BELLSOUTH CORP
Form 10-Q
August 01, 2006

UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

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# FORM 10-Q

(Mark One)

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2006

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 1-8607

# BELLSOUTH CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Georgia** | **58-1533433** |
| (State of Incorporation) | (I.R.S. Employer Identification Number) |

| | |
|---|---|
| **1155 Peachtree Street, N. E., Atlanta, Georgia** | **30309-3610** |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number 404-249-2000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer X Accelerated filer___ Non-accelerated filer___

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ___ No X

At July 27, 2006, 1,815,793,584 common shares were outstanding.

**Table of Contents**

**PART I FINANCIAL INFORMATION**

**BELLSOUTH CORPORATION**

**CONSOLIDATED STATEMENTS OF INCOME**

**(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)**

**(Unaudited)**

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Operating revenues: | | | | |
| Communications Group | $ 4,598 | **$ 4,647** | $ 9,191 | **$ 9,300** |
| Advertising & Publishing Group | 527 | **543** | 1,015 | **1,046** |
| All other | 17 | **16** | 27 | **31** |
| Total operating revenues | 5,142 | **5,206** | 10,233 | **10,377** |
| Operating expenses: | | | | |
| Cost of services and products (excludes depreciation and amortization shown separately below) | 1,925 | **1,960** | 3,845 | **4,069** |
| Selling, general, and administrative expenses | 943 | **970** | 1,837 | **1,901** |
| Depreciation and amortization | 916 | **898** | 1,834 | **1,791** |
| Provisions for restructuring | 8 | **73** | 15 | **65** |
| Total operating expenses | 3,792 | **3,901** | 7,531 | **7,826** |
| Operating income | 1,350 | **1,305** | 2,702 | **2,551** |
| Interest expense | 285 | **279** | 576 | **558** |
| Net earnings (losses) of equity affiliates | 68 | **213** | (12) | **352** |
| Other income (expense), net | 56 | **67** | 112 | **122** |
| Income from continuing operations before income taxes | 1,189 | **1,306** | 2,226 | **2,467** |
| Provision for income taxes | 394 | **419** | 748 | **796** |
| Income from continuing operations | 795 | **887** | 1,478 | **1,671** |
| Income from discontinued operations, net of tax | | | 381 | |
| Net income | $ 795 | **$ 887** | $ 1,859 | **$ 1,671** |
| Weighted-average common shares outstanding: | | | | |
| Basic | 1,831 | **1,806** | 1,831 | **1,802** |
| Diluted | 1,835 | **1,813** | 1,835 | **1,809** |
| Dividends declared per common share | $ 0.29 | **$ 0.29** | $ 0.56 | **$ 0.58** |
| Basic earnings per share: | | | | |
| Income from continuing operations | $ 0.43 | **$ 0.49** | $ 0.81 | **$ 0.93** |
| Discontinued operations, net of tax | | | 0.21 | |
| Net income | $ 0.43 | **$ 0.49** | $ 1.02 | **$ 0.93** |
| Diluted earnings per share: | | | | |
| Income from continuing operations | $ 0. 43 | **$ 0.49** | $ 0.81 | **$ 0.92** |

| | | | | |
|---|---|---|---|---|
| Discontinued operations, net of tax | | | 0.21 | |
| Net income* | $ 0.43 | **$ 0.49** | $ 1.01 | **$ 0.92** |

**Net income per share may not sum due to rounding.*

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

**BELLSOUTH CORPORATION**

**CONSOLIDATED BALANCE SHEETS**

**(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)**

| | December 31, 2005 | **June 30, 2006** (unaudited) |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 427 | **$ 259** |
| Short-term investments | | **483** |
| Accounts receivable, net of allowance for uncollectibles of $289 and $274 | 2,555 | **2,472** |
| Material and supplies | 385 | **408** |
| Other current assets | 842 | **932** |
| Total current assets | 4,209 | **4,554** |
| Investments in and advances to Cingular Wireless | 21,274 | **22,108** |
| Property, plant and equipment, net | 21,723 | **21,920** |
| Other assets | 7,814 | **8,250** |
| Intangible assets, net | 1,533 | **1,606** |
| Total assets | $ 56,553 | **$ 58,438** |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Debt maturing within one year | $ 4,109 | **$ 4,325** |
| Accounts payable | 1,040 | **911** |
| Other current liabilities | 3,505 | **4,131** |
| Total current liabilities | 8,654 | **9,367** |
| Long-term debt | 13,079 | **13,047** |
| Noncurrent liabilities: | | |
| Deferred income taxes | 6,607 | **6,713** |
| Other noncurrent liabilities | 4,679 | **4,740** |
| Total noncurrent liabilities | 11,286 | **11,453** |
| Shareholders equity: | | |
| Common stock, $1 par value (8,650 shares authorized; 1,798 and 1,812 shares outstanding) | 2,020 | **2,020** |
| Paid-in capital | 7,960 | **7,919** |
| Retained earnings | 20,383 | **20,965** |
| Accumulated other comprehensive income (loss) | (14) | **19** |
| Shares held in trust and treasury | (6,815) | **(6,352)** |
| Total shareholders equity | 23,534 | **24,571** |
| Total liabilities and shareholders equity | $ 56,553 | **$ 58,438** |

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

**BELLSOUTH CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(IN MILLIONS)**

**(Unaudited)**

| | For the Six Months Ended June 30, 2005 | **2006** |
|---|---|---|
| **Cash Flows from Operating Activities:** | | |
| Net income | $ 1,859 | **$ 1,671** |
| Less income from discontinued operations, net of tax | (381) | |
| Income from continuing operations | $ 1,478 | **$ 1,671** |
| Adjustments to reconcile income to cash provided by operating activities from continuing operations: | | |
| Depreciation and amortization | 1,834 | **1,791** |
| Provision for uncollectibles | 165 | **147** |
| Net losses (earnings) of equity affiliates | 12 | **(352)** |
| Deferred income taxes | 117 | **58** |
| Pension income | (266) | **(261)** |
| Stock-based compensation expense | 48 | **32** |
| Loss on extinguishment of debt | 42 | |
| Net change in: | | |
| Accounts receivable and other current assets | (163) | **(155)** |
| Accounts payable and other current liabilities | 391 | **410** |
| Deferred charges and other assets | (40) | **3** |
| Other liabilities and deferred credits | 204 | **195** |
| Other reconciling items, net | (2) | **23** |
| Net cash provided by operating activities from continuing operations | 3,820 | **3,562** |
| **Cash Flows from Investing Activities:** | | |
| Capital expenditures | (1,579) | **(2,031)** |
| Investment in short-term instruments | (12) | **(1,105)** |
| Proceeds from sale of short-term instruments | 28 | **622** |
| Proceeds from sale of operations | 930 | |
| Investments in debt and equity securities | (103) | **(343)** |
| Proceeds from sale of debt and equity securities | 14 | **135** |
| Net repayments from (advances to) Cingular Wireless | 787 | **(477)** |
| Other investing activities, net | (12) | **(22)** |
| Net cash provided by (used for) investing activities from continuing operations | 53 | **(3,221)** |
| **Cash Flows from Financing Activities:** | | |
| Net borrowings (repayments) of short-term debt | (1,630) | **633** |
| Repayments of long-term debt | (1,267) | **(429)** |
| Dividends paid | (988) | **(1,046)** |
| Purchase of treasury shares | (83) | **(52)** |
| Proceeds from issuing common stock | 38 | **380** |
| Other financing activities, net | (23) | **5** |
| Net cash (used in) provided by financing activities from continuing operations | (3,953) | **(509)** |
| Net decrease in cash and cash equivalents from continuing operations | (80) | **(168)** |

| | | |
|---|---|---|
| Cash flows from discontinued operations: | | |
| Net cash provided by operating activities | 10 | |
| Net cash used for investing activities | (125) | |
| Net cash provided by financing activities | | |
| Net decrease in cash and cash equivalents from discontinued operations | (115) | |
| Net increase (decrease) in cash and cash equivalents | (195) | **(168)** |
| Cash and cash equivalents at beginning of period | 680 | **427** |
| Cash and cash equivalents at end of period | $ 485 | **$ 259** |

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

**BELLSOUTH CORPORATION**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME**

**(IN MILLIONS)**

**(Unaudited)**

| | Number of Shares | | Amount | | | | |
|---|---|---|---|---|---|---|---|
| | Common Stock | (a) Shares Held in Trust and Treasury | Common Stock | Paid-in Capital | Retained Earnings | Accum. Other Comprehensive Income (Loss) | (a) Shares |
| **Balance at December 31, 2004** | **2,020** | **(189)** | **$ 2,020** | **$ 7,840** | **$ 19,267** | **$ (157)** | **$ (5,9** |
| Net income | | | | | 1,859 | | |
| Other comprehensive income, net of tax | | | | | | 87 | |
| Total comprehensive income | | | | | | | |
| Dividends declared | | | | | (1,024) | | |
| Purchase of treasury stock | | (3) | | | | | (83) |
| Share issuances for employee benefit plans | | 4 | | (55) | (49) | | 142 |
| Stock-based compensation | | | | 48 | | | |
| Tax benefit related to stock options | | | | 3 | | | |
| **Balance at June 30, 2005** | **2,020** | **(188)** | **$ 2,020** | **$ 7,836** | **$ 20,053** | **$ (70)** | **$ (5,8** |
| **Balance at December 31, 2005** | **2,020** | **(222)** | **$ 2,020** | **$ 7,960** | **$ 20,383** | **$ (14)** | **$ (6,8** |
| Net income | | | | | 1,671 | | |
| Other comprehensive income, net of tax | | | | | | 33 | |
| Total comprehensive income | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Dividends declared | | | | | (1,042) | | |
| Purchase of treasury stock | | (2) | | | | | (52) |
| Share issuances for employee benefit plans | | 16 | | (81) | (47) | | 515 |
| Stock-based compensation | | | | 32 | | | |
| Tax benefit related to stock options | | | | 8 | | | |
| **Balance at June 30, 2006** | **2,020** | **(208)** | **$ 2,020** | **$ 7,919** | **$ 20,965** | **$ 19** | **$ (6,3** |

(a) Trust and treasury shares are not considered to be outstanding for financial reporting purposes.

| | As of June 30, | |
|---|---|---|
| | 2005 | **2006** |
| Shares held in trust | 26 | **17** |
| Shares held in treasury | 162 | **191** |
| **Total** | 188 | **208** |

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

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

(Unaudited)

**NOTE A - PREPARATION OF INTERIM FINANCIAL STATEMENTS**

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

The accompanying unaudited consolidated financial statements have been prepared based upon Securities and Exchange Commission (SEC) rules that permit reduced disclosure for interim periods. In our opinion, these statements include all adjustments necessary for a fair presentation of the results of the interim periods presented. All adjustments are of a normal recurring nature unless otherwise disclosed. Revenues, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those for the full year. For a more complete discussion of our significant accounting policies and other information, you should read this report in conjunction with the consolidated financial statements included in our annual report on Form 10-K for the year ended December 31, 2005.

Certain amounts within the prior year s information have been reclassified to conform to the current year s presentation.

**NOTE B RECENTLY ISSSUED ACCOUNTING PRONOUNCEMENTS**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standard (SFAS) No. 109, "Accounting for Income Taxes." This Interpretation prescribes a recognition threshold and measurement attribute of tax positions taken or expected to be taken on a tax return. This Interpretation is effective for BellSouth beginning January 1, 2007. We are currently evaluating the impact FIN 48 will have on our financial statements.

**NOTE C - EARNINGS PER SHARE**

Basic earnings per share are computed based on the weighted-average number of common shares outstanding during each year. Nonvested restricted stock carries dividend and voting rights and, in accordance with Generally Accepted Accounting Principles (GAAP), is not included in the weighted-average number of common shares outstanding used to compute basic earnings per share. Diluted earnings per share are based on the weighted-average number of common shares outstanding plus net incremental shares arising out of employee stock compensation and benefit plans. The earnings amounts used for per-share calculations are the same for both the basic and diluted methods. The following is a reconciliation of the weighted-average share amounts (in millions) used in calculating earnings per share:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Basic common shares outstanding | 1,831 | **1,806** | 1,831 | **1,802** |
| Incremental shares from stock-based compensation and benefit plans | 4 | **7** | 4 | **7** |
| Diluted common shares outstanding | 1,835 | **1,813** | 1,835 | **1,809** |
| Common stock equivalents excluded from the computation | 77 | **57** | 77 | **58** |

Options with an exercise price greater than the average market price of the common stock or that have an anti-dilutive effect on the computation are excluded from the calculation of diluted earnings per share. Restricted stock or restricted stock units that have an anti-dilutive effect on the computation are also excluded from the calculation of diluted earnings per share.

**NOTE D DISCONTINUED OPERATIONS**

In March 2004, we signed an agreement with Telefónica Móviles, S.A., the wireless affiliate of Telefónica, S.A., to sell all of our interests in Latin America. During 2004, we closed on the sale of 8 of the 10 properties. During January 2005, we closed on the sale of the operations in the remaining two Latin American countries for gross proceeds of $1,077 and a gain of $390, net of tax. The gain includes the recognition of cumulative foreign currency translation losses of $68.

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE D DISCONTINUED OPERATIONS (Continued)**

Summarized results of operations for the discontinued operations for the six months ended June 30, 2005 are as follows:

| | 2005 |
|---|---|
| Revenue | $ 66 |
| Operating loss | (5) |
| Gain on sale of operations | 629 |
| Income before income taxes | 616 |
| Income tax expense | 235 |
| Income from discontinued operations | $ 381 |

**NOTE E - MERGER OF BELLSOUTH AND AT&T**

On March 4, 2006, we agreed to merge with a subsidiary of AT&T Inc. (AT&T) in a transaction in which each share of BellSouth common stock will be exchanged for 1.325 shares of AT&T common stock. The stock consideration in the transaction is expected to be tax-free to our shareholders. Our shareholders approved the merger in July 2006. The acquisition, which is subject to approval by regulatory authorities, and other customary closing conditions, is currently expected to close in the fall of 2006. However, it is possible that factors outside of our control could require us to complete the merger at a later time or not to complete it at all. The terms of certain of our agreements, including contracts, employee benefit arrangements and debt instruments, have provisions which could result in changes to the terms or settlement amounts of these agreements upon a change in control of BellSouth.

**NOTE F - INVESTMENTS IN AND ADVANCES TO CINGULAR WIRELESS**

*Investment*

We own a 40 percent economic interest in Cingular Wireless, a joint venture with AT&T. Because we exercise influence over the financial and operating policies of Cingular Wireless, we use the equity method of accounting for this investment. Under the equity method of accounting, we record our proportionate share of Cingular Wireless' earnings in our consolidated statements of income. These earnings are included in the caption "Net earnings (losses) of equity affiliates."

The following table displays the summary financial information of Cingular Wireless. These amounts are shown on a 100 percent basis.

| | December 31, 2005 | **June 30, 2006** |
|---|---|---|
| **Balance Sheet Information:** | | |
| Current assets | $ 6,049 | **$ 6,339** |
| Noncurrent assets | $ 73,270 | **$ 72,605** |
| Current liabilities | $ 10,008 | **$ 9,306** |
| Noncurrent liabilities | $ 23,790 | **$ 23,171** |
| Minority interest | $ 543 | **$ 595** |
| Members capital | $ 44,978 | **$ 45,872** |

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| **Income Statement Information:** | | | | |
| Revenues | $ 8,609 | **$ 9,218** | $ 16,838 | **$ 18,198** |
| Operating income | $ 504 | **$ 1,017** | $ 618 | **$ 1,824** |
| Net income (loss) | $ 147 | **$ 540** | $ (93) | **$ 894** |

As of June 30, 2006, our book investment exceeded our proportionate share of the net assets of Cingular Wireless by $456.

*Advance*

We have an advance to Cingular Wireless that, with interest, totaled $2,622 at December 31, 2005 and June 30, 2006. This advance earns an interest rate of 6.0 percent per annum and matures on June 30, 2008.

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE F - INVESTMENTS IN AND ADVANCES TO CINGULAR WIRELESS (Continued)**

*Revolving Line of Credit*

BellSouth and AT&T provide unsubordinated short-term financing on a pro rata basis for Cingular Wireless ordinary course of business cash requirements. Under the terms of the line of credit, Cingular Wireless available cash (as defined), if any, is applied first to repay amounts loaned to Cingular Wireless under the line of credit. Remaining available cash is applied to the repayment of the advance described above. Borrowings bear interest at 1-Month LIBOR plus 0.05 percent payable monthly. The line of credit terminates on July 31, 2007. Borrowings from BellSouth under the revolving credit line, including interest, were $204 at December 31, 2005 and $681 at June 30, 2006.

*Provision of Services*

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

*Interest and Revenue Earned from Cingular Wireless:*

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Revenues | $ 160 | **$ 196** | $ 334 | **$ 393** |
| Interest income on advances | $ 57 | **$ 48** | $ 116 | **$ 91** |

Interest income on advances are offset by a like amount of interest expense recorded by Cingular Wireless and reported in our financial statements in the caption Net earnings (losses) of equity affiliates.

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

| | December 31, 2005 | **June 30, 2006** |
|---|---|---|
| Receivable from Cingular | $ 51 | **$ 89** |
| Payable to Cingular | $ 54 | **$ 50** |

**NOTE G - DEBT**

On January 18, 2005, we redeemed $400 of 40-year, 6.75 percent debentures, due October 15, 2033. The redemption price was 103.33 percent of the principal amount, and resulted in recognition of a loss of $22, or $14 net of tax, which includes $9 associated with fully expensing remaining discount and deferred debt issuance costs.

On May 18, 2005 we redeemed $300 of 40-year, 7.625 percent debentures, due May 15, 2035. The redemption price was 103.66 percent of the principal amount, and resulted in recognition of a loss of $20, or $12 net of tax, which includes $9 associated with fully expensing remaining discount and deferred debt issuance costs.

**NOTE H - WORKFORCE REDUCTION AND RESTRUCTURING**

Based on competitive activity in the telecommunications industry, continued economic pressures, realignment of our business and productivity improvements, we have periodically initiated workforce reductions and recorded charges for early termination benefits.

In December 2005, we announced that we would reduce our management workforce by approximately 1,500 employees. The plan included a voluntary program offering a special termination benefit followed by an involuntary program to the extent necessary to achieve the targeted reductions. As a result of the pending merger of BellSouth and AT&T, we modified the terms of the fourth quarter 2005 announced workforce reduction by eliminating the involuntary component that was scheduled to follow the voluntary offer. Accordingly, in the first quarter of 2006 we reversed the minimum liability accrued (except with respect to the 60 employees who had already accepted under that program). Based on the acceptances of the voluntary offer, we accrued $73 for the second quarter of 2006 and $127 for the first half of 2006. Under the modified plan, we reduced our management workforce by approximately 1,350 employees. This reduction program was substantially complete at the end of June 2006.

In addition, we recorded restructuring charges totaling $24 for non-management surpluses announced in the first and second quarters of 2006.

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE H - WORKFORCE REDUCTION AND RESTRUCTURING (Continued)**

The following table summarizes activity associated with the workforce reduction and restructuring liability for the six months ended June 30, 2006:

| | |
|---|---|
| Balance at December 31, 2005 | $ 100 |
| Accruals | 151 |
| Cash Payments | (132) |
| Adjustments | (86) |
| **Balance at June 30, 2006** | **$ 33** |

Adjustments to the employee separations accrual are due to the reversal noted above as well as estimated demographics being different than actual demographics of employees that separated from the Company.

**NOTE I - EMPLOYEE BENEFITS PLANS**

Substantially all of our employees are covered by noncontributory defined benefit pension plans. We provide certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrue actuarially-determined postretirement benefit costs as active employees earn these benefits. Management employees hired after January 1, 2001 are provided access to medical benefits at retirement but are required to pay 100 percent of the cost.

The following details pension and postretirement benefit costs included in operating expenses (in cost of sales and selling, general and administrative expenses) in the accompanying Consolidated Statements of Income. Approximately 10 percent of these costs are capitalized to property, plant and equipment with labor related to network construction. We account for these costs in accordance with SFAS No. 87, "Employers' Accounting for Pensions" and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Components of net periodic benefit costs were as follows:

| | Pension Benefits For the Three Months Ended June 30, | | Other Benefits For the Three Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Service cost | $ 51 | **$ 49** | $ 30 | **$ 32** |

| | | | | |
|---|---|---|---|---|
| Interest cost | 147 | **149** | 146 | **146** |
| Expected return on plan assets | (320) | **(318)** | (84) | **(87)** |
| Amortizations: | | | | |
| Unrecognized net obligation | | | 18 | **13** |
| Unrecognized prior service cost | (11) | **(11)** | 57 | **45** |
| Unrecognized (gain) loss | | | 25 | **28** |
| Net periodic benefit cost (income) | $ (133) | **$ (131)** | $ 192 | **$ 177** |

| | Pension Benefits For the Six Months Ended June 30, | | Other Benefits For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Service cost | $ 103 | **$ 98** | $ 61 | **$ 63** |
| Interest cost | 294 | **299** | 292 | **292** |
| Expected return on plan assets | (642) | **(637)** | (168) | **(174)** |
| Amortizations: | | | | |
| Unrecognized net obligation | | | 36 | **26** |
| Unrecognized prior service cost | (21) | **(21)** | 113 | **90** |
| Unrecognized (gain) loss | | | 51 | **57** |
| Net periodic benefit cost (income) | $ (266) | **$ (261)** | $ 385 | **$ 354** |

*Employer Contributions*

Due to the funded status of our pension plans, we do not expect to make contributions to these plans in 2006. Consistent with prior years, we expect to contribute cash to the Voluntary Employee Beneficiary Association trusts to fund other benefit payments. During the six months ended June 30, 2006, we contributed $179 to fund these other benefits and expect to contribute approximately $150 to $200 during the remainder of 2006.

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE I - EMPLOYEE BENEFITS PLANS (Continued)**

*Cash Balance Pension Plans*

In July 2003, a Federal district court in Illinois ruled that the benefit formula used in International Business Machines Corporation's (IBM) cash balance pension plan violated the age discrimination provisions of the Age Discrimination in Employment Act and the Employee Retirement Income Security Act. Subsequent opinions of several other U.S. district courts have conflicted with that court s view, while others have agreed. Congress is presently considering legislation that could clarify the legal status of cash balance plans under the applicable age discrimination rules. At this time, it is unclear what effect, if any, these decisions or possible Congressional action may have on our tax-qualified cash balance pension plans or our financial condition.

**NOTE J - STOCK COMPENSATION PLANS**

We have granted stock-based compensation awards to key employees under several plans. One share of BellSouth common stock is the underlying security for any award under these plans. Under the stock plan approved by shareholders in 2004, the maximum number of shares available for future grants is limited to 80 million reduced by awards granted and increased by shares tendered in option exercises. In 2003, we used the retroactive restatement method provided by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, to adopt the expense recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS No. 123) by restating all periods beginning on or after January 1, 1995 (the effective date of SFAS No. 123). Effective January 1, 2006, we adopted SFAS No. 123 (Revised 2004), Share-Based Payment, (SFAS No. 123R) using the modified prospective application of its provisions; therefore, our financial statements for prior periods will not be restated. The cumulative effect of adopting SFAS No. 123R was immaterial. Because we previously adopted the expense recognition provisions of SFAS No. 123, the impact of adopting SFAS No. 123R resulted in essentially three changes: (1) use of an estimated forfeiture rate versus recognition of actual forfeitures as incurred, (2) use of fair value to measure expense for awards classified as liabilities, and (3) use of the alternative transition method to calculate the pool of excess tax benefits available to absorb tax deficiencies in future years, which increased the pool by $130. Effective with the adoption of SFAS No. 123R, we instituted a policy of recognizing expense for awards with graded vesting provisions using the straight-line method of expense attribution.

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| Compensation cost: | 2005 | **2006** | 2005 | **2006** |
| Stock options | $ 9 | **$ 2** | $ 23 | **$ 7** |

| | | | | |
|---|---|---|---|---|
| Restricted stock and restricted stock units | 13 | **13** | 26 | **24** |
| Performance share units | 14 | **39** | 30 | **76** |
| Total compensation cost | 36 | **54** | 79 | **107** |
| Income tax benefit | (13) | **(21)** | (29) | **(41)** |
| Compensation cost net of income tax benefit | $ 23 | **$ 33** | $ 50 | **$ 66** |

*Stock Option Awards*

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

| | Number of options | Weighted- average option prices per common share | Weighted- average remaining contractual term in years | Aggregate intrinsic value |
|---|---|---|---|---|
| Outstanding at December 31, 2005 | 96,802,789 | $36.12 | | |
| Granted | | | | |
| Exercised | (16,325,450) | $24.08 | | |
| Forfeited or expired | (1,832,724) | $37.53 | | |
| Outstanding at June 30, 2006 | 78,644,615 | $38.57 | 4.14 | $202 |
| Exercisable at June 30, 2006 | 76,526,278 | $38.87 | 4.07 | $185 |

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE J - STOCK COMPENSATION PLANS (Continued)**

As of June 30, 2006, total compensation cost related to unvested stock options of $3 is expected to be amortized by the end of 2006. Information related to stock option exercises is provided below:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Total value received by employees for options exercised | $ 7 | **$ 47** | $ 17 | **$ 137** |
| Tax benefit realized for options exercised | $ 2 | **$ 17** | $ 6 | **$ 51** |
| Cash received for options exercised | $ 19 | **$ 120** | $ 38 | **$ 380** |

*Restricted Stock and Restricted Stock Unit Awards*

Restricted stock and restricted stock unit awards granted to key employees under the plans are settled by issuing shares of common stock at the vesting date. Generally, the restrictions lapse in full on the third anniversary of the grant date, or on a pro rata basis on each of the first three anniversaries of the grant date. The vesting of restricted stock and restricted stock units accelerates if there is a change in control (as defined in the plans) and the employee is terminated or resigns for good cause within two years of the change in control. The grant date fair value of the restricted stock and restricted stock units, which is the stock price on the grant date, is expensed over the period during which the restrictions lapse. The shares represented by restricted stock awards (but not restricted stock unit awards) are considered outstanding at the grant date, as the recipients are entitled to dividends and voting rights. A summary of restricted stock and restricted stock unit activity under the plans is presented below:

| | Number of shares & units | Weighted-average grant date fair value |
|---|---|---|
| Unvested at December 31, 2005 | 4,270,080 | $27.02 |
| Granted | 1,601,986 | $31.86 |
| Vested | (830,466) | $27.54 |
| Forfeited | (158,123) | $28.55 |
| Unvested at June 30, 2006 | 4,883,477 | $28.47 |

The weighted-average grant date fair value of restricted stock and restricted stock units granted during the three months ended June 30, 2005 and 2006 was $26.47 and $34.13, respectively. The weighted-average grant date fair value of restricted stock and restricted stock units granted during the six months ended June 30, 2005 and 2006 was $26.05 and $31.86, respectively. As of June 30, 2006, the total unrecognized compensation cost for unvested restricted stock and restricted stock units of $76 is expected to be amortized over a weighted-average period of approximately 17 months. Information related to shares vested is provided below:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Total value received by employees for shares vested | $ 1 | **$ 5** | $ 15 | **$ 27** |
| Tax benefit realized for shares vested | $ | **$ 1** | $ 4 | **$ 8** |

*Performance Share Unit Awards*

Performance share units granted to key employees are settled in cash based on an average stock price at the end of the three-year performance period multiplied by the number of units earned. The number of performance share units actually earned by recipients is based on the achievement of certain performance goals as defined by the terms of the awards, and can range from 0% to 150% of the number of units granted. At the end of the performance period, recipients also receive a cash payment equal to the dividends paid on a share of BellSouth stock during the performance period for each performance share unit earned. Vesting accelerates and the performance period is modified if there is a change in control (as defined in the plans). For awards granted prior to 2006, performance share unit expense is generally recognized over the performance period; for awards granted in 2006, performance share unit expense is recognized over the vesting period, which approximates the performance period. Since performance share units are settled in cash, our obligations related to these awards are classified as liabilities. A summary of performance share unit activity under the plans is presented below:

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE J - STOCK COMPENSATION PLANS (Continued)**

| | Number of units |
|---|---|
| Unvested at December 31, 2005 | 5,857,605 |
| Granted | 2,254,375 |
| Vested | |
| Forfeited | (79,050) |
| Unvested at June 30, 2006 | 8,032,930 |

Effective with the adoption of the provisions of SFAS No. 123R on January 1, 2006, the amount of expense recognized for all unvested performance share units is based on the fair value of the performance shares at each reporting date and, as applicable, the expected outcome of performance conditions. The fair value of each performance share unit is determined at the grant date and at each reporting date using a Monte Carlo simulation model. The simulation model includes ranges of assumptions for stock price volatility, risk-free interest rates, and expected dividends. Expected volatilities for the three unvested awards are estimated based on a blend of historical volatility of our stock and implied volatilities from traded options on our stock and are currently estimated at 19%. The risk-free interest rate for periods within each performance period is based on the US Treasury yield curve in effect at the valuation date and currently ranges from 5.10% to 5.24%. Expected dividends are estimated based on historical patterns of increases.

The weighted-average fair value of unvested performance share units as of June 30, 2006 was $40.57, and the total unrecognized compensation cost of $183, based on this value, is expected to be amortized over a weighted-average period of approximately 18 months. Information related to performance share units vested and paid is provided below:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Total value received by employees for units vested and paid | $ | **$** | $ 7 | **$ 21** |
| Tax benefit realized for units vested and paid | $ | **$** | $ 2 | **$ 8** |

**NOTE K - SEGMENT INFORMATION**

We have three reportable operating segments: (1) Communications Group; (2) Wireless; and (3) Advertising & Publishing Group. We own a 40 percent economic interest in Cingular Wireless, and share joint control of the venture with AT&T. We account for the investment under the equity method. For management purposes we evaluate our Wireless segment based on our proportionate share of Cingular Wireless results. Accordingly, results for our Wireless segment reflect the proportional consolidation of 40 percent of Cingular Wireless results.

The Company s chief decision makers evaluate the performance of each business unit based on segment net income, exclusive of internal charges for use of intellectual property and adjustments for unusual items that may arise. Unusual items are transactions or events that are included in reported consolidated results but are excluded from segment results due to their nonrecurring or nonoperational nature.

The following table provides information for each operating segment:

| | For the Three Months Ended June 30, 2005 | For the Three Months Ended June 30, 2006 | For the Six Months Ended June 30, 2005 | For the Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| **Communications Group** | | | | |
| External revenues | $ 4,598 | **$ 4,647** | $ 9,191 | **$ 9,300** |
| Intersegment revenues | 27 | **26** | 52 | **52** |
| Total segment revenues | 4,625 | **4,673** | 9,243 | **9,352** |
| Segment operating income | 1,090 | **1,164** | 2,207 | **2,269** |
| Segment net income | $ 660 | **$ 698** | $ 1,324 | **$ 1,352** |
| **Wireless** | | | | |
| Total segment revenues | $ 3,443 | $ **3,687** | $ 6,735 | **$ 7,279** |
| Segment operating income | 462 | **606** | 746 | **1,166** |
| Segment net income | $ 168 | **$ 276** | $ 235 | **$ 519** |

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE K - SEGMENT INFORMATION (Continued)**

| | For the Three Months Ended June 30, 2005 | 2006 | For the Six Months Ended June 30, 2005 | 2006 |
|---|---|---|---|---|
| **Advertising & Publishing Group** | | | | |
| External revenues | $ 527 | **$ 543** | $ 1,015 | **$ 1,046** |
| Intersegment revenues | 4 | **4** | 7 | **7** |
| Total segment revenues | 531 | **547** | 1,022 | **1,053** |
| Segment operating income | 245 | **252** | 476 | **478** |
| Segment net income | $ 154 | **$ 156** | $ 295 | **$ 296** |

RECONCILIATION TO CONSOLIDATED FINANCIAL INFORMATION

| | For the Three Months Ended June 30, 2005 | 2006 | For the Six Months Ended June 30, 2005 | 2006 |
|---|---|---|---|---|
| **Operating revenues** | | | | |
| Total reportable segments | $ 8,599 | **$ 8,907** | $ 17,000 | **$ 17,684** |
| Cingular proportional consolidation | (3,443) | **(3,687)** | (6,735) | **(7,279)** |
| Corporate, eliminations and other | (14) | **(14)** | (32) | **(28)** |
| Total consolidated | $ 5,142 | **$ 5,206** | $ 10,233 | **$ 10,377** |
| **Operating income** | | | | |
| Total reportable segments | $ 1,797 | **$ 2,022** | $ 3,429 | **$ 3,913** |
| Cingular proportional consolidation | (462) | **(606)** | (746) | **(1,166)** |
| Hurricane Katrina-related expenses, net | | **(25)** | | **(119)** |
| AT&T merger costs | | **(27)** | | **(27)** |
| Severance charges | | **(73)** | | **(73)** |
| Corporate, eliminations and other | 15 | **14** | 19 | **23** |
| Total consolidated | $ 1,350 | **$ 1,305** | $ 2,702 | **$ 2,551** |
| **Net Income** | | | | |
| Total reportable segments | $ 982 | **$ 1,130** | $ 1,854 | **$ 2,167** |
| Wireless merger intangible amortization | (91) | **(80)** | (191) | **(165)** |
| Wireless merger integration costs | (42) | **(38)** | (63) | **(94)** |
| Hurricane Katrina-related expenses, net | | **(15)** | | **(73)** |
| AT&T merger costs | | **(17)** | | **(17)** |
| Severance charges | | **(45)** | | **(45)** |
| Early extinguishment of debt | (12) | | (26) | |
| Discontinued operations | | | 381 | |
| Corporate, eliminations and other | (42) | **(48)** | (96) | **(102)** |

| | | | | |
|---|---|---|---|---|
| Total consolidated | $ 795 | $ **887** | $ 1,859 | $ **1,671** |

**NOTE L - OTHER COMPREHENSIVE INCOME**

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

| | December 31, 2005 | **June 30, 2006** |
|---|---|---|
| Cumulative foreign currency translation adjustments | $ (2) | **$ (2)** |
| Minimum pension liability adjustment | (133) | **(128)** |
| Net unrealized gains on derivatives | 5 | **5** |
| Net unrealized gains on securities | 116 | **144** |
| | $ (14) | **$ 19** |

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE L - OTHER COMPREHENSIVE INCOME (Continued)**

Total comprehensive income details are presented in the table below:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | **2006** | 2005 | **2006** |
| Net Income | $ 795 | **$ 887** | $ 1,859 | **$ 1,671** |
| Other comprehensive income, net of tax: | | | | |
| Foreign currency translation: | | | | |
| Adjustments | (3) | | 10 | |
| Sale of foreign entities | | | 68 | |
| | (3) | | 78 | |
| Minimum pension liability adjustment, net of tax | | **2** | | **5** |
| Deferred gains on derivatives: | | | | |
| Deferred gains | 4 | | 11 | |
| Reclassification adjustment for (gains) losses included in net income | | | | |
| | 4 | | 11 | |
| Unrealized gains (losses) on securities: | | | | |
| Unrealized holdings gains (losses) | 9 | **(18)** | (1) | **26** |
| Reclassification adjustment for (gains) losses included in net income | | **3** | (1) | **2** |
| | 9 | **(15)** | (2) | **28** |
| Other comprehensive income | 10 | **(13)** | 87 | **33** |
| Total comprehensive income | $ 805 | **$ 874** | $ 1,946 | **$ 1,704** |

**NOTE M - CONTINGENCIES**

**GUARANTEES**

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

**LEGAL PROCEEDINGS**

***Regulatory-related claims***

In May 2005, we sued AT&T in the U.S. District Court for the Northern District of Georgia for unpaid access charges associated with AT&T s prepaid calling cards and its IP in the middle services that use Internet Protocol technology for internal call processing but use the public switched network to originate and terminate calls. The lawsuit follows two separate rulings by the Federal Communications Commission (FCC), one in April 2004 concerning IP in the middle services and one in February 2005 concerning prepaid card services, that each service was a telecommunications service subject to access charges. AT&T estimated in securities filings that it had saved $340 in access charges on its prepaid card services and $250 in access charges on its IP in the middle services. We believe that some of the improperly avoided access charges should have been paid to us for the use of our network. AT&T appealed the FCC s decision relating to the prepaid card services to the Court of Appeals for the D.C. Circuit, which denied the appeal in July 2006. If the U.S. District Court lawsuit in Georgia progresses, we expect to obtain information from AT&T and other sources that will determine the amount of BellSouth access charges AT&T avoided. In addition, AT&T has asserted certain defenses against BellSouth and has filed the New York lawsuit described below in an effort to reduce any amount it may owe to BellSouth. In April 2006, BellSouth and AT&T agreed to stay the U.S. District Court lawsuit in Georgia until the earlier of 12 months or the consummation or termination of the Merger Agreement between BellSouth and AT&T. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of the amount of gain, if any, be made. Accordingly, no revenue has been recognized with respect to this matter in our consolidated financial statements.

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE M - CONTINGENCIES (Continued)**

On November 4, 2005, AT&T sued BellSouth Long Distance, Inc. (BSLD) and Qwest Communications Corporation (Qwest) in the U.S. District Court for the Southern District of New York. AT&T has asserted claims of breach of contract, fraudulent misrepresentation and unjust enrichment against BSLD and related claims against Qwest. AT&T s claims arise from a contract with BSLD pursuant to which BSLD purchased wholesale long distance minutes that it resold to Qwest. The complaint does not specify the amount of damages sought by AT&T. The parties have agreed to stay the New York lawsuit pending the arbitration of the dispute between AT&T and BSLD. To date, no arbitration has been initiated by AT&T. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

In June 2004, the U.S. Court of Appeals for the 11th Circuit affirmed the District Court s dismissal of most of the antitrust and state law claims brought by a plaintiff competitive local exchange carrier (CLEC) in a case captioned *Covad Communications Company, et al v. BellSouth Corporation, et al.* The appellate court, however, permitted a price squeeze claim and certain state tort claims to proceed. In November 2005, Covad dismissed with prejudice the civil action and then contemporaneously filed complaints with the public service commissions of Florida and Georgia and filed an informal complaint with the FCC. The commission complaints allege breaches of our interconnection contracts approved by the state commissions, including failure to provide collocation, mishandling of orders, ineffective support systems, and failure to provide unbundled loops. The complaints also allege improper solicitation of Covad customers. These claims are similar to the claims raised in the civil action dismissed by Covad. The complaints seek credits and equitable relief. Covad has asked the state commissions to stay proceedings on its complaints pending resolution of its FCC complaint. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

***Employment claim***

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

***Securities and ERISA claims***

From August through October 2002, several individual shareholders filed substantially identical class action lawsuits against BellSouth and three of its senior officers alleging violations of the federal securities laws. The cases have been consolidated in the U.S. District Court for the Northern District of Georgia and are captioned *In re BellSouth Securities Litigation*. Pursuant to the provisions of the Private Securities

Litigation Reform Act of 1995, the court has appointed a Lead Plaintiff. The Lead Plaintiff filed a Consolidated and Amended Class Action Complaint in July 2003 on behalf of two putative classes: (1) purchasers of BellSouth stock during the period November 7, 2000 through February 19, 2003 (the class period) for alleged violations of Sections 10(b) and 20 of the Securities Exchange Act of 1934 and (2) participants in BellSouth s Direct Investment Plan during the class period for alleged violations of Sections 11, 12 and 15 of the Securities Act of 1933. Four outside directors were named as additional defendants. The Consolidated and Amended Class Action Complaint alleged that during the class period the Company (1) overstated the unbilled receivables balance of its Advertising & Publishing subsidiary; (2) failed to properly implement Staff Accounting Bulletin (SAB) 101 with regard to its recognition of Advertising & Publishing revenues; (3) improperly billed CLECs to inflate revenues; (4) failed to take a reserve for refunds that ultimately came due following litigation over late payment charges; and (5) failed to properly writedown goodwill of its Latin American operations.

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

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE M - CONTINGENCIES (Continued)**

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

In September and October 2002, three substantially identical class action lawsuits were filed in the U.S. District Court for the Northern District of Georgia against BellSouth, its directors, three of its senior officers, and other individuals, alleging violations of the Employee Retirement Income Security Act (ERISA). The cases have been consolidated and on April 21, 2003, a Consolidated Complaint was filed. The plaintiffs, who sought to represent a putative class of participants and beneficiaries of BellSouth s 401(k) plans (the Plans), allege in the Consolidated Complaint that the company and the individual defendants breached their fiduciary duties in violation of ERISA, by among other things, (1) failing to provide accurate information to the Plans participants and beneficiaries; (2) failing to ensure that the Plans assets were invested properly; (3) failing to monitor the Plans fiduciaries; (4) failing to disregard Plan directives that the defendants knew or should have known were imprudent and (5) failing to avoid conflicts of interest by hiring independent fiduciaries to make investment decisions. In October 2005, plaintiffs motion for class certification was denied. The plaintiffs are seeking an unspecified amount of damages, injunctive relief, attorneys fees and costs. Certain underlying factual allegations regarding BellSouth s Advertising & Publishing subsidiary and its former Latin American operation are substantially similar to the allegations in the putative securities class action captioned *In re BellSouth Securities Litigation,* which is described above.

Subject to approval of the court, the parties have reached a settlement of the ERISA lawsuits. The settlement is on behalf of the Plans and certain participants who brought claims individually and on behalf of the Plans pursuant to ERISA section 502(a)(2). BellSouth does not expect the settlement to have a material effect on the Company. The principal terms of the settlement increase the minimum levels below which Company matching contributions may not fall for a three-year period. The settlement does not require any other unreimbursed cash payments by the Company.

***Antitrust claims***

In December 2002, a consumer class action alleging antitrust violations of Section 1 of the Sherman Antitrust Act was filed against BellSouth, Verizon, AT&T (formerly known as SBC) and Qwest, captioned *William Twombly, et al v. Bell Atlantic Corp., et al,* in U.S. District Court for the Southern District of New York. The complaint alleged that defendants conspired to restrain competition by agreeing not to compete with one another and to impede competition with others. The plaintiffs are seeking an unspecified amount of treble damages and injunctive relief, as well as attorneys fees and expenses. In October 2003, the district court dismissed the complaint for failure to state a claim. In October 2005, the Second Circuit Court of Appeals reversed the District Court s decision and remanded the case to the District Court. In June 2006, the U.S.

Supreme Court granted the defendants petition for writ of certiorari. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

***Merger-related claims***

On March 9, 2006, two putative class action lawsuits, entitled Williams v. BellSouth Corporation, et al., Case No. 2006CV113858 (March 9, 2006) and Jannett v. BellSouth Corporation, et al., Case No. 2006CV113861 (March 9, 2006), were filed against BellSouth and its directors in the Superior Court of Georgia, Fulton County. The complaints, as subsequently amended and consolidated, purported to be brought on behalf of all BellSouth shareholders (excluding defendants and their affiliates). The plaintiffs alleged that BellSouth's directors violated their fiduciary obligations to BellSouth's shareholders in approving the merger agreement, and by failing to provide material information or by providing materially misleading information in connection with the preliminary proxy statement filed by BellSouth and AT&T with the SEC on March 31, 2006. The consolidated complaint sought various forms of relief, including injunctive relief to prevent the completion of the merger, unspecified compensatory damages, and attorneys' fees and expenses. In July 2006, the plaintiffs voluntarily dismissed the suit.

***Other claims***

We are subject to claims arising in the ordinary course of business involving allegations of personal injury, breach of contract, anti-competitive conduct, employment law issues, regulatory matters and other actions. BellSouth Telecommunications, Inc. is also subject to claims attributable to pre-divestiture events, including environmental liabilities, rates and contracts. Certain contingent liabilities for pre-divestiture events are shared with AT&T. While complete

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE M - CONTINGENCIES (Continued)**

assurance cannot be given as to the outcome of these claims, we believe that any financial impact would not be material to our results of operations, financial position or cash flows.

**NOTE N - SUBSIDIARY FINANCIAL INFORMATION**

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

*Condensed Consolidating Statements of Income*

| | For the Three Months Ended June 30, 2005 | | | | |
|---|---|---|---|---|---|
| | BST | Other | Parent | Adjustments | Total |
| Total operating revenues | $ 4,212 | $ 1,808 | $ | $ (878) | $ 5,142 |
| Total operating expenses | 3,778 | 1,314 | (5) | (1,295) | 3,792 |
| Operating income (loss) | 434 | 494 | 5 | 417 | 1,350 |
| Interest expense | 128 | 7 | 221 | (71) | 285 |
| Net earnings (losses) of equity affiliates | 287 | 68 | 884 | (1,171) | 68 |
| Other income (expense), net | (12) | 57 | 52 | (41) | 56 |
| Income (loss) from continuing operations before income taxes | 581 | 612 | 720 | (724) | 1,189 |
| Provision (benefit) for income taxes | 91 | 212 | (75) | 166 | 394 |
| Income (loss) from continuing operations | 490 | 400 | 795 | (890) | 795 |
| Income (loss) from discontinued operations, net of tax | | | | | |
| Net income (loss) | $ 490 | $ 400 | $ 795 | $ (890) | $ 795 |

| | **For the Three Months Ended June 30, 2006** | | | | |
|---|---|---|---|---|---|
| | **BST** | **Other** | **Parent** | **Adjustments** | **Total** |
| Total operating revenues | **$ 4,206** | **$ 1,850** | **$** | **$ (850)** | **$ 5,206** |
| Total operating expenses | **3,800** | **1,312** | **28** | **(1,239)** | **3,901** |

| | | | | | |
|---|---|---|---|---|---|
| Operating income (loss) | **406** | **538** | **(28)** | **389** | **1,305** |
| Interest expense | **156** | **7** | **231** | **(115)** | **279** |
| Net earnings (losses) of equity affiliates | **279** | **213** | **988** | **(1,267)** | **213** |
| Other income (expense), net | **8** | **46** | **83** | **(70)** | **67** |
| Income (loss) from continuing operations before income taxes | **537** | **790** | **812** | **(833)** | **1,306** |
| Provision (benefit) for income taxes | **76** | **257** | **(75)** | **161** | **419** |
| Income (loss) from continuing operations | **461** | **533** | **887** | **(994)** | **887** |
| Income (loss) from discontinued operations, net of tax | | | | | |
| Net income (loss) | **$ 461** | **$ 533** | **$ 887** | **$ (994)** | **$ 887** |

| | For the Six Months Ended June 30, 2005 | | | | |
|---|---|---|---|---|---|
| | BST | Other | Parent | Adjustments | Total |
| Total operating revenues | $ 8,402 | $ 3,519 | $ | $ (1,688) | $ 10,233 |
| Total operating expenses | 7,478 | 2,561 | 9 | (2,517) | 7,531 |
| Operating income (loss) | 924 | 958 | (9) | 829 | 2,702 |
| Interest expense | 246 | 7 | 446 | (123) | 576 |
| Net earnings (losses) of equity affiliates | 563 | (10) | 1,675 | (2,240) | (12) |
| Other income (expense), net | (30) | 105 | 109 | (72) | 112 |
| Income (loss) from continuing operations before income taxes | 1,211 | 1,046 | 1,329 | (1,360) | 2,226 |
| Provision (benefit) for income taxes | 212 | 360 | (149) | 325 | 748 |
| Income (loss) from continuing operations | 999 | 686 | 1,478 | (1,685) | 1,478 |
| Income (loss) from discontinued operations, net of tax | | 381 | 381 | (381) | 381 |
| Net income (loss) | $ 999 | $ 1,067 | $ 1,859 | $ (2,066) | $ 1,859 |

BELLSOUTH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(Unaudited)

**NOTE N - SUBSIDIARY FINANCIAL INFORMATION (Continued)**

*Condensed Consolidating Statements of Income (Continued)*

| | **For the Six Months Ended June 30, 2006** | | | | |
|---|---|---|---|---|---|
| | **BST** | **Other** | **Parent** | **Adjustments** | **Total** |
| Total operating revenues | **$ 8,422** | **$ 3,746** | **$** | **$ (1,791)** | |