American Telephone and Telegraph Company

1977 Annual Report

The Service Process

The Service Process

This process is a continuous one, extending uninterruptedly from invention through manufacture and supply to customer service. To assure the orderly growth and development of an undertaking as intricately interrelated as the telecommunications network calls for precise, systematic organization of the people and resources required in its design, construction and operation. Cover photos illustrate representative steps in the service process.

Research
At Bell Laboratories the search for new knowledge is unceasing. The transistor and satellite communications are among the products of this quest.

Systems Engineering
Comprehensive planning helps assure that each component will be designed to optimize the performance of the whole.

Product Design
The link between Bell Labs and Western Electric facilitates innovation and products that meet their design intent at lowest cost.

Manufacturing
Since 1882, Western Electric has been a reliable source of compatible, high quality equipment for the Bell telephone companies.

Purchasing
Western Electric and the telephone companies spend hundreds of millions of dollars each year with outside suppliers throughout the U.S.

Distribution
Western Electric maintains a nationwide distribution system to provide equipment and supplies where and when they're wanted.

Construction
The Bell System is constantly adding to its facilities to improve service and meet the public's growing reliance on telecommunications.

Central Office Installation
More and more of the switching equipment being installed in Bell System central offices these days is electronic in design.

Installation and Repair
One of the most familiar figures on the American scene is the telephone installer, bringing service to U.S. homes and offices.

Network Service
The nationwide telecommunications network handles about 515 million calls each business day. Most go through without a hitch.

Operator Services
Still the symbol of service is the telephone operator. Even in this age of automation, the Bell System employs more than 100,000 of them.

Customer Services
The Bell System recognizes that it is the individual customer's satisfaction that is the ultimate test of the service process.

The 93rd Annual Meeting of AT&T shareholders will be held at 2:00 p.m. on Wednesday, April 19, 1978, in the Miami Beach Convention Center, 1901 Convention Center Drive, Miami Beach, Florida.

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:

–1977 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 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 common and preferred stock, bonds, 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 140 New Montgomery St., San Francisco, Calif. 94105 (415) 542-3801.

A RECORD OF THE YEAR

Bell System people pictured in this Annual Report are, starting top left on the cover, Pierre M. Petroff, Ashok L. Kalro, Larry A. Tomko and Richard W. Stahlhut, Bell Laboratories; Robert E. Farrell, Western Electric; Gloria Korkoian, AT&T; Larry Lillo, Western Electric; Wayne Osborne, New Jersey Bell; David Dye, Western Electric, and Lee Brown, Southwestern Bell; Virginia E. Boyd, New England Telephone; Ray Pack, AT&T Long Lines; Donna Balady and Lorraine Wall, New Jersey Bell, and Mary Evans, New York Telephone. Elsewhere in the Report are Robert L. Schauer, left, and James L. Paul, of AT&T, on page 2; Marti Karich, AT&T Long Lines, on page 13; and Chuck W. Smith, left, AT&T Long Lines, with Bernard W. Overeynder, Xerox Corporation, on page 16.

Report of the Chairman of the Board

It is with considerable pride that I present this report of the Bell System's performance in 1977. What is set forth here is of necessity but a brief and summary accounting of the year's work. As such it cannot hope to give adequate recognition to the hundreds of thousands of Bell System people whose skills and commitment produced the results reported here. On behalf of the Board of Directors I salute them.

Nineteen seventy-seven was a year of growth for the Bell System. We grew not only in terms of the volume of business we handled in the course of the year but in service capability as well.

And, I am pleased to report, we grew in earnings.

In 1977 the Bell companies handled ten per cent more long distance calls than in 1976 and they added more telephones than in any year in our history. Indeed, as this is written the gathering momentum in demand for communications services that characterized the year shows no sign of abating. However, it would not be realistic to anticipate that the same degree of acceleration will continue throughout the year. Nonetheless, we anticipate that 1978 will be another good year, another year of strong growth.

To my mind more notable than 1977's immediate results was the strengthening of our business' long term prospects that was accomplished during the year.

We strengthened the Company's financial structure.

We strengthened our service capabilities.

We strengthened our ability to cope with change and complexity, indeed to manage change.

We strengthened understanding of what is at stake in the protracted debate over national telecommunications policy and thereby advanced the day when it might be brought, as I believe it will, to a sensible conclusion.

And, finally, we strengthened our own convictions about the aims of the Bell System and thereby the purposefulness with which we pursue those aims.

These developments are described in the following pages. In the meantime, a comment or two about each.

With respect to the Company's financial structure, it is agreeable to report that your management has been able to accomplish what some years ago it explicitly set out to accomplish and that is to produce a record of sustained earnings improvement that would warrant a market price sufficiently above book value to permit the prudent marketing of equity without dilution of our existing share owners' investment. As a result, the Company's debt ratio is coming down, interest coverage is going up and we have materially increased our financing flexibility.

It is to technology that we owe the strengthening of the Bell System's service capabilities over the years—and most notably in the year just past. What made 1977 unique was technology embodied not only in hardware but in software, computer-based programs that give us more assured control of the complexities of the telecommunications network than ever before and new efficiencies in its administration.

In 1977 we continued the expansion of our planning horizons that has been our deliberate purpose from the beginning of the decade. By taking the measure of the future—five years hence, ten years hence—we apply to ourselves the discipline it takes to assure that we neglect no step that might be required to assure that our business continues to grow in usefulness to its customers and profitability to its share owners.

It now appears that the great debate over the role of "competition" in telecommunications may be moving toward resolution. It now seems clear that such restructuring of the supply of telecommunications services as may be called for must achieve a balance between conflicting public interest objectives. On the one hand, the public interest will be served by providing more customer options and more diversified services in the specialized sectors of telecommunications and, on the other, by maintaining the technical and operational integrity of the public switched network and a rate structure that promotes the widest availability of its services.

Finally, I believe that we ourselves will emerge from the controversies that have characterized these times with a firmer sense of purpose than when we began.

From time to time over the one hundred and one years of our industry's history, the management has undertaken—and usually in times of change and ferment—to set down its sense of the mission of the business.

In this Annual Report, we have set down another such statement of policy (page 21). In essence, it is a statement of our commitments—to our customers, to our employees and to our share owners. These commitments, we recognize, we can only redeem through performance and this we earnestly pledge ourselves to do.

Most particularly do we pledge ourselves to redeem our commitments to share owners. Their confidence is our strength. As we begin another year, our purpose is to confirm that confidence and enlarge it.

February 8, 1978

J. D. deButts

< *Bronze seal symbolizing "universal service" was designed in 1915 by sculptor Paul Manship for AT&T's headquarters in New York City. A matching seal (left) has been installed at the Company's new office building in Basking Ridge, New Jersey.*

RESULTS IN BRIEF

	1977	1976	1975	1974	1973
Earnings per Common Share	$ 6.97	$ 6.05	$ 5.13	$ 5.28	$ 5.07①
Based on average shares outstanding (000)	625,878	595,184	567,915	557,815	554,258
Dividends declared per share	$ 4.20	$ 3.80	$ 3.40	$ 3.24	$ 2.87
Revenues	*Millions*	*Millions*	*Millions*	*Millions*	*Millions*
Local service	$17,071	$15,609	$14,028	$12,813	$11,419
Toll service	18,094	16,065	13,925	12,461	11,278
Other (including other income)	1,896	1,487	1,319	1,439	1,339
	37,061	33,161	29,272	26,713	24,036
Expenses					
Operating	23,516	21,021	18,757	16,716	15,000
Income taxes on operations	3,305	2,933	2,390	2,313	2,138
Other taxes on operations	3,252	2,977	2,681	2,454	2,212
Interest	2,444	2,401	2,296	2,056	1,734
	32,517	29,332	26,124	23,539	21,084
Net income	4,544	3,829	3,148	3,174	2,998①
Preferred dividend requirements	184	227	232	232	186
Income applicable to common shares	$ 4,360	$ 3,602	$ 2,916	$ 2,942	$ 2,812
Telephones in service at end of year	128.5	123.1	118.5	114.5	110.3
Average toll messages per business day②	39.4	35.7	33.1	31.5	29.3

①Includes extraordinary amount of $.08 per common share ($46 million of net income) relating to net gain on sale of Communications Satellite Corporation common stock.
②Stated on the basis of the classification in effect at December 31, 1977 as between toll messages and messages within local calling areas.

MANAGEMENT'S ANALYSIS OF RESULTS IN BRIEF

Earnings per common share rose 92 cents in 1977, as income applicable to common shares increased $758 million and average common shares outstanding increased 31 million. Total revenues (including other income) were up 11.8% while total expenses (including taxes and interest) rose 10.9%. Earnings per common share for 1976 increased 92 cents from 1975 and income applicable to common shares increased $686 million. Average common shares outstanding rose in 1976 by 27 million. The decrease in 1975 earnings was principally the result of a $208 million reduction in Western Electric's net income.

Revenues from local and toll services and other income increased $3.9 billion in 1977 and in 1976 for several reasons: more telephones in service and growth in local and long distance calling volumes in both years; higher intrastate rates, $711 million and $1.3 billion in 1977 and 1976, respectively; higher interstate long distance rates that were authorized by the FCC, $23 million in 1977 and $240 million in 1976; and increased sales of directory advertising in both years. Western Electric's net income increased by $273 million in 1977, reflecting improvement in sales and a continuing control of costs. The $110 million increase in Western Electric's net income in 1976 reflected a turnaround in its operations following the recession of 1975.

Operating expenses rose in 1977 by $2.5 billion and $2.3 billion in 1976. Principal reasons for these increases were higher wages, fringe benefits, depreciation and increased business volumes. Higher wages (including cost-of-living adjustments under provisions of 1974 contracts and new higher wage levels resulting from contracts effective in August 1977) and salaries accounted for about $710 million of the increase in 1977 and $790 million in 1976. About $274 million in 1977 was due to higher pension accruals, caused by higher wages and higher pension accrual rates, and improvements in other fringe benefits while the same costs rose $375 million in 1976. Depreciation expense increased $561 million in 1977 and $396 million in 1976, reflecting larger plant investment and higher depreciation rates authorized by the FCC.

Income taxes on operations rose $372 million in 1977 and $543 million in 1976, reflecting higher income before taxes.

Other taxes on operations increased $275 million in 1977 and $296 million in 1976, largely as a result of a $124 million increase in 1977 and $147 million in 1976 in property taxes applicable to an expanding base of taxable plant. Gross receipts taxes increased $82 million in 1977 and $90 million in 1976. Social Security taxes rose $64 million in 1977 and $54 million in 1976 mainly because of statutory increases in the taxable wage base.

Interest expense increased $43 million or 1.8% in 1977 and $105 million or 4.6% in 1976, primarily because of debt capital obtained by the companies to help finance their construction programs. The average cost of long-term debt issued in 1977 was 8.12% compared to 8.48% in 1976.

Financial Review

In 1977 the Company improved its operating results and thereby materially improved its financial position in a number of respects:

Earnings per share were $6.97, 92 cents and 15.2 per cent higher than the year before. In the last five years earnings per share have risen an average of ten per cent a year, compared with an average annual increase in consumer prices of eight per cent in that period.

Operating revenues amounted to $36.5 billion, an increase of $3.7 billion or 11.2 per cent. Operating expenses amounted to $23.5 billion, up 11.9 per cent.

Our overall volume of business, represented by total operating revenues adjusted to eliminate the effect of rate changes in 1977, grew by 8.8 per cent.

Net income rose $715 million, to $4.5 billion.

The ratio of debt to the combined debt and equity in our capital structure was reduced to 46.6 per cent, the lowest level in six years.

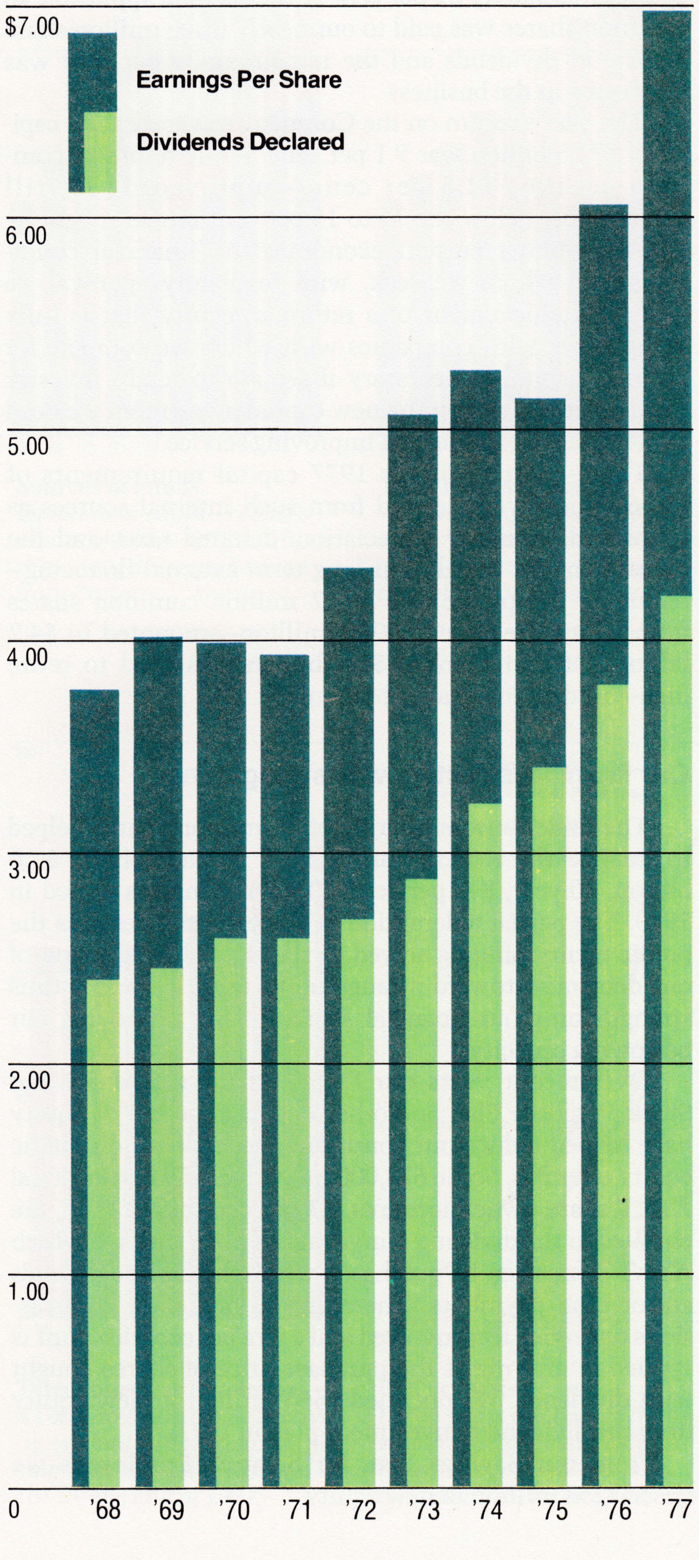
Interest coverage–the number of "times" interest is covered by earnings after taxes–moved up to 3.0.

Western Electric's total sales were up about 17.4 per cent, reflecting increased demand from the operating telephone companies; its net income of $490 million provided a return on investment that for the first time in a decade reached a level appropriate for a capital goods supplier like Western Electric.

Contributing to the year's earnings improvement was a continuing growth in demand for telecommunications services that showed no sign of abatement at year's end. Vigorous marketing of our services and some necessary repricing in some jurisdictions also contributed to the year's increased revenues. At the same time, the Bell companies made the most of more efficient technology and continued their stringent expense control programs.

To further our prospects in 1978 we are working hard to make our services ever more useful and attractive to our customers and to offset increased costs by accelerating the introduction of improved operating methods. However, increasing competition in the supply of customer-provided terminal equipment and of intercity private line services can be expected to slow the growth of Bell System revenues to some degree.

In February, 1977 the AT&T Board of Directors declared a 40-cent annual increase in the dividend. This increase, the fourth in five years, brought the annual dividend to $4.20. As improved earnings have permitted us to do so, it has been our practice to raise the dividend in step with the increasing book value of our share owners' equity



Earnings Per Share, Dividends Declared: *In 1977 the annual dividend was raised to $4.20 a share, the fourth increase in five years. Earnings per share were $6.97 in 1977, 92 cents higher than in 1976.*

and to maintain the integrity of the dividend against inflation. The Directors' action not only confirmed this practice but responded to the growing interest of today's investors in current yield as well as growth prospects.

Approximately 61 per cent of the income applicable to common shares was paid to our nearly three million share owners in dividends and the remaining 39 per cent was reinvested in the business.

The year's return on the Company's average total capital of $77.5 billion was 9.1 per cent. While return to common equity—12.3 per cent—improved, it is still considerably below the 14 to 15 per cent return sought by investors under current economic and financial conditions–and which we seek, with regulatory approval, to achieve. Achievement of a return to equity that is fully competitive with companies with which we compete for investor capital is necessary if we are to retain investor confidence and attract the new capital investment we need to continue expanding and improving service.

Three-quarters of our 1977 capital requirements of $11.6 billion were derived from such internal sources as reinvested earnings, depreciation, deferred taxes and the investment tax credit. Our long term external financing–including the public sale of 12 million common shares from which we raised $698.7 million–amounted to $4.2 billion. Of that amount $1.5 billion was used to retire high-cost debt in advance of maturity.

Our financial structure was strengthened

The underwritten offering of 12 million shares helped to finance the redemption of $855 million of the $1.6 billion, 30-year, 8¾ per cent AT&T debentures issued in 1970. The partial redemption of these debentures plus the public equity offering served to speed up the reduction of our debt ratio toward a range of 40 to 45 per cent–thus strengthening our financial structure and improving our borrowing capacity.

Over recent years our Dividend Reinvestment and Stock Purchase Plan and other ongoing sources of equity have helped reduce our continuing dependence on public equity offerings. Some 673,000 individual and institutional AT&T share owner accounts, 23 per cent of the total, are enrolled in the dividend reinvestment plan, through which AT&T shares can be purchased with reinvested dividends and/or cash payments. There are no brokerage commissions or service fees involved and a five per cent discount is applied in arriving at the purchase price of shares bought with dividends. We obtained $566 million in new equity from the dividend reinvestment plan in 1977.

From our Savings Plan for Salaried Employees we raised $253 million in new equity.

Another source of additional equity is our new Employee Stock Ownership Plan (ESOP). Some 850,000 Bell System people have been allocated AT&T shares or fractions of shares through this plan. It is funded from an extra one per cent investment tax credit–$78.7 million in 1977–that the Federal government makes available to companies that elect to establish such a plan. The AT&T stock will be held in trust for seven years for employees eligible to participate.

The Pacific Telephone and Telegraph Company is not participating in the employee stock ownership plan because of uncertainties in that company's regulatory outlook. More particularly, Pacific Telephone is seeking the reversal of a decision of the California Public Utilities Commission ordering rate reductions and refunds. The order, which appears to be inconsistent with Congress' intention and commonly accepted interpretations of the Federal income tax law governing eligibility for the investment tax credit and accelerated tax depreciation, could result in large additional tax payments for prior years.

For the second consecutive year AT&T issued no long term debt. Such debt offerings by the Associated Companies raised $2.3 billion; the average interest cost was 8.1 per cent.

The Bell System's total operating Federal, state and local taxes for 1977, including deferred taxes, were $6.6 billion–or about 18 cents of every revenue dollar.

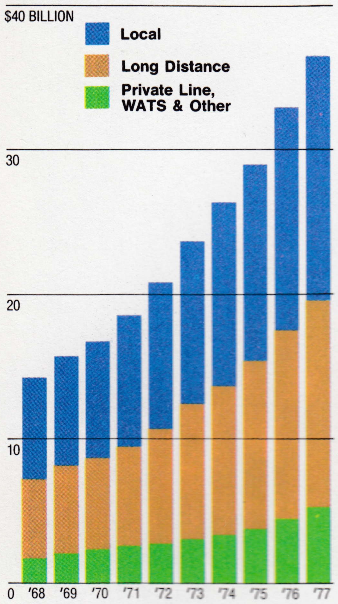
We are looking forward to initiating, with FCC approval, straight line Equal Life Group depreciation accounting. Although it will have the effect of increasing depreciation expense and our revenue requirements in the short run, its adoption will be to the benefit of both customers and investors over the long run.

MARKET AND DIVIDEND INFORMATION

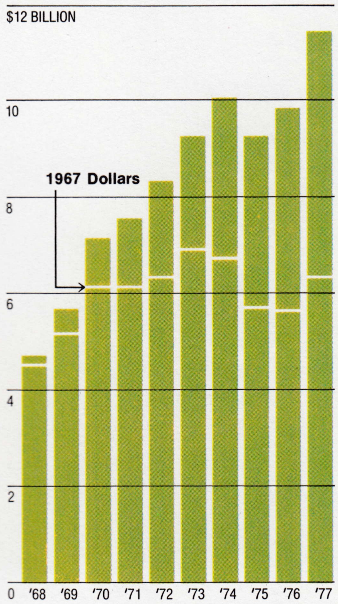
The principal market for trading in AT&T common stock is the New York Stock Exchange. Market data as obtained from the composite tape* and dividend data for the last two fiscal years are listed below.

Calendar Quarter	Market Price High	Market Price Low	Dividend Paid
1976			
1st	58⅞	50⅞	$ .85
2nd	58	53⅛	.95
3rd	62⅞	55⅞	.95
4th	64¾	58½	.95
1977			
1st	65¼	61¾	$ .95
2nd	65⅝	61⅝	1.05
3rd	64⅛	60⅛	1.05
4th	63⅜	58⅜	1.05

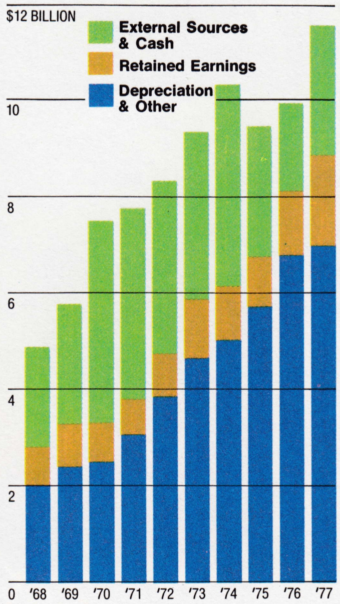
*Encompasses trading on the principal U.S. stock exchanges as well as off-board trading.



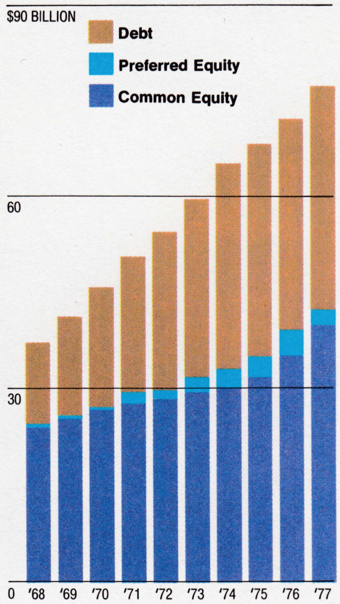
Revenues
Operating revenues in 1977 amounted to $36.5 billion, up $3.7 billion or 11.2 per cent over the prior year.



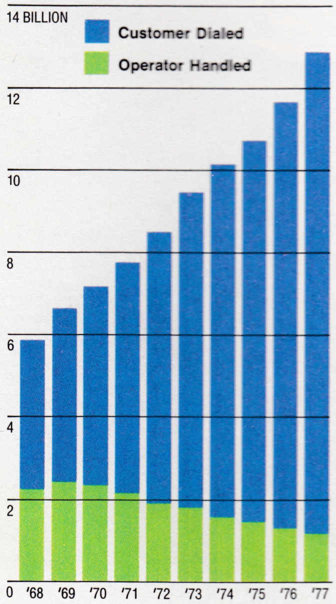
Construction Expenditures
We spent $1.7 billion more for construction than in 1976–in constant dollars, about the same as in 1972.



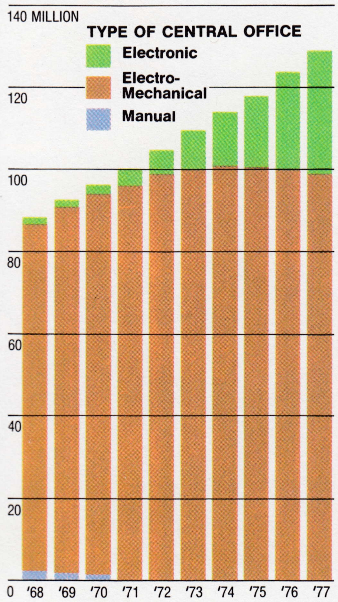
Sources of Funds
Of our new capital requirements of $11.6 billion, about three-fourths were derived from "internal" sources.



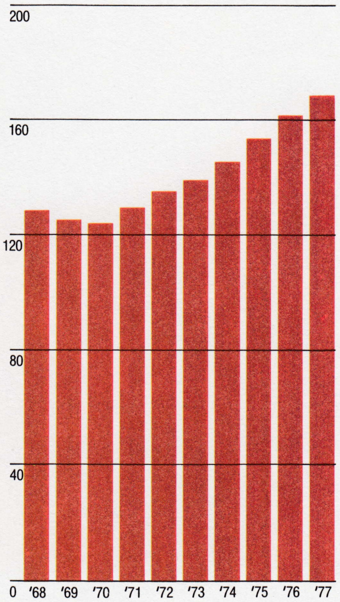
Total Debt and Equity
We issued equity and partially redeemed our 8¾ per cent debentures to reduce the debt ratio to 46.6 per cent.



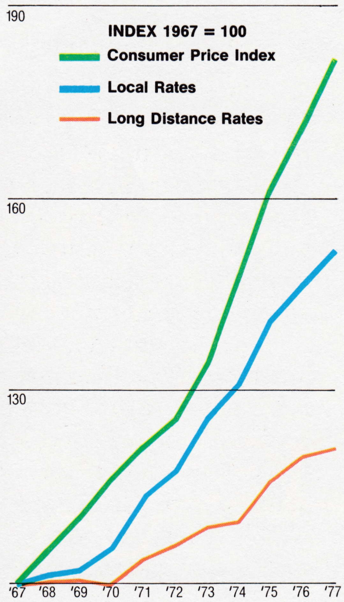
Long Distance Messages
All but ten per cent of the 12.8 billion long distance messages handled in 1977 were customer dialed.



Telephones
By the end of 1977 some 24 per cent of our customers were using telephones linked to electronic central offices.



Telephones Per Employee
As one measure of productivity, we had 130 telephones per employee a decade ago and 167 by the end of 1977.



CPI vs. Rates
In ten years the cost of living went up 82 per cent, local telephone rates 52 per cent, long distance rates 21 per cent.

The Bell System in 1977

In years past we called it the *telephone* system. Its lines, crisscrossing the country, delivered teletypewriter messages and radio and television signals, but mostly they carried telephone calls, calls that not so long ago required an operator's hand to establish the connection. That it worked and worked so well was considered a "miracle" of twentieth century technology.

Transmitting telephone calls–from one house to the next, from one coast to the other–is still its primary function. But now it is a *telecommunications* system. Its intricate switching mechanisms, its wires and cables, radio relay and satellite circuits convey information in almost every conceivable form. Computer-related techniques play an increasingly vital part in its management and operation. Today, however, its users no longer stand in awe of its technology. They take it for granted. It is an integral part of their daily lives.

Composed of millions upon millions of parts that range in size from towering microwave antennas to tiny integrated circuits, the system is designed, engineered and operated as a single entity. It is a system that is continually growing and adapting to meet new conditions and serve new needs.

The Bell System's constant aim is to enhance the service capabilities of this telecommunications system, an aim that in 1977 we pursued with significant results.

A "new" nationwide network takes form

Technology, notably solid state technology with its integrated circuitry, is at the heart of the changes taking place in the nationwide telecommunications system–changes that are producing a system of unprecedented flexibility and efficiency in the way it operates and in the services it can provide.

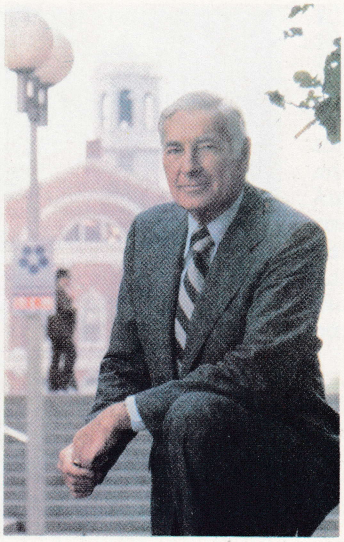
Taking shape is a "stored program-controlled network" that is characterized by the use of programmed instructions to control the electronic switching and new high-speed signalling equipment we are installing. As a technological achievement, the development of this more adaptable network is comparable to the conversion to direct distance dialing in the 1950s and '60s.

One key to its development is the continued installation of electronic switching systems, more than 1,300 of which are now in place serving about 24 per cent of our customers. Another is the addition to the network of Common Channel Interoffice Signalling, a system for passing information about a call among switching centers. Because

The Bell System is an association of companies, each separately managed but all joined in common purpose and sharing common operating procedures. Thus our business achieves coordination on a national scale at the same time that it remains responsive to the unique needs of each community it serves. Pictured on this and the following pages are the chief executive officers of the Bell telephone companies and of the Bell System's three national units–AT&T's Long Lines Department, Western Electric Company and Bell Telephone Laboratories. In 1977 as always, the companies' individual results reflected the diverse operating and regulatory circumstances they faced. Together they produced the Bell System results reported in these pages.

Richard R. Hough
American Telephone and Telegraph Company Long Lines Department

"By working closely with Bell Laboratories and Western Electric, we were able to keep the nationwide network at the forefront of technology. In the years ahead this will mean new, innovative services for the public."

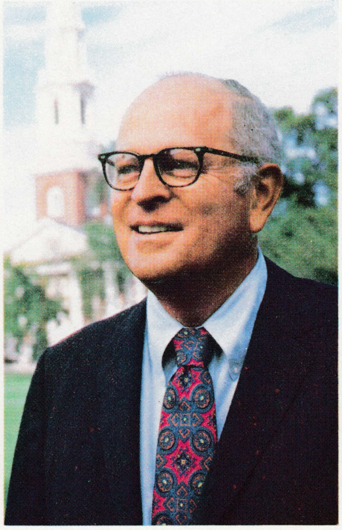


William C. Mercer
New England Telephone and Telegraph Company

"Sustained efforts to improve service and increase the efficiency with which we provide it produced 1977's good results both for our customers and our share owners."

The nationwide telecommunications network is designed, engineered and operated as a single entity by the Bell System in cooperation with the Independent telephone companies. Scene is the Network Operations Center of AT&T's Long Lines Department in Bedminster, New Jersey.

Alfred W. Van Sinderen
The Southern New England Telephone Company
"For Connecticut to attract new business and increase employment, high quality, dependable telephone service is essential. Regulatory recognition of our need for improved earnings helps assure our continuing ability to provide it."



John R. Mulhearn
New York Telephone Company
"Overall business volumes rose strongly as a result of intensified marketing in a gradually recovering state economy. The seasoned skills of our employees kept service at outstanding levels and increased both productivity and sales.

Robert W. Kleinert
New Jersey Bell Telephone Company
"New Jersey is not a big state but no telephone company serves a more diverse and demanding customer body than we do. In 1977 we served better than ever. We aim to keep it that way."

the information travels on data links separate from the voice paths, CCIS speeds up long distance connections and offers new possibilities for customer services.

Customers served by electronic central offices are already getting a taste of the telecommunications services that stored program control offers. They can, if they choose, have their calls automatically forwarded to another number, add a third party to a call, be alerted when another call is waiting or use just a couple of digits in calling frequently called numbers.

As the new telecommunications system evolves we will be able to manage the flow of communications traffic more efficiently, provide more effective maintenance and meet future growth with fewer costly new facilities. The savings will in turn help us to keep our rates down.

High-capacity transmission systems evaluated

Other technological innovations in the works include a system for transmitting large numbers of messages by light through transparent glass fibers as thin as a human hair. We have been evaluating such a lightwave communications system, one we placed in commercial service in Chicago in May. The results so far are excellent. While we initially anticipate using lightwave communications on trunk lines between local central offices, this new technology has potential for intercity routes as well.

Lightwave systems would take up less under-the-street duct space than do present cables and require amplification at less frequent intervals.

Long-life lasers will be needed if lightwave systems are to be used extensively in the future, and in 1977 Bell Laboratories developed lasers with an average projected life expectancy of a million hours, or more than a hundred years, when operated at normal room temperatures. Not so long ago the lifetime of lasers was measured in minutes.

Also being evaluated is a new single sideband radio system that will handle three times as many calls as our highest-capacity microwave radio relay link. Because it would not require the construction of new buildings, towers or antennas, this technology could be introduced with a minimum of new capital investment.

By increasing the capacity of our existing transmission facilities we have been able, despite inflation, to limit interstate construction spending over the last five years to about the same amount, \$2.3 billion, as the previous five. At the same time, the average investment cost for our long haul facilities has declined from \$32 per circuit mile in 1960 to less than half that today, with new facilities costing about \$2.30 per circuit mile.

We currently are at work on still another technological innovation, a high-capacity mobile telecommunications system that could provide higher quality mobile service at lower prices to as many as a million people in a metropolitan area. Equipment tests are scheduled to begin in Chicago this summer. The availability of such a system for cars, trucks and other vehicles will greatly expand the usefulness of mobile calling.

New technology to cut costs, raise revenues

Bell Laboratories, which works closely with Western Electric in developing the facilities for telecommunications, is working no less closely with the operating telephone companies to (1) reduce costs through new operating efficiencies and (2) increase revenues by matching new technology to the emerging communications needs of American society.

An increasing amount of time and effort at Bell Laboratories is being devoted to the development of new programs for computer-based systems that enable us to provide service more efficiently than in the past. We are using such systems to help us manage the nationwide network, optimize its use and monitor its performance. We are using them as well to automate and centralize much of the work involved in establishing service, diagnosing and repairing troubles, controlling inventory and administering our labor force.

As a result of continuing advances in the research and development of integrated circuits, we are able to pack more and more electronic functions onto a single silicon chip, lowering the cost of electronics for a variety of telecommunications applications. In 1977, for example, Bell Laboratories developed a new microprocessor called MAC-8. Less than a tenth the area of a postage stamp, the MAC-8 processor chip contains the equivalent of over 7,000 transistors and can execute several hundred different logic functions using about one-tenth of a watt of power.

Microprocessors, which are capable of performing entire computer processing functions, can be made on tiny chips of silicon at a cost of a few dollars each. It is increasingly economical, therefore, to design them into just about everything from large electronic switching systems to telephone sets. And that's what we are doing.

The achievement of technological advances of the scope referred to in the previous paragraphs has its foundation in basic research, and Bell Laboratories is constantly probing the frontiers of communications science. Scientists there currently are seeking a greater understanding of the physics and chemistry of materials for the development of improved solid state components.

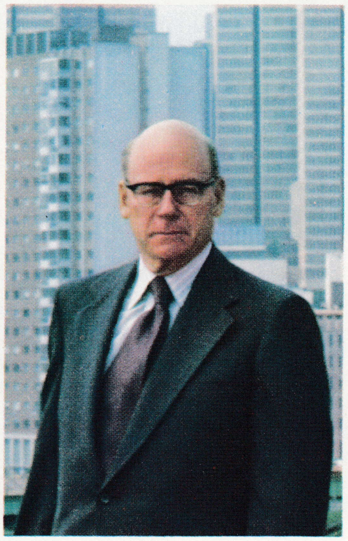
Also, a unique antenna was erected by Bell Labs in 1977 for use in research which may pave the way for satellite systems that operate at higher frequencies than is

William L. Mobraaten
The Bell Telephone Company of Pennsylvania

"We enter 1978 from a position of strength. Surveys indicate that our customers view the cost of our service as reasonable and its quality as high. The skills and commitment of our employee body have never been stronger."

Samuel E. Bonsack
The Chesapeake and Potomac Telephone Companies

"Nineteen seventy-seven was one of our best years, but a critical challenge remains: We must improve our revenues. We recognize that higher rates are not the sole answer and will seek new revenues through marketing and technical innovations."



L. Edmund Rast
Southern Bell Telephone and Telegraph Company

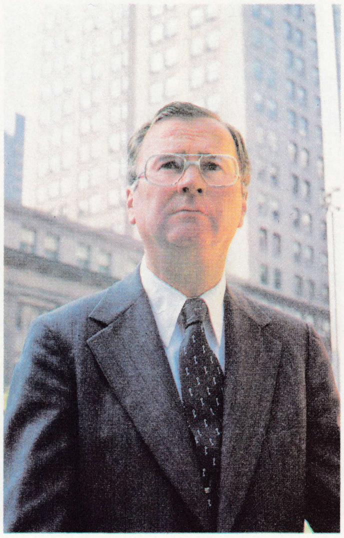
"Our aim is to make each transaction with our customers courteous, helpful and efficient. Employee know-how combined with continuing technical innovation will, I am confident, equip us to meet the increasing expectations of our customers."

W. Cecil Bauer
South Central Bell Telephone Company

"In 1977 South Central Bell gained telephones at a rate about 25 per cent greater than that for the Bell System as a whole. Because of inflation we had to invest more dollars for each customer gained than we had for each existing customer."

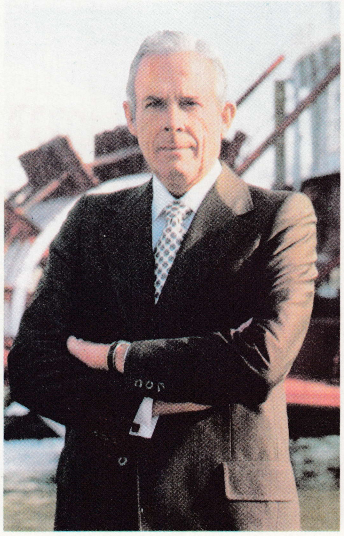
Charles E. Hugel
The Ohio Bell Telephone Company

"We had a good year. In Ohio we are changing our traditional ways of managing so we can find even better ways to meet the service needs of our customers."



Richard T. Dugan
Cincinnati Bell Inc.

"Cincinnati Bell's 1977 service and earnings results were good. Investors are sharing in the benefits of our company's readiness to innovate not only in technology but in operating methods."



feasible today. Such systems, besides adding more capacity and flexibility to the telecommunications network, might also lend themselves to new broadband services. A concept advanced by Bell Labs in 1977–using a narrow microwave beam that would rapidly sweep the entire country along with about a dozen "fixed" beams to serve major cities–may make it possible to more than double the present capacity of communications satellites.

Nineteen seventy-seven became a particularly notable year for Bell Laboratories with the announcement that Philip W. Anderson, employed at Bell Labs since 1949, would share with two others the Nobel Prize in Physics. Dr. Anderson, a theoretician in the field of solid state physics, was cited for work that contributed to the understanding of magnetic properties of materials that are embodied in all modern telecommunications facilities. He is the fifth Bell Laboratories scientist so honored.

We shaped services to match customer needs

More than technology, however, it is our customers' needs that shape our services. Accordingly, our marketing organization has undertaken comprehensive surveys of the operations of the nation's principal industries and the role that communications plays in improving their effectiveness and profitability. Our aim is to design service offerings that meet or–better–anticipate these needs.

In 1977 we developed an Enhanced Private Switched Communications Service for large corporate customers who require capabilities beyond those offered under existing private line switched services. We expanded our Dimension® PBX (private branch exchange) product line and introduced a Remote Call Forwarding service designed for businesses whose intercity communications needs are not large enough to justify using Wide Area Telecommunications Service (WATS). We also offered a system that provides faster telephone billing information to hotels and their guests.

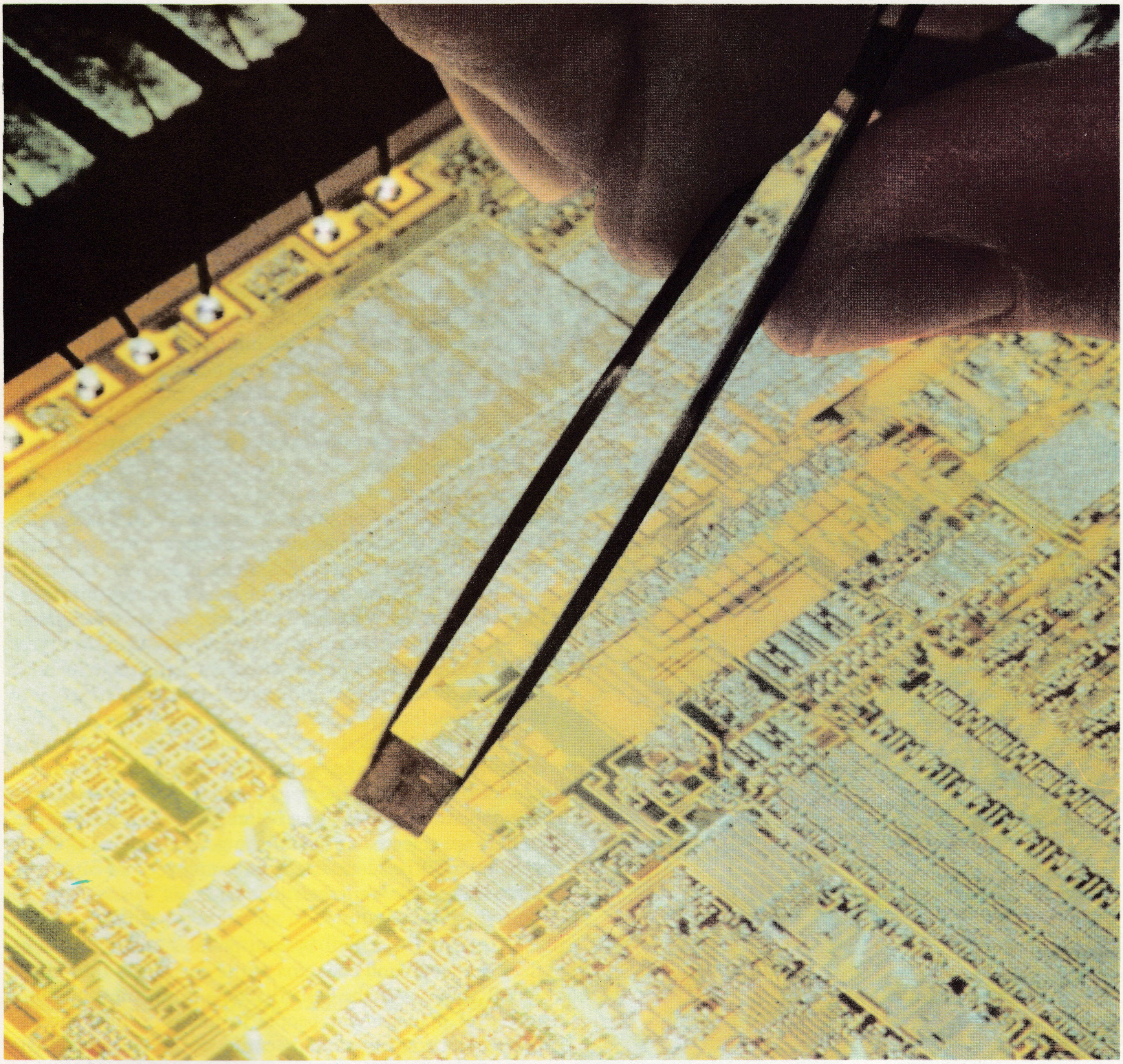
For residence customers we are offering greater variety in telephone design and more convenient methods of obtaining Bell System service.

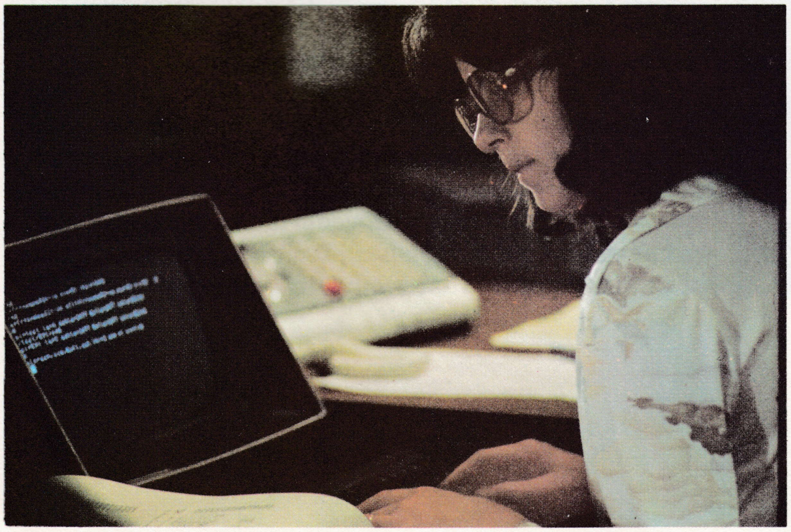
With about 1,500 PhoneCenter Stores opened and more planned, many of our customers are shopping for Bell System telephones and services in much the same way they would for any retail product. A wide variety of sets, including Design Line* decorator phones, are displayed at these stores. We extended this type of retail marketing effort to include booths or kiosks in shopping malls for the 1977 holiday season.

Today the Bell companies are installing about 150,000 jacks in homes and business offices every working day, giving customers greater flexibility in the use of their tele-

®Registered Trademark of AT&T Co.

*Trademark of AT&T Co.





Nineteen seventy-seven's advances in technology included not only new hardware like this MAC-8 microprocessor chip (above) containing the equivalent of 7,000 transistors in one-tenth the area of a postage stamp, but also computer-based operating and administrative systems (left) like EADAS–for Engineering and Administration Data Acquisition System–that help us engineer and operate the telecommunications system more efficiently.

David K. Easlick
Michigan Bell Telephone Company

"With improved earnings we were able to be more flexible and responsive in serving our customers–to find more ways to say 'yes.' The pressing need now is to sustain our financial upturn."

Delbert C. Staley
Indiana Bell Telephone Company, Incorporated

"We organized a consumer affairs task force in 1977 to sharpen our attentiveness to the many forces affecting our business and to improve our responsiveness to individual customer needs."

Gustave H. Moede, Jr.
Wisconsin Telephone Company

"We provided top quality service, continued our adherence to expense control and maintained a high level of productivity. It is disappointing that this effort received such inadequate recognition in the regulatory process."

phone service. Customers whose homes are thus equipped can install the 'phone themselves, thereby saving part of the service connection charge.

We continue to work with local governments to establish and provide facilities for "911" emergency reporting service. About 630 such systems enable some 49 million people to call for police or other emergency assistance by simply dialing the three-digit number.

We spent $11.6 billion to expand, improve service

To expand the nationwide telecommunications system's capacity and capabilities in 1977, we spent $11.6 billion for construction, $1.7 billion more than the year before. About half of these expenditures were used to provide additional facilities to handle growth.

In 1978 we expect to spend some $12.8 billion for construction, reflecting the Associated Companies' higher growth estimates.

As a measure of that growth, we added 5.4 million telephones in 1977, installing 34.2 million and removing 28.8 million others in the process. At year's end there were 128.5 million Bell System telephones in service.

Meanwhile, the volume of long distance messages increased ten per cent to 12.8 billion, while overseas calling–106 million messages–was up 23 per cent. In a year marking the fiftieth anniversary of transatlantic telephone service, overseas calls could be dialed directly from one of every four Bell telephones in the country.

Most important is that we handled this growth while maintaining top quality service. We ended the year with 16 service "weakspots" (out of a possible 5,700), short of our record performance the year before. And of the million customers we selected at random to get their opinion of service, over 90 per cent rated our employees as courteous, knowledgeable about their jobs and able to answer questions satisfactorily.

To ensure that Bell System policies and practices reflect the views and concerns of the customers they affect, AT&T and each of the Bell telephone companies appointed top level management people to newly formed interdepartmental consumer affairs committees. This action was taken following AT&T Chairman John deButts' pledge at a National Consumer Symposium to *listen* to consumers and to treat each customer the way he or she wants to be treated–as an individual.

Unquestionably the year's most impressive demonstration of the telecommunications system's dependability occurred in July when New York City experienced a massive power blackout. The lights went off, the subways stopped running and traffic signals and television sets went dark. But throughout that night and the next day, with the city's normal life almost entirely disrupted, the telephones in New York kept working.

And as in most other years, the effectiveness of Bell System teamwork was tested. This time it was a devastating spring flood in West Virginia's Appalachian area. Part of the service restoration job required the replacement of a central office in the town of Matewan. Within the short span of five days, people from Western Electric, Bell Laboratories and the C&P Telephone Company of West Virginia had installed and placed in service there a new electronic switching system.

Western Electric, our manufacturing and supply unit, experienced a notable increase in demand in 1977. It produced 18 per cent more telephone sets, 24 per cent more data sets, 17 per cent more lines of electronic switching equipment and 19 per cent more exchange cable.

During the year Western Electric achieved engineering cost reductions that will result in savings to the Bell System estimated at $220 million annually. In addition, the company was awarded a $436 million contract to furnish and maintain 300 microwave radio relay stations in Saudi Arabia. (In other international transactions, American Bell International Inc., an AT&T subsidiary, will continue operating in Iran under a new one-year $141 million contract to coordinate the development of an expanded telecommunications system for that country.)

We also look to suppliers other than Western Electric to meet the needs of the Bell telephone companies. In 1977, for example, we purchased approximately $1.3 billion in telecommunications products from general trade suppliers. Taking into account Western Electric purchases of components for its own products, about one-third of all Bell System expenditures for telecommunications products go to general trade suppliers.

In 1977, in response to an order of the FCC, the Company proposed the establishment of a subsidiary to undertake centralized purchasing of communications products and supplies from the general trade.

Rate increases will provide $885 million a year

Ours is a regulated industry; all aspects of the business –including the prices we charge, the services we offer and the profits we earn–come under government purview. Thus, as always, regulatory developments are an integral part of the record of the year.

Rate increases granted in 1977 will add about $885 million annually to our revenues. However, there were signs during the year of increasing consumer and regulatory resistance to further rate applications by the telephone companies. For our part, we recommitted ourselves in 1977 to minimizing the need for future price increases

Charles Marshall
Illinois Bell Telephone Company
"The first full-service lightwave system was installed in Chicago in 1977, and a new high-capacity mobile service is next. Such innovative technology helps us to hold down costs, improve service—and compete."

Jack A. MacAllister
Northwestern Bell Telephone Company
"This is big country, with big responsibilities, and the telephone helps make it manageable. We're proud to be part of the Upper Midwest and we mean to give it the best telephone service possible."

Zane E. Barnes
Southwestern Bell Telephone Company
"We are on the threshold of exciting advances in communications technology, but there is concern over how they will affect telephone jobs. I'm confident we can maintain the proper balance between human values and technology."

Whether it's the installation of a single telephone at the end of a country lane or the deployment of a sophisticated communications system for one of the nation's largest businesses, the Bell System's aim is the same: meeting the unique communications needs of every customer it serves.

by generating new sources of revenues and by slowing the growth rate of expenses. At the same time, though, we intend to continue pressing for higher rates in jurisdictions where earnings are too low.

Our record in offsetting a large part of the inflationary increases in our costs by improved productivity is a good one. From 1970 through 1976, the Bell System increased its total factor productivity at an annual rate of nearly five per cent. This was more than three times the rate of improvement achieved in the nation's private domestic economy as a whole in that period. As a result of productivity improvements, our prices have gone up at a much slower pace over the years than consumer prices generally.

At the end of 1977, special budget rates designed for people on low or fixed incomes were available in about half the states. These service offerings allow customers to pay a lower monthly telephone bill by making only a limited number of outgoing calls while still having full incoming service.

We filed revised rates for our various interstate private line services. The new rates, some higher and some lower than before, were based on an FCC-mandated method of measuring the cost of providing these services.

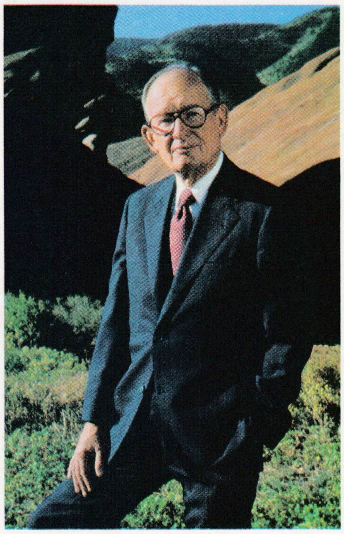
The telephone companies have been seeking with some success to win regulatory and public acceptance of the need to adjust rates so that the costs of Directory Assistance will be borne directly by those customers who use this service most. Also, higher rates are being sought to cover the costs of providing and maintaining coin service.

It seems likely that in the future many more telephone customers than at present will be billed for local service on the basis of the number and duration of their calls, the distance covered and the time of day a call is placed–much as long distance calls are billed. Such measured service pricing gives customers more freedom in determining how much they will pay for telephone service. This concept has already been adopted in some large cities.

Supreme Court declined review of antitrust suit

Regarding litigation, about 40 private antitrust suits are pending against one or more units of the Bell System in addition to the Justice Department action filed in 1974. In November the U.S. Supreme Court turned down our petition to review the jurisdictional issue in the government's suit. Mr. deButts, expressing disappointment at the Court's decision, said:

"We had hoped at the outset the public might be spared the cost of what could become the most complex and expensive antitrust litigation in the nation's history. That cost, we believe, is unnecessary. We are not in violation of the antitrust laws and we remain confident that the Bell



Robert K. Timothy
The Mountain States Telephone and Telegraph Company

"Our progress in 1977 came about largely by putting into effect plans and programs long on the drawing board. By that same token, our progress five years from now will be based on the success of our current planning."

Wallace R. Bunn
Pacific Northwest Bell Telephone Company

"The demand for telephone service in 1977 was the heaviest in our history. To help us keep up with this growth, other Bell companies came through with people and equipment. That's what we mean by 'One Bell System. It Works.'"

Gordon L. Hough
The Pacific Telephone and Telegraph Company

"In 1977 we experienced unprecedented telecommunications growth, and met our commitments to shareholders, customers, employees and the community in the face of regulatory decisions which threaten Pacific Telephone's financial integrity and ability to serve the public."

Donald E. Procknow
Western Electric Company, Incorporated

"With substantially increased sales and effective cost control, our profits rebounded strongly in 1977. We introduced new products and product improvements, and maintained an essentially stable price level."

William O. Baker
Bell Telephone Laboratories, Incorporated

"The Bell System's development of computer programs to help manage telecommunications is opening a new era in industrial capability—comparable to that spawned by the transistor."

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%). In addition, AT&T has a non-controlling ownership in Cincinnati Bell (26.6%) and Southern New England Telephone (18.2%). 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.

System's basic structure, as it has so many times in the past, will once again be demonstrated to be in the public interest."

The Southwestern Bell Telephone Company is appealing court judgments against it for alleged damage to two employees in connection with an internal investigation of employee misconduct in Texas. We believe these cases to have been without merit.

Policy issues moved toward resolution

A number of developments affecting the nation's telecommunications services occurred in the hearing rooms and courtrooms of Washington in 1977.

The FCC's program for registering terminal equipment was extended to main and extension telephones following the U.S. Supreme Court's denial of a petition to review the program. As a result, telephones registered by the FCC—from whatever source they are acquired—can be directly connected to the telecommunications network without the protective devices that previously were required. The program will also apply to PBX and key telephone systems when rules for their direct connection are developed.

Although we remain concerned that registration could result in service problems, we will do our best to make it work. Customers who provide their own station equipment will receive monthly credits on their bill.

At the same time, the Bell System and the Independent telephone companies have urged the FCC to give favorable consideration to a proposal requiring that a single-line customer's primary telephone be supplied and maintained by the telephone company.

The Commission has been conducting its second computer inquiry in five years into the relationship between data processing and data communications. In our response to this rulemaking inquiry we urged the Commission not to preclude the telephone companies from using electronic processing, including data processing, in providing common carrier communications services. We pointed out that communications technology and data processing techniques are increasingly intertwined and that our ability to use the latter is essential to the provision of our services and to the management and operation of our facilities.

Efforts by specialized common carriers to offer services virtually identical to interstate Message Telecommunications Service, which is provided by the telephone companies, continued to draw opposition from the FCC as well as the telephone industry. The Commission has held that specialized common carriers were authorized to provide private line services only.

In July the U.S. Court of Appeals in Washington, D.C. overturned an FCC order that held one such MTS-like service to be unauthorized. And in January, 1978, the Supreme Court declined petitions by the Commission, AT&T and others for review of that decision.

Approval of such services by specialized carriers could result in a diversion of long distance business on high-volume routes because telephone company charges for long distance calls are averaged–that is, the same price for the same distance in all parts of the country, regardless of differences in the cost of providing the calls. And because long distance revenues contribute to the support of local telephone rates, the diversion of this business could bring about higher local rates for all and higher long distance rates in rural areas and along lower-volume routes.

It is anticipated that the Commission will conduct hearings to determine what limitations, if any, the public interest requires be imposed on the service offerings of specialized common carriers.

Various policy issues related to competition in telecommunications were examined in 1977 in hearings held by the Senate and House communications subcommittees. In general, the subcommittees are reviewing the relevancy of the Communications Act of 1934 to current circumstances and, more specifically, to the FCC's policy of injecting competition into parts of the business.

As an outgrowth of the Congressional hearings on national telecommunications policy, the telephone industry in December submitted to Congress a framework for resolving current conflicts over intercity telecommunications policy. This proposal suggests a structuring of intercity services aimed at assuring multiple sources of supply and competitive pricing in the specialized areas of communications without unduly jeopardizing the technical and operational integrity of the public switched network or the current rate structure that provides for low residential and rural prices.

We reached new agreements with unions

The Bell System had 946,100 employees at the end of 1977–18,900 more than the year before.

Labor agreements reached in August with unions representing about 650,000 employees will add almost $3 billion annually to our employment costs by the end of the three-year contract period.

Included in the settlement were wage increases and cost of living adjustments that will keep the earnings of our employees in a favorable relationship to people in comparable jobs in the labor market. Improvements were made in the pension, health and dental plans, and new programs were developed for long term disability and maternity as well as for employees who are affected by technological change and choose to retire early.

A savings plan for non-management people also was included in the agreement. The plan, effective in January, 1979, will give employees an opportunity to allot up to $20 a week for investment in AT&T shares or a guaranteed interest fund; a Company contribution totaling 50 per cent of each allotment will be made in AT&T shares on behalf of each participating employee.

In other employee matters, we achieved 99.3 per cent of our equal employment opportunity objectives in 1977. Minority employees in Bell System management jobs increased by 15.7 per cent, women in management by 6.4 per cent. In addition, the number of women filling skilled craft jobs formerly occupied almost entirely by men was up 13.7 per cent over 1976.

Corporate contributions to community and educational causes in 1977 amounted to $24.6 million.

To encourage middle and upper level managers to participate in the political process by contributing to candidates for public office, AT&T and several of the Bell companies have formed political action committees. Contributions are completely voluntary. Participants can decide on their own what candidates to contribute to or they can leave that choice up to the committee. More than 400 major corporations and many labor unions have such political action committees.

In 1977 we again attained "zero energy growth." In fact, in the last four years the Bell System has reduced by 24 per cent the amount of energy consumed per telephone.

Looked at another way, we used 11 per cent less energy in 1977 than in 1973, although our volume of business has grown 33 per cent and our space requirements 19 per cent since then. As a result of this conservation program, we saved more than $415 million that would otherwise have been spent for energy in that period.

By the nature of its responsibilities for providing such an essential service and because of the long lead times required for the introduction of its technology, the Bell System must plan more comprehensively than most other businesses. Of late we have strengthened our planning capabilities to assure the manageability and responsiveness of our business in light of changes in the operating environment. With improved planning we not only can prepare better for the future but we have a broader vision on which to base decisions in the present.

Analyzing policy alternatives is a particularly significant factor in our planning process in these times of change in the telecommunications business. And because of the quickening pace at which change, technological and otherwise, is occurring in telecommunications, we look upon strategic planning as increasingly essential to the management of our affairs. We are, as a corporate enterprise, open to change. With planning, we are *ready* for change.

A Statement of Policy

This is a time of change—change in technology and change in the needs of the society we serve. It is a time of change in the regulatory environment. And it is a time of change in national communications policy as well. Indeed, the past dozen years or so have been marked by accelerating change in almost every aspect of our business, change so pervasive that not unnaturally the question arises as to whether policies that may have served the Bell System well in the first century of the industry's history can be expected to serve as well in its second. The following statement seeks to answer that question. It states our business' basic policies in light of today's changed circumstances.

The policies outlined here reflect the Bell System's deepest convictions with respect to the public interest and we shall continue to urge them in every appropriate forum. We recognize, however, that we are not the final arbiters of the public interest. That is why over recent years we have undertaken to speak out for policies we believe will help service and against those that might impair it. This we will continue to do. For only as we are ready to speak out for what we believe and to test our convictions against the convictions of others can we do our part in assuring that what is declared to be the public interest actually is.

No less, however, in the telephone industry's second century than in its first is the Bell System ready and willing to conform its technology and its services, its organizational structure and its practices to society's changing expectations. At the same time what has marked our history thus far is an uncommon continuity of purpose. In changing times—and radically changed and changing as our business may be—we serve unchanged goals.

II The Bell System's first responsibility today remains what it has always been—service to the public.

Service dictates the size and shape of our organization and the principles that guide its management. Our responsibilities to share owners and employees do not limit or qualify our commitment to service. Rather they support and sustain it. Only so long as we maintain a competent and well-motivated work force can we serve well. Only so long as we achieve good earnings can we attract the capital necessary to maintain good service and to enhance our ability to serve better.

More particularly, the Bell System's basic aim has been and continues to be the widest availability of high quality communications services at the lowest overall cost to the entire public. It is this aim that governs the design of our services and the way they are marketed and priced.

It is the Bell System's role to provide communications services to and among individuals and institutions in those sectors of the United States its operating units are franchised to serve and to provide as well for nationwide and international access and connection. It is our policy to undertake only those activities which support and enhance this function or derive from it and none that compromise or impair it. For our Government we stand ready to apply our skills and resources to whatever work the nation's interest may require of us.

Endowed with unique responsibilities, our business is at the same time held uniquely accountable for meeting them. Long ago our business accepted—indeed, it endorsed—the principle of public regulation of so vital a service as that we provide. That the United States today enjoys the most highly advanced communications service in the world is attributable to the incentives that derive from the now proven concepts of private enterprise operating under public surveillance.

III Basically, the Bell System's unique reason for being is to provide the nation—in cooperation with the Independent telephone companies—a network of communications by which any user of the service may communicate with any other at any time across the country or across town. To accomplish this end, this network must be—and is—designed as one, a single nationwide facility available to the entire public. It is a unique national resource and matching its capabilities to society's needs is our first responsibility to the public.

It is this responsibility that requires us to set as our goal nothing less than the continuous enhancement of the network's capabilities, the continuous improvement of its efficiency and the continuing strengthening of its reliability. To these ends, the Bell System will continue to conduct a program of research and development, including fundamental scientific investigations, sufficient in scale and kind to assure its continued leadership in communications technology.

But no less in telephony's second century than in its first is universal service the Bell System's goal. Now that just about every U.S. home and business has a telephone, some say that goal has been achieved. We don't. We remain a long way from achieving the universality of communications in our society that our technology can accomplish. Realizing that potentiality, matching our services to the diverse needs of the individuals and organizations we serve, is our continuing goal.

IV But technology is not the only measure of our service. Crucial to the public's appraisal of our performance and therefore to its impression of the character of our business

< *AT&T's General Departments counsel the Associated Companies of the Bell System on a wide range of operating and technical matters. Shown is a portion of the Company's new office complex at Basking Ridge, New Jersey.*

and its judgment of what opportunities we ought to be afforded are the human aspects of our service–the individual consideration we show our customers, the attention that we give to "little things."

The Bell telephone companies handle hundreds of millions of messages every day. What makes our responsibilities unique is that each one of these messages–to someone–is more important than all the others. In short, our obligation to the public requires that we never forget that, although we number our customers in the millions, we serve them one at a time. We can, then, set ourselves no lesser goal than that each one–individually–should feel well and courteously served.

The obligation to treat our customers as individuals applies not just to telephone calls but to our every action and transaction. In credit or collection matters, for example, it requires that our response in each instance be based on relevant considerations alone and not on race, sex, creed, color or place of residence.

We recognize, too, that having been entrusted with a service that is uniquely personal, we have a special obligation to preserve its privacy. We will, therefore, do everything we reasonably can to preserve the confidentiality of the calls we handle and of our customers' calling records. So far as unauthorized wiretaps are concerned, we shall continue to be vigilant to prevent their attachment and prompt in seeing to their removal upon discovery. We will disclose our customers' calling records only in accordance with valid legal process. In fewest words, our aim is to provide a service in every particular worthy of public trust.

V The United States is almost alone among the nations of the world in entrusting the development and operation of its telecommunications services to private enterprise. Thus the realistic need to insure profitability through improved efficiency and continuous innovation is as strong a motivation in our business as it is in others. And it is largely to this motivation that our nation owes the present scope and versatility of its communications services and their low cost. In short, to serve well we must earn well.

Accordingly the management of the Bell System pledges itself to seek out every opportunity for improved efficiency that new technology and new operating methods afford. And wherever opportunities exist profitably to enhance the usefulness of our services we pledge ourselves to do so. And whenever and wherever these efforts fall short of achieving the level of earnings investors have the right to expect of a growing well-managed business, we pledge ourselves to a direct and candid representation of our needs to regulatory authorities. Pledging to our share owners that we will seek in their behalf no less than what we believe is necessary, we pledge at the same time to our customers that we will seek no more.

While operating conditions may vary throughout the country, it is expected that none of the Bell companies will represent a financial burden to the others and that each over a period of years will earn at a level sufficient to attract the continued investment required for the growth and improvement of its service.

In the main our aim is to achieve good earnings *without* raising rates. To that end we are committed to an extraordinary and determined effort–and a continuing one–to hold down price increases for our services.

Over the long run, it is our commitment to service that requires that we earn profits that will justify the continuing confidence of investors in our business. It is this commitment that requires that our financial policies take first account of the interest of our existing share owners and the need to maintain the integrity of their investment. It requires that we set as our goal earnings that are competitive with those of other leading U.S. enterprises with whom investors compare us before they decide where to put their money. It requires that we continuously increase the earning power of our shares by profitably reinvesting that portion of our earnings that remains after dividends. It requires that we strive continuously to maintain the value of our share owners' dividends in the face of inflation. Finally, it requires that we shun any action that is merely expedient, offering temporary advantage or momentary favor at the cost of sound long term progress. When all is said and done, however, our responsibility to investors places no greater obligation on us than that we address ourselves continuously to the enhancement of our business' capabilities and the value of its services to the public.

VI Down through the years it has been our business' commitment to serving the public that has shaped its distinctive character, drawing people to its ranks for whom service was an important personal goal and who in turn transmitted it, enhanced by their accomplishments, to their successors. Maintaining the vitality of this tradition is the first responsibility of telephone management.

It requires that the Bell companies offer wages, benefits and working conditions sufficient to bring into the business people who have the will and can learn the skills necessary to meet our customers' needs.

It requires that we offer opportunities for employment and advancement without discrimination because of age, sex, color or creed.

It requires that we commit no less energy to the development of our human resources than we do to our technical resources and that we provide employees–through effective supervision and good training–the means and–

through good pay–the incentives to enhance continually their ability to serve.

It requires that we provide our employees jobs that are big enough to be worth doing well.

And–perhaps most important of all–it requires that we provide our employees, regardless of their number, a job in an organization where they are known and respected as individuals, where their voices can be heard and their work appreciated.

But no more than other businesses is ours immune from the ups and downs of the economy and no more than jobs in other businesses can Bell System jobs be considered permanent jobs. Indeed by the very nature of its responsibilities to the public the Bell companies are obligated to pursue every increment of efficiency that technology and good management afford.

Nonetheless to the degree that conscientious planning can accomplish it Bell System management will seek to minimize the dislocations that might arise from economic fluctuations or the introduction of new technology and operating methods. Only when other alternatives have been exhausted will we resort to layoffs. In short, we shall exercise every management skill we have to assure the continuity of employment that has been our business' long-standing aim.

VII We in the Bell System recognize our responsibility to be good citizens in the communities we serve. Accordingly we extend every reasonable effort to be sure that our facilities enhance and do not impair the physical environment in which we operate. And as much as we have a responsibility to our customers and share owners to pay no more than our fair share of the community's taxes, we recognize our responsibility as corporate citizens to pay no less. Beyond that, we have a responsibility to the future–to do what we can to help restore where it has been lost–and maintain where it has not–a social environment conducive to the community's security and health and to its progress. It is to this end that each of our Associated Companies conducts its own conscientiously administered program of contributions–of time and talent as well as money–to community welfare organizations and educational institutions. And it is to this end that Bell System employees are encouraged to take an active role in community improvement undertakings.

We have responsibilities, too, to the larger community, the nation at large–first, to take scrupulous account of the impact of what we do on the general economy; second, to respond to the nation's needs whenever and wherever our skills are truly needed; and third, to give our wholehearted support to the goals our country has set for itself: a strong economy, a decent order in society, the conservation of resources and the maintenance of an environment that will sustain the continuing enhancement of our national life.

VIII Basically the aim of the Bell System's marketing program is to respond to our customers' needs by developing and offering communications services that meet those needs. In the Bell System marketing is service.

We shall compete vigorously. To this end, we shall continue to urge that the public interest requires that regulators impose no arbitrary hindrances that might bar us from the timely introduction of new services that meet our customers' needs or preclude the realization of the full potential of our technology.

But competition for competition's sake is not our aim. Only so long as the services we offer in competition with the services of others produce revenues over and above the costs of providing them–or regulators determine that there are overriding public interest reasons for doing so–are we warranted in continuing in the marketplace. That criterion met, however, we do not propose to abdicate any sector of telecommunications in which we believe–and can by our performance prove–we can effectively provide a needed service.

Today the Bell System is unreservedly committed to a sustained initiative aimed at discerning–indeed anticipating–the communications requirements of an increasingly diverse and fast-changing market and to the shaping of products and services matched to those requirements. Our aim is to assure that we know our customers' objectives and their needs and that we are ready to apply communications solutions to helping them fulfill those objectives and meet those needs.

IX It is the Bell System's policy to establish rates that will bring telecommunications services within the economic reach of more and more people, thereby enhancing their usefulness to everybody. To this end certain services –mostly services for business and discretionary services for residence customers–are priced so that their revenues contribute to the joint and common costs of other services, particularly residential exchange service. Our purpose has been to price each of these services at a level that will provide the optimum benefit to the general users of telephone service. To the degree that competition forces us to relate our rates for these services more directly to the costs involved, local exchange rates will rise, thereby jeopardizing the historic trend that has brought telephone service to 95 per cent of American households.

(This policy, we recognize, remains a viable one only so long as our business continues to be regulated in keeping with a standard that equates the public interest with the widest availability of economical service. Changed circumstances would, of course, require changed policy.)

The Bell System recognizes its obligation to demonstrate that its rates for services it offers in competition with others are fully compensatory. But in no instance, we believe, should regulators require us to set higher rates simply to protect competitors or preserve "competition."

In recent years, the Bell System has been moving more and more in the direction of pricing its services to reflect the amount of usage its customers make of them. The cost of directory assistance, for example, should be borne by those who use that service—and in proportion to their use—rather than by the general body of customers. As it becomes practical to do so, this concept of "measured service" will be extended to local calling as well. By separating the costs that only some people occasion but that hitherto have been spread over everybody's bill, we—again—help keep basic service costs down.

X The nationwide telephone network consists of millions upon millions of separate parts, each compatible with all the others and the whole adapted to constant change and improvement. This vast integrated network came into being—and constantly grows in service to the nation—because the people who develop its facilities, the people who manufacture them and the people who operate them all work to common standards and share a common purpose. It is to this end that our business is structured as it is.

In turn, we recognize, the Bell System's unique organizational structure imposes certain unique obligations upon us. It obliges us to be constantly alert to assure that it is the customer's interest and not our own that dictates what we will make and what we will buy. Certainly it obliges us to assure that we neglect no opportunity to achieve efficiencies in production and innovation that vertical integration affords. That is why Western Electric is a unit of the Bell System. At the same time, we recognize that the world of telecommunications is not "ours" and that today there are a great many organizations besides our own whose talents can efficiently be brought to bear on the growth and improvement of the nationwide telephone network. Accordingly, it is the policy of the Bell telephone companies to buy from whatever suppliers can provide them the products they need, when and where they need them, at the lowest cost over their entire service life. In our purchasing decisions, no other criterion applies than our customers' interest in economical and dependable service.

XI As earnestly as any other party to the current debate over national telecommunications policy, the Bell System is committed to the development of ground rules for our industry that will assure that the new and diverse communications needs of government and industry and the community are well met. Where competition's advantages to *some* people cannot be accomplished except at higher costs to *most* people, we believe we have an obligation to the public to say so. But the aim of public policy, we believe, should be to define that *balance* between the interest of the average user and the interest of specialized classes of users that, it might come to be agreed, represents the public interest. The Bell System pledges its sincere effort to this end.

How current issues of telecommunications policy will ultimately be resolved is beyond prediction. Already in some particulars regulatory decisions have been made that run counter to the positions we have voiced. In these instances it should be clear that it is the Bell System's policy to abide—in letter and spirit—by what has been decided.

But if national telecommunications policy remains uncertain, our own does not. In the absence of an explicit government determination that precludes our doing so, we shall continue to shape our policies and address our efforts to the aim that has governed our business virtually from its beginnings and to what we earnestly believe are the best interests of the public—the widest availability of high quality services at the lowest cost to the entire public.

XII Finally, we recognize that what responsibilities the public will be ready to entrust to us in the future depends upon its judgment not only of our competence but of our business' character as well.

It is for this reason that we seek to instill in all our people how important it is that we use our strength fairly and that we apply scrupulous objectivity in all our relations with others.

It is for this reason that we strive to make sure that the men and women we advance to positions of greater responsibility are men and women of the highest character who have demonstrated their qualifications for advancement not only on the basis of the results they have achieved but on the way they achieved those results. Our business simply cannot afford to have among its leaders people who for expediency's sake are ready to accommodate themselves to conduct of which we might be less than proud.

And it is for this reason that we have set for ourselves no lesser standard than excellence in the performance of our responsibilities to the public. What makes service a goal worth striving for is that not at the end of ten years or a hundred can we tell ourselves we have achieved it. Over the long pull, Bell System policy calls for constant improvement of the quality of our service and constant improvement of its usefulness. We have no other business and no greater source of strength.

American Telephone and Telegraph Company
and Associated Companies

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, composed of Directors other than Bell System employees, 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 sheets of American Telephone and Telegraph Company and its subsidiaries as of December 31, 1977 and 1976, and the related consolidated statements of income and reinvested earnings and changes in financial position for the years then ended. Our examinations were 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. The financial statements of two telephone subsidiaries included in the consolidated financial statements (constituting total assets of $14,067,377,000 and $12,644,118,000 and total operating revenues of $5,704,787,000 and $5,092,143,000 included in the consolidated totals for 1977 and 1976, 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.

See note (E) to Financial Statements as to amounts included in income applicable to common shares resulting from intrastate rate increases in a number of states which are subject to investigation and possible refund, and as to related income tax matters with respect to one subsidiary. As note (E) also indicates, the possibility of a material refund of revenues from interstate rate increases is now considered remote and, accordingly, our opinion on the 1976 consolidated statement of income is no longer qualified with respect to such interstate revenues.

In our opinion, based upon our examinations and the reports of other auditors and subject to the final outcome of the intrastate rate and related matters discussed in the preceding paragraph, the consolidated financial statements on pages 26 to 36 present fairly the consolidated financial position of American Telephone and Telegraph Company and its subsidiaries at December 31, 1977 and 1976, and the consolidated results of their operations and the consolidated changes in their financial position for the years then ended, 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, 1978

Statements of Income and Reinvested Earnings

	Thousands Of Dollars Year 1977	Year 1976
OPERATING REVENUES		
Local service	$17,070,909	$15,608,952
Toll service	18,093,752	16,065,472
Directory advertising and other	1,592,185	1,367,727
Less: Provision for uncollectibles	262,040	226,569
Total operating revenues	36,494,806	32,815,582
OPERATING EXPENSES		
Maintenance	7,473,712	6,624,782
Depreciation	5,045,312	4,483,906
Traffic—primarily costs of handling messages	2,296,776	2,205,554
Commercial—primarily costs of local business office operations	1,279,155	1,111,755
Marketing	1,788,698	1,509,429
Accounting	913,226	873,239
Provision for pensions and other employee benefits (C)	3,176,356	2,832,578
Research and fundamental development	278,699	249,867
Other operating expenses	1,264,252	1,129,792
Total operating expenses	23,516,186	21,020,902
Net operating revenues	12,978,620	11,794,680
OPERATING TAXES		
Federal income (A):		
Current	617,042	582,355
Deferred	1,560,628	1,387,782
Investment tax credits—net	820,236	715,944
State and local income:		
Current	178,458	139,726
Deferred	128,738	107,139
Property, gross receipts, payroll-related and other taxes	3,251,680	2,977,469
Total operating taxes	6,556,782	5,910,415
Operating income (carried forward)	$ 6,421,838	$ 5,884,265

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

	Thousands Of Dollars Year 1977	Year 1976
Operating income (brought forward)	$ 6,421,838	$ 5,884,265
OTHER INCOME		
Western Electric Company net income	490,076	217,383
Interest charged construction (B)	228,619	216,284
Miscellaneous income and deductions—net (D)	(152,830)	(87,416)
Total other income	565,865	346,251
Income before interest deductions	6,987,703	6,230,516
INTEREST DEDUCTIONS	2,443,770	2,401,365
NET INCOME	**4,543,933**	**3,829,151**
Preferred dividend requirements	183,804	226,666
INCOME APPLICABLE TO COMMON SHARES (E)	$ 4,360,129	$ 3,602,485
EARNINGS PER COMMON SHARE *(after preferred dividend requirements) based on average shares outstanding, 625,878,000 in 1977 and 595,184,000 in 1976 (E)*	**$6.97**	**$6.05**
REINVESTED EARNINGS		
At beginning of year	$16,126,037	$14,787,277
Add—Net income	4,543,933	3,829,151
	20,669,970	18,616,428
Deduct—Dividends declared:		
Preferred	179,364	225,908
Common—1977, $4.20 per share; 1976, $3.80 per share	2,642,799	2,262,967
Miscellaneous—net	714	1,516
	2,822,877	2,490,391
REINVESTED EARNINGS AT END OF YEAR	$17,847,093	$16,126,037

Balance Sheets

ASSETS	Thousands of Dollars December 31, 1977	December 31, 1976
TELEPHONE PLANT—at cost		
In service	$98,717,261	$91,317,667
Under construction	3,035,359	2,749,418
Held for future use	106,571	100,398
	101,859,191	94,167,483
Less: Accumulated depreciation	19,461,149	18,245,477
	82,398,042	75,922,006
INVESTMENTS		
At equity (F):		
Western Electric Company, Incorporated	3,363,672	3,261,615
Other	322,924	303,033
At cost	114,259	98,742
	3,800,855	3,663,390
CURRENT ASSETS		
Cash and temporary cash investments—less drafts outstanding: 1977, $434,240,000; 1976, $319,943,000 (G)	1,283,079	1,486,733
Receivables—less allowance for uncollectibles: 1977, $99,158,000; 1976, $86,479,000	4,468,280	3,917,505
Material and supplies	663,391	543,578
Prepaid expenses	169,708	177,191
	6,584,458	6,125,007
DEFERRED CHARGES	1,188,937	1,006,586
TOTAL ASSETS	$93,972,292	$86,716,989

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

EQUITY AND LIABILITIES	Thousands of Dollars December 31, 1977	December 31, 1976
EQUITY		
American Telephone and Telegraph Company		
Preferred shares (H)	$ 2,218,703	$ 2,861,572
(Includes excess of proceeds over stated value)		
Common shares (I)	19,571,994	17,331,929
(Includes excess of proceeds over $16⅔ par value)		
Authorized shares: 750,000,000		
Outstanding shares: at December 31, 1977, 647,632,000; at December 31, 1976, 607,405,000		
Reinvested earnings—see page 27	17,847,093	16,126,037
	39,637,790	36,319,538
Ownership interest of others in consolidated subsidiaries	1,260,061	899,082
	40,897,851	37,218,620
LONG AND INTERMEDIATE TERM DEBT (J)	32,499,697	32,524,826
CURRENT LIABILITIES		
Accounts payable	2,426,254	2,200,478
Taxes accrued	1,146,875	1,136,237
Advance billing and customers' deposits	857,604	773,043
Dividends payable	741,422	646,504
Interest accrued	640,891	631,844
	5,813,046	5,388,106
Debt maturing within one year (K)	3,248,724	2,471,163
	9,061,770	7,859,269
DEFERRED CREDITS		
Accumulated deferred income taxes	7,896,478	6,210,104
Unamortized investment tax credits	3,461,901	2,730,282
Other	154,595	173,888
	11,512,974	9,114,274
LEASE COMMITMENTS (L)		
TOTAL EQUITY AND LIABILITIES	**$93,972,292**	**$86,716,989**

	Thousands Of Dollars Year 1977	Year 1976
SOURCE OF FUNDS		
Operations		
Net income	$ 4,543,933	$ 3,829,151
Add—Expenses not requiring funds:		
Depreciation	5,045,312	4,483,906
Deferred income taxes	1,686,374	1,488,938
Investment tax credits—net (A)	731,619	705,054
Deduct—Income not providing funds:		
Interest charged construction (B)	228,619	216,284
Share of equity-basis companies' income in excess of dividends	110,731	58,806
Total funds from operations	11,667,888	10,231,959
Financing		
Issuance of shares	1,597,196	1,212,637
Issuance of long and intermediate term debt	2,285,000	2,026,500
Total funds from financing	3,882,196	3,239,137
Changes in ownership interest of others in consolidated subsidiaries	360,979	35,298
Decrease in working capital	743,050	204,521
	$16,654,113	$13,710,915
APPLICATION OF FUNDS		
Telephone plant	$11,292,729	$ 9,747,710
Dividends	2,822,163	2,488,875
Increase in deferred charges	182,351	173,174
Reduction of long and intermediate term debt	2,310,129	1,295,000
Change in investments in companies accounted for on an equity basis	11,217	25,325
Other—net	35,524	(19,169)
	$16,654,113	$13,710,915
The decrease in working capital is accounted for by:		
Increase in current liabilities:		
Accounts payable	$ 225,776	$ 286,396
Taxes accrued	10,638	288,591
Advance billing and customers' deposits	84,561	70,131
Dividends payable	94,918	81,238
Interest accrued	9,047	35,042
Debt maturing within one year (K)	777,561	242,381
	1,202,501	1,003,779
Less—Increase in current assets:		
Cash and temporary cash investments, net of drafts	(203,654)	363,190
Receivables	550,775	379,841
Material and supplies	119,813	93,138
Prepaid expenses	(7,483)	(36,911)
	459,451	799,258
Decrease in working capital, as above	$ 743,050	$ 204,521

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), (C), (E), (G) and (L).

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 intercompany 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.

Depreciation—Provision in the accounts for depreciation (5.5% in 1977 and 5.3% in 1976 of the cost of depreciable plant in service) is based on straight-line composite rates determined on the basis of the average expected life of categories of plant acquired in a given year. The Company has requested the Federal Communications Commission (FCC) to permit such straight-line composite rates to be determined on the basis of equal life groups (ELG) of categories of plant acquired in a given year which, if granted, will increase depreciation expense above the levels that otherwise would be computed. Such increased depreciation should be allowable in determining revenue requirements in future rate-making proceedings. 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 38.8% in 1977 and 40.6% in 1976. 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 (D). The differences of 9.2% and 7.4% in 1977 and 1976, respectively, between the effective rate and the 48% Federal income tax statutory rate are attributable to the following factors:

	1977	1976
a. Earnings applicable to investments in companies accounted for on an equity basis which are reflected net of income tax	3.2%	1.7%
b. Certain taxes and payroll-related construction costs capitalized for financial statement purposes, but deducted for income tax purposes, net of related depreciation adjustments for current and prior years	3.0%	3.0%
c. Interest charged construction which is excluded from taxable income, net of related depreciation adjustments for current and prior years	1.0%	1.1%
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%)	(.6%)
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 1977 and 1976 by about $224,756,000 and $150,754,000, respectively	3.0%	2.3%
f. Other miscellaneous differences	(.4%)	(.1%)
Total	9.2%	7.4%

Research and Development — Basic research and fundamental development costs are included as expense in determining net income. The cost of specific development and design work related to products to be manufactured by Western Electric is included in the cost of such products (see "Purchases from Western Electric" above).

(B) Interest Charged Construction — Regulatory authorities presently allow the Company and its telephone subsidiaries to provide for a return on capital invested in new telephone plant while under construction by accruing interest as an item of income during the construction period and 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 plant as the resulting higher depreciation expense is recovered in the form of increased revenues.

During 1977 the FCC directed that the accruals for interest described above should not be made for telephone construction projects expected to be completed within a year from the time construction started; rather such plant should be included in the rate base upon which current interstate revenue requirements are determined. Discontinuance of the accruals was to be dependent upon a revision of the FCC's Uniform System of Accounts, which is expected to be issued in 1978 and effective January 1, 1979. The Company's telephone subsidiaries will need approval from state regulatory commissions (and in some cases, changes in state laws) to obtain similar treatment for intrastate rate-making purposes. The Company estimates that about 63% of its 1977 interest charged construction was accrued on plant expected to be completed within a year from the time construction started, of which about 30% is subject to FCC revenue requirement jurisdiction and about 70% subject to that of the various state regulatory commissions.

(C) 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 $2,056,341,000 in 1977 and $1,843,144,000 in 1976, which represented 15.7% in 1977 and 15.5% in 1976 of salaries and wages. Amendments to the plans, adopted pursuant to 1977 union contracts, provide for improved benefits for all employees and are expected to increase 1978 pension accruals by approximately $120,000,000. Based on the latest actuarial valuation, adjusted to reflect those benefits which became effective January 1, 1978, the companies estimate that the actuarially computed value of vested benefits exceeded the cost of trust fund assets by about $560,000,000. The accrual programs contemplate that there will be available in the funds amounts sufficient to provide benefits as stated in the plans.

(D) Miscellaneous Income and Deductions — Miscellaneous deductions include ownership interest of others in the net income of certain consolidated subsidiaries in the amounts of $114,000,000 in 1977 and $94,806,000 in 1976. Also included are income taxes on non-operating income as follows:

	Thousands of Dollars	
	1977	1976*
Federal:		
Current	$(49,341)	$(1,595)
Deferred	724	573
State and local:		
Current	(736)	3,797
Deferred	7	13
Total	$(49,346)	$2,788

*Restated to reflect tax effects of adjustments in 1976 relating to prior years' operations.

(E) Earnings Subject to Possible Refund—On September 13, 1977, the California Public Utilities Commission ordered The Pacific Telephone and Telegraph Company ("Pacific Telephone"), a subsidiary, to refund $206,000,000 applicable to the period August 1974 through December 1977 (equivalent to $96,600,000 of Consolidated Income Applicable to Common Shares) and to reduce future rates by $60,000,000 annually. The American Company believes that the Order could adversely affect Pacific Telephone's past and future eligibility for Job Development Investment Tax Credits and accelerated depreciation tax benefits, which could materially increase Pacific Telephone's cash and revenue requirements. Were ineligibility to be determined, Consolidated Income Applicable to Common Shares could be reduced additionally (by as much as $101,000,000 through December 1977) as a result of interest on taxes held to be payable and from the reversal of Pacific Telephone's amortized Job Development Investment Tax Credits. Pacific Telephone has filed a petition for review with the California Supreme Court. Another party also has appealed to the Court for a decision, the consequences of which would be additional refunds and greater prospective rate reductions.

Until such time as these matters are resolved, their final effects and the years in which such effects would be recorded cannot be determined.

Income Applicable to Common Shares includes the following amounts with respect to the above Order and from other intrastate rate increases all of which are subject to investigation and possible refund:

	Thousands of Dollars	
	1977	1976
California order	$35,600	$27,600
Other intrastate increases	48,160	25,580
Total	$83,760	$53,180
Per common share	$.13	$.09

The Company previously has reported revenues from interstate rate increases effective February 29, 1976 as being subject to investigation and possible refund, but believes now that the possibility of a material refund is remote.

The FCC's Uniform System of Accounts provides that refunds of prior years' revenues, less related income tax adjustments, be accounted for as delayed items charged against income. For financial reporting, the Company treats such refunds, where material, as adjustments of prior years' income.

(F) 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, 1977, for those companies carried at equity:

Western Electric Company, Incorporated and its subsidiaries Wholly-owned and carried on the Company's books at a cost of $1,452,991,000. The consolidated assets and liabilities at December 31, 1977, were $5,875,543,000 and $2,511,871,000, respectively.

Other—Includes principally:

Bell Telephone Laboratories, Incorporated—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—18.2% owned and carried on the Company's books at a cost of $61,537,000 plus $7,100,000 of advances. The Company's equity is $101,763,000. The market value of the shares owned by the Company based on the closing price as obtained from the composite tape* at December 31, 1977, was $77,804,000.

Cincinnati Bell, Inc.—26.6% owned and carried on the Company's books at a cost of $27,454,000. The Company's equity is $57,010,000. The market value of the shares owned by the Company based on the closing price as obtained from the composite tape* at December 31, 1977, was $57,725,000.

(G) 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 most 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 obligations 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.

(H) Preferred Shares—At December 31, 1977, 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, 11,824,000 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 $2,525,000 and $5,213,000 at December 31, 1977 and 1976, respectively.

The $77.50 preferred shares may be redeemed by the Company at a premium of $64.20 per $1,000 share on or before January 31, 1979, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund, under the provisions of which the Company, on February 1, 1978, redeemed 25,000 shares at $1,000 per share reducing stated capital (as defined in the New York Business Corporation Law) by $25,000,000.

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 1977, a total of 12,803,612 shares were converted. See note (I).

The $3.64 preferred shares may be redeemed by the Company at a premium of $3.22 per $50 share on or before April 30, 1978, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund commencing May 1, 1984.

*Encompasses trading on the principal U.S. stock exchanges as well as off-board trading.

The $3.74 preferred shares may be redeemed by the Company at a premium of $3.31 per $50 share on or before January 31, 1979, and at diminishing amounts thereafter. These shares are subject to redemption without premium through an annual sinking fund commencing February 1, 1985.

(I) Common Shares—Proceeds in excess of par value of common shares amounted to $8,778,124,000 and $7,208,511,000 at December 31, 1977 and 1976, respectively. Book value per common share amounted to $57.78 and $55.08 at December 31, 1977 and 1976, respectively.

At December 31, 1977, there were 12,445,862 authorized and unissued shares reserved for the conversion of the Company's outstanding $4 convertible preferred shares.

The Company increased common shares outstanding in 1977 as follows:

13,477,512 shares issued upon conversion of 12,803,612 shares of the Company's $4 convertible preferred shares. See note (H).

7,927,624 shares sold at 95% of market for dividend reinvestments and 1,483,678 shares sold at market for optional cash payments under the Share Owner Dividend Reinvestment and Stock Purchase Plan.

4,064,850 shares sold at market to the Bell System Savings Plan for Salaried Employees.

1,274,008 shares issued at market in connection with the Bell System Employee Stock Ownership Plan through the election of an extra 1% Investment Tax Credit.

12,000,000 shares sold at $59.875 per share through an underwritten offering in November 1977.

(J) Long and Intermediate Term Debt—At December 31, 1977, in millions of dollars:

Maturities	2⅝% to 5⅞%	6% to 7⅞%	8% to 10%	Total
1979	$ 60	$ 725	$ —	$ 785
1980	265	150	—	415
1981	170	—	325	495
1982	365	300	120	785
1983-1992	3,250	187	350	3,787
1993-2002	4,027	1,328	991	6,346
2003-2012	1,422	5,715	5,180	12,317
2013-2017	—	1,850	5,720	7,570
Total	$ 9,559	$10,255	$12,686	$32,500

As of February 8, 1978, two telephone subsidiaries have sold or announced their intention to sell up to $525,000,000 of long term debt. The proceeds of such sales will be used to refund maturing long 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.

(K) 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 (J) above. In the Company's computation of ratios of debt to combined debt and equity (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 1977	1976
Bank loans	$ 777	$ 755
Commercial paper	1,831	951
Other notes	321	170
Long and intermediate term debt maturing within one year (includes $575,000,000 in 1976 called for redemption)	320	595
Total	$3,249	$2,471

The weighted average annual interest rates for bank loans, commercial paper and other notes outstanding at December 31, 1977, were 7.2%, 6.6% and 6.3%, respectively. The maximum amount of interim debt at any month-end during the year 1977 was $2,928,724,000 and the average amount outstanding during the year was approximately $2,436,004,000 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, 1977 carried a weighted average interest rate of 4.2%.

(L) Lease Commitments—The Company and its consolidated subsidiaries lease certain facilities and equipment used in their operations and reflect lease payments as expenses of the period to which they relate. Total rental expense amounted to $846,009,000 and $729,775,000 in 1977 and 1976, respectively. At December 31, 1977, the aggregate minimum rental commitments under noncancellable operating leases for the periods shown were as follows:

Years	Thousands of Dollars
1978	$ 403,253
1979	372,200
1980	324,011
1981	265,907
1982	219,393
Thereafter	2,373,628
Total	$3,958,392

These leases include some which are "capital leases" as defined by the Financial Accounting Standards Board. However, for regulatory accounting and rate-making purposes, leases are not capitalized. Had such leases been capitalized, additional assets of $932,397,000 and $930,072,000 (net of $326,783,000 and $259,494,000 accumulated amortization) and related obligations of $1,029,865,000 and $1,001,404,000 would have been included in the balance sheets as of December 31, 1977 and 1976, respectively. Also, expenses (net of related income taxes) of $9,292,000 and $7,542,000 in excess of those included in determining net income would have been reflected in 1977 and 1976, respectively, rather than in the subsequent years of the lease terms. Under regulatory rate-making procedures, such additional expenses are not recognized currently but are expected to be recovered in revenues of the subsequent years.

(M) 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 and revenue.

(N) 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	Total Operating Revenues	Operating Income	Income Applicable to Common Shares	Earnings per Common Share*
1977				
1st	$ 8,738	$1,519	$1,011	$1.65
2nd	8,991	1,603	1,136	1.83
3rd	9,223	1,642	1,129	1.79
4th	9,543	1,658	1,084	1.69
Total	$36,495	$6,422	$4,360	$6.97
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	$32,815	$5,884	$3,602	$6.05

*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 quarters include approximately $17,640,000, $17,940,000, $19,380,000 and $28,800,000 ($.03, $.03, $.03 and $.04 per common share) in 1977, respectively, and $12,640,000, $12,760,000, $13,330,000 and $14,450,000 ($.02, $.02, $.02 and $.03 per common share) in 1976, respectively, of Income Applicable to Common Shares resulting from rate increases which are subject to investigation and possible refund. See also note (E).

Results for the first three quarters of 1977 have been restated to reflect the use of revised depreciation rates prescribed by the FCC for seven subsidiaries retroactively to January 1, 1977 which reduced Income Applicable to Common Shares for the first two calendar quarters of 1977 by $27,777,000 and $3,887,000 ($.05 and $.— per common share), respectively, and increased Income Applicable to Common Shares for the third quarter of 1977 by $14,853,000 ($.02 per common share).

Results for the fourth quarter of 1977 have been decreased by $32,217,000 ($.05 per common share) reflecting costs related to the early redemption by the Company of certain long-term debt and $22,760,000 ($.04 per common share) reflecting the adjustment of prior years' state income taxes by one subsidiary.

As previously reported, results for the fourth quarter of 1976 were reduced by $17,911,000 ($.03 per common share) reflecting revenues applicable to the current and prior periods which were refunded by one subsidiary pursuant to an order from its regulatory authority; $27,560,000 ($.05 per common share) reflecting revised depreciation rates prescribed by the FCC for the Company and three subsidiaries in the fourth quarter but retroactive to January 1, 1976; and $13,759,000 ($.02 per common share) reflecting costs related to the early redemption by the Company of certain long-term debt.

(O) Replacement Cost (Unaudited)—In response to Securities and Exchange Commission requirements, the following figures compare telephone plant investment as shown on the balance sheets at December 31, 1977 and 1976 with the approximate cost to replace its productive capacity at those dates. They also compare accumulated depreciation at those dates with the amounts that would have been provided had past depreciation accruals contemplated such replacement costs. Additionally, they compare depreciation expense for the years ended December 31, 1977 and 1976 with depreciation expense computed (using historic depreciation assumptions) on these estimates of replacement costs.

	Millions of Dollars		
Year 1977	As Stated	At Replacement Cost	Difference
Telephone plant investment:			
For which replacement costs have been determined	$ 98,038	$141,641	$ 43,603
Included at historic cost	3,821	3,821	—
Total	101,859	145,462	43,603
Accumulated depreciation	19,461	35,162	15,701
Net telephone plant investment	$ 82,398	$110,300	$ 27,902
Depreciation expense	$ 5,045	$ 6,738	$ 1,693
Year 1976			
Telephone plant investment:			
For which replacement costs have 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	$75,922	$101,278	$25,356
Depreciation expense	$ 4,484	$ 5,997*	$ 1,513*

*Restated to reflect $17.6 million of additional depreciation expense.

These replacement cost figures are theoretical, based on the assumptions that, as of December 31, 1977 and 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 replacement cost of net telephone plant investment does not represent additional book value for the Company's stock. The above replacement costs are approximations 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, 1977 and 1976. Replacement actually will take place over many years and the funds needed will be derived from sources similar to those available during 1977.

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 replacement 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.

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4. Member of the Compensation Committee
5. Member of the Committee on Employee Benefits
6. Member of the Corporate Public Policy Committee
7. Member of the Committee on Directors
8. Member of the Proxy Committee

Committees

Executive Committee has authority, within prescribed limits, to act for the Board between meetings.

Audit Committee reviews internal auditing controls and the work of the independent auditors. Each year the Committee nominates independent auditors for share owners' approval.

Finance Committee reviews the Company's financial policies and condition and authorizes investments in the Associated Companies.

Compensation Committee reviews all compensation plans and procedures for assistant vice presidents and above and makes recommendations to the Board for such plans as well as for specific compensation of vice presidents and above.

Committee on Employee Benefits is responsible for administration of assets, auditing and actuarial matters for the Company's pension, benefit and employee savings plans.

Corporate Public Policy Committee examines Company policy on major public issues and provides guidance to management.

Committee on Directors advises on compensation and tenure of Directors and makes recommendations to the Board for filling vacancies.

Proxy Committee votes shares represented by returned proxies in accordance with shareholders' directions.

AT&T

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