AT&T INC.
Form 10-Q
November 02, 2006

FORM 10-Q

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File Number 1-8610

AT&T INC.

Incorporated under the laws of the State of Delaware

I.R.S. Employer Identification Number 43-1301883

175 E. Houston, San Antonio, Texas 78205

Telephone Number: (210) 821-4105

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12-b2 of the Exchange Act. Large accelerated filer X Accelerated filer [ ] Non-accelerated filer [ ]

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

At October 31, 2006, common shares outstanding were 3,842,902,194.

PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

AT&T INC.
CONSOLIDATED STATEMENTS OF INCOME
Dollars in millions except per share amounts
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	**2006**	2005
Operating Revenues				
Voice	**$8,464**	$5,743	**$ 25,725**	$17,355
Data	**4,546**	2,514	**13,465**	7,343
Directory	**906**	917	**2,716**	2,723
Other	**1,722**	1,130	**5,258**	3,434
Total operating revenues	**15,638**	10,304	**47,164**	30,855
Operating Expenses				
Cost of sales (exclusive of depreciation and amortization shown separately below)	**6,664**	4,364	**20,641**	13,153
Selling, general and administrative	**3,620**	2,175	**11,396**	7,229
Depreciation and amortization	**2,437**	1,803	**7,415**	5,437
Total operating expenses	**12,721**	8,342	**39,452**	25,819
Operating Income	**2,917**	1,962	**7,712**	5,036
Other Income (Expense)				
Interest expense	**(442)**	(349)	**(1,378)**	(1,051)
Interest income	**98**	82	**278**	291
Equity in net income of affiliates	**649**	219	**1,438**	342
Other income (expense) net	**11**	(70)	**37**	11
Total other income (expense)	**316**	(118)	**375**	(407)
Income Before Income Taxes	**3,233**	1,844	**8,087**	4,629
Income taxes	**1,068**	598	**2,669**	1,498
Net Income	**$2,165**	$1,246	**$ 5,418**	$3,131
Earnings Per Common Share:				
Net Income	**$0.56**	$0.38	**$ 1.40**	$0.95
Earnings Per Common Share - Assuming Dilution:				
Net Income	**$0.56**	$0.38	**$ 1.39**	$0.95
Weighted Average Number of Common Shares Outstanding Basic (in millions)	**3,873**	3,296	**3,880**	3,300
Dividends Declared Per Common Share	**$0.3325**	$0.3225	**$ 0.9975**	$0.9675

See Notes to Consolidated Financial Statements.

2

AT&T INC.
CONSOLIDATED BALANCE SHEETS
Dollars in millions except per share amounts

	September 30, 2006	December 31, 2005
Assets	**(Unaudited)**	
Current Assets		
Cash and cash equivalents	**$ 1,251**	$ 1,224
Accounts receivable net of allowances for uncollectibles of $936 and $1,176	**8,668**	9,351
Prepaid expenses	**1,038**	1,029
Deferred income taxes	**1,598**	2,011
Other current assets	**957**	1,039
Total current assets	**13,512**	14,654
Property, plant and equipment	**152,573**	149,238
Less: accumulated depreciation and amortization	**94,922**	90,511
Property, Plant and Equipment Net	**57,651**	58,727
Goodwill	**13,385**	14,055
Intangible Assets Net	**7,728**	8,503
Investments in Equity Affiliates	**2,222**	2,031
Investments in and Advances to Cingular Wireless	**33,029**	31,404
Other Assets	**16,365**	16,258
Total Assets	**$ 143,892**	$ 145,632
Liabilities and Stockholders Equity		
Current Liabilities		
Debt maturing within one year	**$ 4,713**	$ 4,455
Accounts payable and accrued liabilities	**14,789**	17,088
Accrued taxes	**3,122**	2,586
Dividends payable	**1,281**	1,289
Total current liabilities	**23,905**	25,418
Long-Term Debt	**26,799**	26,115
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	**14,368**	15,713
Postemployment benefit obligation	**18,150**	18,133
Unamortized investment tax credits	**188**	209
Other noncurrent liabilities	**5,081**	5,354
Total deferred credits and other noncurrent liabilities	**37,787**	39,409
Stockholders Equity		
Common shares issued ($1 par value)	**4,065**	4,065
Capital in excess of par value	**27,116**	27,499
Retained earnings	**30,653**	29,106
Treasury shares (at cost)	**(5,867)**	(5,406)
Additional minimum pension liability adjustment	**(218)**	(218)
Accumulated other comprehensive income	**(348)**	(356)
Total stockholders equity	**55,401**	54,690
Total Liabilities and Stockholders Equity	**$ 143,892**	$ 145,632

See Notes to Consolidated Financial Statements.

AT&T INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
Dollars in millions, increase (decrease) in cash and cash equivalents
(Unaudited)

	Nine months ended September 30,	
	2006	2005
Operating Activities		
Net income	**$ 5,418**	$ 3,131
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**7,415**	5,437
Undistributed earnings from investments in equity affiliates	**(1,359)**	(285)
Provision for uncollectible accounts	**450**	561
Amortization of investment tax credits	**(21)**	(17)
Deferred income tax expense (benefit)	**(269)**	(315)
Net gain on sales of investments	**(10)**	(104)
Changes in operating assets and liabilities:		
Accounts receivable	**249**	(39)
Other current assets	**42**	(249)
Accounts payable and accrued liabilities	**(1,819)**	(242)
Stock-based compensation tax benefit	**(10)**	(3)
Other - net	**507**	508
Total adjustments	**5,175**	5,252
Net Cash Provided by Operating Activities	**10,593**	8,383
Investing Activities		
Construction and capital expenditures	**(6,158)**	(3,743)
Receipts from (investments in) affiliates net	**(633)**	2,603
Dispositions	**72**	126
Acquisitions	**(115)**	(169)
Maturities of held-to-maturity securities	**3**	98
Proceeds from note repayment	**-**	37
Other	**5**	-
Net Cash Used in Investing Activities	**(6,826)**	(1,048)
Financing Activities		
Net change in short-term borrowings with original maturities of three months or less	**2,336**	(1,656)
Repayment of other short-term borrowings	**(3)**	-
Issuance of long-term debt	**1,491**	-
Repayment of long-term debt	**(2,882)**	(2,123)
Purchase of treasury shares	**(1,359)**	(742)
Issuance of treasury shares	**463**	362
Dividends paid	**(3,873)**	(3,196)
Stock-based compensation tax benefit	**10**	3
Other	**77**	-
Net Cash Used in Financing Activities	**(3,740)**	(7,352)
Net increase (decrease) in cash and cash equivalents from continuing operations	**27**	(17)
Net Cash Used in Operating Activities from Discontinued Operations	**-**	(310)
Net increase (decrease) in cash and cash equivalents	**27**	(327)
Cash and cash equivalents beginning of year	**1,224**	760

Cash and Cash Equivalents End of Period	**$ 1,251**	$ 433
Cash paid during the nine months ended September 30 for:		
Interest	**$ 1,503**	$ 1,198
Income taxes, net of refunds	**$ 2,249**	$ 1,535

See Notes to Consolidated Financial Statements.

4

AT&T INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

Dollars and shares in millions, except per share amounts

(Unaudited)

	Nine months ended September 30, 2006	
	Shares	**Amount**
Common Stock		
Balance at beginning of year	**4,065**	**$ 4,065**
Balance at end of period	**4,065**	**$ 4,065**
Capital in Excess of Par Value		
Balance at beginning of year		**$ 27,499**
Issuance of shares		**(302)**
Stock based compensation		**(81)**
Balance at end of period		**$ 27,116**
Retained Earnings		
Balance at beginning of year		**$ 29,106**
Net income ($1.39 per diluted share)		**5,418**
Dividends to stockholders ($1.00 per share)		**(3,865)**
Other		**(6)**
Balance at end of period		**$ 30,653**
Treasury Shares		
Balance at beginning of year	**(188)**	**$ (5,406)**
Purchase of shares	**(45)**	**(1,359)**
Issuance of shares	**21**	**898**
Balance at end of period	**(212)**	**$ (5,867)**
Additional Minimum Pension Liability Adjustment		
Balance at beginning of year		**$ (218)**
Balance at end of period		**$ (218)**
Accumulated Other Comprehensive Income, net of tax		
Balance at beginning of year		**$ (356)**
Other comprehensive income (loss) (see Note 3)		**8**
Balance at end of period		**$ (348)**

See Notes to Consolidated Financial Statements.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Dollars in millions except per share amounts

NOTE 1. PREPARATION OF INTERIM FINANCIAL STATEMENTS

Basis of Presentation Throughout this document, AT&T Inc. is referred to as AT&T, we or the Company. The consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) that permit reduced disclosure for interim periods. We believe that these consolidated financial statements include all adjustments (consisting only of normal recurring accruals) necessary to present fairly the results for the interim periods shown. The results for the interim periods are not necessarily indicative of results for the full year. You should read this document in conjunction with the consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2005.

The consolidated financial statements include the accounts of the Company and our majority-owned subsidiaries and affiliates. Our subsidiaries and affiliates operate in the communications services industry both domestically and internationally providing wireline and wireless telecommunications services and equipment as well as directory advertising and publishing services.

All significant intercompany transactions are eliminated in the consolidation process. Investments in partnerships, joint ventures, including Cingular Wireless (Cingular), and less than majority-owned subsidiaries where we have significant influence are accounted for under the equity method. We account for our 60% economic interest in Cingular under the equity method since we share control equally (i.e., 50/50) with our 40% economic partner in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular. Earnings from certain foreign equity investments accounted for using the equity method are included for periods ended within up to three months of the date of our Consolidated Statements of Income.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, including estimates of probable losses and expenses. Actual results could differ from those estimates.

We have reclassified certain amounts in prior-period financial statements to conform to the current period s presentation. As a result of our November 2005 acquisition of AT&T Corp. (ATTC), in 2006, we revised our segment reporting (see Note 5). In addition, we revised the product categories reported in operating revenue as follows: long-distance voice is now reported in voice revenue; the majority of customer premises equipment and integration services revenue, previously reported as voice and data revenue are now reported in other revenue; and directory revenues now reflect our traditional directory segment revenues. Additionally, in assessing fair value of contracts in conjunction with the acquisition of ATTC (see Note 2) we reduced revenues and operating expenses by $18 in the post-acquisition 2005 period and by $79 for the first six months of 2006 to reflect settlements with foreign carriers for transport/carrying calls at the contract incremental/cash settlement rates rather than contract swap rates. Operating Income remained unchanged.

FIN 48 In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold for tax positions taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact FIN 48 will have on our financial position and results of operations.

EITF 06-3 In June 2006, the Emerging Issues Task Force (EITF), a task force established to assist the FASB on significant emerging accounting issues, ratified the consensus on EITF 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (EITF 06-3). EITF 06-3 provides that taxes imposed by a governmental authority on a revenue producing transaction between a seller and a customer should be shown in the income statement on either a gross or a net basis, based on the entity s accounting policy, which should be disclosed pursuant to Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies. Amounts that are allowed to be charged to customers as an offset to taxes

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

owed by a company are not considered taxes collected and remitted. If such taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. EITF 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. We are currently evaluating the impact EITF 06-3 will have, but do not expect a material impact on our financial position and results of operations.

FAS 157 In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, Fair Value Measurements (FAS 157). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurement. FAS 157 does not require any new fair value measurements and we do not expect the application of this standard to change our current practice. FAS 157 requires prospective application for fiscal years ending after November 15, 2007.

FAS 158 In September 2006, the FASB issued Statement of Financial Accounting Standard No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (FAS 158), an amendment of Statement of Financial Accounting Standard No. 87 Employers Accounting for Pensions (FAS 87), Statement of Financial Accounting Standard No. 88 Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, Statement of Financial Accounting Standard No. 106 Employers Account for Postretirement Benefits Other Than Pensions (FAS 106) and Statement of Financial Accounting Standard No. 132(R) Employers Disclosures about Pensions and Other Postretirement Benefits. FAS 158 will require us to recognize the funded status of defined benefit pension and postretirement plans as an asset or liability in our statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This standard will have no effect on our expense or benefit recognition, nor will it affect the funding requirements imposed under the Employee Retirement Income Security Act of 1974, as amended (ERISA). FAS 158 requires prospective application for fiscal years ending after December 15, 2006. Had FAS 158 been in effect at December 31, 2005, we would have reduced our pension assets approximately $8,700 and increased our postretirement benefit obligation approximately $7,300. The after tax reduction to our stockholders equity would have been approximately $10,000. We will adopt FAS 158 in the fourth quarter of 2006.

Employee Separations In accordance with Statement of Financial Accounting Standards No. 112, Employers Accounting for Postemployment Benefits, we establish obligations for probable termination benefits provided to former or inactive employees after employment but before retirement. These benefits include severance payments, workers compensation, disability, medical continuation coverage and other benefits. At September 30, 2006, for employees not affected by the change-in-control provisions of the ATTC benefit plans, we had severance accruals of $276, of which $241 was established as merger-related severance accruals. In accordance with Statement of Financial Accounting Standards No. 141, Business Combinations (FAS 141), severance accruals recorded for ATTC employees were included in the preliminary purchase price allocation (see Note 2).

NOTE 2. ACQUISITIONS

AT&T Corp. In November 2005, we acquired ATTC in a transaction accounted for under FAS 141, issuing 632 million shares. ATTC was one of the nation s largest business service communications providers, offering a variety of global communications services, including large domestic and multinational businesses, small and medium-sized businesses and government agencies, and operated one of the largest telecommunications networks in the U.S. ATTC also provided domestic and international long-distance and usage-based-communications services to consumer customers. ATTC is now a wholly owned subsidiary of AT&T and the results of ATTC s operations have been included in our consolidated financial statements after the November 18, 2005 acquisition date.

Under the purchase method of accounting, the transaction was valued, for accounting purposes, at $15,517 and the assets and liabilities of ATTC were recorded at their respective fair values as of the date of the acquisition. At the time of the acquisition, we obtained preliminary third-party valuations of property, plant and equipment, intangible assets (including the AT&T trade name), debt

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

and certain other assets and liabilities. Because of the proximity of this transaction to year-end, the values of certain assets and liabilities were based on preliminary valuations and were subject to adjustment as additional information was obtained. Such additional information includes, but is not limited to: valuations and physical counts of property, plant and equipment, valuation of investments and the involuntary termination of employees. As of September 30, 2006, we have obtained additional information on many of the outstanding issues relating to the preliminary valuation, resulting in the adjustment of certain assets and liabilities, offset by a change to goodwill. We have 12 months from the closing of the acquisition to finalize our valuations; any remaining adjustments will be reflected in the fourth quarter.

The following table summarizes the preliminary estimated fair values of the ATTC assets acquired and liabilities assumed and related deferred income taxes as of the acquisition date and adjustments made thereto during the first nine months of 2006.

	Purchase Price Allocation		
	As of 12/31/05	Adjustments	As of 9/30/06
Assets acquired			
Current assets	$ 6,295	$ 16	$ 6,311
Property, plant and equipment	10,921	(662)	10,259
Intangible assets not subject to amortization:			
Trade name	4,900	-	4,900
Licenses	40	-	40
Intangible assets subject to amortization:			
Customer lists and relationships	3,050	-	3,050
Patents	150	-	150
Brand licensing agreements	70	-	70
Investments in unconsolidated subsidiaries	160	(90)	70
Other assets	4,247	165	4,412
Goodwill	12,343	(691)	11,652
Total assets acquired	42,176	(1,262)	40,914
Liabilities assumed			
Current liabilities, excluding current portion of long-term debt	6,740	63	6,803
Long-term debt	8,293	-	8,293
Deferred income taxes	531	(720)	(189)
Postemployment benefit obligation	8,807	(468)	8,339
Other noncurrent liabilities	2,288	(137)	2,151
Total liabilities assumed	26,659	(1,262)	25,397

Net assets acquired	$ 15,517	$ -	$ 15,517

Adjustments were primarily related to property, plant and equipment, head-count assumptions associated with payments for involuntary employee separations, pension asset valuations and the adjustment for certain tax items. Reductions in the value of property, plant and equipment primarily reflects the reduction of estimated real estate values of property in use as well as a more comprehensive look at our fixed asset portfolio. Included in our third-quarter 2006 operating results is a $71 reduction of depreciation expense related to the revaluation of these assets. The timing lag in valuation of certain pension assets (primarily real estate related) resulted in a $20 reduction of operating expense in the third quarter. In addition to the deferred tax impacts associated with valuation adjustments, a net reduction in deferred taxes was recorded as a result of modifications to various pre-merger tax estimates and the resolution of an ATTC Internal Revenue Service audit (an adjustment of $385 for the years 1997-2001). In total we recorded an increase of $97 in operating income, $70 of which related to periods prior to the third quarter of 2006.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

The completion of the final valuation of the assets and liabilities may result in further adjustments to goodwill. Additionally, as ATTC stock options that were converted at the time of the merger are exercised, the tax effect on those options may further reduce goodwill. As of September 30, 2006, we had recorded $11 in related reductions.

ATTC maintained change-in-control provisions with its employees that required enhanced severance and benefit payments be paid to employees of ATTC if a change-in-control occurred. Included in the liabilities assumed at acquisition, was $1,543 accrued for such enhanced severance and benefits. As part of the opening balance sheet adjustments, a revised number of expected employee separations that will result in payments resulted in a decline in the change-in-control severance and benefit accrual of $477. Following is a summary of the accrual recorded at December 31, 2005, cash payments made during the first nine months of 2006 and the purchase accounting adjustments thereto. We will continue to evaluate this accrual through the end of the allocation period.

	Balance at	Cash Payments for the Quarter Ended				Balance at
	12/31/05	3/31/06	6/30/06	9/30/06	Adjustments	9/30/06
Paid out of:						
Company funds	$ 870	$ (46)	$ (59)	$ (86)	$ (97)	$ 582
Pension and Postemployment benefit plans	673	(5)	(27)	(18)	(380)	243
Total	$ 1,543	$ (51)	$ (86)	$ (104)	$ (477)	$ 825

The following unaudited pro forma consolidated results of operations assume that the acquisition of ATTC was completed as of January 1, 2005.

	For the Quarter Ended				For the Year Ended
	3/31/05	6/30/05	9/30/05	12/31/05	2005
Revenues	$ 16,619	$ 16,554	$ 16,414	$ 16,202	$ 65,789
Net Income	1,319	1,257	1,729	1,862	6,167

As part of the process of coordinating benefits, we changed our management vacation pay policy for legacy SBC employees so vacation is earned ratably throughout the year rather than at the end of the preceding year. As a result, we recognized a decrease in operating expenses of $246 in the third quarter of 2006. We anticipate the expense reduction for the fourth quarter of 2006 to be approximately $80.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

NOTE 3. COMPREHENSIVE INCOME

The components of our comprehensive income for the three and nine months ended September 30, 2006 and 2005 include net income, adjustments to stockholders equity for the foreign currency translation adjustment, net unrealized gain (loss) on available-for-sale securities and net unrealized gain (loss) on cash flow hedges. The foreign currency translation adjustment was due to exchange rate fluctuations in our foreign affiliates local currencies and the reclassification adjustment on cash flow hedges was due to the amortization of losses from our interest rate forward contracts.

Following is our comprehensive income:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	**2006**	2005
Net income	**$ 2,165**	$ 1,246	**$ 5,418**	$ 3,131
Other comprehensive income, net of tax:				
Foreign currency translation adjustment	**29**	(2)	**(16)**	28
Net unrealized gains (losses) on securities:				
Unrealized gains (losses)	**(17)**	2	**17**	(21)
Less reclassification adjustment realized in net income	**-**	(4)	**(8)**	(37)
Net unrealized gains on cash flow hedges:				
Unrealized gains, net of taxes	**-**	-	**2**	-
Reclassification adjustment for losses on cash flow hedges included in net income	**4**	2	**12**	3
Other	**-**	(2)	**1**	(2)
Other comprehensive income (loss)	**16**	(4)	**8**	(29)
Total Comprehensive Income	**$ 2,181**	$ 1,242	**$ 5,426**	$ 3,102

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

NOTE 4. EARNINGS PER SHARE

A reconciliation of the numerators and denominators of basic earnings per share and diluted earnings per share for net income for the three and nine months ended September 30, 2006 and 2005 is shown in the table below:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	**2006**	2005
Numerators				
Numerator for basic earnings per share:				
Net income	**$ 2,165**	$ 1,246	**$ 5,418**	$ 3,131
Dilutive potential common shares:				
Other stock-based compensation	**2**	5	**5**	8
Numerator for diluted earnings per share	**$ 2,167**	$ 1,251	**$ 5,423**	$ 3,139
Denominators (000,000)				
Denominator for basic earnings per share:				
Weighted-average number of common shares outstanding	**3,873**	3,296	**3,880**	3,300
Dilutive potential common shares:				
Stock options	**5**	-	**4**	1
Other stock-based compensation	**14**	10	**16**	10
Denominator for diluted earnings per share	**3,892**	3,306	**3,900**	3,311
Basic earnings per share				
Net income	**$ 0.56**	$ 0.38	**$ 1.40**	$ 0.95
Diluted earnings per share				
Net income	**$ 0.56**	$ 0.38	**$ 1.39**	$ 0.95

At September 30, 2006, we had issued and outstanding options to purchase approximately 234 million shares of AT&T common stock. The exercise prices of options to purchase a weighted average of 189 million shares in the third quarter and 212 million for the first nine months exceeded the average market price of AT&T stock. Accordingly, we did not include these amounts in determining the dilutive potential common shares for the respective periods. At September 30, 2006, the exercise price of 47 million share options were below market price, commonly referred to as in the money. Of these options, 11 million will expire by the end of 2007.

At September 30, 2005, we had issued and outstanding options to purchase 202 million shares of AT&T common stock. The exercise prices of options to purchase a weighted average of 191 million shares in the third quarter and 195 million for the first nine months exceeded the average market price of AT&T stock. Accordingly, we did not include these amounts in determining the dilutive potential common shares for the respective periods.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

NOTE 5. SEGMENT INFORMATION

Our segments are strategic business units that offer different products and services and are managed accordingly. We analyze our various operating segments based on segment income. Interest expense, interest income and other income (expense) net are managed only on a total company basis and are, accordingly, reflected only in consolidated results. Therefore, these items are not included in the calculation of each segment s percentage of our consolidated results. As a result of our November 18, 2005 acquisition of ATTC we have revised our segment reporting to represent how we now manage our business, restating prior periods to conform to the current segments. We have four reportable segments: (1) wireline, (2) Cingular, (3) directory and (4) other.

The wireline segment provides both retail and wholesale landline telecommunications services, including local and long-distance voice, switched access, internet protocol and internet access data, messaging services, managed networking to business customers, our U-verse[sm] video service and satellite television services through our agreement with EchoStar Communications Corp.

The Cingular segment reflects 100% of the results reported by Cingular, our wireless joint venture. Although we analyze Cingular s revenues and expenses under the Cingular segment, we eliminate the Cingular segment in our consolidated financial statements. In our consolidated financial statements, we report our 60% proportionate share of Cingular s results as equity in net income of affiliates.

The directory segment includes our directory operations, which publish Yellow and White Pages directories and sell directory and internet-based advertising. Our portion of the results from YELLOWPAGES.COM (YPC), a joint venture with BellSouth Corporation (BellSouth), is recorded in this segment as equity in net income of affiliates.

The other segment includes results from Sterling Commerce Inc. and all corporate and other operations. This segment also includes our portion of the results from our international equity investments and from Cingular as equity in net income of affiliates, as discussed above.

In the following tables, we show how our segment results are reconciled to our consolidated results reported in accordance with GAAP. The Wireline, Cingular, Directory and Other columns represent the segment results of each such operating segment. The Wireline column includes revenues from services sold to Cingular (see Note 6). Since we account for Cingular using the equity method of accounting, these revenues are not eliminated upon consolidation and as such, remain in consolidated revenue. The Consolidation and Elimination column adds in those line items that we manage on a consolidated basis only: interest expense, interest income and other income (expense) net. This column also eliminates any intercompany transactions included in each segment s results. Since our 60% share of the results from Cingular is already included in the Other column, the Cingular Elimination column removes the results of Cingular shown in the Cingular segment.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

For the three months ended September 30, 2006

	Wireline	Cingular	Directory	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from external customers	**$14,577**	**$9,553**	**$906**	**$155**	**$-**	**$(9,553)**	**$15,638**
Intersegment revenues	**9**	**-**	**15**	**49**	**(73)**	**-**	**-**
Total segment operating revenues	**14,586**	**9,553**	**921**	**204**	**(73)**	**(9,553)**	**15,638**
Operations and support expenses	**9,756**	**6,561**	**439**	**161**	**(72)**	**(6,561)**	**10,284**
Depreciation and amortization expenses	**2,376**	**1,576**	**1**	**60**	**-**	**(1,576)**	**2,437**
Total segment operating expenses	**12,132**	**8,137**	**440**	**221**	**(72)**	**(8,137)**	**12,721**
Segment operating income	**2,454**	**1,416**	**481**	**(17)**	**(1)**	**(1,416)**	**2,917**
Interest expense	**-**	**306**	**-**	**-**	**442**	**(306)**	**442**
Interest income	**-**	**6**	**-**	**-**	**98**	**(6)**	**98**
Equity in net income (loss) of affiliates	**-**	**-**	**(2)**	**651**	**-**	**-**	**649**
Other income (expense) net	**-**	**(44)**	**-**	**-**	**11**	**44**	**11**
Segment income before income taxes	**$2,454**	**$1,072**	**$479**	**$634**	**$(334)**	**$(1,072)**	**$3,233**

At September 30, 2006 or for the nine months ended

	Wireline	Cingular	Directory	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from external customers	**$43,970**	**$27,751**	**$2,716**	**$478**	**$-**	**$(27,751)**	**$47,164**
Intersegment revenues	**25**	**-**	**53**	**126**	**(204)**	**-**	**-**
Total segment operating revenues	**43,995**	**27,751**	**2,769**	**604**	**(204)**	**(27,751)**	**47,164**
Operations and support expenses	**30,422**	**19,657**	**1,321**	**497**	**(203)**	**(19,657)**	**32,037**
Depreciation and amortization expenses	**7,233**	**4,854**	**2**	**181**	**(1)**	**(4,854)**	**7,415**
Total segment operating expenses	**37,655**	**24,511**	**1,323**	**678**	**(204)**	**(24,511)**	**39,452**
Segment operating income	**6,340**	**3,240**	**1,446**	**(74)**	**-**	**(3,240)**	**7,712**
Interest expense	**-**	**901**	**-**	**-**	**1,378**	**(901)**	**1,378**
Interest income	**-**	**13**	**-**	**-**	**278**	**(13)**	**278**
Equity in net income (loss) of affiliates	**-**	**-**	**(13)**	**1,451**	**-**	**-**	**1,438**
Other income (expense) net	**-**	**(120)**	**-**	**-**	**37**	**120**	**37**

Segment income before income taxes	**$6,340**	**$2,232**	**$1,433**	**$1,377**	**$(1,063)**	**$(2,232)**	**$8,087**
Segment Assets	**$103,791**	**$80,292**	**$4,718**	**$135,078**	**$(99,695)**	**$(80,292)**	**$143,892**

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

For the three months ended September 30, 2005

	Wireline	Cingular	Directory	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from external customers	$9,222	$8,746	$917	$165	$-	$(8,746)	$10,304
Intersegment revenues	7	-	15	17	(39)	-	-
Total segment operating revenues	9,229	8,746	932	182	(39)	(8,746)	10,304
Operations and support expenses	5,987	6,548	425	168	(41)	(6,548)	6,539
Depreciation and amortization expenses	1,747	1,541	1	54	1	(1,541)	1,803
Total segment operating expenses	7,734	8,089	426	222	(40)	(8,089)	8,342
Segment operating income	1,495	657	506	(40)	1	(657)	1,962
Interest expense	-	304	-	-	349	(304)	349
Interest income	-	8	-	-	82	(8)	82
Equity in net income (loss) of affiliates	-	1	-	219	-	(1)	219
Other income (expense) net	-	(36)	-	-	(70)	36	(70)
Segment income before income taxes	$1,495	$326	$506	$179	$(336)	$(326)	$1,844

For the nine months ended September 30, 2005

	Wireline	Cingular	Directory	Other	Consolidation and Elimination	Cingular Elimination	Consolidated Results
Revenues from external customers	$27,645	$25,584	$2,723	$487	$-	$(25,584)	$30,855
Intersegment revenues	23	-	63	42	(128)	-	-
Total segment operating revenues	27,668	25,584	2,786	529	(128)	(25,584)	30,855
Operations and support expenses	18,733	19,464	1,301	475	(127)	(19,464)	20,382
Depreciation and amortization expenses	5,277	4,845	4	157	(1)	(4,845)	5,437
Total segment operating expenses	24,010	24,309	1,305	632	(128)	(24,309)	25,819
Segment operating income	3,658	1,275	1,481	(103)	-	(1,275)	5,036
Interest expense	-	968	-	-	1,051	(968)	1,051
Interest income	-	44	-	-	291	(44)	291
Equity in net income (loss) of affiliates	-	4	(1)	343	-	(4)	342
Other income (expense) net	-	(76)	-	-	11	76	11

Segment income before income taxes	$3,658	$279	$1,480	$240	$(749)	$(279)	$4,629

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

NOTE 6. TRANSACTIONS WITH CINGULAR

We and BellSouth, the two owners of Cingular, have each made a subordinated loan to Cingular (shareholder loans). Our shareholder loan to Cingular totaled $4,108 at September 30, 2006 and December 31, 2005. This loan bears interest at an annual rate of 6.0% and matures in June 2008. We earned interest income on this loan of $62 in the third quarter and $184 for the first nine months of 2006 and $74 in the third quarter and $248 for the first nine months of 2005.

We and BellSouth agreed to finance Cingular s capital and operating cash requirements to the extent Cingular requires funding above the level provided by operations. We and BellSouth also entered into a revolving credit agreement with Cingular to provide short-term financing for operations on a pro rata basis at an interest rate of LIBOR (London Interbank Offered Rate) plus 0.05%, which expires July 31, 2007. This agreement provides for the repayment of our and BellSouth s shareholder loans made to Cingular in the event there are no outstanding amounts due under the revolving credit agreement and to the extent Cingular has excess cash, as defined by the agreement.

Under the revolving credit agreement we received net repayments from Cingular totaling $91 in the third quarter and had net advances of $624 for the first nine months of 2006. Our share of advances to Cingular under the revolving credit agreement is reflected in Investments in and Advances to Cingular Wireless on our Consolidated Balance Sheets and totaled $931 at September 30, 2006 and $307 at December 31, 2005.

We generated revenues of $359 in the third quarter and $1,106 for the first nine months of 2006 and $220 in the third quarter and $607 for the first nine months of 2005 for services sold to Cingular. These revenues were primarily from access and long-distance services sold to Cingular on a wholesale basis, and commissions revenue related to customers added through AT&T sales sources. The offsetting expense amounts are recorded by Cingular, and 60% of these expenses are included in our Equity in net income of affiliates line on our Consolidated Statements of Income when we report our 60% proportionate share of Cingular s results.

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

NOTE 7. PENSION AND POSTRETIREMENT BENEFITS

Substantially all of our employees are covered by one of various noncontributory pension and death benefit plans. We also provide certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrue actuarially determined postretirement benefit costs as active employees earn these benefits. Our objective in funding these plans, in combination with the standards of ERISA, is to accumulate assets sufficient to meet the plans obligations to provide benefits to employees upon their retirement. No significant cash contributions are required under ERISA regulations during 2006.

The following details pension and postretirement benefit costs included in operating expenses (in cost of sales and selling, general and administrative expenses) in the accompanying Consolidated Statements of Income. We account for these costs in accordance with FAS 87 and FAS 106. In the following table, gains are denoted with parentheses and losses are not.

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	**2006**	2005
Pension cost:				
Service cost benefits earned during the period	**$ 262**	$ 197	**$ 787**	$ 589
Interest cost on projected benefit obligation	**627**	403	**1,881**	1,210
Expected return on assets	**(1,008)**	(636)	**(2,992)**	(1,908)
Amortization of prior service cost and transition asset	**37**	47	**112**	140
Recognized actuarial loss	**91**	39	**271**	118
Net pension cost	**$ 9**	$ 50	**$ 59**	$ 149
Postretirement benefit cost:				
Service cost benefits earned during the period	**$ 108**	$ 95	**$ 326**	$ 290
Interest cost on accumulated postretirement benefit obligation	**485**	355	**1,457**	1,077
Expected return on assets	**(234)**	(189)	**(701)**	(567)
Amortization of prior service benefit	**(90)**	(90)	**(269)**	(254)
Recognized actuarial loss	**119**	110	**354**	329
Postretirement benefit cost	**$ 388**	$ 281	**$ 1,167**	$ 875
Combined net pension and postretirement cost	**$ 397**	$ 331	**$ 1,226**	$ 1,024

Our combined net pension and postretirement cost increased $66 in the third quarter and $202 for the first nine months of 2006 compared with the same periods in 2005. Net pension and postretirement costs in 2006 reflect the November 2005 acquisition of ATTC, changes in our actuarial assumptions, which included the reduction of our discount rate from 6.00% to 5.75% (an increase to expense) and net losses on plan assets in prior years. For development of the expected return on assets, we recognize actual gains and losses on pension and postretirement plan assets equally over a period of five years.

As part of our acquisition of ATTC, we acquired certain non-U.S. operations. Net pension cost for non-U.S. plans, which is not included in the table above, was $4 in the third quarter and $18 for the first nine months of 2006.

We also provide senior- and middle-management employees with nonqualified, unfunded supplemental retirement and savings plans. Net supplemental retirement pension benefits cost, which is not included in the table above, was $38 in the third quarter and $113 for the first nine months of 2006, of which $26 and $77 was interest cost, respectively. Net supplemental retirement pension

AT&T INC.

SEPTEMBER 30, 2006

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) - Continued

Dollars in millions except per share amounts

benefits cost was $27 in the third quarter and $81 for the first nine months of 2005, of which $17 and $51 was interest cost, respectively.

NOTE 8. PENDING ACQUISITION OF BELLSOUTH

On March 4, 2006, we agreed to acquire BellSouth in a transaction in which each share of BellSouth common stock will be exchanged for 1.325 shares of AT&T common stock. Based on the average closing price of AT&T shares for the two days prior to, including, and two days subsequent to the public announcement of the acquisition (March 5, 2006) of $27.32, the total transaction is valued, for purchase accounting purposes, at approximately $66,000.

We and BellSouth jointly own Cingular and the internet-based publisher YPC. In the Cingular joint venture, we hold a 60 percent economic interest and BellSouth holds a 40 percent economic interest and in the YPC joint venture we hold a 66 percent economic interest and BellSouth holds a 34 percent economic interest. For each joint venture control is shared equally (i.e., 50/50). We and BellSouth each account for the joint ventures under the equity method of accounting, recording the proportional share of Cingular s and YPC s income as equity in net income of affiliates on the respective consolidated statements of income and reporting the ownership percentage of Cingular s net assets as Investments in and Advances to Cingular Wireless and the ownership percentage of YPC s net assets as Investments in Equity Affiliates on the respective consolidated balance sheets. After the BellSouth acquisition, BellSouth, Cingular and YPC will be wholly-owned subsidiaries of AT&T.

Upon consolidation, the asset and liabilities of BellSouth and Cingular will be appraised, based on third-party valuations, for inclusion on the opening balance sheet, adjusting 100% of BellSouth s and 40% of Cingular s values. Long-lived assets such as property, plant and equipment will reflect a value of replacing the assets, which takes into account changes in technology, usage, and relative obsolescence and depreciation of the assets, sometimes referred to as a Greenfield approach. This approach often results in differences, sometimes material, from recorded book values even if, absent the acquisition, the assets would be neither increased in value nor impaired. In addition, assets and liabilities that would not normally be recorded in ordinary operations will be recorded at their acquisition values (e.g., customer relationships that were developed by the acquired company). Debt instruments and investments are valued in relation to current market conditions and other assets and liabilities are valued based on the acquiring company s estimates. After all identifiable assets and liabilities are valued, the remainder of the purchase price is recorded as goodwill. These values are subject to adjustment for one year after the close of the transaction as additional information is obtained.

The transaction has been approved by the Board of Directors and the stockholders of each company and various other regulatory authorities. In October 2006, the U.S. Department of Justice completed its review of the transaction without imposing any conditions. The acquisition remains subject to approval by the Federal Communications Commission. We expect the transaction to close in the fall of 2006.

AT&T INC.

SEPTEMBER 30, 2006

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions except per share amounts

RESULTS OF OPERATIONS

For ease of reading, AT&T Inc. is referred to as we, AT&T, or the Company throughout this document and the names of the particular subsidiaries and affiliates providing the services generally have been omitted. AT&T is a holding company whose subsidiaries and affiliates operate in the communications services industry both domestically and internationally providing wireline and wireless telecommunications services and equipment as well as directory advertising and publishing services. You should read this discussion in conjunction with the consolidated financial statements, accompanying notes and management s discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the year ended December 31, 2005. In the tables throughout this section, percentage increases and decreases that equal or exceed 100% are not considered meaningful and are denoted with a dash.

Consolidated Results We completed our acquisition of AT&T Corp. (ATTC) on November 18, 2005. Consolidated results for the third quarter and nine month period ended September 30, 2006 include results from ATTC. In accordance with U.S. generally accepted accounting principles (GAAP), operating results for ATTC prior to our acquisition, including the third quarter and nine months ended September 30, 2005, are not included in our operating results and are therefore not discussed. Our financial results in the third quarter and for the first nine months of 2006 and 2005 are summarized as follows:

	Third Quarter			Nine-Month Period		
	2006	2005	Percent Change	**2006**	2005	Percent Change
Operating revenues	**$15,638**	$10,304	51.8%	**$47,164**	$30,855	52.9%
Operating expenses	**12,721**	8,342	52.5	**39,452**	25,819	52.8
Operating income	**2,917**	1,962	48.7	**7,712**	5,036	53.1
Income before income taxes	**3,233**	1,844	75.3	**8,087**	4,629	74.7
Net Income	**2,165**	1,246	73.8	**5,418**	3,131	73.0

Overview

Operating income As noted above, 2006 revenues and expenses reflect the addition of ATTC s results while our 2005 results do not include ATTC. Accordingly, the following discussion of changes in our revenues and expenses is significantly affected by the ATTC acquisition. Our operating income increased $955, or 48.7%, in the third quarter and $2,676, or 53.1%, for the first nine months of 2006 and our operating income margin decreased from 19.0% to 18.7% in the third quarter and increased from 16.3% to 16.4% for the first nine months. Operating income increased primarily due to expense reduction through merger synergies, partially offset by additional amortization expense on those intangibles identified at the time of our acquisition of ATTC and by the negative effects of a continued decline in access lines. Since our merger with ATTC, our operating income margin has grown from 13.9% in the first quarter to 16.5% in the second quarter and 18.7% in the third quarter of 2006, reflecting realized merger synergies and a merger-related change in our vacation policy (see Note 2).

Retail access lines continued to decline due to increased competition, as customers disconnected both primary and additional lines and began using wireless and Voice over Internet Protocol (VoIP) technology offered by competitors and cable instead of phone lines for voice and data. Access line trends are further discussed in our Wireline segment discussion.

Operating revenues Our operating revenues increased $5,334, or 51.8%, in the third quarter and $16,309, or 52.9%, for the first nine months of 2006 primarily due to our acquisition of ATTC. The increase was slightly offset by continued pressure in voice, reflecting access line decreases in our traditional SBC Communications (SBC) 13-state region (in-region) and decreased demand for wholesale services. (We changed our name to AT&T from SBC after our acquisition of ATTC.) Operating revenues in the third quarter were down about 1% from

18

AT&T INC.

SEPTEMBER 30, 2006

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations - Continued

Dollars in millions except per share amounts

the first two quarters of 2006. Operating revenue changes are discussed in greater detail in our Segment Results sections.

Operating expenses Our operating expenses increased $4,379, or 52.5%, in the third quarter and $13,633, or 52.8%, for the first nine months of 2006 primarily due to our acquisition of ATTC, and also included merger integration costs of $147 in the third quarter and $569 for the first nine months and amortization expense on intangible assets identified at the time of the ATTC merger of $233 in the third quarter and $740 for the first nine months. Operating expenses in the third quarter and for the first nine months of 2006 were $246 lower than prior periods due to a change in our vacation policy (see Note 2). Our expenses in 2006 also include decreases related to workforce reductions, reflecting a decline of approximately 10,500 employees from December 31, 2005, of which 3,600 were in the third quarter. As of September 30, 2006, we were ahead of schedule with our targeted workforce reductions associated with the ATTC acquisition. Sequentially, expenses for the quarter decreased 2.9% in the second quarter and 3.4% in the third quarter, reflecting progress with the integration of ATTC and other cost-reduction initiatives, as well as the merger-related change in our vacation policy. Our significant expense changes are discussed in greater detail in our Segment Results sections.

Interest expense increased $93, or 26.6%, in the third quarter and $327, or 31.1%, for the first nine months of 2006. The increase in 2006 was primarily due to interest expense on ATTC s outstanding debt.

Interest income increased $16, or 19.5%, in the third quarter and decreased $13, or 4.5%, for the first nine months of 2006. The increase in the quarter was primarily due to increased interest income from marketable securities. The decrease in interest income for the first nine months of 2006 was primarily due to the pay-down by Cingular Wireless (Cingular) of our shareholder loan to them. This decrease was partially offset by our benefiting from the reduced interest expense at Cingular due to our 60% ownership in Cingular, which is reflected in equity in net income of affiliates.

Equity in net income of affiliates increased $430 in the third quarter and $1,096 for the first nine months of 2006. The increase was primarily due to our proportionate share of Cingular s improved results of $375 in the third quarter and $968 for the first nine months.

We account for our 60% economic interest in Cingular under the equity method of accounting and therefore include our proportionate share of Cingular s results in our Equity in net income of affiliates line item on our Consolidated Statements of Income. Cingular s operating results are discussed in detail in the Cingular Segment Results section. Our accounting for Cingular is described in more detail in Note 5. Our equity investments are discussed in greater detail in the Other Segment Results section.

Other income (expense) net We had other income of $11 in the third quarter and $37 for the first nine months of 2006, as compared to other expense of $70 in the third quarter and other income of $11 for the first nine months of 2005. Results in the third quarter of 2006 primarily consisted of $14 related to leveraged lease and royalty income and other expenses of $5 related to fair value adjustments on financial instruments. Results for the first nine months of 2006 primarily consisted of royalty income of $15, gains on the sale of Covad Communications Group Inc. shares of $10 and leveraged lease income of $8. These gains were partially offset by other expenses of $20 related to fair value adjustments on financial instruments and net exchange rate losses.

Results in the third quarter of 2005 primarily consisted of other expenses of $82 due to an increase in value of a third-party minority holder s interest in an SBC subsidiary s preferred stock and $21 due to a call premium on early debt retirement, partially offset by a gain of $24 on the sale of a lease partnership. Other income for the first nine months of 2005 primarily included a gain of approximately $82 on the sale of shares of Amdocs Limited, SpectraSite, Inc and Yahoo!, a gain of $24 from the sale of a lease partnership and gains of $24 related to the transfer of wireless properties to Cingular. These gains were partially offset by other expenses of $82 and $21 mentioned above and a charge of $21 related to the other-than-temporary decline in the value of various cost investments.

AT&T INC.

SEPTEMBER 30, 2006

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations - Continued

Dollars in millions except per share amounts

Income taxes increased $470, or 78.6%, in the third quarter and $1,171, or 78.2%, for the first nine months of 2006. The increase in income taxes in the third quarter and for the first nine months of 2006 was due to higher income before income taxes. Our effective tax rates were 33.0% in the third quarter and for the first nine months of 2006 compared to 32.4% in the third quarter and for the first nine months of 2005.

Selected Financial and Operating Data

	September 30,	
	2006	2005
Debt ratio[1]	**36.3%**	36.6%
In-region network access lines in service (000)[2]	**47,087**	50,217
In-region wholesale lines (000)[2]	**3,972**	5,423
In-region broadband connections (000)[2, 3]	**8,155**	6,496
Number of AT&T employees[4]	**179,420**	154,500
Cingular Wireless customers (000)[5]	**58,666**	52,292

[1] See our Liquidity and Capital Resources section for discussion.

[2] In-region represents access lines served by AT&T s incumbent local exchange companies (ILECs).

[3] Broadband connections include DSL lines of 8,148 in 2006 and 6,496 in 2005, U-verse high-speed internet access and satellite broadband.

[4] Number of employees at December 31, 2005 was 189,950.

[5] Amounts represent 100% of the wireless customers of Cingular.

Segment Results

Our segments represent strategic business units that offer different products and services and are managed accordingly. Our operating segment results presented in Note 5 and discussed below for each segment follow our internal management reporting. We analyze our various operating segments based on segment income. Interest expense, interest income and other income (expense) net, are managed only on a total company basis and are, accordingly, reflected only in consolidated results. Therefore, these items are not included in the calculation of each segment s percentage of our total segment income. As a result of our acquisition of ATTC, we have revised our segment reporting to represent how we now manage our business, restating prior periods to conform to the current segments. We have four reportable segments: (1) wireline; (2) Cingular; (3) directory; and (4) other.

The wireline segment provides both retail and wholesale landline telecommunications services, including local and long-distance voice, switched access, internet protocol (IP) and internet access data, messaging services, managed networking to business customers, our U-verse[sm] video service and satellite television services through our agreement with EchoStar Communications Corp. (AT&T | DISH Network offering).

The Cingular segment reflects 100% of the results reported by Cingular, our wireless joint venture. In our consolidated financial statements, we report our 60% proportionate share of Cingular s results as equity in net income of affiliates.

The directory segment includes our directory operations, which publish Yellow and White Pages directories and sell directory and internet-based advertising. Our portion of the results from YELLOWPAGES.COM (YPC) is recorded in this segment as equity in net income of affiliates.

The other segment includes results from Sterling Commerce Inc. (Sterling) and all corporate and other operations. The other segment also includes our portion of the results from our international equity investments and from Cingular as equity in net income of affiliates, as discussed above. Although we analyze Cingular s revenues and expenses under the Cingular segment, we record our portion of Cingular s results as equity in net income of affiliates in the other segment.

AT&T INC.

SEPTEMBER 30, 2006

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations - Continued

Dollars in millions except per share amounts

The following tables show components of results of operations by segment. A discussion of significant segment results is also presented following each table. Capital expenditures for each segment are discussed in Liquidity and Capital Resources.

Wireline

Segment Results

	Third Quarter			Nine-Month Period		
	2006	2005	Percent Change	**2006**	2005	Percent Change
Segment operating revenues						
Voice	**$8,464**	$ 5,743	47.4%	**$25,725**	$17,355	48.2%
Data	**4,546**	2,514	80.8	**13,465**	7,343	83.4
Other	**1,576**	972	62.1	**4,805**	2,970	61.8
Total Segment Operating Revenues	**14,586**	9,229	58.0	**43,995**	27,668	59.0
Segment operating expenses						
Cost of sales	**6,399**	4,096	56.2	**19,830**	12,358	60.5
Selling, general and administrative	**3,357**	1,891	77.5	**10,592**	6,375	66.1
Depreciation and amortization	**2,376**	1,747	36.0	**7,233**	5,277	37.1
Total Segment Operating Expenses	**12,132**	7,734	56.9	**37,655**	24,010	56.8
Segment Income	**$2,454**	$ 1,495	64.1%	**$6,340**	$3,658	73.3%

Operating Margin Trends

Our wireline segment operating income margin was 16.8% in the third quarter of 2006, compared to 16.2% in the third quarter of 2005, and 14.4% for the first nine months of 2006, compared to 13.2% for the first nine months of 2005. Our wireline segment operating income increased $959 in the third quarter of 2006 and $2,682 for the first nine months of 2006 primarily reflecting incremental revenue and expenses from our acquisition of ATTC. Operating income and margins increased primarily due to lower expenses as a result of merger synergies partially offset by additional amortization expense on those intangibles identified at the time of our acquisition of ATTC and lower voice revenue as a result of continued in-region access line declines due to increased competition, as customers disconnected both primary and additional lines and switched to competitors alternative technologies, such as wireless, VoIP and cable for voice and data.

Wireline Operating Results

All changes other than those specifically stated as being due to the ATTC acquisition are related to in-region wireline operations.

Voice revenues increased $2,721, or 47.4%, in the third quarter and $8,370, or 48.2%, for the first nine months of 2006 primarily due to the acquisition of ATTC. Included in voice revenues are revenues from long-distance, local voice and local wholesale services. Voice revenues do not include any of our VoIP revenues, which are included in data revenues. Voice revenues previously reported for the first six months of 2006 were reduced by $79 based on a review of certain international billing arrangements (see Note 1).

Long-distance revenues increased $2,579 in the third quarter and $8,044 for the first nine months of 2006 driven almost entirely by the increase in long-distance customers due to the acquisition of ATTC. Also contributing to the increases were higher long-distance penetration levels. However, our long-distance revenue growth continued to slow, decreasing approximately 4.0% from second-quarter 2006 results, reflecting continuing market maturity since we began providing service to all of our in-region states in late 2003 and a continuing decline in ATTC s mass-market customers.

AT&T INC.

SEPTEMBER 30, 2006

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations - Continued

Dollars in millions except per share amounts

Local voice revenues increased $273 in the third quarter and $783 for the first nine months of 2006 primarily reflecting our acquisition of ATTC. However, we expect that revenues from ATTC s mass-market customers will continue to decline on a sequential quarterly basis. Local voice revenues were also negatively impacted by continued declines in customer demand, calling features (e.g., Caller ID and voice mail), inside wire and retail payphone revenues. We expect our local voice revenue to continue to be negatively affected by increased competition, including customers shifting to competitors wireless, VoIP technology and cable offerings for voice, and the disconnection of additional lines for DSL service and other reasons. Partially offsetting these demand-related declines were revenue increases related to pricing increases for regional telephone service and calling features.

Lower demand for local wholesale services, primarily due to the decline in Unbundled Network Element-Platform (UNE-P) lines provided to competitors, decreased revenue $131 in the third quarter and $457 for the first nine months of 2006. Lines provided under the former UNE-P rules (which ended in March 2006) declined, as competitors moved to alternate arrangements to serve their customers or their customers chose an alternative technology. These lines are classified as wholesale in the Access Line Summary table. Competitors who r