table relates only to the leveraged ESOP arrangement which was terminated at the end of 2003.

Note M – Financial Instruments

The recorded amounts of cash and cash equivalents, temporary cash investments, bank loans and commercial paper approximate fair value due to the short-term nature of these instruments. The fair value for BST's long-term debt is estimated based on the closing market prices for each issue at December 31, 2003 and 2004. Fair value estimates for the BellSouth Corporation long-term debt and interest rate swaps are based on quotes from dealers. Since judgment is required to develop the estimates, the estimated amounts presented herein may not be indicative of the amounts that we could realize in a current market exchange.

Following is a summary of financial instruments comparing the fair values to the recorded amounts as of December 31:

| | 2003 | |
|------------------------------------|--------------------|-------------------------|
| | Recorded Amount | Estimated Fair Value |
| Assets: | | |
| Advance to Cingular | \$ 3,812 | \$ 3,812 |
| Cost-method investments | \$ 382 | \$ 382 |
| Debt: | | |
| Issued by BST | \$ 4,713 | \$ 4,950 |
| Issued by BellSouth Corporation | 8,822 | 9,528 |
| Issue by Discontinued Operations | 1,556 | 1,458 |
| Other debt and discounts | (111) | (111) |
| | \$ 14,980 | \$ 15,825 |
| Interest rate swaps, net liability | \$ 75 | \$ 75 |

| | 2004 | |
|------------------------------------|--------------------|-------------------------|
| | Recorded Amount | Estimated Fair Value |
| Assets: | | |
| Advances to Cingular | \$ 4,460 | \$ 4,460 |
| Cost-method investments | \$ 921 | \$ 921 |
| Debt: | | |
| Issued by BST | \$ 4,482 | \$ 4,699 |
| Issued by BellSouth Corporation | 16,178 | 16,999 |
| Other debt and discounts | (77) | (76) |
| | \$ 20,583 | \$ 21,622 |
| Interest rate swaps, net liability | \$ 29 | \$ 29 |

DERIVATIVE FINANCIAL INSTRUMENTS

We are, from time to time, party to interest rate swap agreements in our normal course of business for purposes other than trading. These financial instruments are used to mitigate interest rate risks, although to some extent they expose us to market risks and credit risks. We control the credit risks associated with these instruments through the evaluation and continual monitoring of the creditworthiness of the counterparties. In the event that a counterparty fails to meet the terms of a contract or agreement, our exposure is limited to the current value at that time of the currency rate or interest rate differential, not the full notional or contract amount. We believe that such contracts and agreements have been executed with creditworthy financial institutions. As such, we consider the risk of nonperformance to be remote.

INTEREST RATE SWAPS

We enter into interest rate swap agreements to exchange fixed and variable rate interest payment obligations without the exchange of the underlying principal amounts. We are a party to various interest rate swaps, which qualify for hedge accounting and we believe are 100% effective. The following table summarizes the weighted average rates and notional amounts of these agreements.

| | For the Years Ended December 31, | |
|--|-------------------------------------|----------|
| | 2003 | 2004 |
| Pay fixed/receive variable (cash flow hedge): | | |
| Weighted average notional amount | \$ 1,120 | \$ 1,000 |
| Rate paid | 5.75% | 5.90% |
| Rate received | 1.22% | 1.36% |
| Pay variable/receive fixed (fair value hedge): | | |
| Weighted average notional amount | \$ 125 | \$ 955 |
| Rate paid | 1.09% | 3.25% |
| Rate received | 2.22% | 5.53% |
| | | |
| | | |
| | As of December 31, | |
| | 2003 | 2004 |
| Pay fixed/receive variable (cash flow hedge): | | |
| Notional amount | \$ 1,120 | \$ 1,000 |
| Pay variable/receive fixed (fair value hedge): | | |
| Notional amount | \$ 500 | \$ 1,400 |

The change in fair market value for derivatives designated as hedging the exposure to variable cash flows of a forecasted transaction is recognized as a component of other comprehensive income, net of tax impacts. The change in fair market value for derivatives designated as hedging the exposure to changes in the fair value of a recognized asset or liability, is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. During 2004, the change in value of our fair value hedges was completely offset by the change in the fair value of the hedged items, resulting in no impact to net income. The cash flow swaps mature in 2005 and the fair value swaps mature in 2008-2009.

CONCENTRATIONS OF CREDIT RISK

Financial instruments that potentially subject us to credit risk consist principally of trade accounts receivable. Concentrations of credit risk with respect to these receivables, other than those from long distance carriers, are limited due to the composition of the customer base, which includes a large number of individuals and businesses. Accounts receivable from long distance carriers totaled \$246 at December 31, 2003 and \$296 at December 31, 2004.

Note N – Shareholders’ Equity

COMMON STOCK AUTHORIZED

Our articles of incorporation authorize the issuance of 8,650,000,000 shares of common stock, par value \$1 per share. Our Board of Directors is authorized to create from the unissued common stock one or more series, and, prior to the issuance of any shares in any particular series, to fix the voting powers, preferences, designations, rights, qualifications, limitations or restrictions of such series. The Board has not created any series of common stock.

PREFERRED STOCK AUTHORIZED

Our articles of incorporation authorize 100 million shares of cumulative first preferred stock having a par value of \$1 per share, of which 30 million shares have been reserved and designated series B for possible issuance under a shareholder rights plan. As of December 31, 2004, no preferred shares had been issued. The series A first preferred stock was created for a previous shareholder rights plan which has expired.

SHAREHOLDER RIGHTS PLAN

In 1999, we adopted a shareholder rights plan by declaring a dividend of one right for each share of common stock then outstanding and to be issued thereafter. This plan was amended in 2005. Each right entitles shareholders to buy one one-thousandth of a share of series B first preferred

stock for \$200.00 per share. The rights may be exercised only if a person or group acquires 15% of the common stock of BellSouth without the prior approval of the Board of Directors or announces a tender or exchange offer that would result in ownership of 15% or more of the common stock. If a person or group acquires 15% of BellSouth’s stock without prior Board approval, other shareholders are then allowed to purchase BellSouth common stock, or units of preferred stock with the same voting and economic characteristics, at half price. The rights currently trade with BellSouth common stock and may be redeemed by the Board of Directors for one cent per right until they become exercisable, and thereafter under certain circumstances. The rights expire in December 2009.

SHARES HELD IN TRUST AND TREASURY

Shares held in trust and treasury, at cost, as of December 31 are comprised of the following:

| | 2003 | | 2004 | |
|-----------------------------------|-------------------------|---------|-------------------------|----------------|
| | Shares (in millions) | Amount | Shares (in millions) | Amount |
| Shares held in treasury | 153 | \$5,333 | 163 | \$5,524 |
| Shares held by grantor trusts | 37 | 659 | 26 | 380 |
| Shares held in trust and treasury | 190 | \$5,992 | 189 | \$5,904 |

Treasury Shares

Shares held in trust and treasury include treasury share purchases made by the company primarily in open market transactions under repurchase plans and to satisfy shares issued in connection with employee and director share plans. The following table summarizes activity with respect to share repurchases for the periods presented:

| | Number of shares purchased (in millions) | Aggregate purchase price | Average price per share |
|-------------|---|--------------------------------|-------------------------------|
| 2002 | 22.3 | \$ 591 | \$26.47 |
| 2003 | 35.0 | \$ 858 | \$24.50 |
| 2004 | 5.6 | \$ 146 | \$26.13 |
| Total | 55.4 | \$1,360 | \$24.55 |

We reissued 4.9 million shares in 2002, 4.5 million shares in 2003 and 6.8 million shares in 2004 in connection with various employee and director benefit plans.

Grantor Trusts

We have grantor trusts that are designed to provide funding for the benefits payable under certain nonqualified benefit plans. The trusts are funded with shares of BellSouth stock and marketable securities. The trusts are irrevocable,

and assets contributed to the trusts can only be used to pay such benefits with certain exceptions. These trusts are wholly owned by BellSouth and its subsidiaries and are consolidated in our financial statements. Accordingly, the shares of BellSouth stock held by the trusts have been classified as a reduction to shareholders' equity in the consolidated balance sheets and are not considered in the computation of shares outstanding for financial reporting purposes.

OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income (loss) is comprised of the following components as of December 31:

| | 2003 | 2004 |
|--|-----------------|-----------------|
| Cumulative foreign currency translation adjustment | \$ (444) | \$ (79) |
| Minimum pension liability adjustment | (89) | (129) |
| Net unrealized losses on derivatives | (56) | (12) |
| Net unrealized gains (losses) on securities | 4 | 63 |
| | <u>\$ (585)</u> | <u>\$ (157)</u> |

Accumulated other comprehensive income (loss) for our discontinued operations included in the amounts above was \$(458) as of December 31, 2003 and \$(77) as of December 31, 2004. Total comprehensive income details are presented in the table below.

| | For the Years Ended December 31, | | |
|---|-------------------------------------|------------|------------|
| | 2002 | 2003 | 2004 |
| Total Comprehensive Income | | | |
| Net Income | \$1,323 | \$3,904 | \$4,758 |
| Foreign currency translation (1): | | | |
| Adjustments | (333) | (103) | (43) |
| Sale of foreign entities | (97) | 268 | 408 |
| | <u>(430)</u> | <u>165</u> | <u>365</u> |
| Minimum pension liability adjustment, net of tax of \$5, \$(10), and \$(20) | 9 | (18) | (40) |
| Deferred gains (losses) on derivatives: | | | |
| Deferred gains (losses), net of tax of \$21, \$8, and \$20 | 33 | 14 | 36 |
| Reclassification adjustment for (gains) losses included in net income, net of tax of \$(11), \$(7), and \$0 | (20) | (13) | 8 |
| | <u>13</u> | <u>1</u> | <u>44</u> |
| Unrealized gains (losses) on securities: | | | |
| Unrealized holdings gains (losses), net of tax of \$(14), \$21, and \$33 | (27) | 39 | 57 |

| | For the Years Ended December 31, | | |
|---|-------------------------------------|----------------|----------------|
| | 2002 | 2003 | 2004 |
| Total Comprehensive Income | | | |
| Reclassification adjustment for (gains) losses included in net income, net of tax of \$(6), \$(17), and \$1 | (11) | (32) | 2 |
| | <u>(38)</u> | <u>7</u> | <u>59</u> |
| Total comprehensive income | \$ 877 | \$4,059 | \$5,186 |

(1) Foreign currency translation amounts had no tax impacts in 2002 and 2003. In 2004, the Adjustments are net of tax of \$42. There were no tax impacts on the 2004 sale of foreign entities.

Note O – Stock Compensation Plans

We grant stock-based compensation awards to key employees under several plans. In April 2004, BellSouth shareholders approved the adoption of The BellSouth Corporation Stock and Incentive Compensation Plan (the Stock Plan), which provides for various types of grants, including stock options, restricted stock, and performance-based awards. One share of BellSouth common stock is the underlying security for any award. The number of shares available for future grants under the Stock Plan shall not exceed 80 million and shall be reduced by awards granted and increased by shares tendered in option exercises. Prior to adoption of the Stock Plan, stock options and other stock-based awards were granted under the BellSouth Corporation Stock Plan and the BellSouth Corporation Stock Option Plan. We adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," effective January 1, 2003 using the retroactive restatement method.

Given trends in long-term compensation awards and market conditions, over the last few years we have moved toward granting a mix of restricted stock and performance share units in lieu of stock options. The table below summarizes the types and numbers of awards granted and total compensation cost for each type of award included in our results of operations:

| | Awards Granted | | | Compensation Cost | | |
|-------------------------|-------------------|-------------------|------------------|-------------------|--------------|--------------|
| | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| Stock options | 19,376,330 | 14,374,127 | 369,076 | \$159 | \$114 | \$ 78 |
| Restricted stock | 1,182,000 | 772,250 | 2,264,300 | 12 | 23 | 43 |
| Performance share units | 545,050 | 1,244,700 | 2,699,400 | 5 | 15 | 40 |
| Totals | 21,103,380 | 16,391,077 | 5,332,776 | \$176 | \$152 | \$161 |

Stock-based compensation cost related to stock options for our discontinued operations included in the amounts above was \$14 in 2002, \$11 in 2003, and \$8 in 2004. As of December 31, 2004, there was \$160 of total unrecognized compensation cost related to nonvested awards, which will

be amortized over the remaining applicable vesting period of each award.

STOCK OPTION AWARDS

Stock options granted under the plans entitle recipients to purchase shares of BellSouth common stock within prescribed periods at a price either equal to, or in excess of, the fair market value on the date of grant. Options generally become exercisable at the end of three to five years, have a term of ten years, and provide for accelerated vesting if there is a change in control (as defined in the plans). A summary of option activity under the plans is presented below:

| | 2002 | 2003 | 2004 |
|---|-------------|-------------|--------------------|
| Options outstanding at January 1 | 93,467,300 | 106,328,465 | 112,840,873 |
| Options granted | 19,376,330 | 14,374,127 | 369,076 |
| Options exercised | (3,757,663) | (4,495,974) | (4,832,564) |
| Options forfeited | (2,757,502) | (3,365,745) | (2,613,812) |
| Options outstanding at December 31 | 106,328,465 | 112,840,873 | 105,763,573 |
| Weighted-average option prices per common share: | | | |
| Outstanding at January 1 | \$35.10 | \$35.68 | \$34.52 |
| Granted at fair market value | \$35.98 | \$21.96 | \$27.25 |
| Exercised | \$17.55 | \$17.94 | \$18.54 |
| Forfeited | \$42.44 | \$38.85 | \$36.37 |
| Outstanding at December 31 | \$35.68 | \$34.52 | \$35.19 |
| Weighted-average fair value of options granted at fair market value during the year | | | |
| | \$ 9.39 | \$ 4.20 | \$ 5.66 |
| Options exercisable at December 31 | 64,431,978 | 70,615,852 | 75,627,927 |
| Shares available for grant at December 31 | 48,345,455 | 54,881,922 | 79,886,521 |

The total intrinsic value of options exercised during the years ended December 31, 2002, 2003, and 2004 was \$59, \$40, and \$48, respectively.

The fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions:

| | 2002 | 2003 | 2004 |
|-------------------------|-------|-------|--------------|
| Expected life (years) | 5 | 5 | 5 |
| Dividend yield | 2.19% | 3.87% | 3.67% |
| Expected volatility | 29.0% | 29.0% | 29.0% |
| Risk-free interest rate | 4.03% | 2.65% | 3.46% |

The following table summarizes information about stock options outstanding at December 31, 2004:

| Exercise Price Range | Outstanding | | Exercisable | |
|----------------------|-------------------|--------------------------------------|-------------------|---------------------------------|
| | Options | Weighted Average Life ^(a) | Options | Weighted Average Exercise Price |
| \$4.77 - \$21.28 | 6,525,924 | 0.93 | 6,519,624 | \$20.34 |
| \$21.38 - \$22.19 | 20,723,475 | 5.91 | 7,834,775 | \$22.11 |
| \$22.20 - \$30.91 | 17,886,842 | 4.61 | 12,801,233 | \$30.63 |
| \$31.03 - \$41.00 | 16,367,327 | 6.76 | 5,097,089 | \$38.72 |
| \$41.26 - \$51.78 | <u>44,260,005</u> | 5.21 | <u>43,375,206</u> | \$44.39 |
| \$4.77 - \$51.78 | 105,763,573 | 5.22 | 75,627,927 | \$37.30 |

(a) Weighted-average remaining contractual life in years.

RESTRICTED STOCK AWARDS

Restricted stock awards granted to key employees under the plans are settled by issuing shares of common stock at the vesting date. Generally, the restrictions lapse in full on the third anniversary of the grant date, or on a pro rata basis on each of the first three anniversaries of the grant date. The vesting of restricted stock accelerates if there is a change in control (as defined in the plans). The grant date fair value of the restricted stock is expensed over the period during which the restrictions lapse. The shares represented by restricted stock awards are considered outstanding at the grant date, as the recipients are entitled to dividends and voting rights. The total fair value of restricted stock vested during the years ended December 31, 2002, 2003, and 2004, was \$2, \$13, and \$11, respectively. A summary of restricted stock activity under the plans is presented below:

| | 2002 | 2003 | 2004 |
|---|-----------|-----------|------------------|
| Restricted shares outstanding at January 1 | 1,058,568 | 2,163,250 | 2,267,667 |
| Restricted shares granted | 1,182,000 | 772,250 | 2,264,300 |
| Restricted shares vested | (65,814) | (489,691) | (407,286) |
| Restricted shares forfeited | (11,504) | (178,142) | (149,830) |
| Restricted shares outstanding at December 31 | 2,163,250 | 2,267,667 | 3,974,851 |
| Weighted-average grant date stock price per restricted share: | | | |
| Outstanding at January 1 | \$41.82 | \$34.69 | \$29.91 |
| Granted | \$28.78 | \$22.11 | \$27.60 |
| Vested | \$41.58 | \$36.45 | \$34.28 |
| Forfeited | \$43.08 | \$36.20 | \$27.31 |
| Outstanding at December 31 | \$34.69 | \$29.91 | \$28.24 |

PERFORMANCE SHARE UNIT AWARDS

Performance share units granted to key employees are settled in cash based on an average stock price at the end of the three-year performance period multiplied by the number of units earned. The number of performance share units actually earned by recipients is based on the achievement of certain performance goals as defined by the terms of the awards, and can range from 0% to 150% of the number of units granted. At the end of the performance period, recipients also receive a cash payment equal to the dividends paid on a share of BellSouth stock during the performance period for each performance share unit earned. Vesting accelerates and the performance period is modified if there is a change in control (as defined in the plans). Performance share unit expense is recognized over the performance period based on the stock price at each reporting date and the expected outcome of the performance condition; expense is also recognized for dividends accrued during the performance period. The total cash payments for units vested in 2003 and 2004 were \$0 and \$12, respectively. A summary of performance share unit activity under the plans is presented below:

| | 2002 | 2003 | 2004 |
|---|-----------|-----------|-----------|
| Performance share units: | | | |
| Outstanding at January 1 | 482,450 | 1,017,050 | 1,718,400 |
| Units granted | 545,050 | 1,244,700 | 2,699,400 |
| Units vested | - | (448,200) | (504,815) |
| Units forfeited | (10,450) | (95,150) | (124,203) |
| Outstanding at December 31 | 1,017,050 | 1,718,400 | 3,788,782 |
| Weighted-average grant date stock price per performance share unit: | \$38.68 | \$26.71 | \$28.22 |

Note P – Segment Information

We have three reportable operating segments: (1) Communications Group; (2) Domestic Wireless; and (3) Advertising & Publishing Group.

We own an approximate 40% economic interest in Cingular Wireless, and share joint control of the venture with SBC. We account for the investment under the equity method. For management purposes we evaluate our domestic wireless segment based on our proportionate share of Cingular's results. Accordingly, results for our domestic wireless segment reflect the proportional consolidation of 40% of Cingular's results.

The following table provides information for each operating segment:

| | 2002 | 2003 | 2004 |
|--|----------|----------|----------|
| Communications Group | | | |
| External revenues | \$18,334 | \$18,255 | \$18,289 |
| Intersegment revenues | 155 | 193 | 163 |
| Total segment revenues | 18,489 | 18,448 | 18,452 |
| Depreciation and amortization | 4,161 | 3,771 | 3,593 |
| Segment operating income | 4,916 | 4,843 | 4,628 |
| Interest expense | 498 | 407 | 367 |
| Income taxes | 1,671 | 1,645 | 1,563 |
| Segment net income | \$ 2,751 | \$ 2,829 | \$ 2,727 |
| Segment assets | \$31,925 | \$32,354 | \$32,303 |
| Capital expenditures | \$ 3,337 | \$ 2,824 | \$ 3,018 |
| Domestic Wireless (40% proportional interest) | | | |
| External revenues | \$ 5,961 | \$ 6,193 | \$ 7,774 |
| Intersegment revenues | - | - | - |
| Total segment revenues | 5,961 | 6,193 | 7,774 |
| Depreciation and amortization | 740 | 835 | 1,232 |
| Segment operating income | 1,086 | 915 | 736 |
| Interest expense | 364 | 343 | 360 |
| Net earnings (losses) of equity affiliates | (106) | (129) | (156) |
| Income taxes | 224 | 159 | 67 |
| Segment net income | \$ 357 | \$ 261 | \$ 129 |
| Segment assets | \$ 9,654 | \$10,212 | \$32,895 |
| Capital expenditures | \$ 1,234 | \$ 1,094 | \$ 1,380 |
| Advertising & Publishing Group | | | |
| External revenues | \$ 2,134 | \$ 2,033 | \$ 2,005 |
| Intersegment revenues | 23 | 17 | 14 |
| Total segment revenues | 2,157 | 2,050 | 2,019 |
| Depreciation and amortization | 29 | 26 | 28 |
| Segment operating income | 898 | 973 | 954 |
| Interest expense | 12 | 7 | 8 |
| Income taxes | 340 | 368 | 363 |
| Segment net income | \$ 545 | \$ 600 | \$ 583 |
| Segment assets | \$ 1,703 | \$ 1,002 | \$ 1,057 |
| Capital expenditures | \$ 29 | \$ 28 | \$ 29 |

RECONCILIATION TO CONSOLIDATED FINANCIAL INFORMATION

| | 2002 | 2003 | 2004 |
|--|----------|----------|----------|
| Operating revenues | | | |
| Total reportable segments | \$26,607 | \$26,691 | \$28,245 |
| Cingular proportional consolidation | (5,961) | (6,193) | (7,774) |
| Advertising & Publishing accounting change | (49) | - | - |
| Unbilled receivable adjustment | (163) | - | - |
| Refund of customer late fees in Florida | (108) | - | - |
| South Carolina regulatory settlement | - | - | (50) |
| Corporate, eliminations and other | (119) | (157) | (121) |
| Total consolidated | \$20,207 | \$20,341 | \$20,300 |

| | 2002 | 2003 | 2004 |
|---|-----------------|-----------------|-----------------|
| Operating income | | | |
| Total reportable segments | \$ 6,900 | \$ 6,731 | \$ 6,318 |
| Cingular proportional consolidation | (1,086) | (915) | (736) |
| Unbilled receivable adjustment | (163) | - | - |
| Restructuring charge and asset impairment | (907) | (158) | (29) |
| Pension settlement loss | (167) | (47) | - |
| Refund of customer late fees in Florida | (108) | - | - |
| South Carolina regulatory settlement | - | - | (53) |
| Hurricane-related expenses | - | - | (164) |
| Corporate, eliminations and other | (15) | (54) | (47) |
| Total consolidated | \$ 4,454 | \$ 5,557 | \$ 5,289 |
| Net income | | | |
| Total reportable segments | \$ 3,653 | \$ 3,690 | \$ 3,439 |
| Unbilled receivable adjustment | (101) | - | - |
| Restructuring charge and asset impairment | (584) | (97) | (18) |
| Pension settlement loss | (100) | (29) | - |
| Refund of customer late fees in Florida | (70) | - | - |
| Net gain (loss) on ownership transactions | 857 | - | 295 |
| Net gains (losses) on sale or impairment of securities | (212) | (5) | - |
| Early extinguishment of debt | (22) | (11) | - |
| South Carolina regulatory settlement | - | - | (33) |
| Hurricane-related expenses | - | - | (100) |
| Wireless merger integration costs and fair value adjustment | - | - | (66) |
| Cingular lease accounting adjustments | - | - | (43) |
| Income (loss) from discontinued operations | (867) | 101 | 1,364 |
| Cumulative effect of changes in accounting principle | (1,285) | 315 | - |
| Corporate, eliminations and other | 54 | (60) | (80) |
| Total consolidated | \$ 1,323 | \$ 3,904 | \$ 4,758 |

The Cingular proportional consolidation shown above represents the amount necessary to reconcile the proportional results of Cingular to GAAP results.

Reconciling items are transactions or events that are included in reported consolidated results but are excluded from segment results due to their nonrecurring or nonoperational nature. Net gain (loss) on ownership transactions include: in 2002, a gain from the conversion of our ownership interest in E-Plus; in 2004, a gain on the sale of our operations in Denmark.

Net revenues to external customers are based on the location of the customer. Geographic information as of December 31 is as follows:

| | United States | (1) International | Total |
|-------------------|-----------------|-------------------|-----------------|
| 2002: | | | |
| Revenues | \$20,207 | \$2,233 | \$20,207 |
| Long-lived assets | 39,106 | 2,511 | 41,617 |
| 2003: | | | |
| Revenues | \$20,341 | \$2,294 | \$20,341 |
| Long-lived assets | 38,537 | 2,316 | 40,853 |
| 2004: | | | |
| Revenues | \$20,300 | - | \$20,300 |
| Long-lived assets | 53,797 | - | 53,797 |

(1) Revenues from our Latin America consolidated entities are not included in the revenue line item in the consolidated statements of income due to the discontinued operations presentation. Long-lived assets from our Latin America entities are not included in the long-lived asset line item in the consolidated balance sheets due to the discontinued operations presentation.

Note Q – Commitments and Contingencies

LEASES

We have entered into operating leases for facilities and equipment used in operations. Rental expense under operating leases was \$300 for 2002, \$309 for 2003 and \$232 for 2004. Capital leases currently in effect are not significant. The following table summarizes the approximate future minimum rentals under noncancelable operating leases in effect at December 31, 2004:

| | Minimum Rentals |
|--------------|-----------------|
| 2005 | \$136 |
| 2006 | 106 |
| 2007 | 85 |
| 2008 | 65 |
| 2009 | 47 |
| Thereafter | 252 |
| Total | \$691 |

OUTSIDE PLANT

We currently self-insure all of our outside plant against casualty losses. Such outside plant, located in the nine southeastern states served by BST, is susceptible to damage from severe weather conditions and other perils. The net book value of outside plant was \$8,527 at December 31, 2003 and \$8,530 at December 31, 2004.

GUARANTEES

In most of our sale and divestiture transactions, we indemnify the purchaser for various items including labor and general litigation as well as certain tax matters.

Generally, the terms last one to five years for general and specific indemnities and for the statutory review periods for tax matters. The events or circumstances that would require us to perform under the indemnity are transaction and circumstance specific. We regularly evaluate the probability of having to incur costs associated with these indemnifications and have accrued for expected losses that are probable. In addition, in the normal course of business, we indemnify counterparties in certain agreements. The nature and terms of these indemnities vary by transaction. Historically, we have not incurred significant costs related to performance under these types of indemnities.

PURCHASE OBLIGATIONS

As of December 31, 2004, we have contracts in place to outsource certain services, principally information technology. We also have various commitments with vendors to purchase telecommunications equipment, software and services.

The following table discloses aggregate information about these purchase obligations and the periods in which payments are due:

| | Payments Due by Period | | | | |
|---|------------------------|---------------------|-----------|-----------|------------|
| | Total | Less than 1 year | 2006-2008 | 2009-2011 | After 2011 |
| Unconditional purchase obligations ⁽¹⁾ | \$3,102 | \$723 | \$1,599 | \$780 | - |

(1) The total unconditional purchase obligation includes \$472 related to agreements with Qwest and Accenture that do not stipulate annual minimum purchases. The agreement with Qwest expires in 2010 and the Accenture agreement expires in 2007. Of this amount, \$6 is included in the 2006-2008 column and \$466 is included in the 2009-2011 column above.

REGULATORY MATTERS

AT&T Prepaid Card

In February 2005, the FCC released an order finding that certain prepaid card services of AT&T were telecommunications services. The FCC held that revenue of the services would accordingly be subject to the same universal service fund and switched access charges as were all other similarly situated telecommunications services. AT&T has estimated in a securities filing that it had "saved" approximately \$160 in universal service fund contributions and \$340 in access charges through use of the prepaid card services that were the subject of the FCC decision. We believe that some of the improperly avoided access charges should have been paid to us for the use of our network. While AT&T has not provided information sufficient for us to reasonably estimate access charge payments we may be owed, we believe the charges could result in additional revenue that is material to our results of operations.

South Carolina Price Regulation

Beginning in 1996, we operated under a price regulation plan approved by the South Carolina Public Service Commission (PSC) under existing state laws. In April 1999, however, the South Carolina Supreme Court invalidated this price regulation plan. In July 1999, we elected to be regulated under a new state statute, adopted subsequent to the PSC's approval of the earlier plan. The new statute allows telephone companies in South Carolina to operate under a price regulation without obtaining approval from the PSC. The election became effective during August 1999. The South Carolina Consumer Advocate petitioned the PSC seeking review of the level of our earnings during the 1996-1998 period when we operated under the subsequently invalidated price regulation plan. The PSC dismissed the petition in November 1999 and issued orders confirming the vote in February and June of 2000. In July 2000, the Consumer Advocate appealed the PSC's dismissal of the petition. In January 2004, the court hearing the appeal affirmed the PSC's decision. An appeal of this decision to the South Carolina Supreme Court was filed in March 2004. In April 2004, BellSouth entered into agreements that would completely terminate the litigation. Under the terms of the settlement, BellSouth agreed to, among other things, refund \$50 to its South Carolina end user customers. The refund was recorded in the first quarter 2004 as a reduction to revenue. Refunds were implemented following court approval of the agreements. BellSouth agreed to settle the case to avoid further expensive litigation and uncertainty relating to the outcome of the litigation. The settlement is not an admission of liability.

Section 272 Claim

In December 2004, the FCC partially granted and otherwise dismissed July 2004 claims of AT&T that two optional discount special access tariffs violated various provisions of the Communications Act. The FCC held that one of the tariffs, the Transport Savings Plan, was unlawful under Section 272 of the Act, which governs dealings between BST and our long distance affiliate. That tariff, originally filed in 1999, provided an overlay discount for carriers that accepted its terms, which included a five year commitment, a commitment for a defined amount of spending on special access, and shortfall charges if commitments were not met. The FCC held that the discount structure in the tariff was insufficiently related to cost, and unduly favored a class of carriers (including our long distance affiliate) with relatively lower volume special access spending, and discriminated against carriers with relatively higher volumes. The FCC dismissed the other claims associated with the Transport Savings Plan, and dismissed all claims associated with the second tariff. We do not agree with the FCC's finding, and appealed its decision to the D.C. Circuit Court of Appeals. We do not believe that AT&T has suffered any damages, and we believe that any such claims would be barred in whole or in part by various provisions of law. At this time, however,

neither the likely outcome of the appeal nor AT&T's potential damages claim can be predicted, and therefore no reasonable estimate of loss, if any, can be made.

LEGAL PROCEEDINGS

Employment Claim

On April 29, 2002, five African-American employees filed a putative class action lawsuit, captioned *Gladys Jenkins et al. v. BellSouth Corporation*, against the Company in the United States District Court for the Northern District of Alabama. The complaint alleges that BellSouth discriminated against current and former African-American employees with respect to compensation and promotions in violation of Title VII of the Civil Rights Act of 1964 and 42 USC. Section 1981. Plaintiffs purport to bring the claims on behalf of two classes: a class of all African-American hourly workers employed by BellSouth Telecommunications at any time since April 29, 1998, and a class of all African-American salaried workers employed by BellSouth Telecommunications at any time since April 29, 1998 in management positions at or below Job Grade 59/Level C. The plaintiffs are seeking unspecified amounts of back pay, benefits, punitive damages and attorneys' fees and costs, as well as injunctive relief. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

Securities and ERISA Claims

From August through October 2002, several individual shareholders filed substantially identical class action lawsuits against BellSouth and three of its senior officers alleging violations of the federal securities laws. The cases have been consolidated in the United States District Court for the Northern District of Georgia and are captioned *In re BellSouth Securities Litigation*. Pursuant to the provisions of the Private Securities Litigation Reform Act of 1995, the court has appointed a Lead Plaintiff. The Lead Plaintiff filed a Consolidated and Amended Class Action Complaint in July 2003 on behalf of two putative classes: (1) purchasers of BellSouth stock during the period November 7, 2000 through February 19, 2003 (the class period) for alleged violations of Sections 10(b) and 20 of the Securities Exchange Act of 1934 and (2) participants in BellSouth's Direct Investment Plan during the class period for alleged violations of Sections 11, 12 and 15 of the Securities Act of 1933. Four outside directors were named as additional defendants. The Consolidated and Amended Class Action Complaint alleged that during the class period the Company (1) overstated the unbilled receivables balance of its Advertising & Publishing subsidiary; (2) failed to properly implement SAB 101 with regard to its recognition of Advertising & Publishing revenues; (3) improperly billed competitive local exchange carriers (CLEC) to inflate revenues; (4) failed to take a reserve for refunds that ultimately came due following litigation over late payment charges; and (5) failed to properly write down goodwill of

its Latin American operations. On February 8, 2005, the district court dismissed the Exchange Act claims, except for those relating to the writedown of Latin American goodwill. On that date, the district court also dismissed the Securities Act claims, except for those relating to the writedown of Latin American goodwill, the allegations relating to unbilled receivables of the Company's Advertising & Publishing subsidiary, the implementation of SAB 101 regarding recognition of Advertising & Publishing revenues and alleged improper billing of CLECs. The plaintiffs are seeking an unspecified amount of damages, as well as attorneys' fees and costs. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

In February 2003, a similar complaint was filed in the Superior Court of Fulton County, Georgia on behalf of participants in BellSouth's Direct Investment Plan alleging violations of Section 11 of the Securities Act. Defendants removed this action to federal court pursuant to the provisions of the Securities Litigation Uniform Standards Act of 1998. In July 2003, the federal court issued a ruling that the case should be remanded to Fulton County Superior Court. The Fulton County Superior Court has stayed the case pending resolution of the federal case. The plaintiffs are seeking an unspecified amount of damages, as well as attorneys' fees and costs. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

In September and October 2002, three substantially identical class action lawsuits were filed in the United States District Court for the Northern District of Georgia against BellSouth, its directors, three of its senior officers, and other individuals, alleging violations of the Employee Retirement Income Security Act (ERISA). The cases have been consolidated and on April 21, 2003, a Consolidated Complaint was filed. The plaintiffs, who seek to represent a putative class of participants and beneficiaries of BellSouth's 401(k) plans (the Plan), allege in the Consolidated Complaint that the company and the individual defendants breached their fiduciary duties in violation of ERISA, by among other things, (1) failing to provide accurate information to the Plans' participants and beneficiaries; (2) failing to ensure that the Plans' assets were invested properly; (3) failing to monitor the Plans' fiduciaries; (4) failing to disregard Plan directives that the defendants knew or should have known were imprudent and (5) failing to avoid conflicts of interest by hiring independent fiduciaries to make investment decisions. The plaintiffs are seeking an unspecified amount of damages, injunctive relief, attorneys' fees and costs. Certain underlying factual allegations regarding BellSouth's Advertising & Publishing subsidiary and its former Latin American operation are substantially similar to the allegations in the putative securities class action captioned *In re BellSouth Securities Litigation*, which is described above. At this time, the likely outcome of the cases cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

Antitrust Claims

In October 2002, a number of antitrust class action lawsuits were filed against BellSouth in federal district courts in Atlanta, Georgia and Ft. Lauderdale, Florida. Pursuant to the plaintiff's motion for voluntary dismissal, the court dismissed the cases on March 9, 2004.

In December 2002, a consumer class action alleging antitrust violations of Section 1 of the Sherman Antitrust Act was filed against BellSouth, Verizon, SBC and Qwest, captioned *William Twombly, et al v. Bell Atlantic Corp., et al*, in Federal Court in the Southern District of New York. The complaint alleged that defendants conspired to restrain competition by "agreeing not to compete with one another and otherwise allocating customers and markets to one another." The plaintiffs are seeking an unspecified amount of treble damages and injunctive relief, as well as attorneys' fees and expenses. In October 2003, the district court dismissed the complaint for failure to state a claim and the case is now on appeal.

In June 2004, the U.S. Court of Appeals for the 11th Circuit affirmed the District Court's dismissal of most of the antitrust and state law claims brought by a plaintiff CLEC in a case captioned *Covad Communications Company, et al v. BellSouth Corporation, et al*. The appellate court, however, permitted a price squeeze claim and certain state tort claims to proceed. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

OTHER CLAIMS

We are subject to claims arising in the ordinary course of business involving allegations of personal injury, breach of

contract, anti-competitive conduct, employment law issues, regulatory matters and other actions. BST is also subject to claims attributable to pre-divestiture events, including environmental liabilities, rates and contracts. Certain contingent liabilities for pre-divestiture events are shared with AT&T Corp. While complete assurance cannot be given as to the outcome of these claims, we believe that any financial impact would not be material to our results of operations, financial position or cash flows.

Note R – Subsidiary Financial Information

We have fully and unconditionally guaranteed all of the outstanding debt securities of BellSouth Telecommunications, Inc. (BST), which is a 100% owned subsidiary of BellSouth. In accordance with SEC rules, we are providing the following condensed consolidating financial information. BST is listed separately because it has debt securities, registered with the SEC, that we have guaranteed. The Other column represents all other wholly owned subsidiaries excluding BST and BST subsidiaries. The Adjustments column includes the necessary amounts to eliminate the intercompany balances and transactions between BST, Other and Parent and to consolidate wholly owned subsidiaries to reconcile to our consolidated financial information.

CONDENSED CONSOLIDATING STATEMENTS OF INCOME

| | For the Year Ended December 31, 2002 | | | | |
|--|--------------------------------------|----------|----------|-------------|----------|
| | BST | Other | Parent | Adjustments | Total |
| Total operating revenues | \$17,515 | \$ 5,190 | \$ - | \$(2,498) | \$20,207 |
| Total operating expenses | 15,292 | 4,322 | 114 | (3,975) | 15,753 |
| Operating income | 2,223 | 868 | (114) | 1,477 | 4,454 |
| Interest expense | 617 | 221 | 640 | (382) | 1,066 |
| Net earnings (losses) of equity affiliates | 1,015 | 548 | 3,766 | (4,787) | 542 |
| Other income (expense), net | (46) | 1,540 | 184 | (241) | 1,437 |
| Income from continuing operations before income taxes, discontinued operations, and cumulative effect of changes in accounting principle | 2,575 | 2,735 | 3,226 | (3,169) | 5,367 |
| Provision (benefit) for income taxes | 582 | 966 | (249) | 593 | 1,892 |
| Income from continuing operations before discontinued operations and cumulative effect of changes in accounting principle | 1,993 | 1,769 | 3,475 | (3,762) | 3,475 |
| Income (loss) from discontinued operations, net of tax | - | (867) | (867) | 867 | (867) |
| Cumulative effect of changes in accounting principle | - | (1,285) | (1,285) | 1,285 | (1,285) |
| Net income (losses) | \$ 1,993 | \$ (383) | \$ 1,323 | \$(1,610) | \$ 1,323 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED

DOLLARS ARE IN MILLIONS, EXCEPT PER SHARE AMOUNTS AND AS OTHERWISE INDICATED

BELLSOUTH CORPORATION

| | For the Year Ended December 31, 2003 | | | | |
|---|--------------------------------------|----------|----------|-------------|----------|
| | BST | Other | Parent | Adjustments | Total |
| Total operating revenues | \$17,400 | \$ 5,695 | \$ - | \$(2,754) | \$20,341 |
| Total operating expenses | 14,838 | 4,169 | 25 | (4,248) | 14,784 |
| Operating income | 2,562 | 1,526 | (25) | 1,494 | 5,557 |
| Interest expense | 537 | 73 | 580 | (243) | 947 |
| Net earnings (losses) of equity affiliates | 1,067 | 498 | 3,799 | (4,912) | 452 |
| Other income (expense), net | (10) | 275 | 111 | (14) | 362 |
| Income before income taxes, discontinued operations, and cumulative effect of changes in accounting principle | 3,082 | 2,226 | 3,305 | (3,189) | 5,424 |
| Provision (benefit) for income taxes | 730 | 770 | (183) | 619 | 1,936 |
| Income before discontinued operations and cumulative effect of changes in accounting principle | 2,352 | 1,456 | 3,488 | (3,808) | 3,488 |
| Income (loss) from discontinued operations, net of tax | - | 101 | 101 | (101) | 101 |
| Cumulative effect of changes in accounting principle | 816 | (501) | 315 | (315) | 315 |
| Net income (losses) | \$ 3,168 | \$ 1,056 | \$ 3,904 | \$(4,224) | \$ 3,904 |

| | For the Year Ended December 31, 2004 | | | | |
|--|--------------------------------------|---------|---------|-------------|----------|
| | BST | Other | Parent | Adjustments | Total |
| Total operating revenues | \$16,884 | \$6,452 | \$ - | \$(3,036) | \$20,300 |
| Total operating expenses | 14,993 | 4,627 | 11 | (4,620) | 15,011 |
| Operating income | 1,891 | 1,825 | (11) | 1,584 | 5,289 |
| Interest expense | 529 | 26 | 607 | (246) | 916 |
| Net earnings (losses) of equity affiliates | 1,125 | 80 | 3,700 | (4,837) | 68 |
| Other income (expense), net | 12 | 667 | 114 | (48) | 745 |
| Income before income taxes and discontinued operations | 2,499 | 2,546 | 3,196 | (3,055) | 5,186 |
| Provision (benefit) for income taxes | 484 | 858 | (198) | 648 | 1,792 |
| Income before discontinued operations | 2,015 | 1,688 | 3,394 | (3,703) | 3,394 |
| Income (loss) from discontinued operations, net of tax | - | 1,364 | 1,364 | (1,364) | 1,364 |
| Net income (losses) | \$ 2,015 | \$3,052 | \$4,758 | \$(5,067) | \$ 4,758 |

CONDENSED CONSOLIDATING BALANCE SHEETS

| | December 31, 2003 | | | | | December 31, 2004 | | | | |
|---|-------------------|-----------------|-----------------|-------------------|-----------------|-------------------|-----------------|-----------------|-------------------|-----------------|
| | BST | Other | Parent | Adjustments | Total | BST | Other | Parent | Adjustments | Total |
| ASSETS | | | | | | | | | | |
| Current assets: | | | | | | | | | | |
| Cash and cash equivalents | \$ 5 | \$ 1,190 | \$ 1,618 | \$ 134 | \$ 2,947 | \$ 7 | \$ 405 | \$ 265 | \$ 3 | \$ 680 |
| Short-term investments | – | – | 1,609 | – | 1,609 | – | – | 16 | – | 16 |
| Accounts receivable, net | 68 | 1,201 | 3,146 | (1,545) | 2,870 | 75 | 1,005 | 2,918 | (1,439) | 2,559 |
| Other current assets | 393 | 773 | 139 | 118 | 1,423 | 528 | 4,418 | 144 | (3,714) | 1,376 |
| Assets of discontinued operations | – | – | – | – | – | – | 1,068 | – | – | 1,068 |
| Total current assets | 466 | 3,164 | 6,512 | (1,293) | 8,849 | 610 | 6,896 | 3,343 | (5,150) | 5,699 |
| Investments and advances to Cingular | 3,464 | 8,162 | 891 | (4,838) | 7,679 | 3,515 | 21,686 | 1,539 | (3,969) | 22,771 |
| Property, plant and equipment, net | 21,818 | 1,947 | 4 | 38 | 23,807 | 21,339 | 665 | 3 | 32 | 22,039 |
| Deferred charges and other assets | 5,029 | 287 | 21,790 | (20,129) | 6,977 | 5,267 | 293 | 39,305 | (37,465) | 7,400 |
| Intangible assets, net | 1,036 | 1,211 | 5 | 138 | 2,390 | 1,072 | 391 | 9 | 115 | 1,587 |
| Total assets | \$31,813 | \$14,771 | \$29,202 | \$(26,084) | \$49,702 | \$31,803 | \$29,931 | \$44,199 | \$(46,437) | \$59,496 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | | | | |
| Current liabilities: | | | | | | | | | | |
| Debt maturing within one year | \$ 2,454 | \$ 920 | \$ 2,470 | \$ (2,353) | \$ 3,491 | \$ 3,016 | \$ 15 | \$ 4,248 | \$ (1,804) | \$ 5,475 |
| Other current liabilities | 3,942 | 1,724 | 916 | (1,615) | 4,967 | 3,941 | 1,165 | 4,905 | (5,946) | 4,065 |
| Liabilities of discontinued operations | – | – | – | – | – | – | 830 | – | – | 830 |
| Total current liabilities | 6,396 | 2,644 | 3,386 | (3,968) | 8,458 | 6,957 | 2,010 | 9,153 | (7,750) | 10,370 |
| Long-term debt | 4,970 | 845 | 6,301 | (627) | 11,489 | 3,704 | 107 | 11,874 | (577) | 15,108 |
| Noncurrent liabilities: | | | | | | | | | | |
| Deferred income taxes | 4,408 | 1,519 | (751) | 173 | 5,349 | 5,063 | 1,735 | (490) | 184 | 6,492 |
| Other noncurrent liabilities | 2,991 | 1,074 | 554 | 75 | 4,694 | 2,974 | 791 | 596 | 99 | 4,460 |
| Total noncurrent liabilities | 7,399 | 2,593 | (197) | 248 | 10,043 | 8,037 | 2,526 | 106 | 283 | 10,952 |
| Shareholders' equity | 13,048 | 8,689 | 19,712 | (21,737) | 19,712 | 13,105 | 25,288 | 23,066 | (38,393) | 23,066 |
| Total liabilities and shareholders' equity | \$31,813 | \$14,771 | \$29,202 | \$(26,084) | \$49,702 | \$31,803 | \$29,931 | \$44,199 | \$(46,437) | \$59,496 |

CONDENSED CONSOLIDATING CASH FLOW STATEMENTS

| | For the Year Ended December 31, 2002 | | | | |
|---|--------------------------------------|-----------------|-------------------|-----------------|-------------------|
| | BST | Other | Parent | Adjustments | Total |
| Cash flows from continuing operations: | | | | | |
| Cash flows from operating activities | \$ 6,174 | \$ 828 | \$ 3,434 | \$(2,724) | \$ 7,712 |
| Cash flows from investing activities | (3,166) | (223) | 1,019 | 458 | (1,912) |
| Cash flows from financing activities | (3,008) | (525) | (3,271) | 2,361 | (4,443) |
| Cash flows from discontinued operations | – | 72 | – | – | 72 |
| Net increase (decrease) in cash | \$ – | \$ 152 | \$ 1,182 | \$ 95 | \$ 1,429 |
| For the Year Ended December 31, 2003 | | | | | |
| Cash flows from continuing operations: | | | | | |
| Cash flows from operating activities | \$ 7,654 | \$ 1,637 | \$ 4,038 | \$(5,446) | \$ 7,883 |
| Cash flows from investing activities | (2,918) | (545) | (777) | 1,534 | (2,706) |
| Cash flows from financing activities | (4,731) | (1,082) | (2,825) | 3,959 | (4,679) |
| Cash flows from discontinued operations | – | 428 | – | – | 428 |
| Net increase (decrease) in cash | \$ 5 | \$ 438 | \$ 436 | \$ 47 | \$ 926 |
| For the Year Ended December 31, 2004 | | | | | |
| Cash flows from continuing operations: | | | | | |
| Cash flows from operating activities | \$ 5,456 | \$ 1,347 | \$ 3,210 | \$(3,212) | \$ 6,801 |
| Cash flows from investing activities | (2,971) | (14,363) | (13,751) | 17,525 | (13,560) |
| Cash flows from financing activities | (2,483) | 12,810 | 9,188 | (14,444) | 5,071 |
| Cash flows from discontinued operations | – | (579) | – | – | (579) |
| Net increase (decrease) in cash | \$ 2 | \$ (785) | \$ (1,353) | \$ (131) | \$ (2,267) |

Note 5 – Quarterly Financial Information (Unaudited)

In the following summary of quarterly financial information, all adjustments necessary for a fair presentation of each period were included.

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Total |
|--|------------------|-------------------|------------------|-------------------|-----------------|
| 2003 | | | | | |
| Operating Revenues | \$5,014 | \$5,079 | \$5,141 | \$5,107 | \$20,341 |
| Operating Income | 1,351 | 1,354 | 1,453 | 1,399 | 5,557 |
| Provision for Income Taxes | 490 | 511 | 486 | 449 | 1,936 |
| Income Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | 850 | 908 | 894 | 836 | 3,488 |
| Income Before Cumulative Effect of Changes in Accounting Principle | 915 | 951 | 936 | 787 | 3,589 |
| Net Income (Loss) | 1,230 | 951 | 936 | 787 | 3,904 |
| Basic Earnings Per Share ^(a) : | | | | | |
| Income Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | \$ 0.46 | \$ 0.49 | \$ 0.48 | \$ 0.46 | \$ 1.89 |
| Income Before Cumulative Effect of Changes in Accounting Principle | \$ 0.49 | \$ 0.51 | \$ 0.51 | \$ 0.43 | \$ 1.94 |
| Net Income (Loss) | \$ 0.66 | \$ 0.51 | \$ 0.51 | \$ 0.43 | \$ 2.11 |
| Diluted Earnings Per Share ^(a) : | | | | | |
| Income Before Discontinued Operations and Cumulative Effect of Changes in Accounting Principle | \$ 0.46 | \$ 0.49 | \$ 0.48 | \$ 0.45 | \$ 1.88 |
| Income Before Cumulative Effect of Changes in Accounting Principle | \$ 0.49 | \$ 0.51 | \$ 0.51 | \$ 0.43 | \$ 1.94 |
| Net Income (Loss) | \$ 0.66 | \$ 0.51 | \$ 0.51 | \$ 0.43 | \$ 2.11 |
| Total comprehensive income | \$1,111 | \$1,031 | \$ 944 | \$ 973 | \$ 4,059 |
| 2004 | | | | | |
| Operating Revenues | \$4,976 | \$5,083 | \$5,095 | \$5,146 | \$20,300 |
| Operating Income | 1,358 | 1,442 | 1,401 | 1,088 | 5,289 |
| Provision for Income Taxes | 623 | 516 | 465 | 188 | 1,792 |
| Income Before Discontinued Operations and Cumulative Effect of Change in Accounting Principle | 1,150 | 939 | 852 | 453 | 3,394 |
| Income Before Cumulative Effect of Change in Accounting Principle | 1,599 | 996 | 799 | 1,364 | 4,758 |
| Net Income (Loss) | 1,599 | 996 | 799 | 1,364 | 4,758 |
| Basic Earnings Per Share ^(a) : | | | | | |
| Income Before Discontinued Operations and Cumulative Effect of Change in Accounting Principle | \$ 0.63 | \$ 0.51 | \$ 0.47 | \$ 0.25 | \$ 1.85 |
| Income Before Cumulative Effect of Change in Accounting Principle | \$ 0.87 | \$ 0.54 | \$ 0.44 | \$ 0.74 | \$ 2.60 |
| Net Income (Loss) | \$ 0.87 | \$ 0.54 | \$ 0.44 | \$ 0.74 | \$ 2.60 |
| Diluted Earnings Per Share ^(a) : | | | | | |
| Income Before Discontinued Operations and Cumulative Effect of Change in Accounting Principle | \$ 0.63 | \$ 0.51 | \$ 0.46 | \$ 0.25 | \$ 1.85 |
| Income Before Cumulative Effect of Change in Accounting Principle | \$ 0.87 | \$ 0.54 | \$ 0.44 | \$ 0.74 | \$ 2.59 |
| Net Income (Loss) | \$ 0.87 | \$ 0.54 | \$ 0.44 | \$ 0.74 | \$ 2.59 |
| Total comprehensive income | \$1,713 | \$1,007 | \$ 789 | \$1,677 | \$ 5,186 |

(a) Due to rounding, the sum of quarterly EPS amounts may not agree to year-to-date EPS amounts.

The quarters shown were affected by the items listed below. These items are specific to net income.

2003

- We recorded losses related to our workforce reduction of approximately 3,400 positions, which reduced net income by \$74, or \$0.04 per share, in the first quarter; by \$12, or \$0.01 per share, in the second quarter; and by \$10, or \$0.01 per share in the fourth quarter.
- Third quarter includes a charge for an asset impairment, which reduced net income by \$32, or \$0.02 per share.
- We recorded income (losses) related to our Discontinued Operations which impacted net income by \$65, or \$0.03 per share, in the first quarter; by \$43,

or \$0.02 per share, in the second quarter; by \$42, or \$0.02 per share, in the third quarter; and by \$(49), or \$(0.03) per share, in the fourth quarter.

2004

- First quarter includes a gain related to the sale of our operations in Denmark, which increased net income by \$295, or \$0.16 per share.
- First quarter also includes a charge for a settlement with the South Carolina Consumer Advocate, which decreased net income by \$33, or 0.02 per share.
- We recorded losses related to service repairs in the wireline business due to Hurricanes Charley, Frances,

Ivan and Jeanne, which reduced net income by \$23, or \$0.01 per share in the third quarter and by \$77, or \$0.04 per share, in the fourth quarter.

- Our equity in earnings from Cingular included losses related to wireless merger integration costs for the Cingular/AT&T Wireless merger, a fair value adjustment for the sale of Cingular Interactive, and lease accounting adjustments, which reduced our net income by \$17, or \$0.01 per share, in the third quarter and by \$92, or \$0.05 per share in the fourth quarter.
- Fourth quarter also includes charges related to severance and lease termination payments, which reduced net income by \$18, or \$0.01 per share.
- We recorded income (losses) related to our Discontinued Operations which impacted net income by \$449, or \$0.24 per share, in the first quarter; by \$57, or \$0.03 per share, in the second quarter; by \$(53), or \$(0.03) per share, in the third quarter; and by \$911, or \$0.50 per share, in the fourth quarter.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

BELLSOUTH CORPORATION

To the Shareholders BellSouth Corporation:

We have completed an integrated audit of BellSouth Corporation's 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits and the report of other auditors, are presented below.

Consolidated financial statements

In our opinion, based on our audits and the report of other auditors, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and shareholders' equity and comprehensive income present fairly, in all material respects, the financial position of BellSouth Corporation and its subsidiaries ("BellSouth") at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Cingular Wireless, LLC ("Cingular"), an equity method investee. BellSouth's consolidated financial statements include an investment of \$18,311 million and \$3,867 million as of December 31, 2004 and 2003, respectively and equity method income of \$24 million, \$408 million and \$497 million, respectively, for each of the three years in the period ended December 31, 2004. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Cingular, is based solely on the report of the other auditors. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

As discussed in Note C to the consolidated financial statements, in 2003, BellSouth adopted Financial Accounting Standards Board Statement No. 143, changing its method of accounting for asset retirement costs and changed its accounting for publication revenues from the publication and delivery method to the deferral method as of January 1, 2003. As discussed in Note G to the consolidated financial statements, BellSouth adopted Financial Accounting Standards Board Statement No. 142 and changed its method of accounting for goodwill and other intangible assets as of January 1, 2002.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying *Report of Management on Internal Control Over Financial Reporting*, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Atlanta, Georgia
March 4, 2005

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
BELLSOUTH CORPORATION

Board of Directors and Shareowners
Cingular Wireless Corporation, Manager of
Cingular Wireless LLC

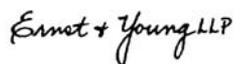
We have audited the consolidated balance sheets of Cingular Wireless LLC as of December 31, 2003 and 2004, and the related consolidated statements of income, changes in members' capital, comprehensive income and cash flows for each of the three years in the period ended December 31, 2004 (not presented separately herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of Omnipoint Facilities Network II, LLC (Omnipoint), a wholly owned subsidiary of GSM Facilities, LLC (an equity investee in which the Company has an approximate 60% interest at December 31, 2004), have been audited by other auditors whose report has been furnished to us; insofar as our opinion on the consolidated financial statements relates to the 2003 and 2004 amounts included for Omnipoint, it is based solely on their report. In the consolidated financial statements, the Company's indirect investment in Omnipoint is stated at \$770 million and \$880 million, respectively, at December 31, 2003 and 2004, and the Company's equity in net losses of Omnipoint is stated at \$100 million and \$135 million, for the years then ended.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cingular Wireless LLC and subsidiaries at December 31, 2003 and 2004 and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with U.S. generally accepted accounting principles.

As described in Note 5 to the consolidated financial statements, in 2002 the Company adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*.

As described in Note 2 to the consolidated financial statements, the consolidated balance sheet as of December 31, 2003 and the related consolidated statements of income, changes in members' capital, comprehensive income and cash flows for each of the years ended December 31, 2002 and 2003 have been restated.



Atlanta, Georgia
March 4, 2005

**REPORT OF MANAGEMENT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING**

BELLSOUTH CORPORATION

The management of BellSouth Corporation is responsible for establishing and maintaining adequate internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) or 15d-15(f) adopted under the Securities Exchange Act of 1934.

BellSouth's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, BellSouth's management used the criteria set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on its assessment, management concluded that BellSouth maintained effective internal control over financial reporting as of December 31, 2004.

PricewaterhouseCoopers LLP, BellSouth's independent registered public accounting firm, has audited our management's assessment of the effectiveness of the company's internal control over financial reporting as of December 31, 2004, as stated in their report which appears on page 92.

March 4, 2005

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Shareholder Information

Corporate Headquarters

BellSouth Corporation
1155 Peachtree Street, N.E.
Atlanta, GA 30309-3610
404-249-2000

Notice of Annual Meeting

The 2005 Annual Meeting of BellSouth Shareholders will be held at 9:00 a.m. EDT Monday, April 25, 2005, at the Cobb Galleria Centre Ballroom, Two Galleria Parkway, Atlanta, GA.

Stock Trading Information

BellSouth stock is listed on the New York Stock Exchange and on the London, Frankfurt, Amsterdam and Swiss exchanges.

Ticker symbol (NYSE)

BLS

Newspaper Stock Listing

BellSouth or BellSo

Services for Registered Shareholders

Mellon Investor Services, the transfer agent for BellSouth Shareholder Services, provides essential services such as record keeping, stock transfer, dividend payment and a toll-free shareholder services line. Registered shareholders who have questions or need assistance with their accounts should contact BellSouth Shareholder Services.

Services available at no cost to you:

- Automatic direct deposit of cash dividends to your bank account;
- Automatic reinvestment of dividends in BellSouth common stock; and
- Safekeeping of stock certificates by the agent.

Internet Delivery of Proxy Material

Registered BellSouth shareholders can elect to receive notice of all future proxy materials over the Internet by enrolling in MLinkSM. MLink is a service offered by our transfer agent that allows you convenient and easy online access to all of your shareholder communications. If you enroll in MLink, your proxy materials, including the Annual Report and Proxy Statement, will be made available to you via an email notification with a hyperlink to the voting site containing the information. You can obtain more information and enroll in MLink by accessing your registered shareholder account at www.melloninvestor.com/isd.

Direct Investment Plan

The BellSouth Direct Investment Plan provides a comprehensive package of services designed to make investing in BellSouth stock easy, convenient and more affordable. There is no charge for existing shareholders to enroll. If you are not a BellSouth shareholder, you can join the Plan for an initial minimum investment of \$500, which includes a \$10 enrollment fee.

To obtain a prospectus and enrollment form, go to www.bellsouth.com/investor and click on shareholder services or call toll-free 888-266-6778.

Investor Information and Publications

Access www.bellsouth.com/investor for information about BellSouth. Inquiries from individual or institutional investors, security analysts and other members of the professional financial community should be directed to:

BellSouth Investor Relations
Room 14B06
1155 Peachtree Street, N.E.
Atlanta, GA 30309-3610
email: investor@bellsouth.com

The Company's Annual Report and Forms 10-K and 10-Q are available on the Internet at BellSouth's investor home page, www.bellsouth.com/investor or without charge by writing to:

Corporate Secretary
BellSouth Corporation
Suite 19A01
1155 Peachtree Street, N.E.
Atlanta, GA 30309-3610

Contact BellSouth Shareholder Services

By Phone

Toll-Free 800-631-6001
Outside the U.S. Collect 201-329-8663
Fax 201-329-8543

Representatives are available 9:00 a.m. to 7:00 p.m. E.T. weekdays. Automated system available 24 hours/7 days a week.



By Internet

Visit www.melloninvestor.com/isd for secure online access to your registered account.

Visit www.bellsouth.com/investor for information about BellSouth.



By Mail

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