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The Telephone in America

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The 92nd Annual Meeting of Shareholders will be held at 2 p.m. on Wednesday, April 20, 1977, in the H. Roe Bartle Exposition Hall of the Convention Center, 301 West 13 Street, Kansas City, Mo.

The consolidated financial results reported herein are for American Telephone and Telegraph Company and its subsidiaries.

If you wish further information, the following are available upon request:

–1976 Statistical Report, with additional data on our operations.

–Form 10-K, AT&T's annual report to the Securities and Exchange Commission.

–Annual reports of the Bell Telephone operating companies and of the Western Electric Company, manufacturing and supply unit of the Bell System.

The AT&T Annual Report is also available in braille and on talking records.

Address requests to the Secretary, American Telephone and Telegraph Company, 195 Broadway, New York, N.Y. 10007. The telephone number of the company is (212) 393-9800.

Information on AT&T securities, dividends or interest payments and the Dividend Reinvestment and Stock Purchase Plan can be obtained by calling without charge 800-631-3311 or, from New Jersey, 800-352-4900. Mailed inquiries should be addressed to AT&T Co., P.O. Box 2018, New Brunswick, N.J. 08903.

The company maintains stock transfer offices at 180 Fulton St., New York, N.Y. 10007; at 444 Hoes Lane, Piscataway, N.J. 08854, both of which can be reached through the toll free telephone numbers above, and at:
185 Franklin St., Boston, Mass. 02107, (617) 743-2775;
225 West Randolph St., Chicago, Ill. 60606, (312) 727-3000;
140 New Montgomery St., San Francisco, Calif. 94105, (415) 542-3801.



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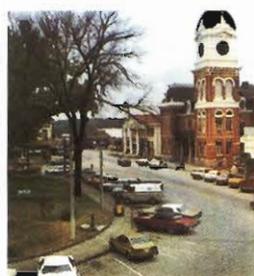
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The Telephone in America. Over the course of a hundred years the telephone—almost without our noticing it—has become an integral part of our society, a pervasive factor in our daily lives. Throughout America—in big cities, in country towns, in big business and small—the telephone has become an indispensable, if taken-for-granted, element in the way we work and the way we live. *Photographs by Jay Maisel.*

Covington, Georgia



Report of the Chairman of the Board

Nineteen seventy-six was the telephone's centennial year. It is gratifying to report that in important ways it was the Bell System's best year as well.

It was our best in terms of the quality of our service.

It was our best in terms of the efficiency with which we provided that service.

And it was our best in earnings.

I trust share owners will agree that there could be no more apt celebration of the telephone's invention than this demonstration that—after a hundred years—telephone people still strive for new levels of achievement.

Our formal observation of the telephone's centennial took place in Boston in March. As part of that observation the Bell System and the Massachusetts Institute of Technology jointly sponsored a symposium to explore the impact of Bell's invention on society.

The Telephone in America

Oddly, until recently not much study has been devoted to appraising the impact of the telephone on the way we live. For the most part it appears to have been taken for granted that in countless large as well as subtle ways the telephone has changed our lives. Clearly contemporary America would be unimaginable without it.

That this is so is attributable in large measure to the aims of the nation's telecommunications policy and their unique match to the basic values of our democracy (see "...To All the People of the United States..." page 21). In pursuit of those aims, we have sought to extend to every American the freedom to communicate with whomever he wants, whenever he wants and wherever he may be. In countries with different values, that freedom is reserved to a political or economic elite. In authoritarian countries, one-way communications commands a higher priority.

Here in the United States the instrument of our freedom to communicate is the nationwide telephone network. That network has been administered under policies aimed at encouraging its extension to the remotest parts of the nation, bringing its services within the reach of as many people as possible.

Some people profess to see irony in the fact that the policies that have guided the telephone industry over the years should—at the very apex of its achievement—be subject to their severest challenge. Troubling as they are, current contentions over the way our industry should be organized and regulated are nonetheless compelling evidence of its still undiminished vitality.

In previous reports, I have sought to make it plain to share owners that the Bell System's concern over the

selective competition Federal regulators are sponsoring in our industry stems not from any lack of confidence in our own ability to compete effectively and profitably but rather from a strong and sincere conviction that this policy will hurt service, add to its cost and restrict its availability.

In 1976 we carried our concern on this matter to the Congress of the United States. Only there, we believe, can we get the authoritative definition of the public interest our industry needs to guide its efforts in its second century. Legislation now before Congress will, we hope, provide the vehicle for that determination.

Until that time comes, however, we propose to speak out no less forcefully than heretofore for the principles that have guided our industry's development up till now. We do so because we believe that further compromise of those principles not only risks undermining what has been done in our first century but what can be done in our second. We are still a long way from achieving the universality of communications in our society that technology can accomplish. But to fulfill that potentiality we shall need regulatory policies no less forward-looking than technology itself. It is our hope, therefore, that by sharing our convictions—and testing them against the convictions of others—we might in time contribute to the development of public policies that will provide a sound basis for the further development of the telephone in America.

Our Second Century

What most occupied us in 1976, then, was not our first century but our second. Indeed, I anticipate that what in retrospect will most characterize the year is not so much the respects we paid to history but the initiatives we took to strengthen our capability to serve the future.

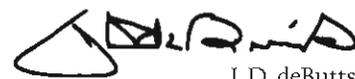
Certainly that is true of the new facilities we added to the telephone network in the course of the year.

And it is true as well of the advanced technology we readied to help us meet the future's service needs.

But it is no less true of the strengthening of our planning capabilities and the improved assurance it provides us that in an uncertain world we shall have the financial strength on which our strength to serve depends.

We have a still greater strength, however—the men and women of the Bell System. They have an unmatched array of skills and those skills are enhanced by teamwork and inspired by common purpose. Theirs is a proud heritage—and a great future.

February 8, 1977



J.D. deButts

RESULTS IN BRIEF	1976	1975	1974	1973	1972
Earnings per Common Share	\$ 6.05	\$ 5.13	\$ 5.28	\$ 5.07*	\$ 4.34
Based on average shares outstanding (000)	595,184	567,915	557,815	554,258	549,501
Dividends declared per share	\$ 3.80	\$ 3.40	\$ 3.24	\$ 2.87	\$ 2.70
Revenues	<i>Millions</i>	<i>Millions</i>	<i>Millions</i>	<i>Millions</i>	<i>Millions</i>
Local service	\$15,609	\$14,028	\$12,813	\$11,419	\$10,363
Toll service	16,065	13,925	12,461	11,278	9,771
Other (including other income)	<u>1,487</u>	<u>1,319</u>	<u>1,439</u>	<u>1,339</u>	<u>1,218</u>
	<u>33,161</u>	<u>29,272</u>	<u>26,713</u>	<u>24,036</u>	<u>21,352</u>
Expenses					
Operating	21,021	18,757	16,716	15,000	13,518
Income taxes on operations	2,933	2,390	2,313	2,138	1,824
Other taxes on operations	2,977	2,681	2,454	2,212	1,983
Interest	<u>2,401</u>	<u>2,296</u>	<u>2,056</u>	<u>1,734</u>	<u>1,495</u>
	<u>29,332</u>	<u>26,124</u>	<u>23,539</u>	<u>21,084</u>	<u>18,820</u>
Net income	3,829	3,148	3,174	2,998*	2,532
Preferred dividend requirements	<u>227</u>	<u>232</u>	<u>232</u>	<u>186</u>	<u>146</u>
Income applicable to common shares	<u>\$ 3,602</u>	<u>\$ 2,916</u>	<u>\$ 2,942</u>	<u>\$ 2,812</u>	<u>\$ 2,386</u>
Telephones in service at end of year	123.1	118.5	114.5	110.3	105.3
Average toll messages per business day	35.2	32.7	31.1	29.0	26.1

*Includes extraordinary amount of \$.08 per common share (\$46 million of income) relating to net gain on sale of Communications Satellite Corporation common stock.

Financial Review

MANAGEMENT'S ANALYSIS OF RESULTS IN BRIEF

Earnings per common share rose 92 cents in 1976, as income applicable to common shares increased \$686 million and average common shares outstanding increased 27 million. Total revenues (including other income) were up 13.3 per cent while total expenses (including taxes and interest) rose 12.3 per cent. Earnings per common share for 1975 decreased 15 cents from 1974 and income applicable to common shares decreased \$26 million. These decreases were principally the result of a \$208 million reduction in Western Electric's net income. Average common shares outstanding rose in 1975 by 10 million.

Revenues from local and toll services and other income increased \$3.9 billion in 1976 and \$2.6 billion in 1975 for several reasons: more telephones in service and growth in calling volumes in both years; higher intrastate rates, \$1.3 billion in 1976 and \$960 million in 1975; higher interstate long distance rates that were authorized by the FCC, \$240 million in 1976 and \$330 million in 1975; and increased sales of directory advertising in both years. Western Electric's net income increased by \$110 million in 1976 compared to a \$208 million decrease in 1975, reflecting the turnaround in Western Electric's operations in 1976 following the recession of 1975.

Operating expenses rose in 1976 by \$2.3 billion and \$2.0 billion in 1975. Principal reasons for these increases were higher wages, fringe benefits, depreciation and increased business volumes. Higher wages (including cost of living adjustments) and salaries accounted for about \$790 million of the increase in 1976 and \$840 million in 1975. About \$375 million in 1976 was attributable to higher pension accruals caused by higher wages, higher pension accrual rates and improvements in other fringe benefits; the same costs rose \$400 million in 1975. Depreciation expense increased \$396 million in 1976 and \$398 million in 1975, reflecting larger plant investment and higher depreciation rates authorized by the FCC.

Income taxes on operations rose \$543 million in 1976 and \$77 million in 1975, reflecting higher taxable income.

Other taxes on operations increased \$296 million in 1976 and \$227 million in 1975, largely as a result of a \$147 million increase in 1976 and \$124 million in 1975 in property taxes applicable to an expanding base of taxable plant. Gross receipts taxes increased \$90 million in 1976 and \$64 million in 1975. Social Security taxes rose \$54 million in 1976 and \$31 million in 1975, mainly because of statutory increases in the taxable wage base.

Interest expense increased \$105 million or 4.6 per cent in 1976 and \$240 million or 11.7 per cent in 1975, primarily because of debt capital obtained by the companies to help finance their construction programs. The increase in 1976 was lower than in 1975 principally because of lower prevailing interest rates. The average cost of debt issued in 1976 was 8.48 per cent compared to 8.88 per cent in 1975.

Earnings improved significantly in 1976.

Revenues increased 13.3 per cent and income applicable to AT&T common shares 23.6 per cent. Earnings per share for the year were \$6.05, compared to \$5.13 in 1975.

Our earnings improvement in 1976 restores a trend interrupted by the recession. Contributing to the improvement were rigorous management of our resources, stronger growth in demand for our services, an active marketing program, continuing advances in technology and improvements in operating methods.

Encouraging as our 1976 earnings were, however, they represent but an 8.9 per cent return on total capital—less than the rate of return the Federal Communications Commission has authorized for our interstate services—and but an 11.2 per cent return on common equity—less than that of most of the other leading companies with which we compete for investor capital.

Our aim, therefore, is a still further improvement in earnings.

We seek improved profits not simply for profit's sake, however. A basic function of our earnings is to ensure our ability to attract on sound terms the continuing investment in new facilities on which our ability to provide good service depends. Only by offering investors the prospect of an adequate return on their investment can we continue to build the communications facilities needed to give service to new customers, to handle our current customers' increasing use of telecommunications service, to modernize our facilities and to replace obsolete equipment on a timely basis.

Thus, good earnings are essential from a service point of view—from our customers' point of view. Moreover, good earnings undergird our ability to attract, train and keep qualified employees.

Rate increases in a number of jurisdictions in 1976 evidenced increased regulatory recognition of the higher costs the Bell companies are facing and the higher earnings levels that are required of us to be competitive in today's financial markets. Increases granted during the year are adding about \$840 million annually to Bell System revenues, and new interstate long distance charges that became effective early in the year are providing additional revenues of over \$200 million a year.

At the start of 1977, intrastate rate applications totaling \$1.6 billion were still pending. To the degree that—even with our above-average rate of productivity improvement—we are unable to offset increases in inflation, we must continue seeking rate adjustments.

With an increase in total sales of only 5.2 per cent over

the year before, Western Electric's earnings in 1976 amounted to \$217 million, a marked recovery from 1975's earnings of but \$107 million. While it has virtually completed a readjustment of its facilities and work force to lower levels of anticipated growth, Western Electric continues to enhance its performance through stringent expense control and increased efficiency. Its cost reduction program in 1976 introduced economies that will result in annual savings of more than \$200 million.

Capital Requirements

One thing that sets our industry apart from most others is the extent of the capital investment we need year after year to meet the public's present and future needs for more and better service. In short, ours is an extremely capital intensive business. Communications facilities must be in place when and where public demand for service dictates. At year's end our net plant investment stood at \$75.9 billion.

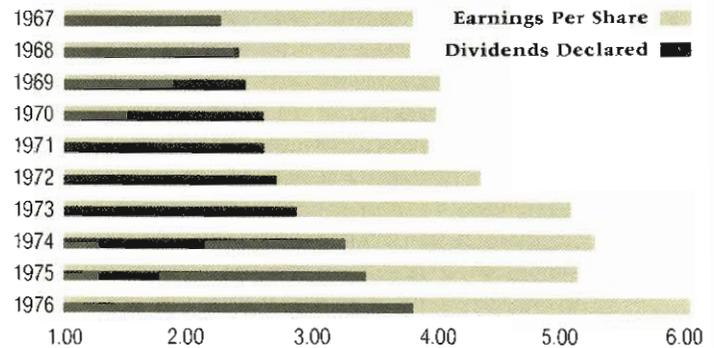
Our capital requirements in 1976 amounted to \$9.9 billion, about \$480 million more than the year before. Approximately four-fifths—82 per cent—of the total was generated from reinvested earnings, deferred taxes, the investment tax credit and depreciation. The remainder—\$1.8 billion—was financed externally. Reflecting debt refundings and other financing activities, our total external financing for the year came to just over \$3 billion.

New equity capital raised during the year came from the sale in June of 12 million new common shares of AT&T, as well as from our Dividend Reinvestment and Stock Purchase Plan and the Bell System Savings Plan for Salaried Employees.

The net proceeds of our equity offering were \$636.3 million, the 12 million common shares being offered to the public at \$54 $\frac{7}{8}$ per share through a nationwide group

Earnings Per Share & Dividends Declared

Dollars



of underwriters.

We raised \$432 million in equity from our Dividend Reinvestment and Stock Purchase Plan, 32 per cent more than in 1975. Some 648,000 AT&T share owners, 22 per cent of the total, were participating in the Plan at the end of the year either by reinvesting their dividends, making cash payments or both. Institutions that own AT&T stock accounted for about 20 per cent of the total annual investment made through the Plan.

At our annual meeting in April, we announced two new features designed to make the Dividend Reinvestment and Stock Purchase Plan more convenient and attractive to share owners: participants no longer have to reinvest all their dividends, and cash payments can now be invested on a monthly rather than a quarterly basis. The year before, a five per cent discount feature was introduced for the purchase of shares with reinvested dividends.

From the Bell System Savings Plan for Salaried Employees we acquired \$146 million in new equity.

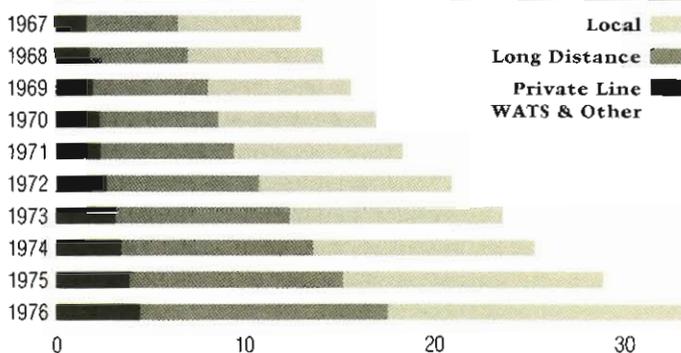
As a result of increased equity financing, our debt ratio—49.6 per cent at the start of 1976, 48.5 per cent at its close—is moving toward our target of about 45 per cent.

About \$2 billion was raised in 1976 through 10 offerings of long term debt by our operating telephone company subsidiaries. Of that, approximately \$550 million was used by four companies in 1976 and early 1977 to refinance outstanding long term debt issues before maturity. Additionally, in 1976 AT&T and two subsidiaries redeemed \$300 million of intermediate term debt a year prior to maturity. Other early redemptions have been made in 1977 and more are planned. In this way, we take advantage of lower interest rates and reduce our average interest cost.

The average cost of the debt that we issued in 1976 was 8.48 per cent, down from 8.88 per cent in 1975.

Revenues

Billions of Dollars



The bonds of AT&T and all but two of its principal subsidiaries continue to be rated Triple-A, the highest rating, by both of the major bond rating agencies.

Tax legislation enacted by Congress in 1976 extended until 1980 the 10 per cent investment tax credit that has applied to utilities and other businesses since 1975. The legislation also included amendments eliminating obstacles to our adopting an Employee Stock Ownership Plan. We intend to establish such a plan, electing an additional one per cent of investment tax credit for 1976 and applying an equivalent amount to the purchase of AT&T shares to be held in trust for our employees.

AT&T Share Owners

At the end of 1976 we had 2.9 million owners of record of AT&T common shares, and the average number of shares outstanding during the year was 595 million, 27 million more than in 1975. During the year our shares traded at their highest level in more than 10 years.

Book value increased from \$52.86 per share at the start of 1976 to \$55.08 at the end of the year. In keeping with our policy of increasing the dividend to reflect the growing book value of share owners' equity whenever our earnings prospects indicate an increase can be sustained, the Board of Directors approved a 10-cent increase in the quarterly dividend payable April 1, 1976. The tenth increase since 1959, it raised the annual dividend rate to \$3.80.

The decision to increase the dividend, made at a time of lingering uncertainty about the course of the nation's economy, also was in keeping with the company's efforts to maintain the integrity of the dividend in the face of continuing inflation.

To make it easier for our stock and bond owners to obtain information about AT&T securities, we have set up new toll-free telephone numbers at our security owners center in New Jersey. There, AT&T correspondents are available to answer questions about individual stock and bond accounts and to provide information about the Dividend Reinvestment and Stock Purchase Plan, the conversion of preferred shares and other matters. The number for this expanded information service for security owners is 800-631-3311; for owners calling from New Jersey, the number is 800-352-4900.

Assistance also is available at our regional stock transfer offices. The addresses and telephone numbers are listed on the inside front cover of this report.

On page 35 (Footnote N) share owners will find certain replacement cost information that we have compiled in accordance with new regulations issued by the Securities

and Exchange Commission. This information indicates that while the prices we pay to replace telephone plant have been increasing, the increases have been offset to a large degree by improved technology that allows not only for additional revenue-generating services but, more importantly, for operating efficiencies.

MARKET AND DIVIDEND INFORMATION

The principal market for trading in AT&T common stock is the New York Stock Exchange. Market and dividend data for the last two fiscal years are listed below.

Calendar Quarter	Market Price		Dividend Paid
	High	Low	
1975			
1st	51 $\frac{3}{4}$	44 $\frac{3}{4}$	\$.85
2nd	52	47 $\frac{1}{2}$.85
3rd	51 $\frac{3}{8}$	44 $\frac{3}{4}$.85
4th	51 $\frac{1}{8}$	45	.85
1976			
1st	58 $\frac{7}{8}$	50 $\frac{7}{8}$	\$.85
2nd	58 $\frac{1}{2}$	53 $\frac{1}{2}$.95
3rd	62 $\frac{7}{8}$	55 $\frac{7}{8}$.95
4th	64 $\frac{3}{4}$	58 $\frac{1}{2}$.95

QUARTERLY FINANCIAL RESULTS

Millions of Dollars

Calendar Quarter	Operating Revenues	Operating Income	Income Applicable to Common Shares	Earnings per Common Share*
1975				
1st	\$ 6,795	\$1,148	\$ 658	\$1.17
2nd	7,201	1,290	758	1.34
3rd	7,368	1,306	737	1.30
4th	7,593	1,385	763	1.31
	<u>\$28,957</u>	<u>\$5,129</u>	<u>\$2,916</u>	<u>\$5.13</u>
1976				
1st	\$ 7,848	\$1,392	\$ 809	\$1.39
2nd	8,138	1,488	917	1.56
3rd	8,361	1,521	957	1.59
4th	8,468	1,483	919	1.52
	<u>\$32,815</u>	<u>\$5,884</u>	<u>\$3,602</u>	<u>\$6.05</u>

*Because of increasing numbers of common shares outstanding each quarter, the sum of quarterly earnings per share does not equal earnings per share for the year.



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The Bell System in 1976

At the end of 1976 there were 123.1 million Bell System telephones in service—4.7 million more than when the year began—and the Bell telephone companies were handling upwards of 500 million messages per working day, some 35 million of them long distance messages.

Long distance calling increased 7.9 per cent over 1975, overseas calling 26 per cent.

But it is not how many messages we handle but how well we handle them that is the basis of the public's judgment of our performance.

We are pleased to report that Bell System service was never better than it was in 1976.

Telephones without reported troubles in the course of a month averaged 95.7 per cent. Some 98.1 per cent of the long distance calls our customers placed went through without interruptions or other difficulties. And Bell company installers met 97.6 per cent of their appointments on time. Each of these measurements of our service performance represents an improvement over 1975.

Semiannually the Bell System reports the number of its service "weakspots" to the Federal Communications

Commission. Two years ago we set ourselves a goal of "zero weakspots" by day one of the telephone industry's second century—March 10, 1976. We met that goal ahead of schedule and maintained it through the first six months of the year. How significant an accomplishment that is may be judged from the fact that it means that in none of 68 service areas did we fall short of agreed-upon standards with respect to seven major indicators of the quality of our service.

In a business as widespread and as susceptible to so many diverse influences as ours is, it is probably unrealistic to expect that so stringent a standard might be maintained without interruption. By the end of the year, however, only nine weakspots had developed, a performance sufficiently encouraging for us to establish "zero weakspots" as a continuing objective of our business.

Encouraging as our own technical indices of service quality may be, we recognize that the ultimate arbiter of our performance is the public we serve. Accordingly, we solicit the comments of approximately a million customers a year and, in addition, conduct surveys of the public's opinion of us. For the most part, customers consistently give us good marks for the quality of our service. But they don't give us top marks for everything we do. Lately some customers have been telling us that our treatment of them doesn't seem as considerate and personally attentive as it once did. We take this comment very seriously indeed and propose to do all we reasonably can to assure that the human dimensions of our service meet as high a standard as do its technical aspects.

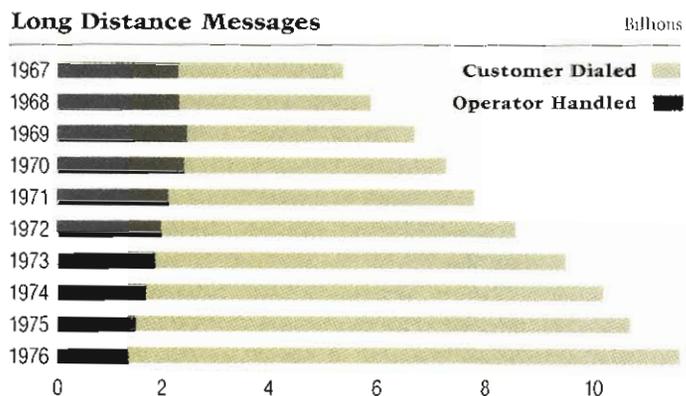
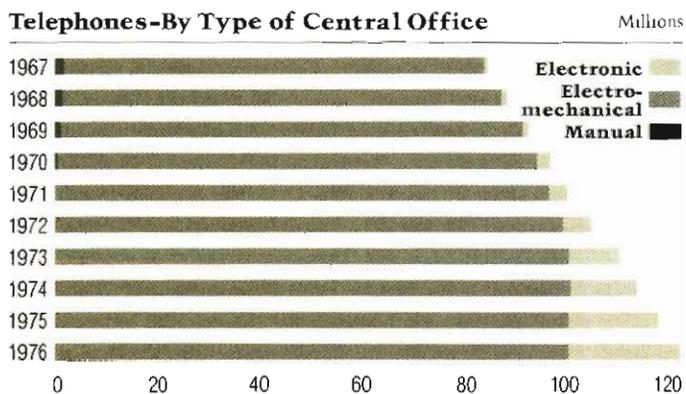
Challenges—As Usual

Nineteen seventy-six brought fresh challenges to our ability to meet unusual service demands and to restore service where it was impaired by disaster.

On the Fourth of July we met unprecedented requests from the television networks for the transmission facilities and broadcast services required for nationwide television coverage of bicentennial events. It was the busiest day in the Bell System's 28-year history of serving the needs of television broadcasters.

Providing communications for the two national political conventions, with their extraordinary service demands from the candidates, delegates and news media, took months of preparation. For the Democratic convention in New York and the Republican convention in Kansas City, we installed complete telephone systems, each comparable in size to a system serving a town of 15,000 persons.

Nature, too, challenged our service capabilities. After



the collapse of the Teton Dam in Idaho in June, Mountain Bell crews converged on the area to restore telephone service disrupted by flooding while the Western Electric Company shipped in replacement equipment from Arizona and Utah. Two months later another flood struck Mountain Bell territory, this time in northcentral Colorado. Emergency microwave equipment was flown in by helicopter to restore long distance service, and Western Electric diverted shipments of cable and equipment destined for other Bell companies.

A few days later and about 2,000 miles to the east, Hurricane Belle lashed the Atlantic coast, and again Bell System units marshaled their resources to reestablish communications for the thousands of homes and businesses whose service had been disrupted by the storm.

The strength of the integrated structure of the Bell System is never more dramatically evident than when emergencies call for quick deployment of telephone people and resources to restore service. But that strength is not reserved for emergencies. Not so dramatically but no less effectively it is being brought to bear—all day, every day—on the “routine” job of managing the nation’s telecommunications network. More than to any other single factor, the nation owes the present advanced state of its communications services to the common purpose that links the people who design the network, the people who build it and the people who operate and maintain it. Their single purpose: service.

The Network

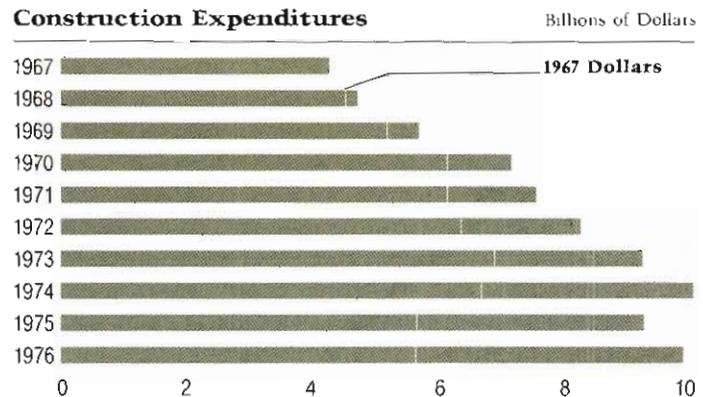
The Bell System’s nationwide network of communications facilities has been aptly described as a vital resource, a resource that over the years has grown steadily more productive and more adaptable to new uses.

The network is an incredibly intricate mechanism that is composed of literally billions of parts, each compatible with all the others and all designed, built, operated and maintained to common standards. Our objective in 1976, as it has been every year since the connection of telephones began a century ago, was to improve this system and in doing so to give our customers even better service.

Toward that end and to meet the demands of growth, we spent \$9.8 billion for construction in 1976—discounting for inflation, about the same as the year before. By making more efficient use of our existing telephone plant, we managed to hold the growth portion of our construction program at about the same level as in 1975 while we increased spending for modernization by over 20 per cent.

A large portion of our modernization expenditures

went toward replacing electromechanical switching equipment with newer electronic equipment. Electronic Switching Systems (ESS) are currently being put into ser-



vice at a rate of about one every working day. At the end of 1976 nearly 23 million Bell System telephones, 18.5 per cent of the total, were being served by these electronic central offices.

During the year we installed our one thousandth local ESS office as well as both the largest and the smallest electronic switching systems ever designed by Bell Laboratories and manufactured by Western Electric.

The one thousandth local installation occurred in Chicago. The system installed, known as the No. 1A ESS, is a technologically improved version of a system first introduced in 1965. It has over twice the call-handling capacity of its predecessor and many new features.

We installed in four cities a new electronic switching system, the No. 4 ESS—the largest and most advanced system of its kind for long distance connections. The No. 4 ESS can process up to a half million calls an hour, four times as many as our largest electromechanical machines.

Because the high speed No. 4 ESS systems have much greater switching capacity than the machines they are replacing, fewer switching centers will be needed in the years ahead to handle the increasing volume of long distance calls. This will enable us to spend less for construction and maintenance than would have been necessary otherwise, thereby helping us to hold down the cost of long distance calling.

We also placed in service the first of our newest and smallest electronic switching systems, the No. 3 ESS. Like our other electronic switchers, the No. 3 ESS monitors its own operations, diagnoses its own troubles and is designed

to have a "downtime" of only a few hours over a period of 40 years. But unlike larger switching systems, it can be assembled, tested, shipped and installed as a single unit. The No. 3 ESS, installed first in Springfield, Nebraska, is designed to serve rural areas and small towns.

In the meantime, other electronic systems are being developed at Bell Laboratories to improve rural telephone service and hold down the cost of providing it.

New customer services and faster long distance calling will be possible with a signaling system introduced in 1976 between Chicago and Madison, Wisconsin. Called Common Channel Interoffice Signaling, it transmits the control signals that establish a call on a separate digital data line rather than on the voice circuit itself. This more efficient method of setting up calls makes more circuit time available for handling revenue-producing calls.

We plan to extend Common Channel Interoffice Signaling to most major metropolitan areas by 1980 and eventually throughout the long distance network. Coupled with the speed of electronic switching, it will enable long distance calls to go through in about two seconds.

Along with electronic switching and other innovations, this new signaling system is part of an evolving electronic telecommunications network that is characterized by the use of solid-state devices and stored program control. With this new electronic network we can automate many behind-the-scenes maintenance and administrative operations, hold down service costs and give customers faster, better and more versatile services.

We began using satellite communications in 1976 for some domestic long distance telephone service. Our satellite system, which we operate jointly with the GTE Satellite Corp., consists of seven earth stations (four operated by AT&T) and two Comstar satellites leased from Comsat General. A third satellite is scheduled for launching in 1978. The satellite circuits have been integrated with the microwave radio and coaxial cable circuits that make up the bulk of our interstate telecommunications network.

The system also is serving as a laboratory in space for scientists from Bell Laboratories who are exploring ways to employ much higher frequencies for satellite communications. The Bell System, of course, pioneered satellite communications with the development of the Telstar satellites in the early 1960s.

We continued in 1976 to expand and improve our transmission facilities. During the year we began adapting for use in rural areas a digital system originally developed for big cities and suburbs. Approximately 50 million circuit miles of digital systems have been installed since the

first such system was introduced 15 years ago.

A major advance in undersea cable technology was achieved with the introduction of a system that can carry up to 4,000 calls and other messages simultaneously. The first such system—our sixth transatlantic cable—went into service in July between Rhode Island and St. Hilaire, France. The United States and 16 other nations share the use of the new cable, known as TAT-6.

This higher capacity cable system, along with our increased use of overseas satellite circuits, will help us to keep pace with the rapidly growing volume of international calling. Transatlantic calling, for example, has grown 27 per cent in the last five years.

To speed the flow of overseas calls and make the service more convenient to use, more and more of our switching centers are being equipped to handle direct customer dialing of these calls. In 1976 about 25 per cent of our customers in over 600 cities and communities could dial directly to telephones in 36 foreign countries. By 1980 we expect to make International Direct Distance Dialing available to 50 per cent of our customers.

Marketing

With the support of a more effective sales force and marketing-oriented advertising, about 17 per cent more revenue was derived in 1976 from a half-dozen services that were targeted for special promotion. For example, revenues from Wide Area Telecommunications Service (WATS) and from Custom Calling Services increased some 30 and 89 per cent, respectively.

Following are some of 1976's new service offerings and marketing developments:

- Design Line* Telephones. Two new models were introduced and design changes made in three others in this line of decorator-type telephones. We also began a trial to determine the potential for merchandising them in shopping malls. Customers purchase the Design Line housings—some made by Western Electric, some by other suppliers—while the Bell telephone companies own and maintain the inside operating parts of the telephones.
- PhoneCenter Stores. These outlets, in which customers can select their telephones and take them home for immediate installation in residences equipped with telephone jacks, represent a more direct retailing approach than has been customary in the telephone business. Some 500 PhoneCenter Stores were in operation in 1976 and 600 more are expected to open in 1977.
- Transaction Network Service. This new data communications service, introduced in Seattle, Washington,

*Trademark of AT&T Co.

was developed to handle large volumes of business transactions that call for short inquiries and responses. Potential customers include retail stores for credit card and check verifications and banks for check cashing and other operations. We also put into production two new variations of our Transaction telephone, which can be used as a communications terminal for the new service.

- Dimension® PBX (Private Branch Exchange). This family of electronic customer "switching systems" was expanded to serve customers needing up to 2,000 lines. The newest system offers more than 150 features. We also added Dimension Custom Telephone Service, providing customers with a broad range of features that can be operated through a new multibutton electronic telephone set, the first such telephone used in commercial Bell System service. In addition, we began tailoring Dimension PBX systems to meet specific needs of different industries, such as the retail and hotel/motel industries.

As part of our marketing effort, we are continuing to develop, test and implement optional payment plans. For example, currently being offered to business customers in nearly all Bell operating territories is a Two-Tier payment plan. Payments related to the investment in the equipment are made according to a fixed time schedule selected by the customer; thereafter, a lower rate, related to on-going expense, applies.

In addition to payment plan changes designed to give customers optional or more convenient methods of payment, we have introduced new pricing plans in recent years to relate charges for some services more directly to their cost or usage. By the end of 1976, for example, we had received regulatory authorization in 16 jurisdictions to bring the charge for coin service more into line with the cost of the service; in 14 states we were charging for directory assistance service; and in 42 states new pricing plans

were in effect for services associated with installing, moving and changing telephones.

Research—Manufacturing

One reason we have been able for so many years to offer telephone users a steady stream of innovative services and products at reasonable prices is Bell Laboratories; another is Western Electric. Both organizations are widely recognized as leaders in their fields, Bell Laboratories as the foremost center for telecommunications research and development and Western Electric as a top-ranked manufacturing company that is known for the efficiency of its operations and the quality of its work.

Key elements in the integrated structure of the Bell System, they have a common interest: serving the needs of the Bell operating telephone companies and, through them, our customers. Because they are part of the same overall enterprise, Bell Laboratories and Western Electric are able to work closely together through all stages of the innovation process. In fact, Bell Laboratories has branch laboratories at eight Western Electric plants, including one near Atlanta, Georgia, where in 1976 we tested and evaluated a lightwave communications system.

The system used light from tiny lasers to transmit signals through glass fibers enclosed in a 2,100-foot cable that was installed in conduit and through manholes. Though only a half-inch in diameter, a cable containing 144 fibers can carry the equivalent of nearly 50,000 telephone calls simultaneously.

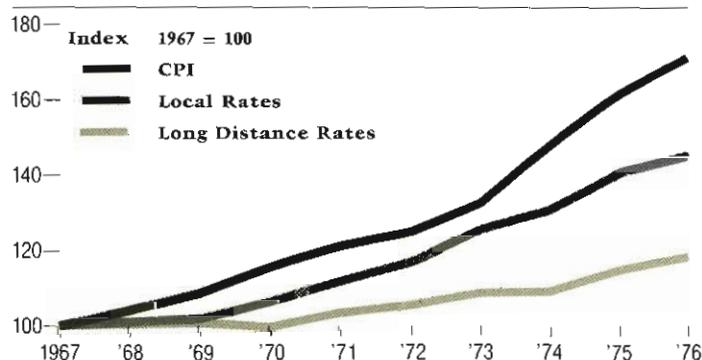
Results of the Atlanta experiments exceeded our expectations and pointed to an early application of this new communications technology. We shortly will be installing an experimental lightwave transmission system in Chicago that we will use for voice, data and Picturephone® Meeting Service. This will be the first lightwave communications system to provide a wide range of telecommunications services under actual operating conditions.

Also under development is a single-sideband microwave radio system that could more than double the capacity of our existing microwave routes without the large capital investment that such an increase in network capacity would otherwise require.

Bell Laboratories has completed an experimental word recognition system, a machine that can "talk" with telephone callers whose voice patterns are stored in its computer. In its present form, the machine recognizes words and phrases and responds orally to requested information.

Other research and development efforts in 1976

Consumer Price Index vs. Telephone Rates





included the development of new lithographic materials for use with an electron beam exposure system in making silicon integrated circuits; development of new telephone applications for tiny computer circuits known as microprocessors; and continued progress in optical electronics, including development work on lasers and light emitting diodes (LEDs) for use in lightwave communications.

Western Electric in 1976 shipped to the Bell companies a total of 11 million telephones, 250,000 data sets, over 21,000 frames of crossbar switching equipment, more than 38,000 frames of electronic switching equipment and 260 billion conductor feet of telephone exchange cable.

Our studies continue to show that on average Western Electric's prices for comparable products are well below—about 19 per cent below—the lowest prices charged by general trade manufacturers and suppliers.

Although we continue to rely on Western Electric for most of the telecommunications equipment used in the Bell System, the Bell telephone companies seek out and procure products of assured quality at the best prices from whatever source. In 1976 they purchased over \$1 billion in telecommunications products from outside suppliers either directly, through Western Electric or by using contracts negotiated by our Purchased Products Division.

The Bell System Purchased Products Division was formed in 1974 to assure fair and equitable treatment of the industry's more than 2,000 general trade suppliers and to facilitate the procurement of high quality equipment by the telephone companies.

Productivity—Conservation

Down through the years we have been alert to the importance to both our share owners and customers of constantly improving our productivity by better motivating our employees, developing new technologies and devising new operating methods. As a result, overall productivity in the Bell System has been growing at a rate well above that of the United States economy as a whole.

One measure of productivity in the telephone business is the number of telephones per employee. Ten years ago that number was 128. Today it is 162.

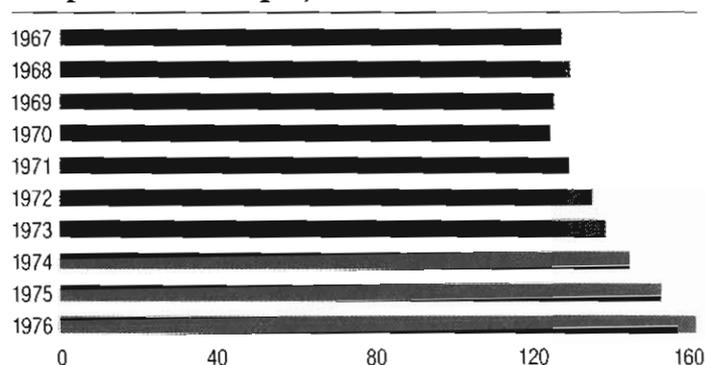
As we enter our second century of service, the accelerating pace of change calls for new and more sophisticated management tools to give us the timely information we need to operate the business efficiently and to maintain the quality of service we provide our customers.

We now are using computer-based operations systems to collect, analyze and summarize traffic data, to help with traffic forecasts and facility plans and to analyze the use of

central office equipment. They are being used, too, to design and automatically test telephone circuits, assist with inventory control and the maintenance of property records, prepare work orders for the plant craft employees and to perform a variety of other functions.

To help relieve our plant and engineering people from routine detail, such computer-based systems in the future will be interconnected to make information automati-

Telephones Per Employee



cally available to managers throughout the Bell System. The increasing use of these systems will provide new, more efficient and more economical ways to manage our operations.

Just as better management is essential to higher productivity, so too is it the key to making more efficient, economical use of scarce natural resources. The Bell System continues to improve and refine its efforts to conserve these resources.

In 1976 our consumption of energy amounted to only about one per cent more than in 1975. Over the last three years, in fact, the Bell System's total energy consumption has been reduced 10 per cent, even though the number of telephones we serve went up 12 per cent.

The energy we saved in 1976 would be sufficient to heat 455,000 homes for an entire year. In the absence of this sustained conservation program, we would have spent an estimated \$250 million more than we did for utility payments and for gasoline and other fuel purchases.

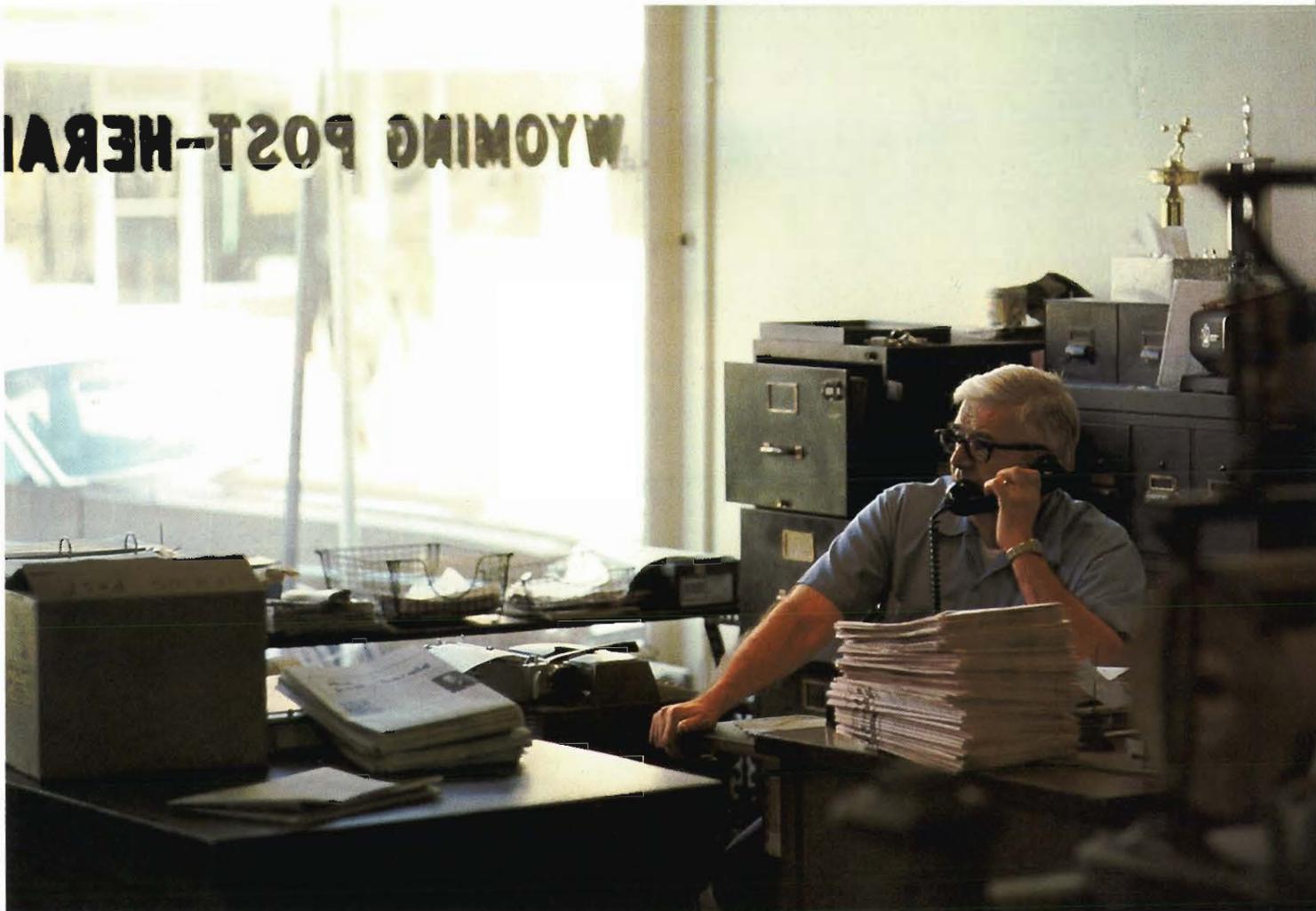
Some of the Bell telephone companies are experimenting with solar energy to supplement conventional heating sources. In one trial, AT&T Long Lines has solar cells atop one of its buildings in New York to supplement the commercial power used for the microwave radio equipment there.



Indianapolis, Indiana



Wyoming, Illinois



We continued in 1976 our decades-old policy of recycling many of the materials that we use in providing service, a policy that has proved economically rewarding as well as beneficial for environmental purposes. Telephone sets, for example, can be reused several times and then recycled for the reclamation of metals and plastics.

Recycling telephone sets and other station apparatus during the year reduced our capital expenditures by more than \$1 billion.

Bell System People

Employment in the Bell System declined by 11,800 in 1976 to a level of 927,200 at the end of the year.

The Bell System companies are good places to work, good places to make a career. We provide jobs that offer attractive wages, interesting work and substantial security. Furthermore, we are an organization where qualified employees have an opportunity to move into higher level and better paying jobs.

AT&T frequently is identified as one of the first of America's large corporations to have entered into equal employment opportunity agreements with the Federal government. In this matter our concern, simply put, is to comply with the law and to treat all our employees fairly while making the best use of their abilities.

In August we implemented an order supplementing the 1973 equal employment opportunity Consent Decree. The order represents a satisfactory resolution to many of the questions that have burdened our affirmative action efforts.

By the end of the year we had achieved 99 per cent of the intermediate objectives agreed to by the company and the government to facilitate the upward movement of minority and women employees.

The number of minority employees and women in management positions increased 14.8 per cent and 2.2 per cent, respectively, over the previous year.

Our continued efforts to move more men and women into nontraditional telephone jobs were reasonably successful in 1976. Women in the skilled crafts formerly occupied primarily by males increased by 10.6 per cent. The placement of men in skilled and semiskilled office, clerical jobs went up 18 per cent.

The key to promotions in the Bell System is the individual's qualifications for handling the increased responsibility and more demanding duties that go with a higher level job. It is management's obligation to identify those employees with the potential for promotion and to help them fulfill that potential. Our efforts in this regard have

been encouraging insofar as demonstrating that within the employment ranks of our companies there is a large reservoir of people with the talents and skills that our management positions require.

Of the more than 19,000 employees who went through various Bell System assessment programs in 1976, 35 per cent were seen as having higher job potential.

In August, 1976 our nonmanagement employees received the final wage adjustments provided for in the collective bargaining agreements reached with the unions in 1974. These adjustments included cost of living and other scheduled increases together with improvements in pensions and other benefits.

The current labor agreements, which cover about 700,000 Bell employees, expire in mid-summer 1977.

The Bell System and the Economy

The Bell System's improved financial results in 1976 reflect resumption of growth in the general economy. At the same time, our operations contribute not a little to the strength of the economy. In the course of the year, for example, we paid out—

\$15 billion in wages and salaries to our Bell System employees.

\$8 billion in payments for products and services that we bought from suppliers in some 5,000 communities from coast to coast.

\$5 billion in dividends and interest payments to some five million investors in our business.

And over \$4 billion in Federal, state and local taxes.

Thus, by our efforts to provide the nation with ever-improving telephone service, we are at the same time doing our share to maintain a healthy economy.

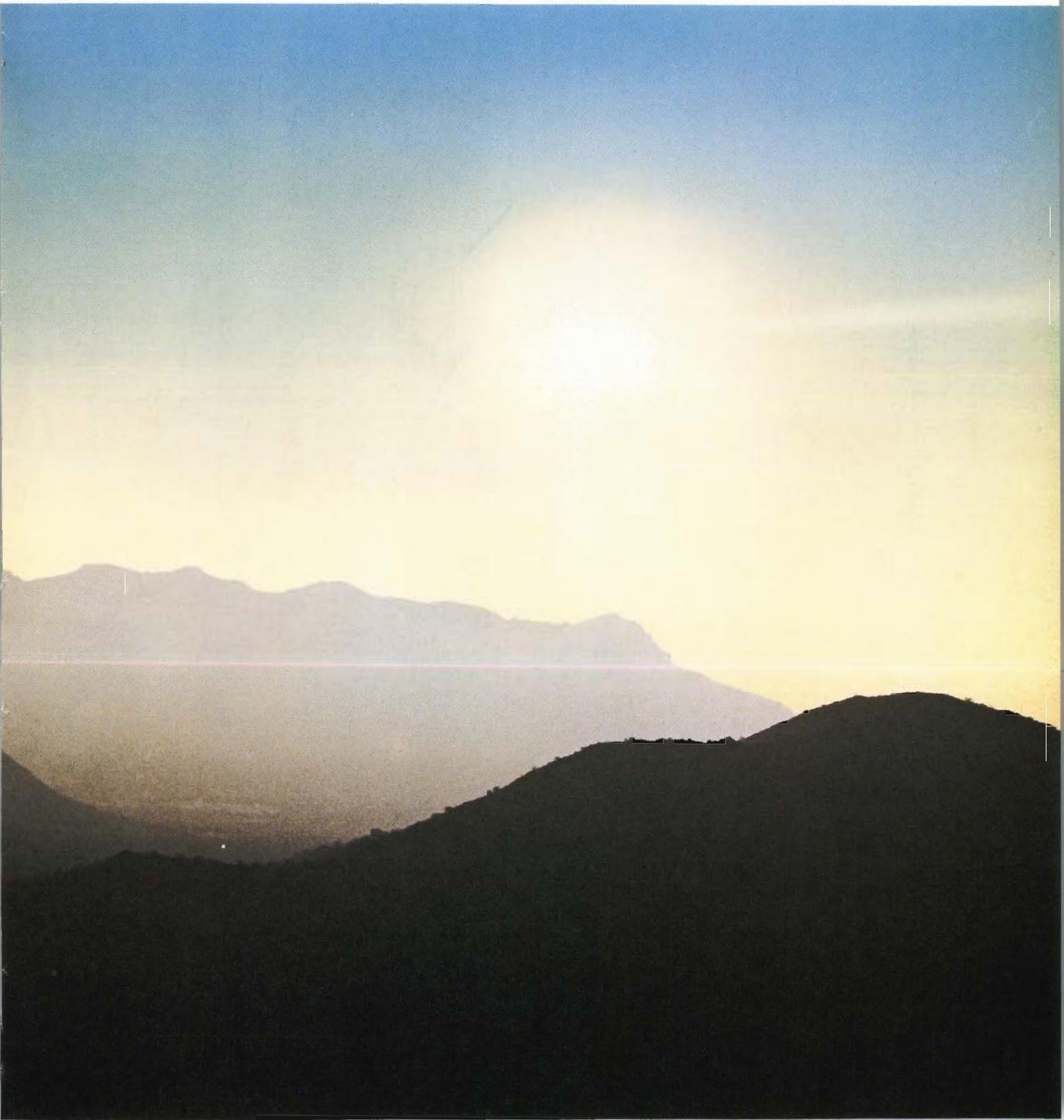
In January, 1977 the Board of Directors elected Charles L. Brown president of the company, effective April 1, upon the retirement of William L. Lindholm. On his retirement, Mr. Lindholm will have been the company's chief operating officer for five years.

Succeeding Mr. Brown as vice chairman and chief financial officer will be William S. Cashel, Jr., currently executive vice president. Mr. Cashel has been elected a director.

William M. Ellinghaus continues as vice chairman and director, positions to which he was elected in 1976.

Apache Junction, Arizona







"...To All the People of the United States...."

The words are from The Communications Act of 1934, more specifically from Section One thereof. There the Congress declared its intent to be "...to make available, so far as possible, to all the people of the United States a rapid, efficient, Nation-wide and world-wide wire and radio communications service with adequate facilities at reasonable charges...."

Thus Congress confirmed—in effect, codified—what had been the aim of the telephone industry—and the public's expectation of it—virtually from its founding.

It was this aim—universal service—that shaped the structure of the Bell System and the integration of its research, manufacturing and operating units. It was this aim that spurred the development of a nationwide network of facilities—some Bell's, some the property of Independent companies but all designed and built to operate as a single entity. And it was this aim that has determined the telephone industry's pricing policy—a policy aimed at making telephone service as widely available as possible.

What have been the results?

Today about 95 per cent of all United States households have telephone service, compared to 31 per cent when The Communications Act of 1934 was passed.

There are more than three times as many telephones here as in Japan, seven times as many as in Great Britain and nine times as many as in the Soviet Union.

And for every 100 persons in this country there are 69.5 telephones, proportionately more than in Sweden, whose much smaller telephone system provides the second largest per capita telephone coverage in the world.

In short, here in the United States the goal of universal telephone service has been achieved to an extent unmatched anywhere else.

Public Policy

Today, however, the principles that have guided the provision and pricing of telephone service for so long and with such success are under challenge as never before. That challenge derives principally from a series of decisions over recent years by which the Federal Communications Commission has sought to implement its declared policy of promoting what it calls competition in certain sectors of the telecommunications market, most notably in the supply of terminal equipment—telephones, switchboards, key systems, etc.—and in the supply of intercity private line services—services of a kind that are for the most part used by businesses.

What we have experienced over the past half-dozen years, however, has not been competition as that word is

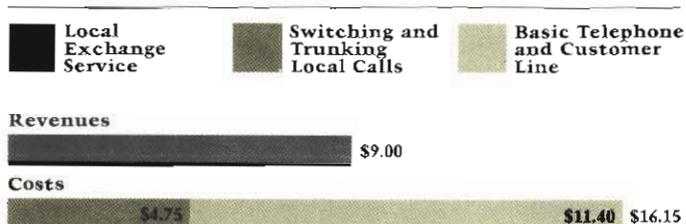
commonly understood but rather an FCC-administered division of the market. Indeed, the plain fact of the matter is that you can't have competition—real competition—when some of the parties—our "competitors"—are free to serve where it will profit them most and some—the telephone companies—are obliged to serve the entire public.

In our view the trend of the FCC's decisions on these matters contradicts what we in the telephone industry have taken to be the basic aim of the nation's telecommunications policy—the widest availability of high quality telecommunications services at the lowest cost to the entire public. By fragmenting responsibility for service, those decisions jeopardize its quality. By encouraging wasteful duplication of facilities, they add unnecessary costs to the nation's telephone bill. And by forcing the rates for basic exchange service up, they will restrict its availability. Over the long run selective competition will force the telephone companies to move away from—and ultimately abandon—the ratemaking principles that have made telephone service so widely affordable.

At present, long distance service and certain business and so-called premium services are priced sufficiently above their direct costs to produce higher contributions to

Residence Service

Average Monthly Revenues vs. Average Monthly Costs



the common costs of the business than does basic home service. It costs the telephone company \$16.15 a month on the average to provide basic home telephone service, including the cost of facilities that local calling shares with long distance. The average revenues from basic residence services, however, are only \$9. A large proportion of the difference is made up by revenues from long distance service.

In time, the FCC's policy of promoting selective competition will make such pricing untenable. Contrived though it be, that competition can have no other consequence than to force the rates for each of our services to a closer and closer match with the direct cost of providing that service. If that happens, the telephone companies will

have no alternative but to raise home telephone rates more than otherwise would be necessary as a consequence of inflation. In no other way can they compensate for the loss of the contributions that long distance and other discretionary services make to the coverage of joint and common costs.

To some, mostly large businesses, there may be temporary advantages in the FCC's brand of selective competition. To most households, it will represent an added burden. And to families on low, fixed incomes, it may deny telephone service altogether. This, we believe, is the exact opposite of what Congress intended the nation's telecommunications policy to be.

Accordingly, in 1976 the Bell System joined the Independent telephone industry in urging the Congress to reaffirm and clarify the intent it expressed in The Communications Act of 1934. To this end, early in the year The Consumer Communications Reform Act was introduced in both houses of Congress. By the time the 94th Congress adjourned, this legislation in one form or another had attracted the sponsorship of more than a third of its members—175 Representatives and 17 Senators.

In September the Subcommittee on Communications of the House Committee on Interstate and Foreign Commerce held three days of exploratory hearings on the issue of competition in the domestic telecommunications industry. Chairman John D. deButts appeared on behalf of the Bell System.

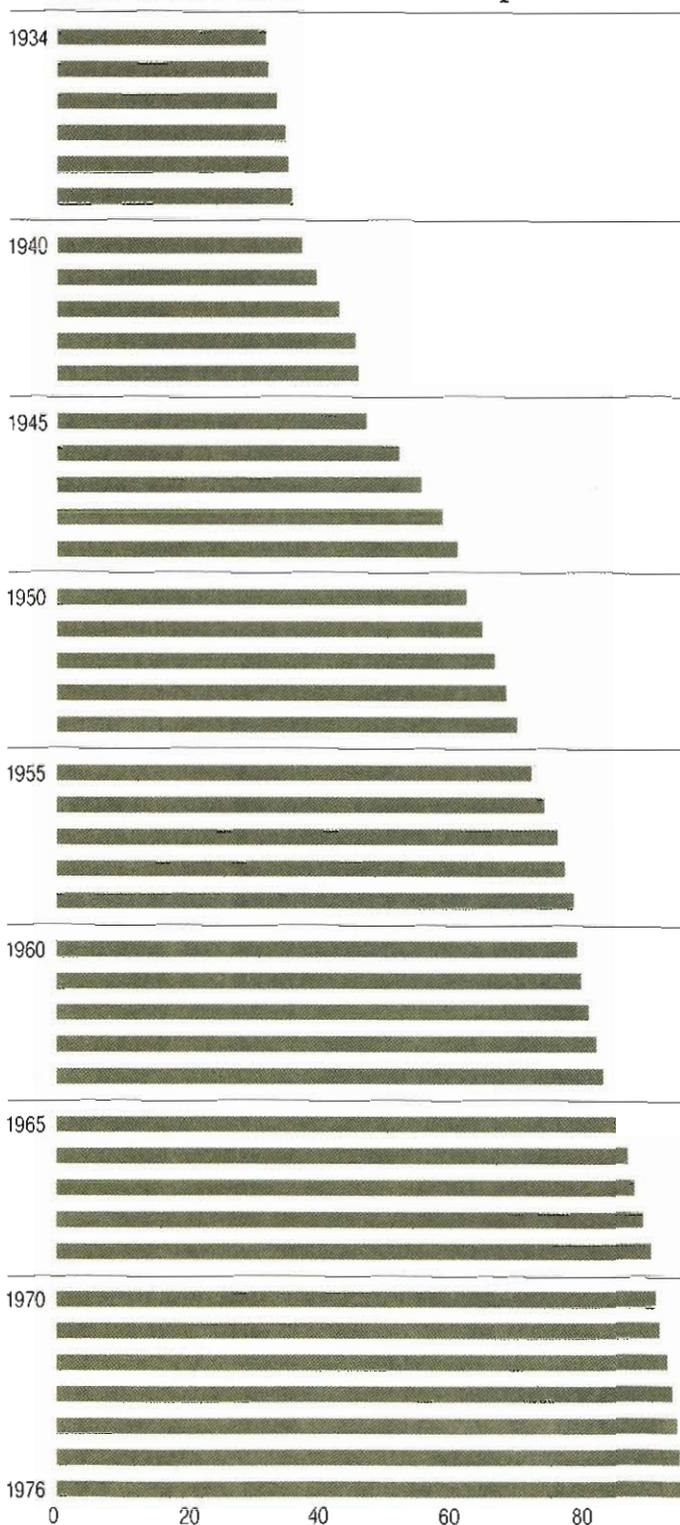
"...I am not here out of concern for AT&T's future profits," Mr. deButts told the Congressmen. "I am here for one reason and one reason only and that is because it appears to me inevitable that over the long run, the FCC's policies will hurt service and add to its costs for the vast majority of our customers, particularly home telephone users.

"We do not believe these are the aims the Congress had in mind when it enacted the Communications Act.

"It was to administer that Act that the Federal Communications Commission was established. But in pursuit of its declared policy of promoting what it calls competition in selected segments of the telecommunications market, the Commission has exceeded its assigned function. It has presumed not merely to regulate but to legislate.

"That, we believe, is Congress' role. Accordingly we welcome the evidence of Congressional concern that these hearings represent and the prospect that they will lead to an authoritative definition of the aims to which our industry should address itself henceforward.

Per Cent of U.S. Households With Telephones



"...the issue confronting us is not simply a question of monopoly versus competition but the rather more fundamental question: What is the basic aim of this country's telecommunications policy? Is it, as we in the industry had conceived it to be and the Communications Act appears to confirm, to promote the widest availability of high quality communications service at the lowest cost to 'all the people of the United States?' Or does that aim now yield to the particularized interests of special classes of users? If the latter be the case, let it be candidly recognized that for what only some people want everybody sooner or later pays. I do not believe we can have it both ways."

The Bell System looks forward to a renewal of interest in telecommunications issues early in the new Congress. It is our hope that before this Congress adjourns we might get the authoritative definition of the public interest our industry needs to guide it in its second century. It is our hope that The Consumer Communications Reform Act might provide a vehicle for that determination.

We in the telephone industry recognize that it is not for us to decide the public interest but rather the public itself or the Congress in the public's behalf. However these matters are resolved, share owners may be assured that the Bell System will accommodate itself to the public's decision. Until that decision is authoritatively rendered, however, we shall continue our efforts to assure that the public is adequately informed of its stake in these matters.

Developments in 1976

A number of significant developments, some bearing on the FCC's encouragement of competition in parts of the business, occurred in 1976 in a variety of regulatory, legislative and legal forums. Following are brief reports on some of them.

In September the FCC issued a "first report" in its inquiry—begun in April, 1974—into the economic implications of competition in the private line and terminal equipment segments of the business. The Commission said it had found no apparent basis for the industry's claim that FCC policies will affect rates for basic home telephone service in the foreseeable future.

FCC Commissioner Benjamin L. Hooks, in a dissenting statement, expressed doubt that AT&T or other large telephone companies will be seriously affected financially by the competition so far authorized, but added: "I cannot, however, make the same prediction with respect to the average consumer. ..."

In June a limited form of the FCC's "registration" program for terminal equipment went into effect, applying for

the moment only to customer-provided data terminals and ancillary equipment, such as automatic answering devices. The Commission's plans to extend the program to include telephones, switchboards and key telephone systems—as well as telephone company-supplied terminal equipment—were stayed by court order.

We do not seek to deny our customers the opportunity to acquire their own telephone terminal equipment, but we have steadfastly opposed efforts to connect such equipment to the network without proper technical safeguards. The registration program, as currently constituted, does not assure the protection of service quality that we believe is necessary.

At the Commission's direction we are in the process of modifying the costing methodology for our interstate services to conform with what is known as a fully distributed cost method. The modifications ultimately may be reflected in revised rates for all interstate services.

The FCC announced plans in 1976 to reconsider the function of computers and modern terminals in providing communications and data processing services. In its original computer inquiry in the 1960s, the Commission adopted rules distinguishing between regulated data communications services and non-regulated data processing services. We welcome this new inquiry because recent advances in technology have blurred old distinctions between the two. We are urging the Commission to avoid arbitrary definitions that might preclude common carriers from offering communications services that employ computer technology.

In this connection, the FCC approved our Dataspeed® 40/4 data terminal as a proper service offering for a common carrier. Authorization to offer the new terminal equipment had been delayed over the question of whether it constituted a data processing service. The Commission ruled that it did not.

Our plans to expand Dataphone® Digital Service, which we provide over specially engineered digital facilities, were sidetracked at least temporarily. While approving our applications to enlarge this network within the 24 cities where it now exists, the FCC deferred action on our long-standing request to add 40 more cities to it. Early this year we were ordered to file higher rates based on our experience in providing the present geographically-restricted service.

In July we respectfully declined a subpoena from the House Commerce subcommittee on oversight and investigations to turn over certain company records relating to national security wiretapping by the Federal government

under expressed authorization from the Attorney General. To do so, we pointed out, would subject us to being held in contempt of a Federal court order denying the records to the subcommittee on national security grounds.

We have long argued for increased legal protection of communications privacy, believing as we do that any undermining of our customers' right to privacy impairs the usefulness and value of telephone communications.

In December the United States Supreme Court declined to review a lower court ruling that reaffirmed the FCC's assertion of jurisdiction over the connection of telephone terminal equipment to local exchanges. AT&T and other common carriers had joined the North Carolina Utilities Commission in maintaining that the FCC had unlawfully preempted the states' authority in the telephone terminal equipment area.

Bell System Structure

In November United States District Court Judge Joseph C. Waddy declined to dismiss the Justice Department's antitrust suit against the Bell System. He found that "at least some" matters at issue in the government's complaint are within the court's antitrust jurisdiction.

On the other hand, Judge Waddy said that some or much of the conduct complained of by the government may be subject to the primary jurisdiction of the FCC and that he will consider referring particular issues to the Commission "at the appropriate time." He concluded that the issues must now be more sharply defined through the "discovery" process, in which parties to the case can examine documents and witnesses prior to trial.

We subsequently sought unsuccessfully to obtain from the United States Supreme Court a prompt review of Judge Waddy's jurisdiction decision. A request for review was filed simultaneously with the United States Court of Appeals in Washington, D.C. This court stayed further proceedings in the lower court pending disposition of our request for review.

We seek dismissal of the suit on the grounds that the matters complained of by the government relate to common carrier activities that are pervasively regulated by the FCC and state regulatory agencies and that, under prior Supreme Court decisions, these matters are not subject to litigation in the antitrust courts.

The suit, filed in November, 1974, alleges monopolization of telecommunications services and equipment by the Bell System and seeks divestiture of Western Electric and the separation of some or all of Long Lines from some or all of the Bell System operating companies.

We said at the time the suit was filed that we were confident that we were not in violation of the antitrust laws and that we were determined to contest the government's action vigorously. Nothing has happened since to change that confidence or alter that determination.

At the end of 1976 there were some 30 private antitrust suits pending against the Bell System, most of them involving charges of monopolization brought by companies engaged in the supply of equipment or services associated with telecommunications.

The structure of the Bell System was subjected to searching scrutiny in a lengthy regulatory proceeding—Phase II of the FCC's interstate rate investigation—in which an initial decision was reached in 1976. FCC Administrative Law Judge David I. Kraushaar found that the "monumental record" compiled during the proceedings "fully justifies AT&T's continuing existence intact as a quality common carrier that provides excellent telephone service to a very large population."

Judge Kraushaar said the record demonstrates that the integration of Western Electric and Bell Laboratories in the Bell System "has provided, and continues to provide, definitive useful public benefits in the form of system-wide expertise and innovations that have, in turn, led to monumental technological advances."

We disagreed with some of Judge Kraushaar's specific findings, but his overall conclusions about the Bell System and its management were, to say the least, heartening.

Planning

It was noted earlier in this report that for our managers to do the best job possible they must be equipped with the best tools available. There is no more necessary tool for superior management than superior planning.

In 1976 we augmented our capabilities for longer range integrated planning, taking a more disciplined and systematic approach to defining the requirements and expectations of all groups who affect—and are affected by—our business. We also organized our planning efforts to keep abreast of society's many economic, social and intellectual movements and trends so that we can better anticipate the problems and opportunities that we may confront in the years ahead.

The telecommunications business, like our society, conceivably could be very different in the future from what it is today. We are planning now so that, whatever changes our business may confront in the years ahead, we'll be ready.

Consolidated Financial Statements

The Financial Statements on the following pages, which consolidate the accounts of American Telephone and Telegraph Company and its subsidiaries, have been prepared in conformity with generally accepted accounting principles. Such principles are consistent in all material respects with accounting prescribed by the Federal Communications Commission for telephone companies, except as to revenue refunds and investments, as discussed in Notes to Financial Statements.

The integrity and objectivity of data in these financial statements are the responsibility of management. To this end, management maintains a highly developed system of internal controls and supports an extensive program of internal audits. More fundamentally, the Company seeks to assure the objectivity and integrity of its accounts by careful selection of its managers, by organizational arrangements that provide an appropriate division of responsibility, and by communications programs aimed at assuring that its policies and standards are understood throughout the organization.

These financial statements have been examined by Coopers & Lybrand, Certified Public Accountants, and their report is shown below. The other auditors referred to in their report are Arthur Young & Company as auditors of Western Electric Company and Southwestern Bell Telephone Company, and Arthur Andersen & Co. as auditors of Illinois Bell Telephone Company. The auditors' report expresses an informed judgment as to whether management's financial statements, considered in their entirety, present fairly in conformity with generally accepted accounting principles the Company's financial condition and operating results. It is based on procedures described in the first paragraph of the report, which include obtaining an understanding of the Company's systems and procedures and performing tests and other procedures sufficient to provide reasonable assurance that the financial statements neither are materially misleading nor contain material errors. While the auditors make extensive tests of Company procedures, it is neither practicable nor necessary for them to scrutinize a large portion of the Company's transactions.

The Board of Directors pursues its responsibility for these financial statements through its Audit Committee, which meets periodically with both management and the independent auditors to assure that each is carrying out its responsibilities. The independent auditors have full and free access to the Audit Committee, and meet with it, with and without management being present, to discuss auditing and financial reporting matters.

R. N. Flint, *Vice President and Comptroller*

Report of Independent Certified Public Accountants

To the Share Owners of American Telephone and Telegraph Company:

We have examined the consolidated balance sheet of American Telephone and Telegraph Company and its subsidiaries as of December 31, 1976 and the related consolidated statements of income and reinvested earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the consolidated financial statements of the Company and its subsidiaries for the year 1975. The financial statements of two telephone subsidiaries included in the consolidated financial statements (constituting total assets of \$12,644,118,000 and \$11,612,936,000 and total operating revenues of \$5,092,143,000 and \$4,531,176,000 included in the consolidated totals for 1976 and 1975, respectively) were examined by other auditors. The consolidated financial statements of Western Electric Company, Incorporated, the Company's principal unconsolidated subsidiary (the investment in and net income of which are disclosed in the accompanying financial statements) were also examined by other auditors. The reports of other auditors have been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included in the consolidated financial statements for subsidiaries examined by them, is based solely upon such reports.

As described in note (D) to Financial Statements, net income includes amounts resulting from intrastate rate increases in a number of states and from interstate rate increases which are subject to investigation and possible refund.

In our opinion, based upon our examination and the reports of other auditors and subject to the final outcome of the rate matters discussed in the preceding paragraph, the consolidated financial statements on pages 26 to 36 present fairly the consolidated financial position at December 31, 1976 and 1975, the consolidated results of operations and the consolidated changes in financial position for the years then ended of American Telephone and Telegraph Company and its subsidiaries, in conformity with generally accepted accounting principles applied on a consistent basis.

Coopers & Lybrand
1251 Avenue of the Americas, New York, N.Y.
February 8, 1977

Statements of Income and Reinvested Earnings

	Thousands of Dollars	
	Year 1976	Year 1975
OPERATING REVENUES		
Local service	\$15,608,952	\$14,027,831
Toll service	16,065,472	13,925,190
Directory advertising and other	1,367,727	1,218,822
Less: Provision for uncollectibles	226,569	214,602
Total operating revenues	<u>32,815,582</u>	<u>28,957,241</u>
OPERATING EXPENSES		
Maintenance	6,624,782	5,919,100
Depreciation	4,483,906	4,088,089
Traffic—primarily costs of handling messages	2,205,554	2,132,119
Commercial—primarily costs of local business office operations	1,111,755	1,017,701
Marketing	1,509,429	1,266,550
Accounting	873,239	786,802
Provision for pensions and other employee benefits (B)	2,832,578	2,363,730
Research and fundamental development	249,867	206,279
Other operating expenses	1,129,792	976,906
Total operating expenses	<u>21,020,902</u>	<u>18,757,276</u>
Net operating revenues	<u>11,794,680</u>	<u>10,199,965</u>
OPERATING TAXES		
Federal income (A):		
Current	582,355	129,102
Deferred	1,387,782	1,303,340
Investment tax credits—net	715,944	741,646
State and local income:		
Current	139,726	108,330
Deferred	107,139	107,825
Property, gross receipts, payroll-related and other taxes	2,977,469	2,680,819
Total operating taxes	<u>5,910,415</u>	<u>5,071,062</u>
Operating income (carried forward)	<u>\$ 5,884,265</u>	<u>\$ 5,128,903</u>

The accompanying notes are an integral part of the financial statements.

AMERICAN TELEPHONE AND TELEGRAPH COMPANY AND ITS SUBSIDIARIES

	Thousands of Dollars	
	Year 1976	Year 1975
Operating income (brought forward)	\$ 5,884,265	\$ 5,128,903
OTHER INCOME		
Western Electric Company net income	217,383	107,308
Interest charged construction	216,284	239,957
Miscellaneous income and deductions—net (C)	(87,416)	(32,220)
Total other income	<u>346,251</u>	<u>315,045</u>
Income before interest deductions	6,230,516	5,443,948
INTEREST DEDUCTIONS	<u>2,401,365</u>	<u>2,296,226</u>
NET INCOME (D)	<u>3,829,151</u>	<u>3,147,722</u>
Preferred dividend requirements	226,666	231,943
INCOME APPLICABLE TO COMMON SHARES	<u>\$ 3,602,485</u>	<u>\$ 2,915,779</u>
 EARNINGS PER COMMON SHARE (after preferred dividend requirements) based on average shares outstanding, 595,184,000 in 1976 and 567,915,000 in 1975 (D)		
	<u>\$6.05</u>	<u>\$5.13</u>
 REINVESTED EARNINGS		
At beginning of year	\$14,787,277	\$13,816,548
Add—Net income	<u>3,829,151</u>	<u>3,147,722</u>
	<u>18,616,428</u>	<u>16,964,270</u>
Deduct—Dividends declared:		
Preferred	225,908	231,934
Common—1976, \$3.80 per share; 1975, \$3.40 per share	2,262,967	1,934,426
Miscellaneous—net	1,516	10,633
	<u>2,490,391</u>	<u>2,176,993</u>
REINVESTED EARNINGS AT END OF YEAR	<u>\$16,126,037</u>	<u>\$14,787,277</u>

Balance Sheets

ASSETS	Thousands of Dollars	
	December 31, 1976	December 31, 1975
TELEPHONE PLANT— at cost		
In service	\$91,317,667	\$84,618,757
Under construction	2,749,418	2,881,158
Held for future use	100,398	120,865
	<u>94,167,483</u>	<u>87,620,780</u>
Less: Accumulated depreciation	18,245,477	17,178,862
	<u>75,922,006</u>	<u>70,441,918</u>
INVESTMENTS		
At equity (E):		
Western Electric Company, Inc.	3,261,615	3,209,232
Other	303,033	271,285
At cost	98,742	74,636
	<u>3,663,390</u>	<u>3,555,153</u>
CURRENT ASSETS		
Cash and temporary cash investments— less drafts outstanding:		
1976, \$319,943,000; 1975, \$269,749,000(F)	1,486,733	1,123,543
Receivables— less allowance for uncollectibles: 1976, \$86,479,000;		
1975, \$76,386,000	3,917,505	3,537,664
Material and supplies	543,578	450,440
Prepaid expenses	177,191	214,102
	<u>6,125,007</u>	<u>5,325,749</u>
DEFERRED CHARGES	<u>1,006,586</u>	<u>833,412</u>
TOTAL ASSETS	<u>\$86,716,989</u>	<u>\$80,156,232</u>

The accompanying notes are an integral part of the financial statements.

LIABILITIES AND CAPITAL	Thousands of Dollars	
	December 31, 1976	December 31, 1975
EQUITY		
American Telephone and Telegraph Company		
Preferred shares (G)	\$ 2,861,572	\$ 3,001,583
(Includes excess of proceeds over stated value)		
Common shares (H)	17,331,929	15,979,281
(Includes excess of proceeds over par value)		
Reinvested earnings—see page 27	<u>16,126,037</u>	<u>14,787,277</u>
	36,319,538	33,768,141
Ownership interest of others in consolidated subsidiaries	<u>899,082</u>	<u>863,784</u>
	<u>37,218,620</u>	<u>34,631,925</u>
LONG AND INTERMEDIATE TERM DEBT (I)	<u>32,524,826</u>	<u>31,793,326</u>
CURRENT LIABILITIES		
Accounts payable	2,200,478	1,914,082
Taxes accrued	1,136,237	847,646
Advance billing and customers' deposits	773,043	702,912
Dividends payable	646,504	565,266
Interest accrued	<u>631,844</u>	<u>596,802</u>
	5,388,106	4,626,708
Debt maturing within one year (J)	<u>2,471,163</u>	<u>2,228,782</u>
	<u>7,859,269</u>	<u>6,855,490</u>
DEFERRED CREDITS		
Accumulated deferred income taxes	6,210,104	4,721,166
Unamortized investment tax credits	2,730,282	2,025,228
Other	<u>173,888</u>	<u>129,097</u>
	<u>9,114,274</u>	<u>6,875,491</u>
LEASE COMMITMENTS (K)		
TOTAL LIABILITIES AND CAPITAL	<u><u>\$86,716,989</u></u>	<u><u>\$80,156,232</u></u>

Statements of Changes
in Financial Position

AMERICAN TELEPHONE AND TELEGRAPH COMPANY
AND ITS SUBSIDIARIES

	Thousands of Dollars	
	Year 1976	Year 1975
SOURCE OF FUNDS:		
Operations		
Net income	\$ 3,829,151	\$ 3,147,722
Add—Expenses not requiring funds:		
Depreciation	4,483,906	4,088,089
Deferred income taxes	1,488,938	1,403,841
Investment tax credits—net (A)	705,054	667,322
Deduct—Income not providing funds:		
Interest charged construction	216,284	239,957
Share of equity-basis companies' income in excess of dividends	58,806	—
Total funds from operations	<u>10,231,959</u>	<u>9,067,017</u>
Financing		
Issuance of shares	1,212,637	1,022,651
Issuance of long and intermediate term debt	<u>2,026,500</u>	<u>2,545,000</u>
Total funds from financing	<u>3,239,137</u>	<u>3,567,651</u>
Changes in ownership interest of others in consolidated subsidiaries	<u>35,298</u>	<u>35,960</u>
Other—net	<u>19,169</u>	<u>92,624</u>
	<u>\$13,525,563</u>	<u>\$12,763,252</u>
APPLICATION OF FUNDS:		
Telephone plant	\$ 9,747,710	\$ 9,354,661
Dividends	2,488,875	2,166,360
Increase in deferred charges	173,174	145,805
Reduction of long and intermediate term debt	1,295,000	110,000
Change in investments in companies accounted for on an equity basis	25,325	(8,300)
Change in working capital	<u>(204,521)</u>	<u>994,726</u>
	<u>\$13,525,563</u>	<u>\$12,763,252</u>
The increase (decrease) in working capital is accounted for by:		
Increase in current assets:		
Cash and temporary cash investments, net of drafts	\$ 363,190	\$ 1,922
Receivables	379,841	405,931
Material and supplies	93,138	612
Prepaid expenses	<u>(36,911)</u>	<u>58,817</u>
	<u>799,258</u>	<u>467,282</u>
Less—Increase in current liabilities:		
Accounts payable	286,396	22,774
Taxes accrued	288,591	13,617
Advance billing and customers' deposits	70,131	72,725
Dividends payable	81,238	19,361
Interest accrued	35,042	65,421
Debt maturing within one year (f)	<u>242,381</u>	<u>(721,342)</u>
	<u>1,003,779</u>	<u>(527,444)</u>
Change in working capital, as above	<u>\$ (204,521)</u>	<u>\$ 994,726</u>

() Denotes negative

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

(A) Accounting Policies—The financial statements reflect the application of certain accounting policies described in this note. Other policies and practices are covered in notes (B) and (F).

Consolidation—The consolidated financial statements include the accounts of American Telephone and Telegraph Company (the "Company") and its telephone subsidiaries. The consolidation process eliminates all significant inter-company transactions except as discussed below under "Purchases from Western Electric." The investment in Western Electric Company, Incorporated ("Western Electric"), an unconsolidated subsidiary, and certain other investments (where it is deemed that the Company's ownership gives it the ability to exercise significant influence over operating and financial policies) are carried at equity (cost plus proportionate share of reinvested earnings). All other investments are carried at cost.

Purchases from Western Electric—Most of the telephone equipment, apparatus and materials used by the consolidated companies have been manufactured or procured for them by Western Electric. Contracts with the telephone companies provide that Western Electric's prices to them shall be as low as to its most favored customers for like materials and services under comparable conditions. The consolidated financial statements reflect items purchased from Western Electric at cost to the companies, which cost includes the return realized by Western Electric on its investment devoted to this business.

Interest Charged Construction—Regulatory authorities allow the Company and its telephone subsidiaries to provide for a return on capital invested in new telephone plant while under construction by including interest charged construction as an item of income during the construction period and also as an addition to the cost of the plant constructed. Such income is not realized in cash currently but, under the regulatory process, will be realized over the service life of the plant as the resulting higher depreciation expense is recovered in the form of increased revenues.

Depreciation—Provision in the accounts for depreciation (5.3% in 1976 and 5.2% in 1975 of the cost of depreciable

plant in service) is based on straight-line composite rates. Depreciation for income tax purposes is provided on different bases and methods as explained under "Income Taxes" below.

Income Taxes:

(1) Under various accelerated depreciation provisions of the tax law, depreciation for income tax purposes on plant placed in service after 1969 is greater than the straight-line depreciation provided in the accounts. In addition, the companies have adopted for income tax purposes shorter depreciation lives than those used for financial statement purposes for certain plant, as allowed in income tax regulations of the Treasury Department. Provision is included in income tax expense for the deferred income taxes resulting from the use of accelerated depreciation and shorter tax lives.

(2) Provisions of the tax law allow for reductions in tax liability for certain construction expenditures. Such reductions, which are captioned "investment tax credits," are accounted for as operating tax expense in the year they occur and are amortized, principally as reductions in operating tax expense, over the life of the plant constructed.

(3) The effective consolidated Federal income tax rate was 40.8% in 1976 and 40.7% in 1975. This rate is determined by dividing Federal income taxes (including non-operating) by the sum of Federal income taxes, Net Income and ownership interest of others in net income—see note (C). The differences of 7.2% and 7.3% in 1976 and 1975, respectively, between the effective rate and the 48% Federal income tax statutory rate are attributable to the following factors:

	<u>1976</u>	<u>1975</u>
a. Earnings applicable to investments in companies accounted for on an equity basis which are reflected net of income tax	1.7%	1.0%
b. Certain taxes and payroll-related construction costs capitalized for financial statement purposes, but deducted for income tax purposes, net of related depre-		

ciation adjustments for current and prior years	3.0%	3.1%
c. Interest charged construction which is excluded from taxable income, net of related depreciation adjustments for current and prior years	1.1%	1.6%
d. Profits on telephone plant items purchased from Western Electric, which are capitalized for financial statement purposes but not for tax purposes, and which reduce depreciation expense for tax purposes	(.6%)	(.7%)
e. Amortization of investment tax credits over the life of the plant which gave rise to the credits. Such amortization reduced income tax expense for the years 1976 and 1975 by about \$150,754,000 and \$112,543,000, respectively	2.3%	2.1%
f. Other miscellaneous differences	<u>(.3%)</u>	<u>.2%</u>
Total	<u>7.2%</u>	<u>7.3%</u>

Research and Development—In addition to basic research and fundamental development costs, which are expensed currently, the cost of specific development and design work incurred by Western Electric is related to products manufactured and is included in the cost of such products (see "Purchases from Western Electric" above).

(B) Provision for Pensions and Death Benefits—The Company and its consolidated subsidiaries have noncontributory plans covering all employees and providing for service pensions and certain death benefits. These companies have accrual programs under which actuarially determined regular payments are made to trust funds that are irrevocably devoted to service pension and death benefit purposes. The total provision for these service pensions and death benefits, including amounts charged to construction, was \$1,843,144,000 in 1976 and \$1,613,132,000 in 1975, which represented 15.5% in 1976 and 14.8% in 1975 of salaries and wages. Amendments to the plans, effective January 1, 1976, adopted pursuant to 1974 union contracts, which provide for improved benefits for all employees, and changes made in compliance with the Employee Retirement Income Security Act of 1974, increased pension accruals in 1976 by about \$61,434,000. Based on the latest actuarial valuation, adjusted to reflect those benefits which became effective January 1, 1977, the companies estimate that the actuarially computed value of vested benefits

exceeded the cost of trust fund assets by about \$684,150,000. The accrual programs contemplate that there will be available in the funds amounts sufficient to provide benefits as stated in the plans.

(C) Miscellaneous Income and Deductions—Miscellaneous deductions include ownership interest of others in the net income of certain consolidated subsidiaries in the amounts of \$94,806,000 in 1976 and \$77,027,000 in 1975, and income taxes on non-operating income as follows:

	Thousands of Dollars	
	1976	1975
Federal:		
Current	\$22,387	\$36,030
Deferred	164	311
State and local:		
Current	3,844	3,403
Deferred	13	27
Total	<u>\$26,408</u>	<u>\$39,771</u>

(D) Earnings Subject to Possible Refund—Net Income includes the following amounts resulting from intrastate rate increases in a number of states, and from interstate rate increases effective February 29, 1976 authorized by the Federal Communications Commission (FCC), all of which are subject to investigation and possible refund.

	Thousands of Dollars	
	1976	1975
Intrastate	\$213,650	\$112,470
Interstate	100,090	—
Total	<u>\$313,740</u>	<u>\$112,470</u>
Per common share	\$.53	\$.20

Of the intrastate amounts, \$130,680,000 for 1976 and \$86,620,000 for 1975 relate to Pacific Telephone, a subsidiary. A proposed order by the hearing examiner of the California Public Utilities Commission relating to amounts subject to refund and to future rates could affect Pacific Telephone's eligibility for Job Development Investment Tax Credit and accelerated tax depreciation. The proposed order, which states that such eligibility would not be adversely affected, includes a provision that the order would be effective 180 days from issuance; however, if the proposed order is issued Pacific Telephone will seek a ruling from the Internal Revenue Service within that period as to whether such order would comply with Federal in-

come tax eligibility requirements for these large amounts of past and future tax benefits. The loss of these tax benefits, while not materially affecting consolidated Net Income, could materially increase Pacific Telephone's cash and revenue requirements.

(E) Investments at Equity—The Uniform System of Accounts of the FCC requires that investments be carried on the books of the companies at cost. In accordance with generally accepted accounting principles, certain investments are included at equity in the accompanying balance sheets. See note (A), "Consolidation."

The following information is provided as of December 31, 1976, for those companies carried at equity:

Western Electric Company, Inc. and its subsidiaries—

Wholly owned and carried on the Company's books at a cost of \$1,451,010,000. The consolidated assets and liabilities at December 31, 1976, were \$5,178,460,000 and \$1,916,845,000, respectively.

Other—Includes principally:

Bell Telephone Laboratories, Inc.—50% owned and carried on the Company's books at a cost of \$141,000,000 plus \$11,000,000 of advances, which also is its investment at equity. Western Electric owns the other 50%.

The Southern New England Telephone Company—17.6% owned and carried on the Company's books at a cost of \$55,545,000 plus \$5,700,000 of advances. The Company's equity is \$90,904,000. The market value of the shares owned by the Company based on the closing price on the New York Stock Exchange at December 31, 1976, was \$75,896,000.

Cincinnati Bell Inc.—25.7% owned and carried on the Company's books at a cost of \$24,345,000 plus \$1,600,000 of advances. The Company's equity is \$50,488,000. The market value of the shares owned by the Company based on the closing price on the New York Stock Exchange at December 31, 1976, was \$42,849,000.

(F) Cash and Temporary Cash Investments—Cash and temporary cash investments have been reduced by the amount of drafts outstanding with a corresponding reduction in accounts payable. It is the practice of the Company and some telephone subsidiaries to make certain payments by draft and to record such drafts as accounts payable until such time as the banks honoring the drafts have presented them for payment. The Company maintains cash and temporary cash investments not only to meet its own obliga-

tions but to maintain funds upon which the subsidiary companies may draw on a day-to-day basis to meet their obligations, including coverage for outstanding drafts.

(G) Preferred Shares—At December 31, 1976, 100,000,000 preferred shares at \$1 par were authorized. Outstanding, at a \$1,000 stated value, were 625,000 shares of \$77.50 cumulative preferred, and at a \$50 stated value, 24,627,000 shares of \$4 cumulative convertible preferred and 10,000,000 shares each of \$3.64 and \$3.74 cumulative preferred. Proceeds in excess of stated value amounted to \$5,213,000 and \$5,799,000 at December 31, 1976 and 1975, respectively.

The \$77.50 preferred shares may be redeemed by the Company at a premium of \$66.40 per \$1,000 share on or before January 31, 1978, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund commencing February 1, 1978.

The \$4 preferred shares may be redeemed by the Company at stated value. Each share is convertible into approximately 1.05 common shares of the Company. During 1976, a total of 2,788,495 shares were converted. See note (H).

The \$3.64 preferred shares may be redeemed by the Company at a premium of \$3.33 per \$50 share on or before April 30, 1977, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund commencing May 1, 1984.

The \$3.74 preferred shares may be redeemed by the Company at a premium of \$3.42 per \$50 share on or before January 31, 1978, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund commencing February 1, 1985.

(H) Common Shares—At December 31, 1976, 750,000,000 common shares at \$16 $\frac{2}{3}$ par value were authorized. Outstanding were 607,405,000 shares and 582,024,000 shares as of December 31, 1976 and 1975, respectively. Proceeds in excess of par value of common shares amounted to \$7,208,511,000 and \$6,278,884,000 at December 31, 1976 and 1975, respectively. Book value per common share amounted to \$55.08 and \$52.86 at December 31, 1976 and 1975, respectively.

At December 31, 1976, there were 25,923,348 authorized and unissued shares reserved for the conversion of the Company's outstanding \$4 convertible preferred shares.

The Company issued common shares in 1976 as follows: 2,935,260 upon conversion of 2,788,495 shares of the

Company's \$4 convertible preferred shares. See note (G). 6,332,814 sold at 95% of market for dividend reinvestments and 1,714,166 at market for optional cash payments under the Share Owner Dividend Reinvestment and Stock Purchase Plan.

2,399,000 sold at market to the Bell System Savings Plan for Salaried Employees.

12,000,000 sold at \$54⁷/₈ per share through an underwritten offering in June 1976.

(I) Long and Intermediate Term Debt—At December 31, 1976, in millions of dollars:

Maturities	2 ⁵ / ₈ % to 5 ⁷ / ₈ %	6% to 7 ⁷ / ₈ %	8% to 10%	Total
1978	\$ 220	\$ 275	\$ —	\$ 495
1979	60	725	—	785
1980	265	150	—	415
1981	170	—	325	495
1982-1991 . . .	3,195	450	470	4,115
1992-2001 . . .	4,167	1,235	1,846	7,248
2002-2011 . . .	1,702	5,245	4,920	11,867
2012-2016 . . .	—	2,250	4,855	7,105
Total	<u>\$ 9,779</u>	<u>\$10,330</u>	<u>\$12,416</u>	<u>\$32,525</u>

On January 21, 1977, four telephone subsidiaries offered to purchase \$630,000,000 of debentures which are included as Long and Intermediate Term Debt in the accompanying balance sheets.

In addition, as of February 8, 1977, nine subsidiaries have sold or announced their intention to sell up to \$1,820,000,000 of long and intermediate term debt. The proceeds of such sales will be used to refund outstanding long and intermediate term debt, applied toward repayment of bank loans, commercial paper and other notes payable, and used for general corporate purposes, including extensions, additions and improvements to plant.

(J) Debt Maturing Within One Year—The Company's telephone subsidiaries follow the practice of financing the construction of telephone plant partially through interim debt (bank loans, commercial paper and other notes payable in 12 months or less after issuance), pending long term financing. See note (I) above. In the Company's computation of ratios of debt to total capitalization (usually referred to as "debt ratios") for regulatory and other purposes, interim debt and long and intermediate term debt maturing within one year are included with Long and Intermediate Term Debt.

Outstanding at December 31 (including amounts subsequently refinanced) were:

	Millions of Dollars	
	1976	1975
Bank loans	\$ 755	\$1,177
Commercial paper	951	942
Other notes	170	—
Long and intermediate term debt maturing within one year (includes \$575,000,000 in 1976 called for redemption)	595	110
Total	<u>\$2,471</u>	<u>\$2,229</u>

The weighted average annual interest rates for bank loans, commercial paper and other notes outstanding at December 31, 1976, were 5.6%, 4.6% and 5.6%, respectively. The maximum amount of interim debt at any month-end during the year 1976 was \$2,419,525,000 and the average amount outstanding during the year was approximately \$1,853,422,000 at an average interest rate of 5.8%, computed by averaging the face amount of the interim debt payable each day of the year and dividing such average into the aggregate related interest expense. Long and intermediate term debt maturing within one year outstanding at December 31, 1976 carried a weighted average interest rate of 8.4%.

(K) Lease Commitments—Total rental expense for the years 1976 and 1975 was about \$729,775,000 and \$672,326,000, respectively. At December 31, 1976, the aggregate minimum rental commitments under noncancelable leases for the periods shown were as follows:

Years	Thousands of Dollars
1977	\$385,354
1978	375,879
1979	342,199
1980	298,729
1981	261,689
1982-1986	835,371
1987-1991	472,760
1992-1996	327,924
Thereafter	986,761

(L) Department of Justice Antitrust Action—In November 1974 the Department of Justice brought a civil antitrust action naming the Company, Western Electric and Bell Telephone Laboratories as defendants, and the 23 Bell System telephone companies as co-conspirators but not defendants. This matter might not be resolved for several

years. The Company believes that the relief sought, which includes dismemberment of the Bell System, is adverse to the public interest and is confident that it has not been in violation of the antitrust laws and that the structure of the Bell System will remain basically unchanged. In the opinion of the Company, dismemberment of the Bell System would have adverse effects on its business, could affect its ability to raise capital, its credit standing and the market value of its securities, and could require an immediate payment of Federal income taxes previously deferred on intercompany profits. A lump sum payment of such deferred taxes, which are being credited to the plant accounts, would have no direct effect on net income but would materially increase requirements for cash which in turn would increase requirements for revenues related to the cost of such funds.

(M) Quarterly Financial Information (Unaudited)—Subject to the outcome of the rate matters referred to below, all adjustments necessary for a fair statement of income for each period have been included.

Millions of Dollars				
Calendar Quarter	Operating Revenues	Operating Income	Income Applicable to Common Shares	Earnings per Common Share*
1976				
1st	\$ 7,848	\$1,392	\$ 809	\$1.39
2nd	8,138	1,488	917	1.56
3rd	8,361	1,521	957	1.59
4th	8,468	1,483	919	1.52
Total	<u>\$32,815</u>	<u>\$5,884</u>	<u>\$3,602</u>	<u>\$6.05</u>

*Because of increasing numbers of common shares outstanding each quarter, the sum of quarterly earnings per share does not equal earnings per share for the year.

Results for the calendar quarters include approximately \$52,520,000, \$82,700,000, \$89,820,000 and \$88,700,000, respectively, of Net Income (\$.09, \$.14, \$.15 and \$.15, respectively, per common share) resulting from intrastate and interstate rate increases which are subject to investigation and possible refund. See note (D).

Results for the fourth quarter reflect a number of factors which decreased earnings per common share. Principal among these, and the effect on earnings per common share, were: (a) revenues applicable to the current and prior periods which were refunded by one subsidiary, pursuant to an order from its regulatory authority (\$.03);

(b) revised depreciation rates for the Company and certain telephone subsidiaries authorized by the FCC in the fourth quarter but retroactive to January 1, 1976 (\$.05); and (c) costs related to the early redemption by the Company of certain long-term debt (\$.02).

(N) Replacement Cost (Unaudited)—In response to Securities and Exchange Commission requirements, the following figures compare telephone plant investment as shown on the balance sheet at December 31, 1976 with the approximate cost to replace its productive capacity at that date. They also compare accumulated depreciation at that date with the amount that would have been provided had past depreciation accruals contemplated such replacement costs. Additionally, they compare depreciation expense for the year ended December 31, 1976 with depreciation expense computed (using historic depreciation assumptions) on these estimates of replacement costs.

	Millions of Dollars		
	As Stated	At Replacement Cost	Difference
Telephone plant investment:			
For which replacement cost has been determined	\$90,660	\$130,405	\$39,745
Included at historic cost	3,507	3,507	—
Total	94,167	133,912	39,745
Accumulated depreciation	18,245	32,634	14,389
Net telephone plant investment	<u>\$75,922</u>	<u>\$101,278</u>	<u>\$25,356</u>
Depreciation expense	<u>\$ 4,484</u>	<u>\$ 5,980</u>	<u>\$ 1,496</u>

These replacement cost figures are theoretical, based on the assumptions that, as of December 31, 1976: electronic switching systems would replace all electromechanical switching systems; most other telephone plant would be replaced in accordance with present replacement practices; and building space would be reduced because of the use of electronic switching systems. Certain telephone plant categories are included at historic cost: principally land, telephone plant under construction, and telephone plant held for future use.

The difference between historic and estimated replace-

ment cost of net telephone plant investment does not represent additional book value for the Company's stock. The above replacement cost is an approximation of the amount of capital that could have been required were the Company to have replaced the entire productive capacity of such plant on December 31, 1976. Replacement actually will take place over many years and the funds needed will be derived from sources similar to those available during 1976.

Depreciation expense based on an estimate of replacement cost also is a theoretical figure and not deductible in determining income tax expense. The excess of depreciation on replacement cost over that determined on historic cost is a measure of the extent to which current operations have not been making provision for the higher replace-

ment cost of present plant capacity. Such provision, if made, would provide funds which would be used in lieu of funds from other sources for plant construction.

It would be unrealistic to impute a reduced net income by the difference between depreciation based on historic cost and that based on estimates of replacement cost. New plant is likely to provide largely-offsetting additional revenue-generating services and operating efficiencies. Additionally, replacement of plant will take place over many years. It is true, however, that the earnings of the Company must be high enough to provide some equity capital from reinvested earnings and to attract additional debt and equity to provide funds for any replacement cost in excess of depreciation accruals based on the historic cost of the plant.

The Bell System operates in every state but Alaska and Hawaii, serving about 80 per cent of the nation's telephones. Of the Bell System's 21 principal operating telephone companies, all but four are wholly-owned by AT&T: Pacific Telephone (89.8%), Pacific Northwest Bell (89.3%), Mountain Bell (88.6%) and New England Telephone (86.0%). In addition, AT&T has a non-controlling ownership in Southern New England Telephone (17.6%) and Cincinnati Bell (25.7%). The Western Electric Company, a wholly-owned subsidiary, is the manufacturing and supply unit of the Bell System. Bell Laboratories, owned by AT&T and Western Electric, provides research and development services. AT&T's Long Lines Dept. is the Bell System's interstate and overseas operating unit.

Bell System telephone companies	Area served	Telephones served as of 12/31/76 (in thousands)
New England Telephone & Telegraph Company	Maine, Massachusetts, New Hampshire, Rhode Island, Vermont	6,264
The Southern New England Telephone Company	Connecticut	2,361
New York Telephone Company	New York and portion of Connecticut	12,005
New Jersey Bell Telephone Company	New Jersey	5,741
The Bell Telephone Company of Pennsylvania	Pennsylvania	7,351
The Diamond State Telephone Company	Delaware	471
The Chesapeake and Potomac Telephone Company	Washington, D.C.	1,021
The Chesapeake and Potomac Telephone Company of Maryland	Maryland	3,086
The Chesapeake and Potomac Telephone Company of Virginia	Virginia	2,605
The Chesapeake and Potomac Telephone Company of West Virginia	West Virginia	852
Southern Bell Telephone and Telegraph Company	Florida, Georgia, North Carolina, South Carolina	10,341
South Central Bell Telephone Company	Alabama, Kentucky, Louisiana, Mississippi, Tennessee	8,948
The Ohio Bell Telephone Company	Ohio	4,680
Cincinnati Bell Inc.	Cincinnati, portions of Kentucky, Indiana	1,079
Michigan Bell Telephone Company	Michigan	5,720
Indiana Bell Telephone Company, Incorporated	Indiana	2,414
Wisconsin Telephone Company	Wisconsin	2,224
Illinois Bell Telephone Company	Illinois	7,449
Northwestern Bell Telephone Company	Iowa, Minnesota, Nebraska, North Dakota, South Dakota	5,073
Southwestern Bell Telephone Company	Arkansas, Kansas, Missouri, Oklahoma, Texas	13,919
The Mountain States Telephone and Telegraph Company	Arizona, Colorado, Idaho, Montana, New Mexico, Utah, Wyoming and portion of Texas	6,140
Pacific Northwest Bell Telephone Company	Oregon, Washington and portion of Idaho	3,204
The Pacific Telephone and Telegraph Company (including Bell Telephone Company of Nevada)	California, Nevada	13,623

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8. Member of the Proxy Committee



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