BIOMARIN PHARMACEUTICAL INC
Form 10-Q
May 01, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2009

Or

¨ **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: 000-26727

BioMarin Pharmaceutical Inc.

(Exact name of registrant issuer as specified in its charter)

Delaware	**68-0397820**
(State of other jurisdiction	**(I.R.S. Employer**
of Incorporation or organization)	**Identification No.)**
105 Digital Drive, Novato, California	**94949**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number: (415) 506-6700

(Former name, former address and former fiscal year, if changed since last report)

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 has submitted electronically and posted on its corporate website, if any, every interactive data fie required to be submitted and posted pursuant to Rule 405 of the Regulation S-T during the preceding 12 months (or for such greater period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨ No ¨

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

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Applicable only to issuers involved in bankruptcy proceedings during the proceeding five years:

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every interactive data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the proceeding 12 months (or for such greater period that the registrant was required to submit and post such files) Yes ¨ No ¨

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨ No ¨

Applicable only to corporate issuers:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 99,986,841 shares common stock, par value $0.001, outstanding as of April 24, 2009.

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BIOMARIN PHARMACEUTICAL INC.

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

BIOMARIN PHARMACEUTICAL INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except for share and per share data)

	December 31, 2008 (1)	March 31, 2009 (unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 222,900	$ 214,579
Short-term investments	336,892	337,290
Accounts receivable, net	54,298	61,355
Inventory	73,162	76,423
Other current assets	50,444	23,928
Total current assets	737,696	713,575
Investment in BioMarin/Genzyme LLC	915	367
Long-term investments	1,633	4,011
Property, plant and equipment, net	124,979	142,252
Intangible assets, net	7,626	6,316
Goodwill	21,262	21,262
Other assets	12,584	12,500
Total assets	$ 906,695	$ 900,283
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 59,033	$ 55,877
Acquisition obligation, net of discount	70,741	70,317
Deferred revenue	307	120
Total current liabilities	130,081	126,314
Convertible debt	497,083	497,083
Other long-term liabilities	2,856	2,946
Total liabilities	630,020	626,343
Stockholders equity:		
Common stock, $0.001 par value: 250,000,000 shares authorized at December 31, 2008 and March 31, 2009; 99,868,145 and 99,977,953 shares issued and outstanding at December 31, 2008 and March 31, 2009, respectively	100	100
Additional paid-in capital	852,947	862,373
Company common stock held by deferred compensation plan	(882)	(854)
Accumulated other comprehensive income	1,106	2,069
Accumulated deficit	(576,596)	(589,748)

Total stockholders equity	276,675	273,940
Total liabilities and stockholders equity	$ 906,695	$ 900,283

(1) December 31, 2008 balances were derived from the audited consolidated financial statements.

See accompanying notes to unaudited consolidated financial statements.

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BIOMARIN PHARMACEUTICAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months Ended March 31, 2008 and 2009

(In thousands, except for per share data, unaudited)

	Three Months Ended March 31,	
	2008	**2009**
Revenues:		
Net product revenues	$ 57,625	$ 71,914
Collaborative agreement revenues	2,465	509
Royalty and license revenues	306	1,557
Total revenues	60,396	73,980
Operating expenses:		
Cost of sales	17,188	14,362
Research and development	17,628	34,358
Selling, general and administrative	23,669	28,568
Amortization of acquired intangible assets	1,093	1,093
Total operating expenses	59,578	78,381
Income (Loss) from operations	818	(4,401)
Equity in the loss of BioMarin/Genzyme LLC	(533)	(547)
Interest income	5,649	2,153
Interest expense	(4,110)	(4,087)
Impairment loss on equity investments		(5,853)
Income (Loss) before income taxes	1,824	(12,735)
Provision for income taxes	138	417
Net income (loss)	$ 1,686	$ (13,152)
Net income (loss) per share, basic and diluted	$ 0.02	$ (0.13)
Weighted average common shares outstanding, basic	97,647	99,902
Weighted average common shares outstanding, diluted	103,869	99,933

See accompanying notes to unaudited consolidated financial statements.

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BIOMARIN PHARMACEUTICAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended March 31, 2008 and 2009

(In thousands, unaudited)

	Three Months Ended March 31,	
	2008	2009
Cash flows from operating activities:		
Net income (loss)	$ 1,686	$ (13,152)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,870	5,103
Amortization of discount on short-term investments	(2,839)	(643)
Imputed interest on acquisition obligation	1,108	1,077
Equity in the loss of BioMarin/Genzyme LLC	533	547
Stock-based compensation	5,210	8,534
Impairment loss on investments		5,848
Excess tax benefit from stock option exercises		(4)
Unrealized foreign exchange gain (loss) on forward contracts	(161)	1,624
Changes in operating assets and liabilities:		
Accounts receivable, net	(30,277)	(7,057)
Advances to BioMarin/Genzyme LLC	1,764	
Inventory	4,474	(3,260)
Other current assets	(418)	25,719
Other assets	(143)	(221)
Accounts payable and accrued liabilities	(7,681)	(4,046)
Other liabilities	143	138
Deferred revenue	(448)	(187)
Net cash provided by (used in) operating activities	(23,179)	20,020
Cash flows from investing activities:		
Purchase of property and equipment	(19,889)	(18,737)
Maturities and sales of short-term investments	254,556	110,100
Purchase of short-term investments	(149,025)	(112,801)
Distributions from BioMarin/Genzyme LLC	16,679	
Investment in La Jolla Pharmaceutical Company		(6,250)
Net cash provided by (used in) investing activities	102,321	(27,688)
Cash flows from financing activities:		
Proceeds from ESPP and exercise of stock options	14,255	891
Excess tax benefit from stock option exercises		4
Repayment of acquisition obligation	(1,750)	(1,500)
Repayment of capital lease obligations		(48)
Net cash provided by (used in) financing activities	12,505	(653)
Net increase (decrease) in cash and cash equivalents	91,647	(8,321)
Cash and cash equivalents:		
Beginning of period	228,343	222,900

End of period	$ 319,990	$ 214,579
Supplemental cash flow disclosures:		
Cash paid for interest	$ 2,155	$ 2,153
Cash paid for income taxes	50	407
Stock-based compensation capitalized into inventory	944	1,303
Depreciation capitalized into inventory	575	650
Supplemental non-cash investing and financing activities disclosures:		
Distribution of inventory resulting from the joint venture restructure	26,780	
Changes in accrued liabilities related to fixed assets	1,261	1,996
Equipment acquired through capital lease		

See accompanying notes to unaudited consolidated financial statements.

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BIOMARIN PHARMACEUTICAL INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2009

(Unaudited)

(1) NATURE OF OPERATIONS AND BUSINESS RISKS

BioMarin Pharmaceutical Inc. (the Company or BioMarin®) develops and commercializes innovative biopharmaceuticals for serious diseases and medical conditions. BioMarin selects product candidates for diseases and conditions that represent a significant unmet medical need, have well-understood biology and provide an opportunity to be first-to-market or offer a significant benefit over existing products. The Company s product portfolio is comprised of three approved products and multiple investigational product candidates. Approved products include Naglazyme ® (galsulfase), Kuvan ® (sapropterin dihydrochloride), and Aldurazyme ® (laronidase).

Through March 31, 2009, the Company had accumulated losses of approximately $589.7 million. Management believes that the Company s cash, cash equivalents, short-term investments and long-term investments at March 31, 2009 will be sufficient to meet the Company s obligations for the foreseeable future based on management s current long-term business plans and assuming that the Company achieves its long-term goals. If the Company elects to increase its spending on development programs significantly above current long-term plans or enter into potential licenses and other acquisitions of complementary technologies, products or companies, the Company may need additional capital. The Company expects to continue to finance net future cash needs that exceed its operating revenues primarily through its current cash, cash equivalents, short-term and long-term investments, and to the extent necessary, through proceeds from equity or debt financings, loans and collaborative agreements with corporate partners.

The Company is subject to a number of risks, including the financial performance of Naglazyme, Kuvan, and Aldurazyme; the potential need for additional financings; its ability to successfully commercialize its product candidates, if approved; the uncertainty of the Company s research and development efforts resulting in successful commercial products; obtaining regulatory approval for such products; significant competition from larger organizations; reliance on the proprietary technology of others; dependence on key personnel; uncertain patent protection; dependence on corporate partners and collaborators; and possible restrictions on reimbursement, as well as other changes in the health care industry.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation

These unaudited consolidated financial statements include the accounts of BioMarin and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated. These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (U.S. GAAP) for interim financial information and the Securities and Exchange Commission (SEC) requirements for interim reporting. However, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included.

Operating results for the three months ended March 31, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

(b) Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

The Company treats liquid investments with original maturities of less than three months when purchased as cash and cash equivalents.

(d) Investments

The Company determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such designation at each balance sheet date. All of the Company s securities are classified as either held-to-maturity or available-for-sale and reported in cash equivalents, short-term investments or long-term investments. Held-to-maturity investments are recorded at amortized cost. Available-for-sale investments are recorded at fair market value, with unrealized gains or losses being included in accumulated other comprehensive income/loss, exclusive of other-than-temporary impairment losses, if any. Short-term and long-term investments are comprised of corporate securities, commercial paper, U.S. federal government agency securities, U.S. treasury bills, money market funds and certificates of deposit. As of March 31, 2009, the Company had no held-to-maturity investments.

As of March 31, 2009, long-term investments included an equity investment denominated in British Pounds. The equity investment is accounted for under the provisions of Statement of Financial Accounting Standard (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* The Company classified the investment as available-for-sale and accordingly the investment is recorded at fair market value. Changes in the fair market value are reported as a component of accumulated other comprehensive income, exclusive of other-than-temporary impairment losses, if any. Translation gains/losses on the equity investment, a non-monetary asset, resulting from fluctuations in foreign exchange rates are included in accumulated other comprehensive income under the provisions of SFAS No. 52, *Foreign Currency Translation.* Losses related to changes in market value and exchange rates determined to be other-than-temporary are reported in earnings in the period in which the impairment occurs.

(e) Inventory

The Company values inventories at the lower of cost or net realizable value. The Company determines the cost of inventory using the average-cost method. The Company analyzes its inventory levels quarterly and writes down inventory that has become obsolete, or has a cost basis in excess of its expected net realizable value and inventory quantities in excess of expected requirements. Expired inventory is disposed of and the related costs are written off to cost of sales.

Manufacturing costs for product candidates are expensed as research and development expenses. The Company considers regulatory approval of product candidates to be uncertain, and product manufactured prior to regulatory approval may not be sold unless regulatory approval is obtained. As such, the manufacturing costs for product candidates incurred prior to regulatory approval are not capitalized as inventory. When regulatory approval is obtained, the Company begins capitalizing inventory at the lower of cost or net realizable value.

In the first quarter of 2008, the Company received $26.8 million of inventory distributed by the Company s joint venture with Genzyme pursuant to the terms of the joint venture restructuring (see Note 4 for further information). The inventory distribution was recorded at the historical production cost, which represented the lower of cost or market value.

Stock-based compensation of $0.9 million and $1.3 million was capitalized into inventory for the three months ended March 31, 2008 and 2009, respectively (see Note 6 for further information).

(f) Investment in BioMarin/Genzyme LLC and Equity in the Loss of BioMarin/Genzyme LLC

Effective January 1, 2008, the Company restructured its relationship with Genzyme (see Note 4 for further information). The Company accounts for its remaining investment in the joint venture using the equity method. Accordingly, the Company records an increase in its investment for contributions to the joint venture and for its 50% share of the loss of the joint venture, and a reduction in its investment for its 50% share of any losses of the joint venture or disbursements of profits from the joint venture. Equity in the loss of BioMarin/Genzyme LLC includes the Company s 50% share of the joint venture s loss for the period. The investment in BioMarin/Genzyme LLC includes the Company s share of the net equity of the joint venture.

(g) Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is computed using the straight-line method over the related estimated useful lives, except for leasehold improvements, which are depreciated over the shorter of the useful life of the asset or the lease term. Significant additions and improvements are capitalized, while repairs and maintenance are charged to expense as incurred. Property and equipment purchased for specific research and development projects with no alternative uses are expensed as incurred. See Note 7 for further information on property, plant and equipment balances as of December 31, 2008 and March 31, 2009.

Certain of the Company s operating lease agreements include scheduled rent escalations over the lease term, as well as tenant improvement allowances. The Company accounts for these operating leases in accordance with SFAS No. 13, *Accounting for Leases*, and Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*. Accordingly, the scheduled increases in rent expense are recognized on a straight-line basis over the lease term. The difference between rent expense and rent paid is recorded as deferred rent and included in other liabilities in the accompanying consolidated balance sheets. The tenant improvement allowances and free rent periods are recognized as a credit to rent expense over the lease term on a straight-line basis.

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(h) Revenue Recognition

The Company recognizes revenue in accordance with the provisions of SEC Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104), and Emerging Issues Task Force Issue (EITF) No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. The Company s revenues consist of net product revenues from Naglazyme and Kuvan, Aldurazyme product transfer and royalty revenues beginning January 1, 2008, revenues from its collaborative agreement with Merck Serono and other license and royalty revenues. Milestone payments are recognized in full when the related milestone performance goal is achieved and the Company has no future performance obligations related to that payment.

Net Product Revenues The Company recognizes net product revenue when persuasive evidence of an arrangement exists, the product has been delivered to the customer, title and risk of loss have passed to the customer, the price to the buyer is fixed or determinable and collection from the customer is reasonably assured. Product sales transactions are evidenced by customer purchase orders, customer contracts, invoices and/or the related shipping documents. Amounts collected from customers and remitted to governmental authorities, which are primarily comprised of value-added taxes (VAT) related to Naglazyme sales in foreign jurisdictions, are presented on a net basis in the Company s statements of operations, in accordance with EITF No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement,* in that taxes billed to customers are not included as a component of net product revenues.

The Company began recognizing revenue related to Aldurazyme in the first quarter of 2008, effective with the restructuring of the Company s Aldurazyme joint venture with Genzyme (see Note 4 for further information). According to the terms of the restructuring, BioMarin receives a 39.5% to 50% royalty on worldwide net Aldurazyme sales by Genzyme depending on sales volume, which is included in net product revenues in the consolidated statements of operations. The Company recognizes a portion of this amount as product transfer revenue when product is released to Genzyme as all of the Company s performance obligations are fulfilled at that point and title to, and risk of loss for, the product has transferred to Genzyme. The product transfer revenue represents the fixed amount per unit of Aldurazyme that Genzyme is required to pay the Company if the product is unsold by Genzyme. The amount of product transfer revenue will eventually be deducted from the calculated royalty rate when the product is sold by Genzyme. The Company records the Aldurazyme royalty revenue based on net sales information provided by Genzyme and records product transfer revenue based on the fulfillment of Genzyme purchase orders in accordance with SAB 104 and the terms of the related agreements with Genzyme. As of March 31, 2009, accounts receivable included $14.3 million of unbilled accounts receivable related to net incremental Aldurazyme product transfers to Genzyme.

The Company sells Naglazyme worldwide and sells Kuvan in the U.S. In the U.S., Naglazyme and Kuvan are generally sold to specialty pharmacies or end-users, such as hospitals, which act as retailers. In the E.U., Naglazyme is sold to the Company s authorized distributors or directly to hospitals, which act as the end-users. The Company records reserves for rebates payable under Medicaid and other government programs as a reduction of revenue at the time product revenues are recorded. The Company s reserve calculations require estimates, including estimates of customer mix, to determine which sales will be subject to rebates and the amount of such rebates. The Company updates its estimates and assumptions each period, and records any necessary adjustments to its reserves. The Company records fees paid to distributors as a reduction of revenue, in accordance with EITF Issue No. 01-09, *Accounting for Consideration given by a Vendor to a Customer (including a Reseller of a Vendor s Products).*

The Company records allowances for product returns, if appropriate, as a reduction of revenue at the time product sales are recorded. Several factors are considered in determining whether an allowance for product returns is required, including market exclusivity of the products based on their orphan drug status, the patient population, the customers limited return rights and the Company s experience with returns. Because of the pricing of Naglazyme and Kuvan, the limited number of patients and the customers limited return rights, most Naglazyme and Kuvan customers and retailers carry a limited inventory. Certain international customers, usually government entities, tend to purchase larger quantities of product less frequently. Although such buying patterns may result in revenue fluctuations from quarter to quarter, the Company has not experienced any increased product returns or risk of product returns. The Company s products are comparable in nature and sold to similar customers with limited return rights, therefore the Company relies on historical return rates for Aldurazyme and Naglazyme to estimate returns for Kuvan, which has a limited history. Genzyme s return rights for Aldurazyme are limited to defective product. Based on these factors, management has concluded that product returns will be minimal, and the Company has not experienced significant product returns to date. In the future, if any of these factors and/or the history of product returns changes, an allowance for product returns may be required. The Company maintains a policy to record allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. As of March 31, 2009, the Company has experienced no significant bad debts and the recorded allowance for doubtful accounts was insignificant.

The Company records reserves for rebates payable under Medicaid and other government programs as a reduction of revenue at the time product revenues are recorded. The Company s reserve calculations require estimates, including estimates of customer mix, to determine which sales will be subject to rebates and the amount of such rebates. The Company updates its estimates and assumptions each period, and records any necessary adjustments to its reserves. The Company records fees paid to distributors as a reduction of revenue, in accordance with EITF Issue No. 01-09, *Accounting for Consideration given by a Vendor to a Customer (including a Reseller of a Vendor s Products).*

The Company records allowances for product returns, if appropriate, as a reduction of revenue at the time product sales are recorded. Several factors are considered in determining whether an allowance for product returns is required, including market exclusivity of the products based on their orphan drug status, the patient population, the customers limited return rights and the Company s experience with returns. The Company s products are comparable in nature and sold to similar customers with limited return rights, therefore the Company relies on historical return rates for Aldurazyme and Naglazyme to estimate returns for Kuvan, which has a limited history. Genzyme s return rights for Aldurazyme are limited to defective product. Based on these factors, management has concluded that product returns will be minimal. In the future, if any of these factors and/or the history of product returns changes, an allowance for product returns may be required. The Company maintains a policy to record allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. As of March 31, 2009, the Company has experienced no significant bad debts and the recorded allowance for doubtful accounts was insignificant.

Collaborative agreement revenues Collaborative agreement revenues from Merck Serono include both license revenue and contract research revenue. Nonrefundable up-front license fees where the Company has continuing involvement through research and development collaboration are initially deferred and recognized as collaborative agreement license revenue over the estimated period for which the Company continues to have a performance obligation. The Company s performance obligation related to the $25.0 million upfront payment from Merck Serono ended in the fourth quarter of 2008. There is no cost of sales associated with the

amortization of the up-front license fee received from Merck Serono. Nonrefundable amounts received for shared development costs are recognized as revenue in the period in which the related expenses are incurred. Contract research revenue included in collaborative agreement revenues represents Merck Serono s share of Kuvan development costs under the agreement, which are recorded as research and development expenses. Allowable costs during the development period must have been included in the pre-approved annual budget in order to be subject to reimbursement, or must be separately approved by both parties.

Collaborative agreement revenues during the first quarter of 2008 included the recognition of $1.5 million of the $25.0 million up-front license fee received from Merck Serono and $1.0 million of reimbursable development costs for Kuvan, compared to the first quarter of 2009, which included $0.5 million of reimbursable development costs for Kuvan.

Royalty and license revenues Royalty revenue includes royalties on net sales of products with which the Company has no direct involvement and is recognized based on data reported by licensees or sublicensees. Royalties are recognized as earned in accordance with the contract terms, when the royalty amount is fixed or determinable based on information received from the sublicensee and when collectibility is reasonably assured.

Due to the significant role the Company plays in the operations of Aldurazyme, primarily the manufacturing and regulatory activities, as well as the rights and responsibilities to deliver the product to Genzyme, the Company elected not to classify the Aldurazyme royalty as other royalty revenues.

Royalty and license revenues in the first quarter of 2009 include $1.4 million of Orapred product royalties, a product the Company acquired in 2004 and sublicensed in 2006, and $0.2 million of Kuvan royalty revenues for product sold in Japan and Europe compared to the first quarter of 2008 which included only included $0.3 million of Orapred royalties. There is no cost of sales associated with the royalty and license revenues recorded during the periods and no related costs are expected in future periods.

(i) Research and Development

Research and development expenses include expenses associated with contract research and development provided by third parties, product manufacturing prior to regulatory approval, clinical and regulatory costs, and internal research and development costs. In instances where the Company enters into agreements with third parties for research and development activities, costs are expensed upon the earlier of when non-refundable amounts are due or as services are performed unless there is an alternative future use of the funds in other research and development projects. Amounts due under such arrangements may be either fixed fee or fee for service, and may include upfront payments, monthly payments, and payments upon the completion of milestones or receipt of deliverables. The Company accrues costs for clinical trial activities based upon estimates of the services received and related expenses incurred that have yet to be invoiced by the vendors that perform the activities.

The Company believes that regulatory approval of its product candidates is uncertain, and does not assume that products manufactured prior to regulatory approval will be sold commercially. As a result, inventory costs for product candidates are expensed as research and development until regulatory approval is obtained in a major market, at which time inventory is capitalized at the lower of cost or net realizable value.

(j) Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income/loss by the weighted average shares of common stock outstanding during the period. Diluted net income (loss) per share reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock; however, potential common equivalent shares are excluded if their effect is anti-dilutive. Potential shares of common stock include shares issuable upon the exercise of outstanding employee stock option awards, common stock issuable under our Employee Stock Purchase Plan (ESPP), restricted stock and contingent issuances of common stock related to convertible debt and a portion of acquisition costs payable in stock at the Company s option.

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The following represents a reconciliation from basic weighted shares outstanding to diluted weighted shares outstanding and the earnings per share for the three months ended March 31, 2008 (in thousands, except per share data):

	For the Three Months Ended March 31, 2008		
	Net Income (Numerator)	**Weighted Average Shares Outstanding (Denominator)**	**Per Share Amount**
Basic Earnings Per Share:			
Net Income	$ 1,686	97,647	$ 0.02
Effect of dilutive shares:			
Stock options using the treasury method		5,637	
Portion of acquisition obligation payable in common stock at the option of the Company		243	
Potentially issuable restricted stock		85	
Potentially issuable common stock for ESPP		257	
Diluted Earnings Per Share:			
Net Income	$ 1,686	103,869	$ 0.02

In addition to the stock options included in the above table, options to purchase approximately 0.3 million shares of common stock were outstanding during the first quarter of 2008, but were not included in the computation of diluted earnings per share because they were anti-dilutive during the period using the treasury stock method. These options were anti-dilutive because the fair value of the Company s stock exceeded the assumed proceeds. Additionally, approximately 26.4 million of the underlying shares of the Company s convertible debt were not included in the diluted average common shares outstanding because they were antidilutive during the first quarter of 2008 using the if-converted method whereby the related interest expense on the convertible debt is added to net income for the period.

The following represents a reconciliation from basic weighted shares outstanding to diluted weighted shares outstanding and the earnings per share for the three months ended March 31, 2009 (in thousands, except per share data):

	For the Three Months Ended March 31, 2009		
	Net Income (Numerator)	**Weighted Average Shares Outstanding (Denominator)**	**Per Share Amount**
Basic Earnings Per Share:			
Net Loss	$ (13,152)	99,902	$ (0.13)
Effect of dilutive shares:			
Nonqualified Deferred Compensation Plan obligation using the treasury method	(156)	31	
Diluted Earnings Per Share:			
Net Income	$ (13,308)	99,933	$ (0.13)

In addition to the shares of common stock held by the Nonqualified Deferred Compensation Plan included above, the following potential shares of common stock were excluded from the computation as they were anti-dilutive during the period using the treasury stock method (in thousands):

	March 31, 2009

Options to purchase common stock	12,137
Common stock issuable under convertible debt	26,343
Portion of acquisition obligation payable in common stock at the option of the Company	696
Potentially issuable common stock for ESPP purchases	137
Potentially issuable restricted stock	243
Total	39,556

(k) Stock-Based Compensation

Stock-based compensation is accounted for in accordance with SFAS No. 123R, *Share-Based Payment,* and related interpretations. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating future stock price volatility and employee stock option exercise behaviors. If actual results differ significantly from these estimates, stock-based compensation expense and results of operations could be materially impacted.

Expected volatility is based upon proportionate weightings of the historical volatility of the Company s common stock and the implied volatility of traded options on the Company s common stock. The expected life of stock options is based on observed historical exercise patterns, which can vary over time.

As stock-based compensation expense recognized in the consolidated statements of operation is based on awards expected to vest, the amount of expense has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Forfeitures are estimated based on historical experience.

If factors change and different assumptions are employed in the application of SFAS No. 123R, the compensation expense recorded in future periods may differ significantly from what was recorded in the current period (see Note 3 for further information).

(l) Nonqualified Deferred Compensation Plan

Other non-current assets include $0.9 million and $1.2 million, respectively, of investments held in trust related to our Nonqualified Deferred Compensation Plan for certain employees and directors as of December 31, 2008 and March 31, 2009, respectively. All of the investments held in the Nonqualified Deferred Compensation Plan are classified as trading securities and recorded at fair value in accordance with SFAS No. 115 with changes in the investments fair values recognized in earnings in the period they occur. In accordance with EITF 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested,* restricted stock issued into the Nonqualified Deferred Compensation Plan is accounted for similarly to treasury stock in that, the value of the employer stock is determined on the date the restricted stock vests and the shares are issued into the Nonqualified Deferred Compensation Plan. The restricted stock issued into the plan is recorded in equity and changes in its fair value are not recognized. Additionally, the Company has recorded a corresponding liability for the Nonqualified Deferred Compensation Plan in other liabilities.

The Nonqualified Deferred Compensation Plan allows eligible employees, including management and certain highly-compensated employees as designated by the plan s administrative committee and members of the Board to make voluntary deferrals of compensation to specified dates, retirement or death. Participants are permitted to defer portions of their salary, annual cash bonus and restricted stock. The Company is not allowed to make additional direct contributions to the Nonqualified Deferred Compensation Plan on behalf of the participants without further action by the Board.

(m) Income Taxes

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities using tax rates expected to be in effect in the years in which the differences are expected to reverse. A valuation allowance is recorded to reduce deferred tax assets to the amount that is more likely than not to be realized. There was a full valuation allowance against net deferred tax assets of $294.7 million at December 31, 2008. Future taxable income and ongoing prudent and feasible tax planning strategies have been considered in assessing the need for the valuation allowance. An adjustment to the valuation allowance would increase or decrease income in the period such adjustment was made. During the first quarters of 2008 and 2009, the Company recognized $0.1 million and $0.4 million of income tax expense, respectively, primarily related to income earned in certain of the Company s international subsidiaries, California state income tax and U.S. Federal Alternative Minimum Tax expense.

(n) Foreign Currency and Other Hedging Instruments

The Company has transactions denominated in foreign currencies and, as a result, is exposed to changes in foreign currency exchange rates. The Company manages some of these exposures on a consolidated basis, which results in the netting of certain exposures to take advantage of natural offsets and through the use of forward contracts. Gains or losses on net foreign currency hedges are intended to offset losses or gains on the underlying net exposures in an effort to reduce the earnings and cash flow volatility resulting from fluctuating foreign currency exchange rates.

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The Company accounts for its derivative instruments as either assets or liabilities on the balance sheet and measures them at fair value. Derivatives that are not defined as hedges in SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* are adjusted to fair value through earnings. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting (see Note 11 for further information).

(o) Fair Value of Financial Instruments

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, requires the Company to disclose the fair value of financial instruments for assets and liabilities for which it is practicable to estimate that value.

The carrying amounts of all cash equivalents and forward exchange contracts approximate fair value based upon quoted market prices or discounted cash flows. The fair value of trade accounts receivables, accounts payable and other financial instruments approximates carrying value due to their short-term nature.

(p) Comprehensive Income and Accumulated Other Comprehensive Income (Loss)

Comprehensive income includes net income/loss and certain changes in stockholders equity that are excluded from net income (loss), such as changes in unrealized gains and losses on the Company s available-for-sale securities, unrealized gains/losses on foreign exchange hedges, and changes in the Company s cumulative foreign currency translation account. There were no tax effects allocated to any components of other comprehensive income (loss) during the first quarters of 2008 and 2009.

Comprehensive loss was approximately $12.2 million for the three months ended March 31, 2009, compared to comprehensive net income of $1.9 million for the three months ended March 31, 2008. The fluctuation in accumulated other comprehensive income (loss) is comprised of the following (in thousands):

	Three Months Ended March 31,	
	2008	**2009**
Net unrealized gain (loss) on available-for-sale securities	$ 213	$ (632)
Net unrealized gain on foreign currency hedges		1,932
Net unrealized loss on equity investments		(337)
Net foreign currency translation gain (loss)	(1)	
Accumulated other comprehensive income	$ 212	$ 963

(q) Restricted Cash

The Company s balance of restricted cash amounted to $7.3 million and $8.9 million at December 31, 2008 and March 31 2009, respectively. The December 31, 2008 and March 31, 2009 balances include $6.2 million and $7.7 million related to cash received for royalties earned pursuant to the Orapred sublicense agreement, respectively, which are restricted from use until August 2009 and are included in other current assets. Restricted cash also includes investments of $0.9 million and $1.2 million held by the Company s Nonqualified Deferred Compensation Plan as of December 31, 2008 and March 31, 2009, respectively, which is included in other assets.

(r) Recent Accounting Pronouncements

In April 2009, the FASB issued FASB Staff Position FAS 157-4, *Determining Whether a Market Is Not Active and a Transaction Is Not Distressed,* or FSP FAS 157-4; FSP FAS 157-4 provides guidelines for making fair value measurements more consistent with the principles presented in SFAS No. 157. FSP FAS 157-4 provides additional authoritative guidance in determining whether a market is active or inactive, and whether a transaction is distressed, is applicable to all assets and liabilities (i.e., financial and nonfinancial) and will require enhanced disclosures. This standard is effective for periods ending after June 15, 2009, which for the Company is the second quarter of fiscal 2009. The Company is evaluating the impact this standard will have on its consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position (FSP) FAS 115-2, FAS 124-2, and EITF 99-20-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, or FSP FAS 115-2, FAS 124-2, and EITF 99-20-2; and FSP FAS 115-2, FAS 124-2, and EITF 99-20-2 provides additional guidance to provide greater clarity about the credit and noncredit component of an other-than-temporary impairment event and to more effectively communicate when an other-than-temporary impairment event has occurred. This FSP applies to debt securities and is effective for periods ending after June 15, 2009 with early adoption permitted. The Company is currently evaluating the impact this FSP will have on its consolidated financial statements.

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In April 2009, the FASB issued FASB Staff Position FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, or FSP FAS 107-1 and APB 28-1. FSP FAS 107-1 and APB 28-1, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments in interim as well as in annual financial statements. This FSP also amends Accounting Principles Board Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in all interim financial statements. This FSP is effective for periods ending after June 15, 2009, which for the Company is the second quarter of fiscal 2009. The Company is currently evaluating the impact this FSP will have on its financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (SFAS No. 161). The standard requires additional quantitative disclosures and qualitative disclosures for derivative instruments. The required disclosures include how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows; relative volume of derivative activity; the objectives and strategies for using derivative instruments; the accounting treatment for those derivative instruments formally designated as the hedging instrument in a hedge relationship; and the existence and nature of credit-related contingent features for derivatives. The Company adopted the provision of SFAS No. 161 on January 1, 2009. As a result of adopting the provision of this standard, the Company has expanded its disclosures regarding derivative instruments and hedging activities within Note 11.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (SFAS No. 157). SFAS No. 157 provides enhanced guidance for using fair value to measure assets and liabilities. In February 2008, the FASB issued FSP No. 157-2, which deferred the effective date of SFAS No. 157 for one year relative to certain nonfinancial assets and liabilities. On January 1, 2009, the beginning of our fiscal 2009, the Company adopted the requirements of SFAS No. 157 that had been deferred under FSP 157-2, *Effective Date of FASB Statement No. 157*. The adoption did not have a material impact on the Company s consolidated financial statements during the first quarter of 2009.

In October 2008, the FASB issued Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset in a Market That Is Not Active* (FSP FAS 157-3). FSP FAS 157-3 clarifies the application of FAS No. 157 in a market that is not active and defines additional key criteria in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS 157-3 applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with FAS No. 157. FSP FAS 157-3 was effective upon issuance and the application of FSP FAS 157-3 did not have a material impact on the Company s consolidated financial statements in the first quarter of 2009.

(s) Reclassifications and Adjustments

Certain items in the prior year s consolidated financial statements have been reclassified to conform to the current presentation.

(3) STOCK-BASED COMPENSATION

The Company s stock-based compensation plans include the 2006 Share Incentive Plan and the ESPP. These plans are administered by the Compensation Committee of the Board of Directors, which selects persons to receive awards and determines the number of shares subject to each award and the terms, conditions, performance measures and other provisions of the award. See Note 3 of the Company s consolidated financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2008 for additional information related to these stock-based compensation plans.

Determining the Fair Value of Stock Options

The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model and the assumptions noted in the table below. The expected life of options is based on observed historical exercise patterns. Groups of employees that have similar historical exercise patterns were considered separately for valuation purposes, but none were identified that had distinctly different exercise patterns as of March 31, 2009. The expected volatility of stock options is based upon proportionate weightings of the historical volatility of the Company s stock and the implied volatility of traded options on the Company s stock for fiscal periods in which there is sufficient trading volume in options on the Company s stock. The risk free interest rate is based on the implied yield on a U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the option. The dividend yield reflects that the Company has not paid any cash dividends since inception and does not intend to pay any cash dividends in the foreseeable future. During the first quarter of 2009, the Company granted 228,750 stock options under the 2006 Share Incentive Plan, with a weighted average fair value of $6.52. The Company also granted 232,324 options under the ESPP with a weighted average fair value of $7.63 during the first quarter of 2009. The assumptions used to estimate the fair value of stock options granted and stock purchase rights granted under the Company s 2006 Share Incentive Plan and ESPP for the three months ended March 31, 2008 and 2009 are as follows:

	Three Months Ended March 31,	
	2008	2009
Stock options:		
Weighted average fair value of common stock	$ 36.78	$ 12.49
Expected life	5.2 years	6.0 years
Volatility	44.7%	54.5%
Risk-free interest rate	2.8%	1.9%
Dividend yield	0%	0%

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	Three Months Ended March 31,	
	2008	2009
ESPP:		
Fair market value of common stock	$ 27.18	$ 19.36
Expected life	6 24 months	6 24 months
Volatility	44.4%	51.4%
Risk-free interest rate	3.8-4.0%	1.1-1.5%
Dividend yield	0%	0%

Restricted Stock Units

Restricted stock units (RSUs) are generally subject to forfeiture if employment terminates prior to the release of vesting restrictions. The Company expenses the cost of the RSUs, which is determined to be the fair market value of the shares underlying the RSU at the date of grant, ratably over the period during which the vesting restrictions lapse. During the first quarter of 2009, the Company granted 20,000 RSUs with a weighted average fair market value of $11.05 per share.

Stock-based Compensation Expense

The compensation expense that has been included in the Company s consolidated statement of operations for stock-based compensation arrangements were as follows (in thousands):

	Three Months Ended March 31,	
	2008	2009
Cost of sales	$ 197	$ 564
Research and development expense	1,557	2,475
Selling, general and administrative expense	2,710	4,757
Total stock-based compensation expense	$ 4,464	$ 7,796

There was no income tax benefit associated with stock-based compensation in the first quarters of 2008 and 2009 because the deferred tax asset resulting from stock-based compensation was offset by an additional valuation allowance for deferred tax assets.

Stock-based compensation of $0.9 million and $1.3 million was capitalized into inventory during the first quarters of 2008 and 2009, respectively. Capitalized stock-based compensation is recognized into cost of sales when the related product is sold.

(4) JOINT VENTURE

Effective January 2008, the Company and Genzyme restructured BioMarin/Genzyme LLC. Under the revised structure, the operational responsibilities for BioMarin and Genzyme did not significantly change, as Genzyme continues to globally market and sell Aldurazyme and BioMarin continues to manufacture Aldurazyme. The restructuring had two significant business purposes. First, since each party now has full control over its own operational responsibilities, without the need to obtain the approval of the other party, and the parties do not need to review and oversee the activities of the other, it reduces management s time and effort and therefore improves overall efficiencies. Second, since each party will realize 100% of the benefit of their own increased operational efficiencies, it increases the incentives to identify and implement cost saving measures. Under the previous 50/50 structure, each company shared 50% of the expense associated with the other s inefficiencies and only received 50% of the benefit of its own efficiencies. Specifically, the Company will be able to realize the full benefit of any manufacturing cost reductions and Genzyme will be able to realize the full benefit of any sales and marketing efficiencies.

On January 1, 2008, Genzyme began to record sales of Aldurazyme to third party customers and pay BioMarin a tiered payment ranging from approximately 39.5% to 50% of worldwide net product sales depending on sales volume, which is recorded by BioMarin as product revenue. The Company recognizes a portion of this amount as product transfer revenue when product is

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released to Genzyme as all of the Company s performance obligations are fulfilled at this point and title to, and risk of loss, for the product has transferred to Genzyme. The product transfer revenue represents the fixed amount per unit of Aldurazyme that Genzyme is required to pay the Company if the product is unsold by Genzyme. The amount of product transfer revenue is deducted from the calculated royalty rate when the product is sold by Genzyme. Genzyme s return rights for Aldurazyme are limited to defective product. Certain research and development activities and intellectual property related to Aldurazyme continues to be managed in the joint venture with the costs shared equally by BioMarin and Genzyme. Pursuant to the terms of the joint venture restructuring, the Company received distributions of $16.7 million of cash and $26.8 million of inventory from the joint venture in the first quarter of 2008.

As a result of restructuring the joint venture, the Company made an initial transfer of inventory on-hand to Genzyme, resulting in the recognition of product transfer revenue of $14.0 million during the first quarter of 2008. A portion of that initial inventory transfer representing $4.5 million of the related product transfer revenue was also sold by Genzyme during the first quarter of 2008, which resulted in a royalty due to the Company totaling $14.6 million. There were no similar upfront inventory shipments in the first quarter of 2009.

The Company presents the related cost of sales and its Aldurazyme-related operating expenses as operating expenses in the consolidated statements of operations. Equity in the loss of BioMarin/Genzyme LLC subsequent to the restructuring includes BioMarin s 50% share of the net income/loss of BioMarin/Genzyme LLC related to intellectual property management and ongoing research and development activities.

(5) SHORT-TERM AND LONG-TERM INVESTMENTS

At December 31, 2008, the principal amounts of short-term and long-term investments by contractual maturity are summarized in the table below (in thousands).

	Contractual Maturity Date For the Years Ending December 31,			December 31, 2008
	2009	Total Book Value	Unrealized Gain (Loss)	Aggregate Fair Value
Corporate securities	$ 55,270	$ 55,270	$ (100)	$ 55,170
Commercial paper	33,076	33,076	48	33,124
Equity securities	3,633	3,633	332	3,965
U.S. Government agency securities	220,914	220,914	977	221,891
U.S. Government backed commercial paper	24,370	24,370	5	24,375
Total	$ 337,263	$ 337,263	$ 1,262	$ 338,525

At March 31, 2009, the principal amounts of short-term and long-term investments by contractual maturity are summarized in the table below (in thousands).

	Contractual Maturity Date For the Years Ending December 31,			March 31, 2009	
	2009	2010	Total Book Value	Unrealized Gain (Loss)	Aggregate Fair Value
Certificates of deposit	$ 7,234	$ 2,806	$ 10,040	$ (109)	$ 9,931
Corporate securities	39,602	1,029	40,631	32	40,663
Commercial paper	29,437		29,437	34	29,471
Equity securities	4,021		4,021	6	4,027
U.S. Government agency securities	256,884		256,884	325	257,209
Total	$ 337,178	$ 3,835	$ 341,013	$ 288	$ 341,301

The Company completed an evaluation of its investments and determined that it did not have any other-than-temporary impairments as of March 31, 2009. The investments are placed in financial institutions with strong credit ratings and management expects full recovery of the amortized costs.

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At March 31, 2009, the aggregate amounts of unrealized losses related to fair value of investments with unrealized losses were as follows (in thousands). All investments were classified as available-for-sale at March 31, 2009.

	Less Than 12 Months To Maturity		12 Months or More To Maturity		Total	
	Aggregate Fair Value	Unrealized Losses	Aggregate Fair Value	Unrealized Losses	Aggregate Fair Value	Unrealized Losses
Certificates of deposit	$ 7,155	$ (78)	$ 2,776	$ (31)	$ 9,931	$ (109)
Corporate securities	15,468	(15)			15,468	(15)
Commercial paper	4,985	(4)			4,985	(4)
U.S. Government agency securities	16,518	(15)			16,518	(15)
Total	$ 44,126	$ (112)	$ 2,776	$ (31)	$ 46,902	$ (143)

At December 31, 2008, the aggregate amount of unrealized losses and related fair value of investments with unrealized losses were as follows (in thousands). All investments were classified as available-for-sale at December 31, 2008.

	Less Than 12 Months To Maturity		Total	
	Aggregate Fair Value	Unrealized Losses	Aggregate Fair Value	Unrealized Losses
Corporate securities	$ 44,941	$ (147)	$ 44,941	$ (147)
Commercial paper	1,992	(6)	1,992	(6)
U.S. Government agency securities	6,928	(12)	6,928	(12)
U.S. Government back commercial paper	9,947	(31)	9,947	(31)
Total	$ 63,808	$ (196)	$ 63,808	$ (196)

(6) SUPPLEMENTAL BALANCE SHEET INFORMATION

As of December 31, 2008 and March 31, 2009, inventory consisted of the following (in thousands):

	December 31, 2008	March 31, 2009
Raw materials	$ 10,314	$ 11,008
Work in process	29,998	29,103
Finished goods	32,850	36,312
Total inventory	$ 73,162	$ 76,423

As of December 31, 2008 and March 31, 2009, other current assets consisted of the following (in thousands):

	December 31, 2008	March 31, 2009
Kuvan European Medicines Agency (EMEA) approval milestone receivable	$ 30,000	$
Non-trade receivables	4,828	6,170

Prepaid expenses	3,013	4,359
Deferred cost of goods sold	3,879	2,446
Short-term restricted cash	6,202	7,748
Other	2,522	3,205
Total other current assets	$ 50,444	$ 23,928

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As of December 31, 2008 and March 31, 2009, accounts payable and accrued liabilities consisted of the following (in thousands):

	December 31, 2008	March 31, 2009
Accounts payable	$ 922	$ 5,178
Accrued accounts payable	26,214	25,646
Accrued vacation	3,798	4,621
Accrued compensation	11,737	6,270
Accrued interest and taxes	2,684	3,175
Accrued royalties	3,401	3,620
Other accrued expenses	6,094	3,135
Accrued rebates	3,194	3,035
Other	989	1,197
Total accounts payable and accrued liabilities	$ 59,033	$ 55,877

As of December 31, 2008 and March 31, 2009, other long-term liabilities consisted of the following (in thousands):

	December 31, 2008	March 31, 2009
Long-term portion of deferred rent	$ 1,176	$ 1,157
Long-term portion of capital lease liability	270	222
Long-term portion of deferred compensation liability	1,410	1,567
Total other long-term liabilities	$ 2,856	$ 2,946

(7) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at December 31, 2008 and March 31, 2009, consisted of (in thousands):

Category	December 31, 2008	March 31, 2009	Estimated Useful Lives
Leasehold improvements	$ 27,544	$ 27,549	Shorter of life of asset or lease term
Building and improvements	61,183	64,356	20 years
Manufacturing and laboratory equipment	26,996	28,347	5 years
Computer hardware and software	13,088	19,900	3 to 5 years
Office furniture and equipment	4,602	4,642	5 years
Land	10,056	10,056	Not applicable
Construction-in-progress	27,589	36,941	Not applicable
Gross property, plant and equipment	$ 171,058	$ 191,791	
Less: Accumulated depreciation	(46,079)	(49,539)	
Total property, plant and equipment, net	$ 124,979	$ 142,252	

Depreciation for the first quarters of 2008 and 2009 was $2.4 million and $3.5 million, respectively, of which $0.6 million and $0.7 million was capitalized into inventory, respectively.

Capitalized interest related to the Company s property, plant and equipment purchases during the first quarters of 2008 and 2009 was insignificant.

In January 2008, the Company purchased its previously leased laboratory/office building located at 300 Bel Marin Keys Drive, Novato, California for approximately $12.0 million. As a result of the purchase, the Company capitalized certain pre-existing deferred rent liabilities of approximately $0.5 million as a reduction to the acquisition cost of the building.

(8) INVESTMENT IN SUMMIT CORPORATION PLC

In July 2008, the Company entered into an exclusive worldwide licensing agreement with Summit Corporation plc (Summit) related to Summit s preclinical drug candidate SMT C1100 and follow-on molecules (2008 Summit License), which are being developed for the treatment of Duchenne muscular dystrophy (DMD). The Company paid Summit $7.1 million for an equity investment in Summit shares and licensing rights to SMT C1100. The initial equity investment represents the acquisition of approximately 5.1 million Summit shares with a fair value of $5.7 million, based on public market quotes. The Company s investment in Summit represents less than 10% of Summit s outstanding shares. The $1.4 million paid in excess of the fair value of the shares acquired was allocated to the license fee using the residual method and expensed under the provisions of SFAS No. 2, *Accounting for Research and Development Costs* (SFAS No. 2), in the third quarter of 2008. Under the terms of the licensing agreement, the Company is obligated to make future development and regulatory milestone payments totaling $51.0 million contingent on future development and regulatory milestones, as well as tiered royalties based on future net sales. All payments pursuant to the Company s investment in, and license from, Summit were denominated in British pounds.

In March 2009, the Company entered into an asset purchase agreement with Summit. Pursuant to the terms of the asset purchase agreement, the Company purchased certain of Summit s assets which included the rights, title to, and interest in Summit s preclinical drug candidate SMT C1100, thus terminating the 2008 License Agreement. These assets were acquired by issuing a secured promissory note and assuming $56,000 in related liabilities. The promissory note is secured by all of the assets acquired from Summit. The value of the assumed liabilities was expensed under the provisions of SFAS No. 2, in the first quarter of 2009. Under the secured promissory note, the Company is obligated to make up to $50.0 million in future development and regulatory milestone payments contingent on achieving certain development and regulatory milestones, as well as tiered royalties based on future net sales.

The Company accounts for the Summit shares, which are traded on the London Stock Exchange, under the provisions of SFAS No. 115. The investment is classified as available-for-sale, with changes in the fair value reported as a component of accumulated other comprehensive income/loss, exclusive of other-than-temporary impairment losses, if any. Losses determined to be other-than-temporary are reported in earnings in the period in which the impairment occurs.

As of March 31, 2009, the Company has recognized cumulative impairment charges of $5.5 million for the decline in the investment s value determined to be other-than-temporary. The impairment charges are comprised of $4.1 million and $1.4 million, recognized in December 2008 and March 2009, respectively. The determination that the decline was other-than-temporary is, in part, subjective and influenced by several factors including: the length of time and to the extent to which the market value had been less than the value on the date of purchase, Summit s financial condition and near-term prospects, including any events which may influence their operations, and the Company s intent and ability to hold the investment for a period of time sufficient to allow for the anticipated recovery in market value. Based on the current market conditions, the low volume of trading in Summit securities and their current financial condition, the Company determined that its investment in Summit was other-than-temporarily impaired and adjusted the recorded amount of the investment to the stock s market price on March 31, 2009.

(9) INVESTMENT IN LA JOLLA PHARMACEUTICAL COMPANY

On January 4, 2009, the Company entered into a co-exclusive worldwide (excluding Asia Pacific) licensing agreement with La Jolla Pharmaceutical Company (La Jolla) to develop and commercialize Riquent, La Jolla s investigational drug for lupus nephritis. Riquent was being evaluated by La Jolla in an international double blind, placebo controlled randomized Phase III clinical study for lupus nephritis (Phase III ASPEN Study). The Company paid La Jolla $7.5 million for the license rights and $7.5 million for 339,104 shares of La Jolla s Series B Preferred Stock. The initial equity investment represents the acquisition of the La Jolla Series B Preferred shares with a fair value of $6.2 million. The $1.3 million paid in excess of the fair value of the shares acquired was allocated to the license fee using the residual method and expensed under the provisions of SFAS No. 2, in the first quarter of 2009. Research and development expense related to the Company s agreements with La Jolla in the first quarter of 2009 approximated $8.8 million, and is comprised of the $7.5 million up-front license fee and the $1.3 million premium paid in excess of the preferred stock s fair value.

On February 12, 2009, the results of the first interim efficacy analysis for the Phase III ASPEN Study clinical trial were announced, and the Independent Data Monitoring Board determined that the continuation of the trial was futile. Based on the results of this interim efficacy analysis, the Company and La Jolla have decided to stop the study, unblind all of the data and evaluate all of the clinical results, including the secondary endpoints.

On March 26, 2009, the Company terminated its licensing agreement with La Jolla, triggering the preferred stock s automatic conversion feature at a rate of one preferred share to thirty shares of common stock. Thus, as of the conversion date, the Company holds approximately 10.2 million shares of common stock, or approximately 15.5% La Jolla s outstanding common stock. The Company accounts for the converted La Jolla shares, which are traded on NASDAQ Stock Exchange, under the provisions of SFAS No. 115. The investment is classified as available-for-sale, with changes in the fair value reported as a component of accumulated other comprehensive income/loss, exclusive of

other-than-temporary impairment losses, if any. Losses determined to be other-than-temporary are reported in earnings in the period in which the impairment occurs.

During the first quarter of 2009, the Company has recognized an impairment charge of $4.5 million for the decline in the La Jolla investment s value determined to be other-than-temporary. The determination that the decline was other-than-temporary is, in part, subjective and influenced by several factors, including: the length of time and the extent to which the market value of La Jolla s common stock has been less than the value on the date of purchase, La Jolla s financial condition and near-term prospects, including any events which may influence their operations, and the Company s intent and ability to hold the investment for a period of time sufficient to allow for the anticipated recovery in market value. Based on the current market conditions, La Jolla s current financial condition and their business prospects, the Company determined that its investment in La Jolla was other-than-temporarily impaired and adjusted the recorded amount of the investment to the stock s market price on March 31, 2009. The investment is included in short-term investments as of March 31, 2009.

(10) CONVERTIBLE DEBT

In April 2007, the Company sold approximately $324.9 million of Senior Subordinated Convertible Notes due 2017. The debt was issued at face value and bears interest at the rate of 1.875% per annum, payable semi-annually in cash. The debt is convertible, at the option of the holder, at any time prior to maturity or redemption, into shares of Company common stock at a conversion price of approximately $20.36 per share, subject to adjustment in certain circumstances. There is no call provision included and the Company is unable to unilaterally redeem the debt prior to maturity on April 23, 2017. The Company also must repay the debt if there is a qualifying change in control or termination of trading of its common stock.

In connection with the placement of the April 2007 debt, the Company paid approximately $8.5 million in offering costs, which have been deferred and are included in other assets. They are being amortized as interest expense over the life of the debt. The Company recognized $0.2 million of amortization expense in each of the first quarters of 2008 and 2009.

In March 2006, the Company sold $172.5 million of Senior Subordinated Convertible Notes due 2013. The debt was issued at face value and bears interest at the rate of 2.5% per annum, payable semi-annually in cash. The debt is convertible, at the option of the holder, at any time prior to maturity or redemption, into shares of Company common stock at a conversion price of approximately $16.58 per share, subject to adjustment in certain circumstances. There is no call provision included and the Company is unable to unilaterally redeem the debt prior to maturity on March 29, 2013. The Company also must repay the debt if there is a qualifying change in control or termination of trading of its common stock.

In connection with the placement of the March 2006 debt, the Company paid approximately $5.5 million in offering costs, which have been deferred and are included in other assets. They are being amortized as interest expense over the life of the debt, and the Company recognized $0.2 million of amortization expense during each of the first quarters of 2008 and 2009. During the first quarter of 2008, certain note holders voluntarily exchanged an insignificant number of convertible notes for shares of the Company s common stock.

Interest expense in each of the first quarters of 2008 and 2009 was $4.1 million, and included $1.1 million of imputed interest expense related to the Company s acquisition obligation.

(11) DERIVATIVE INSTRUMENTS AND HEDGING STRATEGIES

The Company uses hedging contracts to manage the risk of its overall exposure to fluctuations in foreign currency exchange rates. All of the Company s designated hedging instruments are considered to be cash flow hedges.

Foreign Currency Exposure

The Company uses forward foreign exchange contracts to hedge certain operational exposures resulting from changes in foreign currency exchange rates. Such exposures result from portions of our forecasted revenues being denominated in currencies other than the U.S. dollar, primarily the Euro and British Pound.

The Company designates certain of these forward contract hedges as hedging instruments and enters into some forward contracts that are considered to be economic hedges which are not designated as hedging instruments. Whether designated or undesignated, these forward contracts protect against the reduction in value of forecasted foreign currency cash flows resulting from Naglazyme revenues designated in currencies other than the U.S. dollar. The fair values of foreign currency agreements are estimated as described in Note 12, taking into consideration current interest rates and the current creditworthiness of the counterparties or the Company, as applicable. Details of the specific instruments used by the Company to hedge its exposure to foreign currency fluctuations follow below.

At March 31, 2009, the Company had 17 forward contracts outstanding to purchase a total of 30.4 million Euros with expiration dates ranging from April 30, 2009 through February 26, 2010. These hedges were entered into to protect against the fluctuations in Euro denominated

Naglazyme revenues. The Company has formally designated these contracts as cash flow hedges, and they are expected to be highly effective in offsetting fluctuations in revenues denominated in Euros related to changes in the foreign currency exchange rates.

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The Company also enters into forward foreign currency contracts that are not designated as hedges for accounting purposes. The changes in fair value of these foreign currency hedges are included as a part of selling, general and administrative expenses in the consolidated statements of operations. At March 31, 2009, the Company had two outstanding foreign currency contracts that were not designated as hedges for accounting purposes.

The maximum length of time over which the Company is hedging its exposure to the reduction in value of forecasted foreign currency cash flows through foreign currency forward contracts is through February 2010. Over the next 12 months, the Company expects to reclassify $1.7 million from accumulated other comprehensive income to earnings as related forecasted revenue transactions occur.

The Company did not enter into any derivative transactions which qualified for hedge accounting under SFAS No. 133, as amended, prior to the second quarter of 2008. For the three months ended March 31, 2009, the Company recognized foreign currency transaction gains of $1.2 million from derivative transactions that qualified for hedge accounting.

At December 31, 2008 and March 31, 2009, the fair value carrying amount of the Company s derivative instruments was recorded as follows (in thousands):

	Asset Derivatives December 31, 2008		Liability Derivatives December 31, 2008	
	Balance Sheet Location	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Derivatives designated as hedging instruments under FAS 133				
Foreign exchange contracts	Other current assets	$ 754	Other current liabilities	$ 1,129
Total		$ 754		$ 1,129
Derivatives not designated as hedging instruments under FAS 133				
Foreign exchange contracts	Other current assets	$ 49	Other current liabilities	$
Total		$ 49		$
Total derivative contracts		$ 803		$ 1,129

	Asset Derivatives March 31, 2009		Liability Derivatives March 31, 2009	
	Balance Sheet Location	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Derivatives designated as hedging instruments under FAS 133				
Foreign exchange contracts	Other current assets	$ 1,437	Other current liabilities	$
Total		$ 1,437		$
Derivatives not designated as hedging instruments under FAS 133				
Foreign exchange contracts	Other current assets	$ 110	Other current liabilities	$
Total		$ 110		$
Total derivative contracts		$ 1,547		$

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The effect of derivative instruments on the consolidated statement of operations for the three months ended March 31, 2009, was as follows (in thousands):

Derivatives in FAS 133 Hedging Relationships	Amount of Gain/(Loss) Recognized in OCI (Effective Portion)	Location of Gain/(Loss) Reclassified from Accumulated OCI into income (Effective Portion)	Amount of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Foreign exchange contracts	$ 1,740	Net product revenues	$ 1,184	Selling, general and administrative	$ 209
Total	$ 1,740		$ 1,184		$ 209

Derivatives Not Designated as Hedging Instruments under Statement 133	Location of Gain/(Loss) Recognized in Income on Derivative	Amount of Gain/(Loss) Recognized in Income on Derivative
Foreign exchange contracts	Selling, general and administrative	$ 1,165
Total		$ 1,165

At December 31, 2008 and March 31, 2009, accumulated other comprehensive income associated with forward contracts qualifying for hedge accounting treatment was a loss of $0.2 million and $1.7 million, respectively.

The Company is exposed to counterparty credit risk on all of our derivative financial instruments. The Company has established and maintained strict counterparty credit guidelines and enter into hedges only with financial institutions that are investment grade or better to minimize the Company s exposure to potential defaults. The Company does not require collateral under these agreements.

(12) FAIR VALUE MEASUREMENTS

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including available-for-sale fixed income and equity securities, other equity securities and foreign currency derivatives. The table below presents the fair value of these certain financial assets and liabilities determined using the inputs defined at March 31, 2009, by SFAS No. 157.

		Fair Value Measurements (in thousands) at March 31, 2009		
	Total	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market instruments and overnight deposits (1)	$ 214,579	$ 17,356	$ 197,223	$
Certificates of deposit (6)	9,931	9,931		

Corporate securities (2)	40,663		40,663	
Equity securities (7)	4,027	3,823	204	
Government agency securities (2)	257,209		257,209	
Commercial paper (2)	29,471		29,471	
Foreign currency derivatives (3)	1,547		1,547	
Total	$ 557,427	$ 31,110	$ 526,317	$
Liabilities:				
Deferred compensation liability (4)	$ 1,657	$	$ 1,657	$
Total	$ 1,657	$	$ 1,657	$

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The fair value of these financial assets and liabilities was determined using the following inputs at December 31, 2008 (in thousands):

		Fair Value Measurements (in thousands) at December 31, 2008		
	Total	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market instruments and overnight deposits (1)	$ 222,900	$ 12,959	$ 209,941	$
Corporate securities (2)	55,170		55,170	
Equity securities (7)	3,965	2,332	1,633	
Government agency securities (2)	221,891		221,891	
Government backed commercial paper (2)	24,375		24,375	
Commercial paper (2)	33,124		33,124	
Foreign currency derivatives (3)	803		803	
Total	$ 562,228	$ 15,291	$ 546,937	$
Liabilities:				
Deferred compensation liability (4)	$ 1,428	$	$ 1,428	$
Foreign currency derivatives (5)	1,129		1,129	
Total	$ 2,557	$	$ 2,557	$

(1) Included in cash and cash equivalents investments in the Company s consolidated balance sheet.

(2) Included in short-term investments in the Company s consolidated balance sheet.

(3) Included in other current assets on the Company s consolidated balance sheet. Foreign currency derivatives at March 31, 2009 include forward foreign exchange contracts for the Euro. Foreign currency derivatives at December 31, 2008 include forward foreign exchange contracts for Euros and British Pounds.

(4) Included in other long-term liabilities on the Company s consolidated balance sheet.

(5) Included in accounts payable and accrued liabilities on the Company s consolidated balance sheet.

(6) 72% and 28% are included in short-term and long-term investments in the Company s consolidated balance sheet, respectively.

(7) Included in short-term investments and long-term investments in the Company s consolidated balance sheet. At December 31, 2008 and March 31, 2009, 0.5% is included in long-term investments and the remaining balances are included in short-term investments.

(13) REVENUE AND CREDIT CONCENTRATIONS

The Company considers there to be revenue concentration risks for regions where net product revenue exceeds 10% of consolidated net product revenue. The concentration of the Company s revenue within the regions below may expose the Company to a material adverse effect if sales in the respective regions were to experience difficulties. The table below summarizes product revenue concentrations based on patient location for the three months ended March 31, 2008 and 2009.

	Three Months Ended March 31,	
	2008	**2009**
Region:		
United States	61%	52%
Europe	25%	24%
Latin America	7%	11%
Rest of World	7%	13%
Total Net Product Revenue	100%	100%

As of March 31, 2009, accounts receivable related to net product sales of Naglazyme and Kuvan and Aldurazyme product transfer and royalty revenues. On a consolidated basis, three customers accounted for 51% of our net product revenues during the first quarter of 2009. On a consolidated basis, two customers accounted for 47% and 15% of the March 31, 2009 accounts receivable balance, respectively. The Company does not require collateral from its customers, but performs periodic credit evaluations of its customers financial condition and requires immediate payment in certain circumstances.

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

Forward-Looking Statements

This Form 10-Q contains forward-looking statements as defined under securities laws. Many of these statements can be identified by the use of terminology such as believes, expects, anticipates, plans, may, will, projects, continues, estimates, potential, opportunity a These forward-looking statements may be found in Overview, and other sections of this Form 10-Q. Our actual results or experience could differ significantly from the forward-looking statements. Factors that could cause or contribute to these differences include those discussed in Risk Factors, in our Form 10-K for the year ended December 31, 2008, as well as those discussed elsewhere in this Form 10-Q. You should carefully consider that information before you make an investment decision.

You should not place undue reliance on these statements, which speak only as of the date that they were made. These cautionary statements should be considered in connection with any written or oral forward-looking statements that we may issue in the future. We do not undertake any obligation to release publicly any revisions to these forward-looking statements after completion of the filing of this Form 10-Q to reflect later events or circumstances, or to reflect the occurrence of unanticipated events.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and notes to those statements included elsewhere in this Quarterly Report on Form 10-Q.

Overview

We develop and commercialize innovative biopharmaceuticals for serious diseases and medical conditions. We select product candidates for diseases and conditions that represent a significant unmet medical need, have well-understood biology and provide an opportunity to be first-to-market. Our product portfolio is comprised of three approved products and multiple investigational product candidates. Approved products include Naglazyme, Aldurazyme, and Kuvan.

Naglazyme received marketing approval in the U.S. in May 2005, in the E.U. in January 2006, and subsequently in other countries. Naglazyme net product revenues for the first quarters of 2008 and 2009 were $27.7 million and $39.4 million, respectively.

Aldurazyme has been approved for marketing in the U.S., E.U., and in other countries. Prior to 2008, we developed and commercialized Aldurazyme through a joint venture with Genzyme. Effective January 2008, we restructured our relationship with Genzyme whereby Genzyme sells Aldurazyme to third parties and we recognize royalty revenue on net sales by Genzyme. We recognize a portion of the royalty as product transfer revenue when product is released to Genzyme and all obligations related to the transfer have been fulfilled. The product transfer revenue represents the fixed amount per unit of Aldurazyme that Genzyme is required to pay us if the product is unsold by Genzyme. The amount of product transfer revenue will eventually be deducted from the calculated royalties earned when the product is sold by Genzyme. Our Aldurazyme net product revenues for the first quarters of 2008 and 2009 were $24.1 million and $17.0 million, respectively.

Kuvan was granted marketing approval in the U.S. in December 2007. Kuvan net product sales for the first quarters of 2008 and 2009 were $5.8 million and $15.5 million, respectively.

We are developing PEG-PAL, an experimental enzyme substitution therapy for the treatment of PKU, for patients that are not responsive to Kuvan. In May 2008, we initiated a Phase I open label clinical trial of PEG-PAL in PKU patients. The primary objective of this study is to assess the safety and tolerability of single subcutaneous injections of PEG-PAL in subjects with PKU. We have completed the dosing of the fifth cohort of patients in the Phase I trial, and are in communications with the FDA regarding the Phase II trial design and expect to initiate the study in the second quarter of 2009. In 2007 and early 2008 we devoted substantial resources to the development of 6R-BH4, the active ingredient in Kuvan, for the treatment of certain cardiovascular indications including peripheral arterial disease and sickle cell disease. We released data from several 6R-BH4 trials in early February 2009. We expect to initiate an open label Phase I/II clinical trial of GALNS, an enzyme replacement therapy for the treatment of MPS IVA in April 2009. We expect the results form this trial in the fourth quarter of 2009. We are conducting preclinical development of several other enzyme product candidates for genetic and other diseases, and a small molecule for the treatment of Duchenne Muscular Dystrophy.

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Key components of our results of operations for the three months ended March 31, 2008 and 2009 include the following:

	Three Months Ended March 31,	
	2008	2009
Total net product revenues	$ 57,625	$ 71,914
Collaborative agreement revenues	2,465	509
Cost of sales	17,188	14,362
Research and development expense	17,628	34,358
Selling, general and administrative expense	23,669	28,568
Net income (loss)	1,686	(13,152)
Stock-based compensation expense	4,464	7,796

See *Results of Operations* for discussion of the detailed components and analysis of the amounts above. Our cash, cash equivalents, short-term investments and long-term investments totaled $555.9 million as of March 31, 2009, compared to $561.4 million as of December 31, 2008.

Critical Accounting Policies and Estimates

In preparing our condensed consolidated financial statements in accordance with GAAP and pursuant to the rules and regulations of the SEC, we make assumptions, judgments and estimates that can have a significant impact on our net income (loss) and affect the reported amounts of certain assets, liabilities, revenue and expenses, and related disclosures. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis, we evaluate our assumptions, judgments and estimates. We also discuss our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

We believe that the assumptions, judgments and estimates involved in the accounting for the impairment of long-lived assets, revenue recognition and related reserves, income taxes, inventory, research and development, and stock-based compensation have the greatest impact on our consolidated financial statements, so we consider these to be our critical accounting policies. Historically, our assumptions, judgments and estimates relative to our critical accounting polices have not differed materially from actual results.

There have been no significant changes in our critical accounting policies and estimates during the three months ended March 31, 2009 as compared to the critical accounting policies and estimates disclosed *in 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, 2008.

Recent Accounting Pronouncements

See Note 2(r) of our accompanying consolidated financial statements for a full description of recent accounting pronouncements and our expectation of their impact, if any, on our results of operations and financial condition.

Results of Operations

Net Income (Loss)

Our net loss for the three months ended March 31, 2009 was $13.2 million compared to a net income of $1.7 million for the three months ended March 31, 2008, with the change primarily due to the following (in millions).

Net income for the period ended March 31, 2008	$ 1.7
Increased Naglazyme gross profit	8.8
Increased Kuvan gross profit	8.3
Decreased Kuvan license fee revenues	(1.3)
Increased research and development expenses	(16.8)
Increased selling, general and administrative expense	(4.9)
Impairment loss on La Jolla investment	(4.5)

Increased Orapred royalty income	1.1
Decreased interest income	(3.5)
Impairment loss on Summit investment	(1.4)
Other individually insignificant fluctuations	(0.7)
Net loss for the period ended March 31, 2009	$ 13.2

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The increase in Naglazyme gross profit in the first quarter of 2009 as compared to the first quarter of 2008 is primarily a result of additional patients initiating therapy outside the U.S. and the E.U. The increase in Kuvan gross profit during the first quarter of 2009 compared to the first quarter of 2008 is primarily a result of additional patients initiating therapy in the U.S. The decrease in Kuvan license fee revenues is attributed to us fulfilling all performance obligations relating to the 2005 $25.0 million up-front license payment from Merck Serono in December 2008. The increase in selling, general and administrative expense was primarily due to the continued international expansion of Naglazyme and commercialization of Kuvan in the U.S. The increase in research and development expense was primarily due to increases in development expense for our GALNS program, the up-front costs associated with a product licensed from La Jolla for the treatment of lupus nephritis, and other early stage programs. See below for additional information related to the primary net income (loss) fluctuations presented above, including details of our operating expense fluctuations.

Net Product Revenues, Cost of Sales and Gross Profit

The following table shows a comparison of net product revenues for the three months ended March 31, 2008 and 2009 (in millions):

	Three Months Ended March 31,		
	2008	**2009**	**Change**
Naglazyme	$ 27.7	$ 39.4	$ 11.7
Kuvan	5.8	15.5	9.7
Aldurazyme	24.1	17.0	(7.1)
Total Net Product Revenues	$ 57.6	$ 71.9	$ 14.3

Net product revenue for Naglazyme in the first quarter of 2009 totaled $39.4 million, of which $34.5 million was earned from end-user customers based outside the U.S. The negative impact of foreign currency exchange rates on Naglazyme sales from customers based outside the U.S. was approximately $2.0 million in the first quarter of 2009. Gross profit from Naglazyme in the first quarter of 2009 was approximately $31.3 million, representing gross margins of approximately 80% as compared to $22.2 million in the first quarter of 2008, representing gross margins of approximately 80%. The decrease in gross margins is attributed to the negative foreign currency impact during the first quarter of 2009.

We received marketing approval for Kuvan in the U.S. in December 2007 and began shipping product that same month. Net product revenue for Kuvan in the U.S. during the first quarter of 2009 was $15.5 million, compared to $5.8 million during the first quarter of 2008. Gross profit from Kuvan in the first quarter of 2009 was approximately $13.1 million, representing gross margins of approximately 84%. During the first quarter of 2008, gross profit from Kuvan was approximately $5.1 million, representing gross margins of 88%. Both periods reflect royalties paid to third parties of 11%. In accordance with our inventory accounting policy, we began capitalizing Kuvan inventory production costs after U.S. regulatory approval was obtained in December 2007. As a result, the product sold in 2008 had an insignificant cost basis. We expect that a significant portion of Kuvan sold during 2009 will be previously expensed product and will have a minimal cost basis. The cost of sales for Kuvan for the first quarters of 2008 and 2009 is primarily comprised of royalties paid to third parties based on Kuvan net sales.

As a result of the restructuring of the BioMarin/Genzyme LLC joint venture, we record a 39.5% to 50% royalty on worldwide net product sales of Aldurazyme. We also recognize product transfer revenue when product is released to Genzyme and all of our obligations have been fulfilled. Genzyme s return rights for Aldurazyme are limited to defective product or product. The product transfer revenue represents the fixed amount per unit of Aldurazyme that Genzyme is required to pay us if the product is unsold by Genzyme. The amount of product transfer revenue will eventually be deducted from the calculated royalty rate when the product is sold by Genzyme.

Aldurazyme net product revenue during the first quarter of 2009 was $17.0 million, compared to $24.1 million in the first quarter of 2008. Aldurazyme net product revenues in the first quarter of 2009 was comprised of $14.5 million in royalty revenues and incremental net product transfer revenue of $2.5 million. Aldurazyme net product revenue in the first quarter of 2008 was comprised of $14.6 million of royalty revenue and $9.5 million of net product transfer revenue. Royalty revenue from Genzyme is based on 39.5% of net Aldurazyme sales by Genzyme, which totaled $36.8 million in the first quarters of 2009 and 2008. Incremental Aldurazyme net product transfer revenue reflects incremental shipments of Aldurazyme to Genzyme to meet future product demand. In January 2008, we transferred existing finished goods on-hand to Genzyme under the restructured terms of the BioMarin/Genzyme LLC agreements, resulting in the recognition of significant incremental product transfer revenue during 2008. In the future, to the extent that Genzyme Aldurazyme inventory quantities on hand remain flat, we expect that our total Aldurazyme revenues will approximate the 39.5% to 50% royalties on net product sales by Genzyme. In the first quarter of 2009, Aldurazyme gross profit was $13.2 million, representing a gross margin of 77%, which reflects the profit earned on royalty revenue and net

incremental product transfer revenue. For the same period in 2008, Aldurazyme gross profit was $13.2 million, representing a gross margin of 55%. The increase in gross margins is attributed to a shift in revenue mix between royalty revenue and net product transfer revenues. In the first quarter of 2009, the revenue mix was 85% royalty revenues and 15% net product transfer revenues, compared to the first quarter of 2008, where the revenue mix was 61% royalty revenues and 39% net product transfer revenues. Aldurazyme gross margins are expected to fluctuate depending on the mix of royalty revenue, from which we earn higher gross profit, and product transfer revenue, from which we earn a lower gross profit.

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Total cost of sales during the first quarters of 2008 and 2009, was $17.2 million and $14.4 million, respectively. The decrease in cost of sales is primarily due to the Aldurazyme product revenue mix in the first quarter of 2009 compared to the first quarter of 2008 as cost of sales related to Aldurazyme are recorded in the period the product is shipped to Genzyme offset by the increased net product revenues discussed above.

Collaborative Agreement Revenues

Collaborative agreement revenues include both license revenue and contract research revenue under our agreement with Merck Serono, which was executed in May 2005. License revenues are related to amortization of the $25.0 million up-front license payment received from Merck Serono and contract research revenues are related to shared development costs that are incurred by us, of which approximately 50% is reimbursed by Merck Serono. Our performance obligations related to the initial $25.0 million up-front license payment were completed in December 2008. Therefore, periods subsequent to December 31, 2008 will not include amortization amounts related to this payment. As shared development spending increases or decreases, contract research revenues will also change proportionately. Reimbursable revenues are expected to increase if PEG-PAL or 6R-BH4 successfully complete Phase II clinical trials and Merck Serono exercises its option to co-develop the program. The related costs are included in research and development expenses.

Collaborative agreement revenues in the first quarters of 2008 and 2009 were $2.5 million and $0.5 million, respectively. Collaborative agreement revenues in the first quarter of 2009 were comprised of reimbursable Kuvan development costs, compared to the first quarter of 2008 which included amortization of the $25.0 million up-front license payment received from Merck Serono and reimbursable Kuvan development of $1.5 million and $1.0 million, respectively. Kuvan development costs decreased during the first quarter of 2009 as compared to the first quarter of 2008 due to reductions in Kuvan clinical trial activities.

Royalty and License Revenues

Royalty and license revenue for the first quarter of 2009 totaled $1.6 million, compared to $0.3 million in the first quarter of 2008. Royalty and license revenues for the three months ended March 31, 2009 included royalty revenues from Orapred product sold by the sublicensee of $1.4 million and Kuvan royalty revenues for products sold in Japan and Europe of $0.2 million. Royalty and license revenues for the first quarter of 2008 included royalty revenues from Orapred product sold by the sublicensee of $0.3 million.

Research and Development Expense

Our research and development expense includes personnel, facility and external costs associated with the research and development of our product candidates and products. These research and development costs primarily include preclinical and clinical studies, manufacturing of our product candidates prior to regulatory approval, quality control and assurance and other product development expenses, such as regulatory costs.

Research and development expenses increased by $16.8 million to $34.4 million for the three months ended March 31, 2009, from $17.6 million for the three months ended March 31, 2008. The change in research and development expenses for the first quarter of 2009 is primarily as a result of the following (in millions):

Research and development expenses for period ended March 31, 2008	$ 17.6
License payment related to collaboration with La Jolla Pharmaceutical Company	8.8
Increased GALNS for Morquio Syndrome Type A development expense	2.8
Increased Kuvan development costs	0.7
Increased Prodrug development expenses	0.8
Increased stock-based compensation expense	0.9
Increased Duchene Muscular Dystrophy program development expense	0.3
Decreased 6R-BH4 development costs for indications other than PKU	(0.8)
Decreased research and development expense on early development stage programs	(0.3)
Increase in non-allocated research and development expense and other net changes	3.6
Research and development expenses for the period ended March 31, 2009	$ 34.4

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During the first quarter of 2009, we paid La Jolla Pharmaceutical Company an up-front license fee for the rights to develop and commercialize their investigational drug, Riquent, for the treatment of lupus nephritis. In February 2009, the results of the first interim efficacy analysis for the Phase III ASPEN Study were announced, and the Independent data Monitoring Board determined that the continuation of the trial was futile, as such we do not expect to continue incurring development costs for the licensed product. The increase in GALNS development costs is primarily attributed to an increase in pre-clinical studies and manufacturing costs in preparation for the Phase I/II clinical trial that we initiated in April 2009. The decrease in 6R-BH4 development costs for indications other than PKU is primarily due to a decline in pre-clinical studies in 2009. The increase in Kuvan research and development costs is attributed to long-term clinical activities related to post-approval regulatory commitments. We expect to continue incurring significant Kuvan research and development costs for the foreseeable future due to long-term clinical activities related to Kuvan post-approval regulatory commitments and spending on our GALNS program for the treatment of Morquio Syndrome Type A and PEG-PAL and Prodrug programs. The increase in stock-based compensation expense is a result of an increased number of options outstanding due to increased number of employees and a higher average stock price on the related grant date. The increase in non-allocated research and development primarily includes increases in facilities costs, general research costs and research and development personnel.

Selling, General and Administrative Expense

Our selling, general and administrative expense includes commercial and administrative personnel, corporate facility and external costs required to support our commercialized products and product development programs. These selling, general and administrative costs include: corporate facility operating expenses and depreciation; marketing and sales operations; human resources; finance, legal and support personnel expenses; and other external corporate costs such as insurance, audit and legal fees.

Selling, general and administrative expenses increased by $4.9 million, to $28.6 million for the three months ended March 31, 2009, from $23.7 million for the three months ended March 31, 2008. The components of the change for first quarter of 2009 primarily include the following (in millions):

Selling, general and administrative expense for the period ended March 31, 2008	$ 23.7
Increased Naglazyme sales and marketing expenses	1.2
Increased stock-based compensation expense	2.0
Increased Kuvan commercialization expenses	1.7
Increased foreign exchange losses on un-hedged transactions	(0.2)
Net increase in corporate overhead and other administrative costs	0.2
Selling, general and administrative expenses for the period ended March 31, 2009	$ 28.6

Naglazyme sales and marketing expenses increased in the first quarter of 2009, primarily due to the expansion of our international commercial activities. We also incurred increased commercialization expenses related to the Kuvan commercial launch. The increase in stock-based compensation expense was the result of an increased number of outstanding stock options and a higher average stock price on the related grant date. We expect selling, general and administrative expenses to increase in future periods as a result of the international expansion of Naglazyme and the U.S. commercialization activities for Kuvan.

Amortization of Intangible Assets

Amortization of acquired intangible assets includes the current amortization expense of the intangible assets acquired in the Ascent Pediatrics transaction in May 2004, including the Orapred developed and core technology. The Orapred intangible asset is being amortized over approximately 3.5 years, and is expected to total approximately $1.8 million through the end of its expected useful life in August 2009.

Kuvan license payments, recorded as intangible assets, made to third parties as a result of the Food and Drug Administration (FDA) approval of Kuvan in December 2007 and the European Medicines Agency (EMEA) approval of Kuvan in December 2008 are being amortized over approximately 7.0 years and 10.0 years, respectively. Amortization of the Kuvan intangible assets is recorded as a component of cost of goods sold and is expected to approximate $0.6 million annually through 2014 and $0.3 million annually through 2018. Amortization expense related to the Kuvan intangible assets for the three months ended March 31, 2008 and 2009 was $0.1 million and $0.2 million, respectively. The increase in Kuvan related amortization expense is attributed to the EMEA approval milestone paid in December 2008.

Equity in the Loss of BioMarin/Genzyme LLC

Equity in the loss of BioMarin/Genzyme LLC includes our 50% share of the joint venture s loss for the period. Effective January 2008, we and Genzyme restructured BioMarin/Genzyme LLC regarding the manufacturing, marketing and sale of Aldurazyme. As of January 1, 2008, BioMarin/Genzyme LLC s operations consist primarily of certain research and development activities and the intellectual property which continues to be managed by the joint venture with costs shared equally by BioMarin and Genzyme.

Equity in the loss of the joint venture remained materially consistent for the first quarter of 2009, compared to the first quarter of 2008 at approximately $0.5 million.

Interest Income

We invest our cash, short-term and long-term investments in government and other high credit quality securities in order to limit default and market risk. Interest income decreased to $2.2 million for the first quarter of 2009, from $5.6 million for the same period in 2008. The reduced interest yields during the first quarter of 2009 were due to lower market interest rates and decreased levels of cash and investments. We expect that interest income will decline in future quarters in 2009 as compared to 2008 due to reduced interest yields and lower cash and investment balances.

Interest Expense

We incur interest expense on our convertible debt. Interest expense also includes imputed interest expense on the discounted acquisition obligation for the Ascent Pediatrics transaction. Interest expense in each of the first quarters of 2008 and 2009 was $4.1 million and included $1.1 million of imputed interest. Imputed interest on the outstanding balance will be incurred through August 2009 when payment is due on the Medicis obligation.

Changes in Financial Position

March 31, 2009 Compared to December 31, 2008

From December 31, 2008 to March 31, 2009, our inventory increased by approximately $3.3 million. Our accounts receivable increased by $7.1 million due to increased sales of Naglazyme and Kuvan and receivables from Genzyme for Aldurazyme product transfer and royalty revenues. Other current assets decreased approximately $26.5 million from December 31, 2008 to March 31, 2009, primarily as a result of the subsequent receipt of the $30.0 million related to the EMEA milestone earned from Merck Serono in December 31, 2008. Our net property, plant and equipment increased by approximately $17.3 million from December 31, 2008 to March 31, 2009, primarily as a result continued expansion and improvements to our facilities practically offset by depreciation expense during the period. We expect property, plant and equipment to increase in future periods, due to several ongoing facility improvement projects.

Liquidity and Capital Resources

Cash and Cash Flow

As of March 31, 2009, our combined cash, cash equivalents, short-term and long-term investments totaled $555.9 million, a decrease of $5.5 million from $561.4 million at December 31, 2008. During the three months ended March 31, 2009, we financed our operations primarily through net product sales and available cash, cash equivalents, short-term and long-term investments and the related interest income earned thereon.

The decrease in our combined balance of cash, cash equivalents, short-term and long-term investments during the first quarter of 2009 was $5.5 million, which was $5.3 million less than the net decrease in cash, cash equivalents and short-term investments during the first quarter of 2008 of $10.8 million. The primary items contributing to the increase in net cash outflow in 2009 were as follows (in millions):

Decreased distributions from Genzyme/BioMarin LLC	$ (18.4)
Decreased capital asset purchases	1.2
Investment in La Jolla Pharmaceutical Company	(6.3)
Milestone payment received for Kuvan EMEA approval	30.0
Decreased proceeds from ESPP and stock option exercises	(13.4)
Net decreased cash used in operating activities, including net payments for working capital, other	12.2
Total decrease in net cash outflow	$ 5.3

The net decrease in operating spend includes increases in cash receipts from net revenues partially offset by increases in cash payments made for operating activities, such as research and development and sales and marketing efforts, as discussed in the *Results of Operations* section above. Increased capital purchases primarily relate to continued expansion of corporate and manufacturing facilities at our Novato, California campus. Net payments for working capital in the first quarter of 2009 primarily include decreased inventory build of $7.7 million, which excluded the inventory distribution from the joint venture, decreased accounts receivable build of $23.2 million, the receipt of the Merck Serono $30.0 million milestone payment earned in December 2008 related to the EMEA approval of Kuvan, and decreased accounts payable and accrued liabilities build of $3.6 million.

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With respect to the restructuring of our joint venture with Genzyme, our liquidity was not materially impacted by the restructuring despite the change in the Aldurazyme transaction structure. We remain responsible for the cash outflows for the investment in inventory and continue to receive the cash inflows from sales of Aldurazyme on a quarterly basis, except we currently receive cash through the royalty from Genzyme instead of cash distributions from the joint venture prior to the restructuring. However, as we now record accounts receivable from Genzyme that include both amounts related to royalty revenue and incremental product transfer revenue, our days sales outstanding has increased as a result of the joint venture restructuring and we expect our days sales outstanding to either remain consistent with the current level or increase modestly in the future. Genzyme is required to pay the royalty due within 45 days of the quarter in which the relevant sales were made, and with respect to the incremental product transfer revenue for unsold Aldurazyme, Genzyme is required to pay within 45 days after the calendar quarter in which the unit was determined to be unsold, which is not determinable until the product is lost, destroyed or expires before a sale to a customer. Further, pursuant to the terms of the restructured joint venture, we received a cash distribution of $16.7 million and an inventory distribution of $26.8 million from the joint venture in the first quarter of 2008.

We expect that our net cash outflow in the remainder of 2009 related to capital asset purchases will increase significantly compared to 2008. The expected increase in capital asset purchases primarily includes: expansion of our manufacturing facility, increased spending on manufacturing and lab equipment, expansion of our corporate campus including leasehold improvements and the continued development of information technology systems upgrades.

We have historically financed our operations primarily by the issuance of common stock, convertible debt and by relying on equipment and other commercial financing. During the remainder of 2009, and for the foreseeable future, we will be highly dependent on our net product revenue to supplement our current liquidity and fund our operations. We may in the future elect to supplement this with further debt or equity offerings or commercial borrowing. Further, depending on market conditions, our financial position and performance and other factors in the future we may choose to use a portion of our cash or cash equivalents to repurchase our convertible debt or other securities.

Funding Commitments

We expect to fund our operations with our net product revenues from Naglazyme, Aldurazyme and Kuvan, cash, cash equivalents and short-term investments supplemented by proceeds from equity or debt financings, loans or collaborative agreements with corporate partners, to the extent necessary. We expect our current cash, cash equivalents and short-term investments will meet our operating and capital requirements for the foreseeable future based on our current long-term business plans and assuming that we are able to achieve our long-term goals. This expectation could also change depending on how much we elect to spend on our development programs and for potential licenses and acquisitions of complementary technologies, products and companies.

Our investment in our product development programs and continued development of our existing commercial products has a major impact on our operating performance. Our research and development expenses for the three months ended March 31, 2008 and 2009 and for the period since inception (March 1997 for the portion not allocated to any major program) represent the following (in millions):

	Three Months Ended March 31,		Since Program Inception
	2008	2009	
Naglazyme	$ 2.2	$ 2.3	$ 124.9
Kuvan	2.0	2.6	92.4
GALNS for Morquio disease	1.4	4.1	20.5
6R-BH4 for other indications	3.5	3.1	45.2
PEG-PAL	2.3	2.3	33.5
Not allocated to specific major current projects	5.6	8.6	186.5
	$ 17.0	$ 23.0	$ 503.0

We cannot estimate the cost to complete any of our product development programs. Additionally, except as disclosed under *Overview* above, we cannot estimate the time to complete any of our product development programs or when we expect to receive net cash inflows from any of our product development programs. Please see *Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008, for a discussion of the reasons that we are unable to estimate such information, and in particular the following risk factors included in our Form 10-K If we fail to maintain regulatory approval to commercially market and sell our drugs, or if approval is delayed, we will be unable to generate revenue from the sale of these products, our potential for generating positive cash flow will be diminished, and the capital necessary*

to fund our operations will be increased; To obtain regulatory approval to market our products, preclinical studies and costly and lengthy preclinical and clinical trials are required and the results of the studies and trials are highly uncertain; If we are unable to successfully develop

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manufacturing processes for our drug products to produce sufficient quantities and at acceptable costs, we may be unable to meet demand for our products and lose potential revenue, have reduced margins or be forced to terminate a program; If we fail to compete successfully with respect to product sales, we may be unable to generate sufficient sales to recover our expenses related to the development of a product program or to justify continued marketing of a product and our revenue could be adversely affected; and If we do not achieve our projected development goals in the time frames we announce and expect, the commercialization of our products may be delayed and the credibility of our management may be adversely affected and, as a result, our stock price may decline.

We may elect to increase our spending above our current long-term plans and may be unable to achieve our long-term goals. This could increase our capital requirements, including: costs associated with the commercialization of our products; additional clinical trials and the manufacturing of Naglazyme, Aldurazyme and Kuvan; preclinical studies and clinical trials for our other product candidates; potential licenses and other acquisitions of complementary technologies, products and companies; general corporate purposes; payment of the amounts due with respect to the Ascent Pediatrics transaction; and working capital.

Our future capital requirements will depend on many factors, including, but not limited to:

- our ability to successfully market and sell Naglazyme and Kuvan;
- Genzyme s ability to successfully market and sell Aldurazyme;
- the progress, timing, scope and results of our preclinical studies and clinical trials;
- the time and cost necessary to obtain regulatory approvals and the costs of post-marketing studies which may be required by regulatory authorities;
- the time and cost necessary to develop commercial manufacturing processes, including quality systems and to build or acquire manufacturing capabilities;
- the time and cost necessary to respond to technological and market developments;
- any changes made to or new developments in our existing collaborative, licensing and other commercial relationships or any new collaborative, licensing and other commercial relationships that we may establish; and
- whether our convertible debt is converted to common stock in the future.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that are currently material or reasonably likely to be material to our financial position or results of operations.

Borrowings and Contractual Obligations

In April 2007, we sold approximately $324.9 million of senior subordinated convertible debt due April 2017. The debt was issued at face value and bears interest at the rate of 1.875% per annum, payable semi-annually in cash. The debt is convertible, at the option of the holder, at any time prior to maturity, into shares of our common stock at a conversion price of approximately $20.36 per share, subject to adjustment in certain circumstances. There is a no call provision included and we are unable to unilaterally redeem the debt prior to maturity in 2017. We also must repay the debt if there is a qualifying change in control or termination of trading of our common stock. In March 2006, we sold approximately

$172.5 million of senior subordinated convertible notes due 2013. The debt was issued at face value and bears interest at the rate of 2.5% per annum, payable semi-annually in cash. There is a no call provision included and we are unable to unilaterally redeem the debt prior to maturity in 2013. The debt is convertible, at the option of the holder, at any time prior to maturity, into shares of our common stock at a conversion price of approximately $16.58 per share, subject to adjustment in certain circumstances. However, we must repay the debt prior to maturity if there is a qualifying change in control or termination of trading of our common stock. Our $497.1 million of convertible debt will impact our liquidity due to the semi-annual cash interest payments and the scheduled repayments of the debt.

As a result of the Ascent Pediatrics transaction, we expect to pay Medicis $72.1 million through the end of 2009, of which $8.6 million at our election is payable through the issuance of our common stock.

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We have contractual and commercial obligations under our debt, operating leases and other obligations related to research and development activities, purchase commitments, licenses and sales royalties with annual minimums. Information about these obligations as of March 31, 2009 is presented below (in thousands).

	Payments Due by Period					
	2009	2010	2011-2012	2013-2014	2015 and Thereafter	Total
Medicis obligations	$ 72,100	$	$	$	$	$ 72,100
Convertible debt and related interest	8,246	10,401	20,801	186,544	340,104	566,096
Operating leases	2,832	3,859	6,481	3,423	3,158	19,753
Research and development and purchase commitments	31,218	14,787	5,162	4,820	3,084	59,071
Total	$ 114,396	$ 29,047	$ 32,444	$ 194,787	$ 346,346	$ 717,020

We are also subject to contingent payments related to various development activities totaling approximately $108.0 million, which are due upon achievement of certain regulatory and licensing milestones, and if they occur before certain dates in the future.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Our market risks at March 31, 2009 have not changed significantly from those in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2008, on file with the Securities and Exchange Commission (SEC).

Item 4. Controls and Procedures

(a) *Controls and Procedures*

An evaluation was carried out, under the supervision of and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report.

Based on the evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls are effective to ensure that the information required to be disclosed by us in this Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC s rules and instructions for Form 10-Q.

(b) *Change in Internal Controls over Financial Reporting*

There were no changes, except as noted below, in our internal control over financial reporting during our most recently completed quarter that have materially affected or are reasonably likely to materially affect our internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act.

On January 1, 2009, we implemented a new Enterprise Resource Planning (ERP) system. As appropriate, we have modified the design and operation of our internal controls to supplement the ERP system and complement existing internal controls over financial reporting. Based on management s evaluation, the necessary steps have been taken to monitor and maintain appropriate internal control over financial reporting during this period.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors

The risk factors previously disclosed in Part 1, Item 1A of our Form 10-K for the fiscal year ended December 31, 2008 have remained substantially unchanged.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

10.1	Employment Agreement dated March 18, 2009 with Henry J. Fuchs, previously filed with the Commission on March 23, 2009 as Exhibit 10.1 to the Company s Current Report on Form 8-K, which is incorporated by reference.
10.2+	Development and Commercialization Agreement dated as of January 4, 2009 by and between BioMarin CF Limited and La Jolla Pharmaceutical Company, previously filed with the Commission on February 27, 2009 as Exhibit 10.29 to the Company s Annual Report on Form 10-K, which is incorporated by reference.
10.3+	Securities Purchase Agreement dated as of January 4, 2009 by and between BioMarin Pharmaceutical Inc. and La Jolla Pharmaceutical Company, previously filed with the Commission on February 27, 2009 as Exhibit 10.30 to the Company s Annual Report on Form 10-K, which is incorporated by reference.
10.4	Amendment No. 1 to the Development and Commercialization Agreement dated as of January 16, 2009 by and between BioMarin CF Limited and La Jolla Pharmaceutical Company, previously filed with the Commission on February 27, 2009 as Exhibit 10.31 to the Company s Annual Report on Form 10-K, which is incorporated by reference.
10.5	Amendment No. 1 to the Securities Purchase Agreement dated as of January 16, 2009 by and between BioMarin Pharmaceutical Inc. and La Jolla Pharmaceutical Company, previously filed with the Commission on February 27, 2009 as Exhibit 10.32 to the Company s Annual Report on Form 10-K, which is incorporated by reference.
31.1*	Certification of Chief Executive Officer pursuant to Rules 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer pursuant to Rules 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This Certification accompanies this report and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed for purposes of §18 of the Securities Exchange Act of 1934, as amended.

* Filed herewith

\+ Pursuant to a request for confidential treatment, portions of this Exhibit have been redacted from the publicly filed document and have been furnished separately to the Securities and Exchange Commission as required by Rule 24b-2 under the Securities Exchange Act of 1934, as amended.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Cost of services and products increased $155 in 2003. The increase was primarily caused by cost of equipment increases from higher gross additions and upgraded handsets. Increases in cost of services also reflect higher interconnect costs driven by $39 of additional expense recorded in Ecuador associated with an interconnect settlement previously described, as well as growth in minutes of use, partially offset by devaluation in Venezuela.

Costs also increased due to a $40 contingency accrual recorded in 2003. Changes in administrative regulations in one of the countries in which we operate, regarding the inclusion of interconnection income in the taxable revenue base, contradicted the method of calculation used by our subsidiary in computing and paying its liability for taxes on telecommunications services. We believe we have a valid argument under existing law for our method of calculating the tax. However, because of uncertainty in the outcome of this issue, our subsidiary has recorded a contingency accrual for prior unpaid taxes based on the new regulations and it intends to calculate taxes in future periods in conformity with these regulations until the legal issues are

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

BELLSOUTH CORPORATION

resolved. We plan to defend our position, in the courts if necessary. We cannot predict how long it will take to resolve this issue, however we do not expect the impact, if any, to be material to our results of operations, financial position or cash flows.

The cost of services change also was impacted by a $24 decrease in 2003 due to the exit from the advertising and publishing business in 2002.

Selling, general, and administrative expenses

Selling, general, and administrative expenses decreased $72 in 2003. The decrease in US Dollar terms was caused primarily by the currency devaluation in Venezuela, which recorded a decline of $31, and by a decrease of $33 related to the exit from the advertising and publishing business in 2002.

In local currency terms, selling, general, and administrative expenses increased modestly due to strong customer growth, as well as inflationary pressures, partially offset by cost containment efforts and operational efficiencies. Customer gross adds increased 28.6%, and the customer base increased by 18.6% as compared to the prior year. The variance in 2003 also reflects a benefit in Ecuador associated with cumulative future deductions to be used to calculate employee profit-sharing expense.

Depreciation and amortization

Depreciation and amortization expense decreased $73 in 2003, reflecting the impact of currency devaluations on the amortizable basis of tangible and intangible assets and the impact of certain customer intangibles becoming fully amortized.

Net earnings (losses) of equity affiliates

Net earnings from our Latin America Group equity affiliates improved from a loss of ($10) in 2002 to income of $18 in 2003, primarily as a result of the cessation of recording losses from our equity investments in Brazil during the second quarter of 2002.

2002 COMPARED TO 2001

Segment operating revenues

Segment operating revenues decreased $697, or 23.7%, in 2002. The decrease was almost entirely attributable to the continued weakening of our Latin America operations local currencies against the US Dollar. Significant economic challenges continued in Argentina and Venezuela, two of BellSouth s largest Latin America markets. The currency devaluations that began during the first quarter continued to worsen throughout the year. As of November 30, 2002, the Argentine Peso had devalued approximately 71% relative to the US Dollar and the Venezuelan Bolivar had depreciated approximately 44% since the beginning of 2002. The decreases in Argentina and Venezuela were partially offset by increases in service revenues totaling $118 at our operations in Colombia and Ecuador, attributable to growth in the customer bases of those operations.

Other revenues relate primarily to wholesale long distance voice, data access and transport and Internet access. The decrease in 2002 related primarily to currency fluctuations. Advertising and publishing revenues decreased in 2002 due to devaluation, competitive pressures and our exit of the business in 2002. Revenue per customer decreased in 2002 primarily due to the effect of foreign currency translation.

Segment operating expenses

Cost of services and products

Cost of services and products decreased $220, or 20.7%, in 2002. The 2002 decrease was almost entirely attributable to the declining value of most Latin American currencies against the US Dollar. Reductions in expenses are also being driven by lower customer acquisition costs.

Selling, general, and administrative expenses

Selling, general, and administrative expenses decreased $323, or 32.3%, in 2002. The 2002 decrease was almost entirely attributable to the declining value of most Latin American currencies against the US Dollar. Reductions in expenses are also being driven by targeted reductions in administrative costs through headcount reductions.

Depreciation and amortization

Depreciation expense decreased $86 in 2002 as a result of currency devaluations and true-ups of depreciation on network assets in Chile and Colombia. Amortization expense decreased $79 during 2002 primarily as a result of the cessation of amortization of goodwill due to the adoption of SFAS No. 142, and to a lesser extent, to the effect of foreign currency translation.

Net earnings (losses) of equity affiliates

Net losses from our Latin America Group equity affiliates improved $26 to $(10) in 2002. The 2002 improvement was primarily due to the cessation of recording losses in our Brazil investments during the second quarter of 2002.

Unusual items excluded from segment net income

Unusual items which were excluded from this segment s results consisted of the following: in 2003, $(120) related to loss on disposal of our wireless property in Brazil-Sao Paulo, bond impairment, loan write-off and severance costs, partially offset by foreign currency transaction gains, gain on sale of stock and gain on sale of our wireless property in Brazil NE; in 2002, $(2,198) related to impairment losses under SFAS No. 142, foreign currency transaction losses, Brazil loan impairment, losses on the sale of Brazilian yellow

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pages operation, asset impairments and severance costs, partially offset by gain on sale of stock; in 2001, $(346) related to foreign currency transaction losses, asset impairments and restructuring costs, partially offset by a gain from the sale of our investment in BellSouth International Wireless Services.

Advertising and Publishing Group

Our Advertising and Publishing Group is comprised of companies in the US that publish, print, sell advertising in and perform related services concerning alphabetical and classified telephone directories and electronic product offerings.

As discussed more fully in Note C to our consolidated financial statements, effective January 1, 2003, we changed our method for recognizing revenues and expenses related to our directory publishing business from the publication and delivery method (issue-basis) to the deferral method (deferral basis). For BellSouth s consolidated results, this change was treated as a prospective change and prior year consolidated results were not restated. However, to align internal reporting, the 2002 and 2001 segment results for the Advertising and Publishing Group were recast to reflect the change.

Under the issue basis, we recognized 100% of revenues and direct expenses at the time the directories were published and delivered. Under the deferral basis, we amortize, or recognize ratably, revenues and direct expenses over the life of the related directory, generally 12 months. When compared to the issue-basis method, the deferral method causes trends in current-period operating results to be recognized in the income statement over a longer period of time and to cross fiscal years.

In 2003, our Advertising and Publishing Group was negatively affected by weak economic conditions and competition. Although an improving economy should result in higher advertising spending, we expect continued competitive pressure to impact volumes and pricing.

				Percent Change	
	2001	**2002**	**2003**	**2002 vs. 2001**	**2003 vs. 2002**
Segment operating revenues					
Advertising and publishing revenues	$1,966	$2,010	**$1,906**	2.2	**(5.2)**
Commission revenues	124	147	**144**	18.5	**(2.0)**
Total segment operating revenues	2,090	2,157	**2,050**	3.2	**(5.0)**
Segment operating expenses:					
Cost of services and products	390	351	**345**	(10.0)	**(1.7)**
Selling, general, and administrative expenses	689	879	**706**	27.6	**(19.7)**
Depreciation and amortization	29	29	**26**	0.0	**(10.3)**
Total segment operating expenses	1,108	1,259	**1,077**	13.6	**(14.5)**
Segment operating income	982	898	**973**	(8.6)	**8.4**
Segment net income	$ 596	$ 545	**$ 600**	(8.6)	**10.1**
Segment net income including unusual items	$ 593	$ 428	**$ 96**	(27.8)	**(77.6)**
Capital Expenditures	$ 63	$ 29	**$ 28**	(54.0)	**(3.4)**

2003 COMPARED TO 2002

Segment operating revenues

The overall industry environment continues to reflect weak economic conditions and increasing competitive activity. Segment operating revenues decreased $107 from 2002 to 2003. The decrease includes a reduction in print revenues due to lower overall spending by our advertisers. The decline in print revenue was partially offset by an increase in revenues from electronic media offerings, resulting from increased penetration of the print customer base. Sales agency commission revenues decreased slightly as the result of a discontinued line of business.

Because of the accounting convention used for publishing revenue, the revenue decline during 2003 was primarily driven by the amortization of revenues from directories issued in 2002, and to a lesser extent from those issued in 2003. Revenues from directories issued in 2003 also declined when compared to their 2002 issues attributable to the factors discussed previously. Approximately 50% of the decline was recognized in the segment s 2003 income statement, with the remainder to be recognized in 2004.

Segment operating expenses

Cost of services and products decreased $6 in 2003, primarily reflecting the impact of manufacturing cost reduction efforts. Selling, general, and administrative expenses decreased $173 in 2003. Uncollectible expense was the primary driver of the reductions, decreasing $141. The decrease reflects the impact of improved collection performance in 2003. In addition, variable costs associated with selling decreased as the result of the reduction in revenues. Depreciation and amortization expenses were relatively flat in 2003.

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

BELLSOUTH CORPORATION

2002 COMPARED TO 2001

Segment operating revenues

Segment operating revenues increased $67 during 2002. The improvement was attributable to several factors, including improvements in print customer adjustment activity and an increase in revenues from electronic media offerings resulting from further penetration of the print customer base. Print revenues were relatively flat, reflecting the impact on the overall industry of weak economic conditions and increased competitive activity. Sales agency commission revenues increased as the result of new agency agreements generated outside of the Southeastern US.

Segment operating expenses

Cost of services and products decreased $39 in 2002. The decrease primarily reflects the impact of cost reduction efforts in manufacturing and distribution expenses. Selling, general, and administrative expenses increased $190 in 2002. This increase is primarily due to a higher provision for uncollectible receivables expense that increased $181 for 2002. The higher provision was primarily due to weak economic conditions and increased bankruptcies of our advertisers. Depreciation and amortization remained flat in 2002.

Unusual items excluded from segment net income

Unusual items which were excluded from this segment s results consisted of the following: in 2003, $(504) included the cumulative effect of a change in accounting principle and severance and pension costs; in 2002, $(117) related to an unbilled receivable adjustment, severance costs and employee benefits related to workforce reduction; in 2001, $(3) related to restructuring costs.

Liquidity and Financial Condition

DESCRIPTION OF CASH FLOWS

Net cash provided by (used for):

				Percent Change	
	2001	2002	2003	2002 vs. 2001	2003 vs. 2002
Operating activities	$ 7,998	$ 8,246	**$ 8,529**	3.1	**3.4**
Investing activities	(7,039)	(1,707)	**(1,698)**	75.7	**0.5**
Financing activities	(1,428)	(4,649)	**(4,757)**	(225.6)	**(2.3)**

Net cash provided by operating activities

Cash generated by operations increased $283 during 2003 compared to the prior year. The increase was driven primarily by lower severance payments and better receivables collections. Severance payments of $125 in 2003 declined $369 as compared to $494 of payments in 2002. We have enhanced our processes with respect to receivable collection management resulting in improved collections as net accounts receivable decreased $356 (excluding the accounts receivable decrease impacted by the advertising and publishing accounting change). Decreases in interest income, due to lower rates on our advance to Cingular and the loss of income on an advance to KPN were substantially offset by lower interest expense due to lower borrowings. Operating cash flows for the next few years will be negatively impacted by higher federal income tax payments as the timing of accelerated tax deprecation in 2002 and 2003 begins to reverse.

Cash generated by operations increased $248 during 2002 compared to 2001, favorably impacted by lower income tax payments of $431 and a $200 payment made in 2001 to a supplier settling a lawsuit. The reduction of income tax payments in 2002 from 2001 is primarily due to additional accelerated depreciation and severance deductions in 2002. These cash increases were somewhat offset by lower operating cash flows in the Communications Group impacted by a decline in revenue.

Net cash used for investing activities

Capital expenditures

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

Total investment in property, plant and equipment has increased from $58 billion at January 1, 1999 to $66 billion at December 31, 2003, not including deductions for accumulated depreciation. Between 1999 and 2001, significant additions to property, plant and equipment were required to meet the growing demand for telecommunications services and to continually modernize and improve such services to meet competitive demands. However, during late 2001 through 2003 demand decreased significantly. Although current demand is down, we project continued population and economic expansion in certain growth centers within our nine-state area during the next five to ten years. In addition, our Latin America Group will continue to make investments to transition technology for its wireless networks and to support customer growth.

Our capital expenditures for 1999 through 2003 were as follows:

	Millions	% of Revenue

1999	$6,200	24.6
2000	$6,995	26.7
2001	$5,997	24.9
2002	$3,785	16.9
2003	**$3,200**	**14.1**

Decreases in capital spending levels in 2002 and 2003 reflect continued decreases in demand and targeted capital deployment. We project 2004 capital expenditures to be between 13 and 15 percent of revenue. A majority of the expenditures will be to expand, enhance and modernize current wireline operating systems.

We expect expenditures for 2004 to be financed substantially through internal sources and, to the extent necessary, from external financing sources.

Other investing activities

Other 2003 investing activities include net proceeds of $1,458 resulting from an early repayment by KPN of the entire outstanding balance of the loan we had extended to them and the settlement of related currency swaps. In addition, we received proceeds of $35 from the exercise of a loan put agreement with our Colombian partner, proceeds of $70 related to the sale of two equity investments in Brazil, and proceeds of $105 related to the sale of equity securities. In June 2003, we sold our entire interest in two real estate partnerships for net proceeds of $26. In conjunction with the sale, we received proceeds of $97 for the repayment of loans we had extended to the partnerships. During 2003, we purchased $261 in debt and equity securities.

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Other 2002 investing activities include receipt of $2,358 in proceeds from the sale of shares in Qwest, KPN and portions of our investment in TCO as well as proceeds from a principal payment related to a loan to KPN. In addition, we contributed a total of $309 to equity affiliates, including $200 to Cingular and $94 to Brazil. The $200 contribution related to income tax benefits realized by BellSouth associated with our investment in Cingular.

During 2001, we advanced $1,850 to E-Plus via demand notes that replaced previously guaranteed debt, invested $279 in loan participation agreements related to our Colombian operations and invested approximately $105 in our Brazilian wireless affiliates. We also generated approximately $1,100 from the sale of a portion of our investment in Qwest common stock.

In February 2004, we closed on the sale of our interest in Sonofon. We received approximately $600 in proceeds.

Net cash used for financing activities

Cash used for financing activities increased $108 during 2003 compared to 2002 due primarily to an increase in dividends paid of $148 and an increase in purchases of treasury shares of $267, partially offset by a reduction in debt pay downs of $256. During 2003, we paid dividends of $.87 per share totaling $1,608 and purchased 35.0 million shares of our common stock for $858. During 2002, we paid dividends of $.78 per share totaling $1,460 and purchased 22.3 million shares of our common stock for $591. Dividends paid in 2001 were $.76 per share totaling $1,424.

We utilized cash in 2003 to pay down short-term borrowings by $427 and long-term notes by $1,932. Our debt to total capitalization ratio of 43.1% at December 31, 2003 decreased from 49.2% at December 31, 2002, reflecting both the $2.4 billion debt pay down for both short-term and long-term notes as well as an increase in equity due to earnings partially offset by dividends declared.

The increase in cash used for financing activities during 2002 compared to 2001 reflects substantial debt pay downs during 2002. We utilized cash from operations to reduce our short-term borrowings by $1,408 and long-term notes by $1,223. This includes early extinguishment of $1,120 in long-term debt, which resulted in a loss on extinguishment of $40.

Our debt to total capitalization ratio of 49.2% at December 31, 2002 decreased from 51.7% at December 31, 2001 reflecting the $2.6 billion debt pay down for both short-term and long-term notes described above.

Anticipated sources and uses of funds

Cash flows from operations are our primary source of cash for funding existing operations, capital expenditures, interest and principal payments on debt, and dividend payments to shareholders. Should the need arise, however, we believe we are well positioned to raise capital in the public debt markets. As of December 31, 2003 our consolidated cash balance was $4,556.

The Communications Group and Advertising and Publishing Group generate substantially all of our consolidated cash provided by operating activities. These segments generate sufficient cash flow to fund operating, investing and financing needs and dividend excess cash to BellSouth for corporate uses. The Domestic Wireless segment, which consists entirely of our equity investment in Cingular, typically does not rely on BellSouth for funding; Cingular generates sufficient cash flow to meet its operating, investing and financing needs through its own operations or through its own financing activities.

Although the Latin America Group currently holds approximately $1,000 in cash, it has not historically remitted dividends to BellSouth. The local currency equivalent of US $346 was held in local accounts in Venezuela at November 30, 2003. Due to government restrictions, we have not been able to freely convert this local currency to US Dollars at the official rate. We have converted some, and we are seeking to convert

more, of this local currency to US Dollars in the parallel market. As discussed below, some of the operations within this segment may experience financing needs for the purchase of additional ownership interests or to meet debt payments that could require funding from other financing sources. We are restricting new investment in Latin America and expect that the group will fund its financial needs from current cash and the group s future cash flow from operations. We do not expect to enter into additional, or increase existing, debt guarantees.

In addition, cash includes $144 held in grantor trusts that is not readily available for general corporate purposes.

At December 31, 2003, our long-term debt rating was A1 from Moody s Investor Service and A+ from Standard and Poor s. Our short-term credit rating at December 31, 2003 was P-1 from Moody s and A-1 from Standard and Poor s. Moody s and Standard & Poor s have placed us on negative credit watch due to the Cingular announcement as described below. Our authorized commercial paper program as of December 31, 2003 is $8.0 billion, with $1.5 billion outstanding. We believe we have ready access to the commercial paper market in the event funding in excess of our operating cash flows is needed. We also have a registration statement on file with the SEC under which $2.3 billion of long-term debt securities could be issued. We believe that these sources of funds will be sufficient to meet the operating needs of our business for at least the next twelve months.

On February 17, 2004, Cingular announced an agreement to acquire AT&T Wireless Services, Inc. in an all cash transaction. Under the terms of the agreement, which were approved by our board of directors and the boards of directors of SBC and Cingular as well as AT&T Wireless, shareholders of AT&T Wireless will receive $15 cash per common share or approximately $41 billion. The acquisition, which is subject to the approvals of AT&T Wireless shareholders and federal regulatory authorities, and to other customary closing conditions, is expected to be completed in the fourth quarter of 2004.

We have committed to funding our proportionate share of the all cash transaction. We expect our funding requirement will be approximately $16 billion. Funding will be achieved through a combination of existing cash on hand, cash generated from our operations prior to closing and potential asset sales. We plan to access the public debt markets for the remainder. At the time of closing, we currently anticipate our likely external funding needs to be in the $9.5 to $10.5 billion range.

Cingular expects to achieve significant operating and capital synergies through this acquisition by consolidating networks, distribution, billing, procurement, marketing, advertising and other functions. Due to the impacts of purchase accounting at Cingular, integration costs and additional financing costs of indebtedness we expect to incur to satisfy our funding commitment to the transaction, we expect some dilution to GAAP earnings per share in the first few years subsequent to the closing of the transaction.

SBC s and BellSouth s proportionate equity stake in Cingular will remain unchanged following the transaction, with SBC holding 60 percent and BellSouth 40 percent. SBC and BellSouth will continue to have equal management control.

CASH MANAGEMENT

BellSouth s primary source of cash flow is dividends from its subsidiaries. Generally, we do not permit our subsidiaries to accumulate cash, requiring them to pay out either net income or cash flow available in the form of dividends. BellSouth Telecommunications pays dividends in the amount of net income. For all other wholly owned domestic subsidiaries, companies must pay out cash flow available (less interest expense) if it exceeds net income. Any funding requirements for wholly owned domestic subsidiaries are filled by BellSouth Corporation. Cingular pays dividends to BellSouth in an amount equal to cash taxes paid by BellSouth on behalf of Cingular. Latin American subsidiaries dividend policies vary by company and are dependent upon financing needs and ownership structure. All Latin America Group dividends are invested in the region and funds may be loaned from one subsidiary to another to facilitate funding needs.

DEBT INSTRUMENTS

Publicly held indebtedness

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

International operations

Our Latin American operations generally have local credit facilities denominated in local currency and other facilities denominated in US dollars. We are seeking, where feasible, to replace our dollar denominated debt with local currency facilities to reduce the impact of currency fluctuations on our operations. Except as noted below, these facilities are generally non-recourse to BellSouth. The facilities have customary terms and financial covenants for non-recourse obligations of this type.

BellSouth Enterprises, a subsidiary of BellSouth, has guaranteed our Chilean operation s $180 syndicated loan facility, our Peruvian operation s $200 credit facility and approximately $30 of the long-term debt of our Guatemalan operation. The credit facilities of our Latin American operations in many cases may become due and payable upon a change of control or the sale of the operation to a third party.

Our operation in Colombia, of which BellSouth owns 66%, has outstanding $346 of indebtedness pursuant to its senior credit facilities. The debt is non-recourse to BellSouth. In 2003, the Colombian operations commenced negotiations with the lenders of these facilities to extend the facilities amortization schedule. To facilitate the negotiations, the lenders have agreed to waive certain financial covenants until February 27, 2004. If the refinancing is not completed prior to the expiration of the waiver, the Colombian operations may be in default of debt service coverage ratio and minimum EBITDA covenants. In this event, after the

expiration of applicable cure periods, the lenders could declare the facilities to be immediately due and payable. Although the Colombian operations currently expect to seek an additional waiver for a limited time to permit completion of the negotiations, if necessary, there can be no assurance that the negotiations will be concluded successfully.

Our operation in Argentina, of which BellSouth owns 86.7%, is in default on $490 of its US Dollar-denominated debt as a result of the cumulative devaluation of the Argentina Peso. The debt is non-recourse to BellSouth. The Argentine operations are currently working with lenders to resolve this matter. However, there can be no assurance that this debt can be successfully refinanced.

Line of credit

We have a syndicated line of credit in the amount of $1,500 that we would use in the event we are unable to access the commercial paper market. We do not have any balances outstanding under the line of credit. Except as described in this paragraph, the line of credit contains no financial covenants or requirements for compensating balances. The line of credit does not contain any provisions that are tied to the ratings assigned to us or our affiliates

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by an external debt rating agency. At our election, any outstanding borrowings may be converted to a one-year term, in which case the debt of the company and its consolidated subsidiaries are not permitted to exceed 300% of consolidated earnings before interest, taxes, depreciation and amortization on a rolling four-quarter basis. In addition, the line of credit prohibits the company and its significant subsidiaries from permitting liens to be placed on their properties or assets except in specified circumstances. If BellSouth or any of our subsidiaries, except for our Latin American entities, defaults on any outstanding debt in excess of $200, this will cause an event of default to occur under the line of credit. If we draw on this line of credit, a similar event of default clause will be brought into certain of our Latin American credit facilities. If the line of credit is not drawn and the term conversion is not exercised, the line of credit will expire on April 30, 2004. We expect to enter into a new line of credit on substantially similar terms.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

OFF-BALANCE SHEET ARRANGEMENTS

We have guaranteed approximately $30 of the long-term debt of our Guatemalan entity. We own 60% of that company and we account for it using the equity method.

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

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

CONTRACTUAL OBLIGATIONS

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

	Payments Due by Period				
	Total	**Less than 1 year**	**2005-2007**	**2008-2010**	**After 2010**
Debt maturing within 1 year	$ 1,637	$1,637	$	$	$
Long-term debt[(1)]	13,742	1,897	3,314	1,990	6,541
Operating leases	988	160	363	210	255
Unconditional purchase obligations[(2)]	3,563	807	2,156	600	
Interest rate swaps[(3)]	77	38	31	8	
Total contractual cash obligations	$20,007	$4,539	$5,864	$2,808	$6,796

(1) The long-term debt amount above excludes $(116) of unamortized discounts and premiums included in long-term debt on the balance sheet as of December 31, 2003. Payments after the year 2010 include the final principal amount of $500 for the Zero-to-Full Debentures due in 2095, which have a carrying value of $217 as of December 31, 2003.

(2) The total unconditional purchase obligation includes $323 related to agreements with Qwest and Accenture that do not stipulate annual minimum purchases. The agreement with Qwest expires in 2006 and the Accenture agreement expires in 2007. These amounts are included in the 2005 - 2007 column.

(3) The amounts due for the interest rate swaps and forward contracts are based on market valuations at December 31, 2003. Actual payments, if any, may differ at settlement date.

Pensions and other retiree benefits

As of December 31, 2003, our defined benefit pension plans were fully funded. Therefore, we do not currently anticipate any cash funding needs to meet minimum required funding thresholds. Other retiree benefits, primarily health and life benefits, are generally funded to cover current year claims. Over the past three years, funding for other retiree benefits was $425 in 2001, $493 in 2002, and $563 in 2003. We anticipate funding in 2004 to be in the range of $475 to $525.

OTHER POTENTIAL OBLIGATIONS

Debt put options

Several issues of long-term debt included in the table above contain embedded options which may require us to repurchase the debt or which alter the interest rate associated with that debt. Please refer to Note H to our consolidated financial statements for further information on these instruments. Those issues, their amounts and the date of the related options, are as follows:

Issue	Amount	Date of Put Option
20-put-1 Securities	$1,000	Annually in April
Extendible Liquidity Securities	745	Quarterly
Putable debentures	281	November 2006

Venezuelan put-call provision

We own a 78.2% interest in Telcel, our Venezuelan operation. Telcel s other major shareholder holds an indirect 21% interest in Telcel. Under a Stock Purchase Agreement, that shareholder has the right to initiate a process that could require us to purchase (the puts), and we have the right to initiate a process that could require that shareholder to sell (the calls) to us, the shareholder s interest in Telcel. Notice of the initiation of the process with respect to approximately half of that shareholder s interest was to be given in 2000 and notice with respect to the remaining balance was to be given in 2002. If we exercise our call right, we would purchase that shareholder s interest at between 100% and 120% of its appraised fair value. If we are required to purchase the interest, we would do so at between 80% and 100% of its appraised fair value.

In 2000, the shareholder initiated a process for appraising the value of approximately half of its interest in Telcel, but the process was not completed. The shareholder also has sent a letter purporting to exercise the balance of the puts under the Stock Purchase Agreement. We are currently in arbitration with the shareholder over alleged breaches by BellSouth and the shareholder of the Stock Purchase Agreement, including the timing of the valuation and whether the process was properly initiated in 2000. The arbitration does not directly involve the valuation of the balance of the puts. The shareholder is seeking damages and specific performance, and BellSouth is seeking, among other things, unspecified damages and a ruling that it has not breached the Stock Purchase Agreement in any respect. The arbitration also related to an alleged oral agreement to buy out the shareholder s entire interest in Telcel, which we argue does not exist. The first stage of the hearing on these matters occurred in early 2004, with additional hearings scheduled for the second quarter of 2004. If the arbitration panel rules against BellSouth, it is possible that the appraised fair value of the shareholder s interest in Telcel could be substantially in excess of current value. At this time, the likely outcome of this arbitration cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

Colombian put-call provision

We own approximately 66% of BellSouth Colombia. Our principal partner holds approximately 34%. We have agreed with our partner to a series of related put and call agreements where by we can acquire, or could be compelled by our partner to acquire, additional shares of the Colombian operation currently held by our partner for a price equal to the appraised fair value. During the first put/call period, we have the right, but not the obligation, to call and our partner has the right, but not the obligation, to put to us approximately one-third of our partner s holding in the Colombian operation. In February 2004, we exercised our call right with respect to the first put/call provision. As a result, we agreed to purchase 11.6% of the Colombian operation from our partner. The purchase price for the additional interest is $32 and will be funded from cash on hand. Under a second put/call option, the remaining balances of our partner s shares (100% of the partner s shares if the first put/call expires unexercised) can be called by us or put to us beginning in 2006 until 2009. We cannot predict if either party will exercise its rights under the second put/call option provision.

RELATED PARTY TRANSACTIONS

We own an approximate 40% interest in Cingular. We generated revenues of approximately $426 in 2003, $386 in 2002, and $304 in 2001 from the provision of local interconnect, long distance and complex business services to Cingular and agent commissions for selling wireless services for Cingular. We also earned $256 in 2003, $284 in 2002, and $287 in 2001 from interest income on advances to Cingular.

In addition, we have receivables and payables incurred in the ordinary course of business recorded in our balance sheets as follows:

	As of December 31,	
	2002	**2003**
Receivable from Cingular	$49	**$57**
Payable to Cingular	$23	**$33**

Quantitative and Qualitative Disclosure About Market Risk

DESCRIPTION OF RISK

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

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agreements. We do not hold derivatives for trading purposes.

Interest rate risk

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

Foreign currency translation

The functional currency for most of our foreign operations is the local currency. The translation of income statement and balance sheet amounts of these entities into US Dollars gives rise to cumulative translation adjustments, which are included in accumulated other comprehensive income (loss) in our consolidated statements of shareholders equity and comprehensive income. We have not hedged our accounting translation exposure to foreign currency fluctuations relative to these investments.

Foreign exchange risk

Our objective in managing foreign exchange risk is to protect against cash flow and earnings volatility resulting from changes in foreign exchange rates. Short-term foreign currency transactions and commitments expose us to changes in foreign exchange rates. We occasionally enter into forward contracts and similar instruments to mitigate the potential impacts of such risks. The success of these strategies, however, depends on many factors and, as a result, such hedging may be ineffective.

Several of our foreign operations hold US Dollar denominated debt and recognize foreign currency gains or losses based on movements in the exchange rate between the US Dollar and local currencies. The amount of US Dollar denominated debt for consolidated entities at November 30, 2003, is $1,489. See Operating Environment Foreign Risks.

There are currently currency restrictions in place in Venezuela that limit our ability to physically convert local currency to US Dollars. In preparing our consolidated financial statements, we used the exchange rate established by the Venezuelan government of 1,600 Bolivars to the US Dollar to translate the local currency financial statements into our reporting currency, the US Dollar. During February 2004, the official exchange rate was adjusted by the government to 1,920 Bolivars to the US Dollar, but the currency exchange restrictions were not lifted. This devaluation will result in a reduction to revenues and net income of our Venezuelan operation beginning in the first quarter of 2004.

In the event the currency restrictions are deemed other-than-temporary, we would be required under generally accepted accounting principles to cease consolidation of this operation and would reflect the investment using the cost method of accounting. Under the cost method, the financial results of this operation would not be included in our income statement. See Note P to our consolidated financial statements.

Risk sensitivity

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

The following table provides information, by maturity date, about our interest rate sensitive financial instruments, which consist of fixed and variable rate debt obligations and, other than indicated below, includes the debt of our consolidated Latin America operations. Fair values for the majority of our long-term debt obligations are based on quotes from dealers.

	Maturity Dates							Fair Value		
	2004	2005	2006	2007	2008	Thereafter	Total Book Value	Underlying Debt	Associated Derivative	Total
Debt:[1]										
Fixed rate debt	$1,261	501	1,310	25	629	7,549	$11,275	$12,189	(5)	$12,184
Average interest rate	4.55%	6.65%	5.25%	6.33%	5.78%	6.92%	6.39%			
Variable rate debt	$1,785	440	1,035				$ 3,260	$ 3,673	80	$ 3,753
Average interest rate	1.52%	4.49%	2.64%				2.28%			

(1) CRM, our subsidiary in Argentina, is in default on $490 of its US Dollar-denominated debt; therefore we have excluded the debt from the table.

PROPORTIONAL DEBT

Our consolidated debt at December 31, 2003 was $14,980, which represented the debt of all consolidated subsidiaries. We have minority partners in various consolidated wireless properties as well as significant investments in other wireless properties that are not consolidated for accounting pur-

poses due to the fact that we do not exercise control over those operations. The following table presents our proportionate share of total debt for all of our investments adjusting our share of debt in each of our consolidated subsidiaries or equity method investments based on ownership percentages.

Consolidated debt	$ 14,980
Less: debt attributable to minority partners	(129)
Plus: debt associated with unconsolidated investments (excluding shareholder loans)	1,682
Proportional debt	$ 16,533

Debt attributable to minority partners represents our minority partners share of external debt included in our consolidated balance sheet at December 31, 2003. Debt associated with unconsolidated investments relates primarily to our interest in Cingular. This is non-recourse debt.

Operating Environment

DOMESTIC ECONOMIC TRENDS

On average, the economy of the nine-state region tends to closely track the US economy. Real gross domestic product (GDP) grew at an average annual rate of 2 percent in the first quarter of 2003, 3.1 percent in the second quarter, and 8.2 percent in the third quarter. The improvement in the economy was widespread, with business fixed investment spending, government purchases, personal consumption, and exports all registering strong gains. Nonagricultural employment increased in the second half of 2003, but at a very slow pace, and the unemployment rate was at a relatively high 5.7 percent at the end of the year. The economy s momentum is expected to carry over into 2004 with GDP growth near 4.5 percent. Employment gains are expected to reduce the unemployment rate to near 5.2 percent by the end of 2004.

We believe real personal income in the nine-state region grew near 2.5 percent in 2003. Growth is expected to accelerate to 4.5 percent in 2004. Employment in the region, which has been closely correlated with various measures of BellSouth s business performance in the past, increased 0.4 percent in 2003. A gain of 1.7 percent is anticipated for 2004. With housing starts exceeding 500,000, residential construction activity was strong in the region and in the nation in 2003. A strong pace is projected for 2004 as well.

Historically, our business has generally followed the timing of the cycle in the overall economy. However, given the issues impacting our industry, expected improvements to the economy during 2004 may not have as pronounced an impact on our business.

REGULATORY DEVELOPMENTS

The FCC regulates rates and other aspects of carriers provision of interstate (across states) telecommunications services while state regulatory commissions have jurisdiction over carriers provision of intrastate (within states) telecommunications services. Our future operations and financial results will be substantially influenced by developments in a number of federal and state regulatory proceedings. Adverse results in these proceedings could materially affect our revenues, expenses and ability to compete effectively against other telecommunications carriers.

Price regulation

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

Our intrastate prices are regulated under price regulation plans provided by statute or approved by state public service commissions. Under these plans, the state regulatory commissions or state legislatures have established maximum prices that can be charged for certain telecommunication services. While such plans limit the amount of increases in prices for specified services, they enhance our ability to adjust prices and service options to respond more effectively to changing market conditions and competition. Price regulation also provides an opportunity to benefit more fully from productivity enhancements. The majority of these plans have limitations on raising prices for basic local exchange services during the early years with provisions for inflation-based price increases in later years.

While some plans are not subject to either review or renewal, other plans contain specified termination dates and/or review periods. Upon review or renewal, a regulatory commission could attempt to require substantial modifications to prices and other terms of these plans. During 2003, our plan in Louisiana was renewed. A review of our Kentucky plan is pending. We also expect reviews of our plans in Alabama, Mississippi and North Carolina during 2004.

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

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affirmed the PSC s decision. An appeal of this decision to the South Carolina Supreme Court is probable. If the Consumer Advocate eventually prevails, the case could be remanded to the PSC, which could, after considering evidence, order refunds to customers in South Carolina, which in the aggregate may be material to the company. At this time, we are unable to predict the outcome of this possible appeal and, therefore, cannot determine the impact, if any, this matter may have on future earnings.

Access charge reform

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

We continue to participate in FCC examinations of further access reform. The FCC has undertaken a comprehensive examination of intercarrier compensation the payments among telecommunications carriers resulting from use of their respective interconnecting networks. In general, there are two classes of intercarrier compensation: (1) reciprocal compensation that applies to local calls; and (2) access charges that apply to long distance calls. The objective of the FCC s comprehensive examination is to examine existing rules pertaining to intercarrier compensation and explore alternative forms of intercarrier compensation. This examination could lead to permanent changes in the way carriers compensate one another and in the way carriers receive compensation from their end-user customer. One alternative under consideration is bill and keep, a policy that requires carriers to exchange traffic freely with each other and to recover from end-user customers the costs of transmitting traffic. Either in this proceeding or in a separate proceeding, the FCC will reconsider its methodology and rates for reciprocal compensation.

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

Universal service

Historically, network access charges paid by other carriers were set at levels that subsidized the cost of providing local residential service. The Telecommunications Act of 1996 requires that the FCC identify and remove the historical implicit local service subsidy from network access rates, arrange for a universal service fund to ensure the continuation of service to high-cost, low-income service areas and develop the arrangements for payments into that fund by all carriers. The FCC s universal service order established funding mechanisms for high-cost and low-income service areas. We began contributing to the new funds in 1998 and are recovering our contributions through increased interstate charges to retail end-users. We are receiving support for service to residents in Alabama, Kentucky and Mississippi.

FCC interconnection order

Under the Telecommunications Act of 1996, the FCC is obliged to consider the extent to which we must make elements of our network available to other providers of local service. The FCC can require access to proprietary network elements only when necessary. For non-proprietary elements, the FCC can order access only when failure to do so will impair the ability of the requesting carrier to provide services.

The FCC issued its most recent set of rules governing the provision of elements with local competitors in August 2003. The order establishing the rules is referred to as the Triennial Review Order. The previous two sets of rules were vacated by the courts. The most recent set of rules generally presume that carriers will be impaired without access to our unbundled switching when the competitor is serving a mass market customer. The new rules assume that competitors will not be impaired without such access if they are serving medium

to large business customers. The rules make other presumptions about our transport and high capacity loop elements. These presumptions are subject to proceedings that the FCC has delegated to the state commissions. Under the new rules, the states are required to conduct proceedings, all of which are to be completed by July 2, 2004, and to determine the elements that the carriers subject to the rules will have to provide, and to specify the markets in which they will be provided.

The FCC s order establishing the rules has been appealed and is pending before the DC Circuit Court of Appeals. Some carriers, including BellSouth, have challenged the Triennial Review Order as requiring too much unbundling of their networks and delegating authority to the states that should be exercised by the FCC. Other carriers, mostly new entrants since the 1996 Act, have appealed the rules, contending that they provide too little unbundling of our network. State commissions have also challenged the order as being an illegal restriction on their powers. Argument in the case occurred in late January, and we expect a decision during the first half of 2004. While the appeal is pending, we continue to participate in the state proceedings required by the rule.

In addition, we asked the FCC to reconsider certain different portions of its Triennial Review Order related to the regulation of broadband facilities. We asked the FCC to expand the unbundling freedom its Order provides to some broadband facilities. Other parties have sought reconsideration of many other portions of the Order.

If the appeal, reconsideration or state decisions require us to increase the number or scope of elements we must

provide, or if the appeal, reconsideration or state decisions allow competitors greater ability to substitute unbundled elements for special access services, or contain other negative decisions, we could experience a material adverse effect on revenues and results of operation.

Other state regulatory matters

In each of our states, we are subject to performance measurement plans that measure our service performance to competitors against certain benchmarks and our own retail performance. When we do not meet the relevant standards, we make payments to the competitors or the State s treasury. In some states, if we continuously fail to meet certain criteria, we also would suspend our marketing and sale of long distance services. We made payments in all states in 2002 and 2003, and likely will make payments in 2004. The plans are reviewed regularly for necessary changes.

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

PENSION AND RETIREE MEDICAL COSTS

In 2003 equity markets rebounded from recent declines, resulting in improvements to the funded status of our pension and other postretirement benefit plans which will translate into lower expense in 2004. Expense related to retiree medical costs in 2004 will also benefit from the impact of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). BellSouth remeasured its obligation as of December 1, 2003 to incorporate the impact of the Act which resulted in a reduction to the accumulated benefit obligation of $572. Specific authoritative guidance on the accounting for the federal Medicare subsidy is pending and that guidance, when issued, could require BellSouth to change its estimated impact on 2004 results.

Our current contract with non-management employees expires in August 2004. Retirement benefits are collectively bargained for as part of the overall contract with the union. In accordance with the provisions of SFAS No. 106, we account for non-management employee retirement benefits based on the terms of the contract. The impacts of future negotiations, including changes in benefit levels, could have a material impact on our financial results.

LATIN AMERICA ECONOMIC TRENDS

Economic conditions improved in much, but not all, of Latin America during 2003. Argentina s economy began to recover after four years of contraction, with the economic data available at the end of the year implying that real GDP grew 7 to 8 percent during 2003. The recovery is fragile, however, and the risk of instability in 2004 is significant.

Aided by stronger exports, real GDP growth in Chile, Peru, and Colombia is projected to have been better than 3 percent in 2003. If the global economy improves as expected, stronger gains are possible for 2004. The short-term risks of political uncertainty and guerilla violence are likely to remain high in Colombia.

Economic indicators show a mixed economic performance for the remaining countries in which we have operations. Central American economies grew 2 to 2.5 percent in 2003. The economies of Ecuador and Uruguay showed little, if any, improvement in 2003. With a stronger global economy, prospects for growth are better in 2004.

Venezuela s economy contracted sharply in 2003 as a result of the country s ongoing political crisis. A recovery is expected to be underway in 2004, but there is no end to the political crisis in sight and the recovery is at risk.

In the Latin America Group companies, our overall penetration of wireless services is 6.0%. As we increase penetration into lower socio-economic groups, revenue per customer declines. We are responding to these trends by seeking new sources of revenue growth and by attempting to increase the profitability of customers from lower socio-economic groups.

FOREIGN RISKS

Our reporting currency is the US Dollar. However, most of our Latin America Group revenues are generated in the currencies of the countries in which we operate. In addition, many of our operations and equity investees hold US Dollar-denominated short- and long-term debt. The currencies of many Latin America countries have experienced substantial volatility and depreciation. Declines in the value of the local currencies in which we are paid relative to the US Dollar will cause local currency-denominated revenues and expenses to decrease in US Dollar terms and dollar-denominated assets and liabilities, as well as interest expense, to increase in local currency terms. Where we consider it to be economically feasible, we attempt to limit our exposure to exchange rate fluctuations by using foreign currency forward exchange contracts or similar instruments as a vehicle for hedging; however, a substantial amount of our exposures are unhedged.

The impact of a devaluation or depreciating currency on an entity depends on the residual effect on the local economy and the ability of an entity to raise prices and/or reduce expenses. Our ability to raise prices is limited in many instances by government regulation of tariff rates and competitive constraints. Where our local operations have borrowed in US Dollars, a significant devaluation substantially increases the costs in the local currency, in which our operations generally earn revenues, of servicing and repaying such loans in dollars. Due to our constantly changing currency exposure and the potential substantial volatility of currency exchange rates, we cannot quantify the anticipated effect of exchange rate fluctuations on our business.

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

BELLSOUTH CORPORATION

Economic, social and political conditions in Latin America are, in some countries, unfavorable and volatile, which have adversely affected our operations. Many of these conditions continued to exist at the end of 2003, particularly in Venezuela. However, economic conditions began to improve in much of Latin America in 2003. In particular, Argentina s currency rebounded 16% by the end of 2003 and several countries in the region are projected to have had modest GDP growth for 2003. Nonetheless, there are still significant economic risks in 2004.

Historically, recessions and volatility have been primarily caused by: monetary, exchange rate and/or fiscal policies; currency devaluations; significant governmental influence over many aspects of local economies; political and economic instability; unexpected changes in regulatory requirements; social unrest or violence; slow or negative economic growth; imposition of trade barriers; and wage and price controls.

Most or all of these factors have occurred at various times in the last two decades in our core Latin America markets. We have no control over these matters. Economic conditions in Latin America are generally less attractive than those in the US, and poor social, political and economic conditions may limit use of our services which may adversely impact our business.

For a discussion of certain of the factors that are currently affecting our operations in Latin America, see Operating Environment Latin America Economic Trends.

COMPETITION

There are many competitive forces that impact our businesses. The Telecommunications Act of 1996 removed the regulatory barriers to local service competition in the wireline market and required incumbent carriers such as us to open our networks to other carriers. In the wireless market, the auction of PCS licenses has created as many as six new wireless competitors in domestic markets in addition to resellers, and the deregulation of international communications markets has introduced new global competitors to nearly all of our international businesses.

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

The presence of six national competitors in the domestic wireless market makes it more difficult for Cingular to attract new customers and retain existing ones. Furthermore, while Cingular does not compete solely on the basis of price, low prices offered by competitors attempting to obtain market share have pressured them to reduce prices and develop pricing plans attractive to lower usage customers. These trends are expected to continue and could adversely affect our results of operations in the future. BellSouth s Latin America business has three major regional competitors America Movil, Telefonica Moviles and Telecom Italia Mobile. It is likely that these three major players will increase their share by acquisition.

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

TECHNOLOGY

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

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

LEGAL MATTERS

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

NEW ACCOUNTING PRONOUNCEMENTS

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

Critical Accounting Policies

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

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

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

See Note G to our consolidated financial statements for more information regarding costs and assumptions for Property, Plant and Equipment.

Nature of estimates required

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

Sensitivity analysis

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

	2004 Depreciation Expense Higher/(Lower)
Increasing economic life by one year	$(250)
Decreasing economic life by one year	350

PENSIONS

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

Nature of estimates required

The measurement of our pension obligations, costs and liabilities is dependent on a variety of assumptions including estimates of the present value of projected future pension payments to plan participants, consideration of the likelihood of potential future events such as salary increases and demographic experience. These assumptions may have an effect on the amount and timing of future contributions, if any. Additionally, the plan trustee conducts an independent valuation of the fair value of pension plan assets. During 2002, we reduced our estimated return on plan assets to 8.5% reflecting lower expected long-term market returns.

Assumptions and approach used

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

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

The discount rate enables us to state expected future cash flows at a present value on the measurement date. We have little latitude in selecting this rate, as it is required to represent the market rate for high-quality fixed income investments. A lower discount rate increases the present value of benefit obligations. Our inflation assumption is based on an evaluation of external market indicators. The salary growth assumptions reflect our long-term actual experience, the near-term outlook and assumed inflation. The expected return on plan assets reflects asset allocations, investments strategy and the views of investment managers and other large pension plan sponsors. Retirement and mortality rates are based primarily on actual plan experience. The effects of actual results differing from our assumptions are accumulated and amortized into the income statement in future periods.

Sensitivity analysis

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

Assumption	Percentage Point Change	December 31, 2003 Obligation Higher/(Lower)	2004 Expense Higher/(Lower)
Discount rate	+/- 0.5 pts.	$(452)/$470	$15/$(18)
Expected return on assets	+/- 1.0 pts.		(155)/155

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

BELLSOUTH CORPORATION

OTHER POSTRETIREMENT BENEFITS

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

Nature of estimates required

We provide certain medical, dental and life insurance benefits to substantially all retired employees under various plans and accrue actuarially determined postretirement benefit costs as active employees earn these benefits. For postretirement benefit plans, the benefit obligation is the accumulated postretirement benefit obligation, the actuarial present value as of a date of all future benefits attributed under the terms of the postretirement benefit plan to employee service rendered to that date. The measurement of our obligations associated with postretirement benefits (e.g., retiree health care) is dependent on a variety of assumptions. This includes estimating the present value of projected future payments to plan participants and consideration of the likelihood of potential future events such as demographic experience. These assumptions may have an effect on the amount and timing of future payments. Additionally, the plan trustee conducts an independent valuation of the fair value of plan assets. For the periods presented we have adjusted the discount rate used to determine the obligation based on declining interest rates in the market.

Assumptions and approach used

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

Discount rates
Health care cost trends
Retirement rates
Inflation
Expected return on plan assets
Mortality rates

The discount rate enables us to state expected future cash flows at a present value on the measurement date. We have little latitude in selecting this rate, as it is required to represent the market rate for high-quality fixed income investments. A lower discount rate increases the present value of benefit obligations. Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook, and an assessment of likely long-term trends. Our inflation assumption is based on an evaluation of external market indicators. The expected return on plan assets reflects asset allocations, investments strategy and the views of investment managers and other large plan sponsors. Retirement and mortality rates are based primarily on actual plan experience. The effects of actual results differing from our assumptions are accumulated and amortized into the income statement in future periods.

Sensitivity analysis

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

Assumption	**Percentage Point Change**	**December 31, 2003 Obligation Higher/(Lower)**	**2004 Expense Higher/(Lower)**
Discount rate	+/- 0.5 pts.	$(362)/$384	$(20)/$18
Health care cost trend	+/- 1.0 pts.	487/(411)	70/(58)

OTHER LOSS CONTINGENCIES

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

OTHER SIGNIFICANT ACCOUNTING POLICIES

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

Cautionary Language Concerning Forward-Looking Statements

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

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-

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looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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

- a change in economic conditions in domestic or international markets where we operate or have material investments which could affect demand for our services;
- changes in US or foreign laws or regulations, or in their interpretations, which could result in the loss, or reduction in value, of our licenses, concessions or markets, or in an increase in competition, compliance costs or capital expenditures;
- continued pressures on the telecommunications industry from a financial, competitive and regulatory perspective;
- the intensity of competitive activity and its resulting impact on pricing strategies and new product offerings;
- changes in the federal and state regulations governing the terms on which we offer wholesale services to our competitors;
- continued successful penetration of the interLATA long distance market;
- the unwillingness of banks or other lenders to lend to our international operations or to restructure existing debt, particularly in Latin America;
- consolidation in the wireline and wireless industries in which we operate;
- higher than anticipated start-up costs or significant up-front investments associated with new business initiatives;
- the outcome of pending litigation;
- unanticipated higher capital spending from, or delays in, the deployment of new technologies;
- continued deterioration in foreign currencies relative to the US Dollar in foreign countries in which we operate, particularly in Latin America;
- the impact of terrorist attacks on our business;
- the impact and the success of the wireless joint venture with SBC, known as Cingular Wireless, including marketing and product development efforts, technological change, financial capacity and closing and integration of the pending acquisition of AT&T Wireless; and
- Cingular Wireless failure to realize, in the amounts and within the timeframe contemplated, the capital and expense synergies and other financial benefits expected from its proposed acquisition of AT&T Wireless as a result of technical, logistical, regulatory and other factors.

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REPORT OF MANAGEMENT

BELLSOUTH CORPORATION

To the Shareholders of BellSouth Corporation:

These financial statements have been prepared in conformity with generally accepted accounting principles and have been audited by PricewaterhouseCoopers LLP, independent auditors, whose report is contained herein. The integrity and objectivity of the data in these financial statements, including estimates and judgments relating to matters not concluded by the end of the year, are the responsibility of the management of BellSouth. Management has also prepared all other information included therein unless indicated otherwise.

Management maintains a system of internal controls over financial reporting, which is continuously reviewed and evaluated. However, there are inherent limitations that should be recognized in considering the assurances provided by any system of internal controls. The concept of reasonable assurance recognizes that the cost of a system of internal controls should not exceed, in management s judgment, the benefits to be derived. Management believes that BellSouth s system does provide reasonable assurance that the transactions are executed in accordance with management s general or specific authorizations and are recorded properly to maintain accountability for assets and to permit the preparation of financial statements in conformity with generally accepted accounting principles. Management also believes that this system provides reasonable assurance that access to assets is permitted only in accordance with management s authorizations, that the recorded accountability for assets is compared with the existing assets at reasonable intervals and that appropriate action is taken with respect to any differences. Management also seeks to assure the objectivity and integrity of its financial data by the 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, standards and managerial authorities are understood throughout the organization. Management is also aware that changes in operating strategy and organizational structure can give rise to disruptions in internal controls. Special attention is given to controls while the changes are being implemented.

Management maintains a strong internal auditing program that independently assesses the effectiveness of the internal controls and recommends possible improvements thereto. In addition, as part of its audit of these financial statements, PricewaterhouseCoopers LLP completed a review of the internal controls over financial reporting to establish a basis for reliance thereon in determining the nature, timing and extent of audit tests to be applied. Management has considered the recommendations of the internal auditor and PricewaterhouseCoopers LLP concerning the system of internal controls and has taken actions that it believes are cost-effective in the circumstances to respond appropriately to these recommendations.

Management believes that the system of internal controls was adequate to accomplish the objectives discussed herein.

Management also recognizes its responsibility for fostering a strong ethical climate so that BellSouth s affairs are conducted according to the highest standards of personal and corporate conduct and in compliance with applicable laws and regulations. This responsibility is communicated to all employees through policies and guidelines addressing such issues as conflict of interest, safeguarding of BellSouth s real and intellectual properties, providing equal employment opportunities and ethical relations with customers, suppliers and governmental representatives. BellSouth maintains a variety of comprehensive programs to assess compliance with these policies and our ethical standards through its Senior Vice President Corporate Compliance and Corporate Secretary.

F. Duane Ackerman
CHAIRMAN OF THE BOARD, PRESIDENT AND
CHIEF EXECUTIVE OFFICER

Ronald M. Dykes
CHIEF FINANCIAL OFFICER

February 23, 2004

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REPORT OF INDEPENDENT AUDITORS

BELLSOUTH CORPORATION

To the Shareholders
BellSouth Corporation

In our opinion, based on our audits and the report of other auditors, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and shareholders equity and comprehensive income present fairly, in all material respects, the financial position of BellSouth Corporation and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United State of America. These financial statements are the responsibility of the Company s management; our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Cingular Wireless, LLC, an equity method investee. BellSouth s consolidated financial statements include an investment of $3,618 million and $3,202 million as of December 31, 2003 and 2002, respectively, and equity method income of $408 million, $497 million and $675 million, respectively, for each of the three years in the period ended December 31, 2003. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Cingular Wireless, LLC, is based solely on the report of the other auditors. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

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

Atlanta, Georgia
February 9, 2004, except with respect to Note U, as to which the date is February 17, 2004

REPORT OF INDEPENDENT AUDITORS

BELLSOUTH CORPORATION

Board of Directors and Shareowners

Cingular Wireless Corporation, Manager of
Cingular Wireless LLC

We have audited the consolidated balance sheets of Cingular Wireless LLC as of December 31, 2002 and 2003, and the related consolidated statements of income, changes in members capital and cash flows for each of the three years in the period ended December 31, 2003 (not presented separately herein). These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the

financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cingular Wireless LLC at December 31, 2002 and 2003 and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States.

As discussed in Note 4 to the financial statements, in 2002 the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets.

Atlanta, Georgia
February 6, 2004, except for Note 18, as to which the date is February 17, 2004

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CONSOLIDATED STATEMENTS OF INCOME

BELLSOUTH CORPORATION

	For the years ended December 31,		
(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)	**2001**	**2002**	**2003**
Operating Revenues:			
Communications Group	$ 18,984	$ 18,226	**$ 18,255**
Latin America Group	2,910	2,233	**2,294**
Advertising and Publishing Group	2,073	1,921	**2,033**
All other	163	60	**53**
Total Operating Revenues	24,130	22,440	**22,635**
Operating Expenses:			
Cost of services and products (excludes depreciation and amortization shown separately below)	8,049	7,512	**7,988**
Selling, general, and administrative expenses	4,803	4,542	**4,353**
Depreciation and amortization	4,782	4,643	**4,179**
Provisions for restructuring and asset impairments	358	997	**209**
Total Operating Expenses	17,992	17,694	**16,729**
Operating income	6,138	4,746	**5,906**
Interest expense	1,315	1,188	**1,048**
Net earnings of equity affiliates	465	80	**465**
Gain (loss) on sale of operations	38	1,261	**(229)**
Foreign currency transaction gains (losses)	(81)	(679)	**159**
Other income (expense), net	(1,431)	196	**347**
Income Before Income Taxes and Cumulative Effect of Changes in Accounting Principle	3,814	4,416	**5,600**
Provision for Income Taxes	1,367	1,808	**2,011**
Income Before Cumulative Effect of Changes in Accounting Principle	2,447	2,608	**3,589**
Cumulative Effect of Changes in Accounting Principle, Net of Tax		(1,285)	**315**
Net Income	$ 2,447	$ 1,323	**$ 3,904**
Weighted-Average Common Shares Outstanding:			
Basic	1,875	1,870	**1,848**
Diluted	1,888	1,876	**1,852**
Basic Earnings Per Share:			
Income Before Cumulative Effect of Changes in Accounting Principle	$ 1.31	$ 1.39	**$ 1.94**
Net Income	$ 1.31	$ .71	**$ 2.11**
Diluted Earnings Per Share:			

Income Before Cumulative Effect of Changes in Accounting Principle	$ 1.30	$ 1.39	**$ 1.94**
Net Income	$ 1.30	$ .71	**$ 2.11**
Dividends Declared Per Common Share	$ .76	$ .79	**$ .92**

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

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CONSOLIDATED BALANCE SHEETS

BELLSOUTH CORPORATION

(IN MILLIONS)	December 31, 2002	December 31, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,482	**$ 4,556**
Accounts receivable, net of allowance for uncollectibles of $476 and $438	4,129	**2,928**
Material and supplies	313	**375**
Other current assets	938	**990**
Total current assets	7,862	**8,849**
Investments and advances	9,741	**8,552**
Property, plant and equipment, net	23,445	**23,807**
Deferred charges and other assets	5,726	**5,855**
Goodwill	347	**342**
Intangible assets, net	2,358	**2,297**
Total assets	$49,479	**$49,702**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Debt maturing within one year	$ 5,114	**$ 3,491**
Accounts payable	1,572	**1,339**
Other current liabilities	2,897	**3,628**
Total current liabilities	9,583	**8,458**
Long-term debt	12,283	**11,489**
Noncurrent liabilities:		
Deferred income taxes	4,452	**5,349**
Other noncurrent liabilities	5,255	**4,694**
Total noncurrent liabilities	9,707	**10,043**
Shareholders equity:		

Common stock, $1 par value (8,650 shares authorized; 1,860 and 1,830 shares outstanding)	2,020	**2,020**
Paid-in capital	7,546	**7,729**
Retained earnings	14,531	**16,540**
Accumulated other comprehensive income (loss)	(740)	**(585)**
Shares held in trust and treasury	(5,372)	**(5,992)**
Guarantee of ESOP debt	(79)	
Total shareholders equity	17,906	**19,712**
Total liabilities and shareholders equity	$49,479	**$49,702**

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

BELLSOUTH CORPORATION

	For the years ended December 31,		
(IN MILLIONS)	**2001**	**2002**	**2003**
Cash Flows from Operating Activities:			
Net Income	$ 2,447	$ 1,323	**$ 3,904**
Adjustments to net income:			
Depreciation and amortization	4,782	4,643	**4,179**
Provision for uncollectibles	587	850	**563**
Net losses (earnings) of equity affiliates	(465)	(80)	**(465)**
Dividends received from equity affiliates	369		
Minority interests in income (loss) of subsidiaries	25	(74)	**47**
Deferred income taxes and investment tax credits	(244)	1,179	**958**
Net losses (gains) on sale or impairment of equity securities	1,937	349	**(42)**
Pension income	(797)	(826)	**(535)**
Pension settlement losses		167	**47**
Stock-based compensation expense	215	171	**137**
Curtailment and termination benefit charges	97	60	
Unbilled receivable adjustment		163	
Asset impairments	89	302	**52**
Foreign currency transaction (gains) losses	81	679	**(159)**
Cumulative effect of changes in accounting principles		1,285	**(539)**
(Gain) loss on sale of operations	(38)	(1,261)	**229**
Net change in:			
Accounts receivable and other current assets	(756)	(204)	**(213)**
Accounts payable and other current liabilities	(452)	(463)	**280**
Deferred charges and other assets	(22)	30	**290**
Other liabilities and deferred credits	41	4	**(284)**
Other reconciling items, net	102	(51)	**80**
Net cash provided by operating activities	7,998	8,246	**8,529**
Cash Flows from Investing Activities:			
Capital expenditures	(5,997)	(3,785)	**(3,200)**
Investments in and advances to equity affiliates	(2,032)	(309)	
Investments in debt and equity securities	(319)	(36)	**(261)**
Proceeds from sale of debt and equity securities	1,210	1,473	**166**
Proceeds from sale of operations	47		**70**
Purchase of short-term investments	(77)		
Proceeds from disposition of short-term investments	96	2	
Proceeds from repayment of loans and advances	17	885	**1,899**
Settlement of derivatives on advances		85	**(352)**
Other investing activities, net	16	(22)	**(20)**
Net cash used for investing activities	(7,039)	(1,707)	**(1,698)**
Cash Flows from Financing Activities:			
Net repayments of short-term debt	(3,990)	(1,408)	**(427)**
Proceeds from long-term debt	4,603	17	**1**

Repayments of long-term debt	(759)	(1,223)	**(1,932)**
Dividends paid	(1,424)	(1,460)	**(1,608)**
Purchase of treasury shares		(591)	**(858)**
Other financing activities, net	142	16	**67**
Net cash used by financing activities	(1,428)	(4,649)	**(4,757)**
Net (decrease) increase in cash and cash equivalents	(469)	1,890	**2,074**
Cash and cash equivalents at beginning of period	1,061	592	**2,482**
Cash and cash equivalents at end of period	$ 592	$ 2,482	**$ 4,556**

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

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME

BELLSOUTH CORPORATION

	Number of Shares		Amount						
(IN MILLIONS)	Common Stock	Shares Held in Trust and Treasury[a]	Common Stock	Paid-in Capital	Retained Earnings	Accum. Other Compre-hensive Income (Loss)	Shares Held in Trust and Treasury[a]	Guar-antee of ESOP Debt	Total
Balance at December 31, 2000	**2,020**	**(148)**	**$ 2,020**	**$ 7,030**	**$ 13,865**	**$ (488)**	**$ (5,222)**	**$ (212)**	**$ 16,993**
Net Income					2,447				2,447
Other comprehensive income, net of tax									
Foreign currency translation adjustment[b]						(30)			(30)
Net unrealized losses on securities[c]						(277)			(277)
Adjustments for other-than-temporary losses included in income						595			595
Net unrealized gains on derivatives						(71)			(71)
Minimum pension liability adjustment						(23)			(23)
Total comprehensive income									2,641
Dividends declared					(1,424)				(1,424)
Share issuances for employee benefit plans		5		(4)	(85)		230		141
Purchase of stock by grantor trusts							(4)		(4)
Stock-based compensation				215					215
Tax benefit related to stock options				127					127
ESOP activities and related tax benefit					2			67	69
Balance at December 31, 2001	**2,020**	**(143)**	**$ 2,020**	**$ 7,368**	**$ 14,805**	**$ (294)**	**$ (4,996)**	**$ (145)**	**$ 18,758**
Net Income					1,323				1,323

Other comprehensive income, net of tax									
Foreign currency translation adjustment[b]						(430)			(430)
Net unrealized losses on securities[c]						(38)			(38)
Net unrealized gains on derivatives[d]						13			13
Minimum pension liability adjustment						9			9
Total comprehensive income									877
Dividends declared					(1,477)				(1,477)
Share issuances for employee benefit plans		5		(33)	(104)		197		60
Purchase of treasury stock		(22)					(591)		(591)
Purchase of stock by grantor trusts					(18)		18		
Stock-based compensation				171					171
Tax benefit related to stock options				40					40
ESOP activities and related tax benefit					2			66	68
Balance at December 31, 2002	**2,020**	**(160)**	**$ 2,020**	**$ 7,546**	**$ 14,531**	**$ (740)**	**$ (5,372)**	**$ (79)**	**$ 17,906**
Net Income					3,904				3,904
Other comprehensive income, net of tax									
Foreign currency translation adjustment[b]						165			165
Net unrealized losses on securities[c]						7			7
Net unrealized gains on derivatives[d]						1			1
Minimum pension liability adjustment						(18)			(18)
Total comprehensive income									4,059
Dividends declared					(1,696)				(1,696)
Share issuances for employee benefit plans		5		(19)	(89)		169		61
Purchase of treasury stock		(35)					(858)		(858)
Purchases and sales of treasury stock with grantor trusts				43	(112)		69		
Stock-based compensation				137					137

Tax benefit related to stock options				22					22
ESOP activities and related tax benefit					2			79	81
Balance at December 31, 2003	**2,020**	**(190)**	**$2,020**	**$7,729**	**$16,540**	**$(585)**	**$(5,992)**	**$**	**19,712**

(a) Trust and treasury shares are not considered to be outstanding for financial reporting purposes. As of December 31, 2003, there were approximately 37 shares held in trust and 153 shares held in treasury.

(b) Net unrealized foreign currency translation adjustments include realized gains of $1 in 2001 and $96 in 2002 and realized losses of $268 in 2003.

(c) Net unrealized losses on securities include adjustments for realized losses of $129 in 2001, realized gains of $19 in 2002, and realized gains of $26 in 2003.

(d) Net unrealized gains on derivatives include an adjustment for realized gains of $33 in 2002 and $20 in 2003.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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BELLSOUTH CORPORATION

Note A Accounting Policies

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

ORGANIZATION

We are an international telecommunications company headquartered in Atlanta, Georgia. For management purposes, our operations are organized into four reportable segments: Communications Group; Domestic Wireless; Latin America Group; and Advertising and Publishing Group.

BASIS OF PRESENTATION

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

USE OF ESTIMATES

Our consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles (US GAAP). We are required to make estimates and assumptions that affect amounts reported in our financial statements and the accompanying notes. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. Investments with an original maturity of over three months to one year are not considered cash equivalents and are included as other current assets in the consolidated balance sheets. Interest income on cash equivalents and temporary cash investments was $82 for 2001, $95 for 2002, and $76 for 2003.

Included in the December 31, 2003 cash balance of $4,556 are cash balances of $1,002 held by subsidiaries in Latin America, which historically have not remitted dividends to BellSouth. The local currency equivalent of US $346 is held in local accounts in Venezuela. Due to government restrictions, our ability to physically convert this local currency to US Dollars is limited. In addition, $144 was held in grantor trusts that is not available for general corporate purposes.

MATERIAL AND SUPPLIES

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

PROPERTY, PLANT AND EQUIPMENT

The investment in property, plant and equipment is stated at original cost. For plant dedicated to providing regulated telecommunications services, depreciation is based on the group remaining life method of depreciation and straight-line rates determined on the basis of equal life groups of certain categories of telephone plant acquired in a given year. This method requires the periodic revision of depreciation rates. When depreciable telephone plant is disposed of, the original cost less any net salvage proceeds is charged to accumulated depreciation. We perform inventories of the Telephone Plant to verify the existence of these assets and reconcile these inventories to our property records. In addition, the inventory reconciliation results allow us to correct our records for investment moved from one location to another and to account for delayed retirements. The cost of other property, plant and equipment is depreciated using either straight-line or accelerated methods over the estimated useful lives of the assets. Depreciation of property, plant and equipment was $4,195 for 2001, $4,039 for 2002, and $3,546 for 2003.

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

VALUATION OF LONG-LIVED ASSETS

Long-lived assets, including property, plant and equipment and intangible assets with finite lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The communications industry is rapidly evolving and therefore it is reasonably possible that our long-lived assets could become impaired as a result of technological or

other industry changes. For assets we intend to hold for use, if the total of the expected future undiscounted cash flows is less than the carrying amount of the asset, we recognize a loss for the difference between the fair value and carrying value of the asset. For assets we intend to dispose of, we recognize a loss for the amount that the estimated fair value, less costs to sell, is less than the carrying value of the assets. We principally use the discounted cash flow method to estimate the fair value of long-lived assets.

We hold equity interests in several wireless properties (see Note D). These investments are accounted for under the equity method of accounting. In accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, we periodically review equity method investments for impairment. These reviews are performed to determine whether a decline in the fair value of an investment below its carrying value is deemed to be other than temporary.

FOREIGN CURRENCY

Assets and liabilities of foreign subsidiaries and equity investees with a functional currency other than US Dollars are translated into US Dollars at exchange rates in effect at the end of the reporting period. Foreign entity revenues and expenses are translated into US Dollars at the average rates that prevailed during the period. The resulting net translation gains and losses are reported as foreign currency translation adjustments in shareholders equity as a component of accumulated other comprehensive income (loss). Operations in countries with hyperinflationary economies consider the US Dollar the functional currency. Foreign currency translation gains (losses) of $1 in 2001, $96 in 2002 and $(268) in 2003 were recognized in gains (losses) on sale of operations.

Foreign currency gains and losses on transactions and equity investments denominated in a currency other than their functional currency are generally included in results of operations as incurred unless the transactions are hedged. Transaction gains and (losses) included in net income amounted to $(81) for 2001, $(679) for 2002 and $159 for 2003.

DERIVATIVE FINANCIAL INSTRUMENTS

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

REVENUE RECOGNITION

Revenues are recognized when earned. Certain revenues derived from local telephone and wireless services are billed monthly in advance and are recognized the following month when services are provided. Revenues derived from other telecommunications services, principally network access, long distance and wireless airtime usage, are recognized monthly as services are provided. Marketing incentives, including cash coupons, package discounts and free service are recognized as revenue reductions and are accrued in the period the service is provided. With respect to coupons, accruals are based on historical redemption experience. While cash is generally received at the time of sale, revenues from installation and activation activities are deferred and recognized over the life of the customer relationship, which is generally four years. Print advertising and publishing revenues and related directory costs are recognized ratably over the life of the related directory, generally 12 months. Allowances for uncollectible accounts are determined based on analysis of history and future expectations. The provision for such uncollectible accounts was $587 for 2001, $850 for 2002, and $563 for 2003.

ADVERTISING

We expense advertising costs as they are incurred. These expenses include production, media and other promotional and sponsorship costs. Our total advertising expense was $268 for 2001, $309 for 2002, and

$412 for 2003.

INCOME TAXES

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

EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average number of common shares outstanding during each year. Diluted earnings per share are based on the weighted-average number of common shares outstanding plus net incremental shares arising out of employee stock options and benefit plans. The following is a

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED
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reconciliation of the weighted-average share amounts (in millions) used in calculating earnings per share:

	2001	2002	2003
Basic common shares outstanding	1,875	1,870	**1,848**
Incremental shares from stock options and benefit plans	13	6	**4**
Diluted common shares outstanding	1,888	1,876	**1,852**

The earnings amounts used for per-share calculations are the same for both the basic and diluted methods. Outstanding options of 51 million shares for 2001, 77 million shares for 2002, and 92 million shares for 2003 were not included in the computation of diluted earnings per share because the exercise price of these options was greater than the average market price of the common stock or the effect was anti-dilutive.

GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist primarily of capitalized software, wireless licenses and customer related intangibles. Goodwill represents the excess of consideration paid over the fair value of net assets acquired in purchase business combinations. In 2001, goodwill, embedded goodwill related to equity investments and certain wireless licenses were amortized using the straight-line method over periods of benefit that did not exceed 40 years. Effective with the adoption of Statement of Financial Accounting Standards (SFAS) No. 142 as of January 1, 2002, no amortization was recognized on these assets in 2002 and 2003. Customer-related intangible assets represent values placed on customer lists, contracts and non-contractual relationships of acquired businesses and are amortized over periods up to eight years using the sum-of-the-years digits method. Capitalized software costs are being amortized ratably over periods of three to five years. Amortization of goodwill and intangibles was $587 for 2001, $604 for 2002, and $633 for 2003.

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

Note B Recently Issued Accounting Pronouncements

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This standard amends and clarifies the accounting for and definition of derivative instruments and hedging activities under SFAS No. 133. This statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Adoption of this standard did not have a material impact on our results of operations, financial position or cash flows.

FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability because that financial instrument embodies an obligation of the issuer. This Statement was effective beginning July 1, 2003.

On November 7, 2003, FASB Staff Position (FSP) FAS 150-3 was issued deferring the effective date for the measurement provisions of paragraphs 9 and 10 of FAS 150, as they apply to mandatorily redeemable non-controlling interests (e.g., minority interests in finite-lived entities). The FSP indicated, however, that the disclosure requirements of FAS 150 continue to apply. The majority of our consolidated entities in Latin America where we have minority partners have finite lives, generally 99 years as a function of law. While there are no provisions in the shareholder agreements that require liquidation upon expiration of the corporations stated life, the guidance in FAS 150 requires disclosure of the settlement value as if the minority interest will be liquidated at that time. The estimated fair value of mandatorily redeemable non-controlling interests is approximately $300. This compares to the liability for minority interests recorded in our balance sheet of $209.

CONSOLIDATION OF VARIABLE INTEREST ENTITIES

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 clarified the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated support from other parties. FIN 46 requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if

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the entities do not effectively disperse risks among parties involved. We have completed an evaluation of this guidance as it applies to our business and concluded that we do not have business arrangements with entities, including our interest in Cingular Wireless, that qualify as a variable interest entity as described in FIN 46. Accordingly, these entities did not qualify for consolidation under FIN 46 and our accounting treatment of these entities remains unchanged.

REVENUE RECOGNITION FOR MULTI-ELEMENT DELIVERABLES

In November 2002, the Emerging Issues Task Force (EITF) of the FASB reached a consensus on EITF No. 00-21, Accounting for Revenue Arrangements with Multiple Element Deliverables. The issue addresses how to account for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet certain criteria. Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values. The issue also supersedes certain guidance set forth in Staff Accounting Bulletin No. 101 (SAB 101), Revenue Recognition in Financial Statements. The final consensus is applicable to agreements entered into in quarters beginning after June 15, 2003, with early adoption permitted. Additionally, companies are permitted to apply the consensus guidance to all existing arrangements as a cumulative effect of a change in accounting principle. We adopted this new pronouncement effective July 1, 2003 on a prospective basis. The impact of adoption did not have a material impact on our results of operations, financial position and cash flows.

EXIT COSTS AND DISPOSAL ACTIVITIES

In January 2003, we adopted SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), which addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) (EITF 94-3). The principal difference between SFAS No. 146 and EITF 94-3 relates to SFAS No. 146 s requirements for recognition of a liability for a cost associated with an exit or disposal activity. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF 94-3, a liability for an exit cost as generally defined in EITF 94-3 was recognized at the date of an entity s commitment to an exit plan.

Note C Changes in Accounting Principle

ASSET RETIREMENT OBLIGATIONS

Effective January 1, 2003, we adopted SFAS No. 143, Accounting for Asset Retirement Obligations (SFAS No. 143). This statement provides the accounting for the cost of legal obligations associated with the retirement of long-lived assets. SFAS No. 143 requires that companies recognize the fair value of a liability for asset retirement obligations in the period in which the obligations are incurred and capitalize that amount as part of the book value of the long-lived asset. SFAS No. 143 also precludes companies from accruing removal costs that exceed gross salvage in their depreciation rates and accumulated depreciation balances if there is no legal obligation to remove the long-lived assets. For our outside plant accounts, such as telephone poles and cable, estimated cost of removal does exceed gross salvage.

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

In connection with the adoption of this standard, we removed existing accrued net costs of removal in excess of the related estimated salvage from our accumulated depreciation for those accounts. The adjustment was reflected in the income statement as a cumulative effect of accounting change adjustment and on the balance sheet as an increase to net plant and equipment of $1,334 and an increase to deferred income taxes of

$518. The cumulative effect of change increased net income by $816 for the year ended December 31, 2003.

Since we have previously accrued for net cost of removal through our depreciation rates, depreciation expense was approximately $130 lower in 2003 than it otherwise would have been absent this change in accounting. We are expensing net cost of removal as incurred beginning January 1, 2003 for the affected plant accounts. Cost of removal expensed in 2003 was $36.

REVENUE RECOGNITION FOR PUBLISHING REVENUES

Effective January 1, 2003, we changed our method for recognizing revenues and expenses related to our directory publishing business from the publication and delivery method to the deferral method. Under the publication and delivery method, we recognized 100% of the revenues and direct expenses at the time the directories were published and delivered to end-users. Under the deferral method,

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revenues and direct expenses are recognized ratably over the life of the related directory, generally 12 months. The change in accounting method is reflected in the income statement as a cumulative effect of accounting change adjustment and on the balance sheet as a decrease to accounts receivable of $845, increase to other current assets of $166, increase to current liabilities of $129, and a decrease to deferred income taxes of $307. The cumulative effect of the change resulted in a decrease to net income of $501 for 2003. Absent this one-time adjustment, the change in accounting did not materially affect our annual results.

PRO FORMA IMPACT OF ACCOUNTING CHANGES

The following table presents our 2002 and 2001 results adjusted to reflect the changes in accounting for asset retirement obligations and revenue recognition for publishing revenues:

	For the Year Ended December 31,				
	2001 (As reported)	**SFAS No. 143 (Unaudited)**	**Directory Publishing (Unaudited)**	**2001 Pro Forma (Unaudited)**	**2002 Pro Forma (Unaudited)**
Total Operating Revenue	$24,130	$	$ (1)	$24,129	$22,489
Operating Expenses					
Cost of services and products	8,049	34	29	8,112	7,642
Selling, general, and administrative expenses	4,803		12	4,815	4,494
Depreciation and amortization	4,782	(138)		4,644	4,510
Provision for restructuring and asset impairments	358			358	997
Total operating expenses	17,992	(104)	41	17,929	17,643
Operating income	6,138	104	(42)	6,200	4,846
Non-operating income (expense), net	(2,324)			(2,324)	(330)
Income before income taxes and cumulative effect of changes in accounting principle	3,814	104	(42)	3,876	4,516
Provision for income taxes	1,367	40	(15)	1,392	1,847
Income before cumulative effect of changes in accounting principle	2,447	64	(27)	2,484	2,669
Cumulative effect of changes in accounting principle, net of tax					(1,285)
Net Income	$ 2,447	$ 64	$ (27)	$ 2,484	$ 1,384
Basic earnings per share*:					
Income before cumulative effect of changes in accounting principle	$ 1.31	$ 0.03	$ (0.01)	$ 1.32	$ 1.43
Net income	$ 1.31	$ 0.03	$ (0.01)	$ 1.32	$ 0.74
Diluted earnings per share*:					
Income before cumulative effect of changes in accounting principle	$ 1.30	$ 0.03	$ (0.01)	$ 1.32	$ 1.42

Net income	$ 1.30	$ 0.03	$ (0.01)	$ 1.32	$ 0.74

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	For the Year Ended December 31,				
	2002 (As reported)	SFAS No. 143 (Unaudited)	Directory Publishing (Unaudited)	2002 Pro Forma (Unaudited)	2003
Total Operating Revenue	$22,440	$	$ 49	$22,489	**$22,635**
Operating Expenses					
Cost of services and products	7,512	32	37	7,581	**7,988**
Selling, general, and administrative expenses	4,542		13	4,555	**4,353**
Depreciation and amortization	4,643	(133)		4,510	**4,179**
Provision for restructuring and asset impairments	997			997	**209**
Total operating expenses	17,694	(101)	50	17,643	**16,729**
Operating income	4,746	101	(1)	4,846	**5,906**
Non-operating income (expense), net	(330)			(330)	**(306)**
Income before income taxes and cumulative effect of changes in accounting principle	4,416	101	(1)	4,516	**5,600**
Provision for income taxes	1,808	39		1,847	**2,011**
Income before cumulative effect of changes in accounting principle	2,608	62	(1)	2,669	**3,589**
Cumulative effect of changes in accounting principle, net of tax	(1,285)			(1,285)	**315**
Net Income	$ 1,323	$ 62	$ (1)	$ 1,384	**$ 3,904**
Basic earnings per share*:					
Income before cumulative effect of changes in accounting principle	$ 1.39	$ 0.03	$ 0.00	$ 1.43	**$ 1.94**
Net income	$ 0.71	$ 0.03	$ 0.00	$ 0.74	**$ 2.11**
Diluted earnings per share*:					
Income before cumulative effect of changes in accounting principle	$ 1.39	$ 0.03	$ 0.00	$ 1.42	**$ 1.94**
Net income	$ 0.71	$ 0.03	$ 0.00	$ 0.74	**$ 2.11**

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

Note D Investments and Advances

We hold investments in various domestic and international partnerships and ventures that are accounted for under the equity method. We also hold investments in equity securities that are accounted for under the cost method. Investments and advances at December 31 consist of the following:

	2002	2003
Investments accounted for under the equity method	$3,502	**$3,988**
Investments accounted for under the cost method	134	**382**
Advances to and notes receivable	5,772	**3,932**
Other investments	333	**250**
Investments and advances	$9,741	**$8,552**

EQUITY METHOD INVESTMENTS

Ownership in equity investments at December 31 is as follows:

	2002		2003	
	Ownership Percentage	Investment Balance	Ownership Percentage	Investment Balance
Abiatar (Uruguay)	46.0%	$ 25	**46.0%**	**$ 26**
BellSouth Guatemala[1]	60.0%	10	**60.0%**	**7**
BellSouth Panama	43.7%	73	**43.7%**	**86**
BCP São Paulo (Brazil)	45.4%			
BSE Northeast (Brazil)	47.6%			
Cellcom (Israel)	34.8%	144	**34.8%**	**191**
Cingular Wireless	40.0%	3,202	**40.0%**	**3,618**
Sonofon (Denmark)	46.5%	39	**46.5%**	**57**
Other		9		**3**
		$3,502		**$3,988**

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

Cingular

We own an approximate 40% economic interest in Cingular Wireless, and share joint control of the venture with SBC Communications, Inc. The following table presents 100% of

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Cingular s assets, liabilities, and results of operations for the years ended December 31:

	2002	2003
Balance Sheet Information:		
Current assets	$ 2,731	**$ 3,300**
Noncurrent assets	$21,391	**$22,226**
Current liabilities	$ 2,787	**$ 3,187**
Noncurrent liabilities	$13,227	**$13,196**
Minority Interest	$ 567	**$ 659**
Members capital	$ 7,541	**$ 8,484**

	2001	2002	2003
Income Statement Information:			
Revenues	$14,268	$14,903	**$15,483**
Operating Income	$ 2,548	$ 2,521	**$ 2,289**
Income Before Cumulative Effect of Change in Accounting Principle	$ 1,692	$ 1,239	**$ 1,022**
Cumulative Effect of Change in Accounting Principle		$ (32)	
Net Income	$ 1,692	$ 1,207	**$ 1,022**

As of December 31, 2003, our book investment exceeded our proportionate share of the net assets of Cingular by $224.

E-Plus

We previously owned a 22.51% stake in E-Plus, a German wireless carrier. In March 2002, we exercised an option to exchange our stake in E-Plus for 234.7 million shares of Dutch telecommunications provider Royal KPN N.V. (KPN). As a result of this exchange, we recorded a gain of $1,335, or $854 after tax, representing the difference in the fair value of the KPN shares received and the carrying value of our investment in E-Plus. We sold our entire stake of 234.7 million shares in March 2002 for $1,076 in proceeds and recognized a loss of $27, or $17 after tax, on the sale.

Brazil (BCP and BSE)

We previously owned equity interests in two wireless communications companies in Brazil (BCP and BSE). As a result of the deteriorating financial condition of the companies and subsequent loan defaults, we recorded an impairment loss of approximately $383 during 2002, reducing the balance of our investment and shareholder loans to zero. Because our investment and net advances to BSE and BCP was reduced to zero and due to the fact we had no further commitment or intention of financial support, we ceased recognizing losses related to these operations.

In May 2003, we sold our entire stake in BSE to Telecom Americas, a subsidiary of America Movil. We received net proceeds of $20 and recorded a loss of $75, or $73 net of tax, which included the recognition of cumulative foreign currency translation losses of $86. In October 2003, we closed a settlement agreement and transferred our equity interests in BCP to BCP s senior secured creditors. In addition, under a separate agreement, we sold our debt in BCP to these creditors for proceeds of $50. We recorded a loss of $154, or $161 with tax impacts, which included the recognition of cumulative foreign currency translation losses of $182. No tax benefit was recognized for the capital losses generated by these sales due to our current capital loss carryforward position.

Guatemala

As a result of difficult economic conditions and increasing competition, we evaluated the long-term value of our equity investment in Guatemala during 2002. The valuation and assessment indicated that the decline in fair value below carrying value was other-than-temporary and, accordingly, we recorded an impairment loss of $62 with no tax benefit. This charge reduced the carrying amount of our investment to its fair value.

COST METHOD INVESTMENTS

Cost method investments at December 31 consist of the following:

	2002	2003
Investments accounted for under the cost method	$134	**$382**

We have investments in marketable securities, primarily common stocks, which are accounted for under the cost method. These investments are held primarily in grantor trusts and our captive insurance subsidiary. Securities classified as available-for-sale under SFAS No. 115 are carried at fair value, with unrealized gains and losses, net of income taxes, recorded in accumulated other comprehensive income (loss) in the statement of changes in shareholders equity and comprehensive income. The fair values of individual investments in marketable securities are determined based on market quotations. Equity securities that are restricted for more than one year or not publicly traded are recorded at cost.

There were significant declines in public equity markets in recent years, particularly in technology and communications stocks. We concluded that the depressed market for these investments, as well as the difficulties experienced by similar companies, indicated that the decline was other than temporary. As a result, we recorded other-than-temporary impairments to reduce the carrying value of certain investments, principally our investment in Qwest (see table below). These are included in Other income (expense), net in the accompanying consolidated statements of income.

Qwest

At the beginning of 2001, we held 74.0 million shares of Qwest common stock. Since that time, we have disposed of our entire investment for a total of $1.4 billion in cash

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proceeds. The following table summarizes our Qwest transactions (in millions):

	Shares	Cash Proceeds	Losses on Sales	Other-than-Temporary Impairments
December 31, 2000	74.0			
Less Sales:				
2001	28.5(a)	$1,137	$131	$1,517
2002	45.5	300	129	207
December 31, 2002	0.0	$1,437	$260	$1,724

(a) 1.7 million shares were exchanged for services (at book value of $81).

Tele Centro Oeste Celular Participacoes SA (TCO)

In May 2000, we completed the purchase of a combination of voting common stock and American Depositary Receipts representing nonvoting preferred stock of TCO, a Brazilian wireless company, for a total purchase price of approximately $240. In 2001, we reduced the carrying value by $138 for an other-than-temporary impairment. In 2002, we sold the American Depositary Receipts for proceeds of $90 and recognized a gain of $22, or $14 net of tax. In 2003, we sold our remaining shares of TCO common stock for proceeds of $82 and recognized a gain of $50, or $27 net of tax.

ADVANCES AND NOTES RECEIVABLE

Advances and notes receivable at December 31 are as follows:

	2002	2003
Cingular	$3,817	**$3,812**
KPN	1,717	
Other	238	**120**
Total advances and notes receivable	$5,772	**$3,932**

Effective July 1, 2003, BellSouth and SBC Communications agreed to amend the terms of our notes with Cingular. The amendment included reducing the fixed interest rate from 7.5% to 6.0% per annum and extending the maturity date from March 31, 2005 to June 30, 2008. We earned $287 in 2001, $284 in 2002, and $256 in 2003 from interest income on this advance to Cingular. In addition, we have receivables and payables incurred in the ordinary course of business recorded in our balance sheets as follows:

	As of December 31,	
	2002	2003
Receivable from Cingular	$ 49	**$ 57**
Payable to Cingular	$ 23	**$ 33**

In April 2003, we received net proceeds of $1,458 resulting from an early repayment by KPN of the entire outstanding balance of a Euro loan we had extended to KPN and the settlement of related currency swaps. The net proceeds include $1,802 for the full face value of the loan and $8 for accrued interest, reduced by a settlement of a $352 liability associated with foreign currency swap contracts. As a result of the early repayment and settlement of the currency contracts, we recorded a gain of $20, or $13 net of tax.

In June 2003, in connection with the sale of our interest in two real estate partnerships, we received proceeds of $97 for the repayment of loans we had extended to the partnerships.

Interest income earned from advances other than to Cingular was $93 in 2001, $117 in 2002, and $31 in 2003.

OTHER INVESTMENTS

Other investments at December 31, 2003 consist primarily of $244 in loan participation agreements related to the Colombian operations. In January 2003, we exercised a put in our loan participation agreement with our Colombian partner and received proceeds of $35. As a result, no gain or loss was recognized.

Note E Acquisitions and Divestitures

We have completed various transactions to further our strategy of expanding our core operations and have divested of interests that no longer meet our strategic objectives.

Acquisitions

In August 2003, we purchased an additional 21.7% of our wireless operation in Argentina for a nominal amount. The transaction increased our ownership of the operation to 86.7%. We consolidated this operation prior to this additional purchase. Additionally, we have been recording 100% of the earnings/losses of the operation since 2002, when the minority partner s equity accounts were exhausted and we ceased allocating losses to the minority interests. Accordingly, this additional purchase did not impact the earnings or losses we record from this operation. The assignment of the purchase price to the estimated fair values of assets acquired and liabilities assumed resulted in decreases to intangible assets of $15, decreases to property, plant and equipment of $28 and a decrease to the debt of $43. No goodwill was recorded as a result of the purchase price allocation.

Divestitures

In June 2003, we sold our interests in two real estate partnerships that held buildings, portions of which we used for general and administrative space. We received proceeds of $26 for our interest in the partnerships resulting in recognition of a gain of $16, or $11 net of tax.

In November 2002, we sold our 100% ownership interest in Listel, our remaining Brazilian yellow pages operation, resulting in a pre-tax loss of $74, or $48 after tax. In

January 2002, we exited our investment in OESP Midea, a Brazilian yellow pages provider, through the exercise of a put. There were no proceeds as the fair value of the put was $0.

Note F Intangible Assets

Intangible assets are summarized as follows:

	December 31, 2002		December 31, 2003	
	Carrying Amount	Accumulated Amortization	Carrying Amount	Accumulated Amortization
Intangible assets subject to amortization:				
Capitalized Software	$2,557	$ 957	**$2,893**	**$1,303**
Wireless Licenses	790	277	**764**	**294**
Customer related intangible assets	327	265	**330**	**288**
Other	37	12	**38**	**15**
Total	$3,711	$1,511	**$4,025**	**$1,900**
Intangible assets not subject to amortization:				
Wireless Licenses	$ 145	$ 7	**$ 164**	**$ 12**
MMDS Licenses	20		**20**	
Total	$ 165	$ 7	**$ 184**	**$ 12**
Total Intangible Assets	$3,876	$1,518	**$4,209**	**$1,912**

The following table presents current and expected amortization expense of the existing intangible assets as of December 31, 2003 for each of the following periods:

Aggregate amortization expense:	
For the year ended December 31, 2003	**$633**
Expected amortization expense for the years ending December 31,	
2004	610
2005	476
2006	330
2007	207
2008	120

We adopted SFAS No. 142, Goodwill and Other Intangible Assets, as a cumulative effect of change in accounting principle on January 1, 2002. Accordingly, our 2001 results presented herein are not comparable with those in 2002 and 2003 results. On a pro forma basis, retroactively applying the provisions of SFAS No. 142 to exclude amortization of goodwill and indefinite-lived wireless licenses, 2001 income before income taxes and cumulative effect of changes in accounting principle would have been $3,939, or $125 higher than the reported $3,814, and diluted earnings per share would have been $1.36, or $0.06 higher than the reported $1.30.

Intangible asset impairments

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

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

The changes in the carrying amount of goodwill by operating segment for 2002 and 2003 are as follows:

	Domestic Wireless	Latin America	Total
Balance at December 31, 2001	$244	$ 1,395	$ 1,639
SFAS No. 142 impairment		(1,277)	(1,277)
Other changes	6	(21)	(15)
Balance at December 31, 2002	$250	$ 97	$ 347
Other changes		(5)	(5)
Balance at December 31, 2003	**$250**	**$ 92**	**$ 342**

The $1,285 cumulative effect of change in accounting principle in the consolidated income statements includes $8 recorded through net earnings (losses) of equity affiliates. Other changes above consist primarily of foreign currency translation adjustments.

Other impairments of intangible assets

As of December 31, 2001, we had Multichannel Multipoint Distribution Service (MMDS) licenses classified as held for sale under the transition provisions of SFAS No. 144. During our 2002 quarterly assessment, we evaluated the recoverability of the MMDS licenses for impairment. Based on a probability weighted cash flow assessment, we determined that the fair value of the licenses was less than the carrying amount. Accordingly, we adjusted the carrying value to the estimated fair value of $20, resulting in an impairment loss of $221. The charge is included in the provision for restructuring and asset impairments in the consolidated statements of income. In addition, the MMDS licenses were reclassified to held and used, as we no longer meet the criteria for held for sale classification under the provisions of SFAS No. 144.

In September 2003, a decision was reached to abandon a software project related to a network operations system.

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The project was terminated due to changes in the business since the initiation of the project and an assessment of the remaining costs to complete the project. As a result, we recorded an asset impairment charge of $52 to write-off capitalized software associated with the project.

Note G Supplemental Balance Sheet and Cash Flow Information

PROPERTY, PLANT AND EQUIPMENT

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

	Estimated Depreciable Lives (In Years)	Average Remaining Life	2002	2003
Central office equipment	8 11	4.8	$25,823	**$26,066**
Outside plant:				
Copper cable	15 16	6.8	19,577	**19,975**
Fiber cable	20	11.2	2,949	**3,094**
Poles and conduit	36 55	28.3	3,516	**3,567**
Operating and other equipment	5 15	3.2	4,289	**4,419**
Building and building improvements	25 45	28.0	4,532	**4,780**
Furniture and fixtures	10 15	8.9	2,388	**2,478**
Station equipment	6	2.8	722	**763**
Land			285	**293**
Plant under construction			354	**280**
			64,435	**65,715**
Less: accumulated depreciation			40,990	**41,908**
Property, plant and equipment, net			$23,445	**$23,807**

DEFERRED CHARGES AND OTHER ASSETS

Deferred charges and other assets are summarized as follows at December 31:

	2002	2003
Deferred activation and installation expenses	$1,800	**$1,614**
Prepaid pension and postretirement benefits	3,357	**3,851**
Other	569	**390**
Deferred charges and other assets	$5,726	**$5,855**

OTHER CURRENT LIABILITIES

Other current liabilities are summarized as follows at December 31:

	2002	2003
Advanced billing and customer deposits	$ 791	$ 863
Interest and rents accrued	438	470
Taxes payable	225	632
Dividends payable	380	461
Salaries and wages payable	329	359
Accrued compensated absences	222	224
Restructuring and severance accrual	115	72
Other	397	547
Other current liabilities	$2,897	$3,628

OTHER NONCURRENT LIABILITIES

Other noncurrent liabilities are summarized as follows at December 31:

	2002	2003
Deferred installation and activation revenues	$1,800	$1,614
Accrued pension and postretirement benefits	1,001	983
Deferred credits	790	724
Compensation related accruals	664	747
Minority interests in consolidated subsidiaries	205	209
Postemployment benefits	265	237
Derivatives liability	374	80
Other	156	100
Other noncurrent liabilities	$5,255	$4,694

SUPPLEMENTAL CASH FLOW INFORMATION

	2001	2002	2003
Cash paid for:			
Income taxes	$1,371	$ 940	$ 754
Interest	$1,321	$1,238	$1,023

During 2003, we purchased a building and land, which we were previously using under an operating lease, for $21 in cash and an assumed mortgage with a balance of $33.

During 2001, we tendered 1.7 million shares of our investment in Qwest as payment for services rendered in connection with a wholesale services agreement.

FLORIDA LATE PAYMENT REFUND

In 2000, the Florida Public Service Commission (PSC) issued a proposed agency action stating that our change in 1999 from a late charge based on a percentage of the amounts overdue to a flat rate fee plus an interest charge violated the Florida price regulation statute and voted that approximately $65 should be refunded. We protested the decision. On August 30, 2001, the PSC issued an order adopting its proposed action. We appealed to the Florida Supreme Court and continued to bill and collect the charges subject to

refund. On October 31, 2002, the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS CONTINUED
DOLLARS ARE IN MILLIONS, EXCEPT PER SHARE AMOUNTS AND AS OTHERWISE INDICATED

BELLSOUTH CORPORATION

Florida Supreme Court affirmed the decision of the PSC. This required a one-time refund to affected customers in Florida. Based on this decision, we recorded a reduction to revenues of $108 and additional interest expense of $6 in the third quarter of 2002. Refunds related to the accrual were made during 2003.

WORLDCOM BANKRUPTCY

On July 21, 2002, WorldCom (currently known as MCI) and certain of its subsidiary corporations filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code. A plan of reorganization was filed in April 2003 and confirmation hearings commenced in September 2003. On October 31, 2003, the Bankruptcy Court confirmed the plan. On July 25, 2003, WorldCom filed a motion with the Bankruptcy court requesting approval of a settlement with us regarding pre-petition and post-petition claims through April 30, 2003. As of April 30, 2003, we had not paid certain pre-petition amounts due WorldCom primarily related to a billing and collection agreement pending this settlement. In addition, WorldCom had not paid us a lesser amount they owed us for purchases of telecommunications services. As a result of the settlement, we will make a net payment of approximately $81 to WorldCom representing the negotiated difference between the amounts owed. The settlement also resolves numerous business issues that existed between the parties and with certain exceptions, releases all claims arising on or before April 30, 2003. The settlement will be final upon the effective date of the plan of reorganization.

Note H Debt

DEBT MATURING WITHIN ONE YEAR

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

	2002	2003
Short-term notes payable:		
Bank loans	$ 22	**$ 29**
Argentina bank loans[1]	138	**138**
Commercial paper	1,883	**1,470**
Current maturities of long-term debt	3,071	**1,854**
Debt maturing within one year	$5,114	**$3,491**

Weighted-average interest rate at end of period:

	2002	2003
Bank loans	5.60%	**6.35%**
Argentina bank loans[1]	5.02%	**5.02%**
Commercial paper	1.33%	**1.04%**

(1) CRM, our subsidiary in Argentina, is in default on $490 of its US Dollar-denominated debt, which includes bank loans; therefore we have shown the balances and rates separately in the above tables.

Credit lines at end of period:	2002	2003
Available domestic committed credit lines	$2,019	**$1,500**
Borrowings under domestic credit lines	$	**$**
Available international uncommitted credit lines	$ 40	**$ 118**
Borrowings under international credit lines	$ 11	**$ 12**

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

LONG-TERM DEBT

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

		2002	2003
Issued by BellSouth Telecommunications, Inc.			
5.85% 5.88%	2009 2045	$ 437	**$ 437**
6.13% 7%	2003 2033[1]	2,600	**2,151**
7.5% 7.63%	2033 2035	600	**300**
7%	2095	500	**500**
1.24% 2.42%	Extendible Liquidity Securities due 2006	1,800	**745**
6.65%	Zero-to-Full Debentures due 2095	196	**217**
6.3%	Amortizing Debentures due 2015	299	**277**
Issued by BellSouth Corporation			
5% 7.38%	2006 2039[1]	3,849	**3,852**
7.75% 7.88%	2010 2030	2,000	**2,000**
7.12%	2097	500	**500**
4.11%	20-put-1 Securities due 2021	1,000	**1,000**
9.13% 9.19%	Guarantee of ESOP Debt	108	
Issued by Foreign Operations			
3.30% 9.25%	Argentina due 2003-2008[2]	350	**350**
1.72%	Chile due 2004	180	**180**
2.95% 14.18%	Colombia due 2005 2006	722	**641**
4.19% 4.59%	Venezuela due 2004	23	**23**
1.79% 2.06%	Peru due 2005	200	**200**
Capital leases and other		68	**86**
Unamortized discount, net of premium		(78)	**(116)**
		15,354	**13,343**
Current maturities		(3,071)	**(1,854)**
Long-term debt		$12,283	**$11,489**

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

(2) CRM, our subsidiary in Argentina, is in default on $490 of its US Dollar-denominated debt. The debt is classified as current in our consolidated December 31, 2003 balance sheet. This debt is non-recourse to BellSouth.

Several issues of long-term debt contain embedded options, which may require us to repurchase the debt or

will alter the interest rate associated with that debt. Those issues, and their related options, are as follows:

Issue	Date of Put Option
20-put-1 Securities	Annually in April
Extendible Liquidity Securities	Quarterly
Putable $281 debentures	November 2006

If the holders of the put options on the 20-put-1 Securities do not require us to repurchase the securities, the interest rates for these securities will be reset based on current market conditions. Since the 20-put-1 Securities can be put to us annually, the balance is included in current maturities of long-term debt in our balance sheet. The extendible liquidity securities may be extended in thirteen-month increments by the holders of the notes but will not extend later than January 2006. The extendible liquidity securities bear interest at the three-month LIBOR, plus or minus a spread ranging from minus 0.02% to plus 0.06%. A portion of the extendibles have not been extended. Holders of our 6.04% bond maturing November 15, 2026, have a one-time ability to put the bond back to us on November 15, 2006.

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

Maturities of long-term debt outstanding, in principal amounts, at December 31, 2003 are summarized below. Maturities after the year 2008 include the final principal amount of $500 for the Zero-to-Full Debentures due in 2095.

Maturities	
2004	$ 1,897
2005	941
2006	2,348
2007	25
2008	631
Thereafter	7,900
Total	$ 13,742

At December 31, 2003, we had a shelf registration statement on file with the Securities and Exchange Commission under which $2,250 of debt securities could be publicly offered.

During the second quarter of 2003 we redeemed $300 of 40-year, 7.5% debentures, due June 15, 2033. The redemption price was 104.75% of the principal amount resulting in a loss of $18, or $11 net of tax, on the early extinguishment of this debt.

Note I Income Taxes

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

The provision for income taxes is summarized as follows:

	2001	2002	2003
Current			

Federal	$ 1,440	$ 494	**$ 1,022**
State	88	36	**129**
Foreign	97	109	**120**
	1,625	639	**1,271**
Deferred, net			
Federal	(277)	1,127	**737**
State	41	113	**85**
Foreign	25	(34)	**(48)**
	(211)	1,206	**774**
Investment tax credits, net			
Federal	(33)	(27)	**(27)**
Foreign	(14)	(10)	**(7)**
	(47)	(37)	**(34)**
Total provision for income taxes	$ 1,367	$ 1,808	**$ 2,011**

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

	2002	**2003**
Loan impairments	$ 112	**$**
Operating loss and tax credit carryforwards	869	**718**
Capital loss carryforwards	326	**781**
Severance accrual	65	**58**
Allowance for uncollectibles	112	**183**
Regulatory accruals	25	**39**
Other	85	**184**
	1,594	**1,963**
Valuation Allowance	(906)	**(1,135)**
Deferred tax assets	$ 688	**$ 828**
Property related	$ (3,075)	**$ (3,705)**
Equity investments	(982)	**(1,647)**
Issue basis accounting	(246)	
Licenses	(126)	**(69)**
Compensation related	(190)	**(286)**
Other	(176)	**(165)**
Deferred tax liabilities	(4,795)	**(5,872)**
Unamortized investment tax credits	(27)	
Net deferred tax liability	$ (4,134)	**$ (5,044)**

The valuation allowance on deferred tax assets increased by $229 in 2003. The valuation allowance relates to excess U.S. capital losses, foreign and state operating losses, and state credits that may not be utilized during the carryforward period. The carryforward periods for the excess capital losses expire in 2007 and 2008. Approximately 45% of the operating losses are in foreign jurisdictions with expirations in years between 2004 and 2009. The remainder are state losses and credit carryforwards expiring in various years beginning in 2004.

At December 31, 2003, net deferred tax liabilities include a deferred tax asset of $267 relating to compensa-

tion expense under SFAS 123, Accounting for Stock-Based Compensation. The provisions of SFAS No. 123 do not allow a valuation allowance to be recorded unless future taxable income is expected to be insufficient to recover the asset. Full realization of the deferred asset requires stock options to be exercised at a price equaling the sum of the strike price plus the fair value at the grant date. A significant number of the options for which a tax benefit has been recognized have a combined strike price and fair value at grant date in excess of $45. Accordingly, there can be no assurance that the stock price of BellSouth will rise to levels sufficient to realize the entire tax benefit currently reflected in our balance sheet.

The net deferred tax liability at December 31, 2003 included a current asset balance of $305 and a noncurrent liability balance of $5,349. At December 31, 2003, deferred investment tax credits were fully amortized. The net deferred tax liability at December 31, 2002 included a current asset balance of $318 and a noncurrent liability balance, including investment tax credits, of $4,452.

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

	2001	2002	2003
Federal statutory tax rate	35.0%	35.0%	**35.0%**
State income taxes, net of federal income tax benefit	2.3	2.2	**2.5**
Net earnings (losses) of equity affiliates	1.9	(0.3)	**(0.4)**
Change in valuation allowance	1.8	7.1	**0.7**
Investment tax credits	(0.9)	(0.6)	**(0.3)**
Book / tax differences on dispositions of subsidiaries and investments	(3.2)	(0.9)	
Other	(1.1)	(1.6)	**(1.6)**
Effective tax rate	35.8%	40.9%	**35.9%**

At December 31, 2003, we had approximately $954 of cumulative unrepatriated earnings on consolidated foreign subsidiaries and equity investments in unconsolidated businesses. The deferred tax liability related to these unrepatriated earnings was excluded under SFAS No. 109 because such earnings are intended to be reinvested indefinitely. The determination of the deferred tax liability is not practicable at this time.

Note J Workforce Reduction and Restructuring

WORKFORCE REDUCTION CHARGES

Based on ongoing challenges in the telecom industry, continued economic pressures, the uncertainty resulting from regulatory rulings and productivity improvements, we have initiated workforce reductions and recorded charges related to approximately 13,400 employees in the last three years. These downsizings were implemented on a voluntary and non-voluntary basis. The positions were both management and non-management, primarily in network operations where the volume of work has substantially decreased. Charges to earnings have been recognized in accordance with provisions of SFAS No. 112, Employer s Accounting for Postemployment Benefits (SFAS No. 112), and consisted primarily of cash severance, outplacement and payroll taxes under pre-existing separation pay plans. The following table summarizes the charges by year:

	Employee separations	Related charge
2001	6,100	$232
2002	3,800	$430
2003	3,500	$132

ASSET IMPAIRMENTS

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

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

RESTRUCTURING LIABILITY

As of December 31, 2003, the aggregate liability related to the charges described above, excluding postretirement and pension impacts, was $72. As of December 31, 2003 announced workforce reductions are expected to be completed by the end of the first quarter 2004.

	Type of Cost		
	Employee Separations	Other Exit Costs	Total
Balance at December 31, 2001	$ 202	$	$ 202
Additions	430	38	468
Deductions	(548)	(7)	(555)
Balance at December 31, 2002	$ 84	$ 31	$ 115
Additions	132	1	133
Deductions	(150)	(26)	(176)
Balance at December 31, 2003	$ 66	$ 6	$ 72

The $132 in additions to the accrual associated with employee separations relates to accruals for estimated payments for the current year workforce reductions. Deductions of $150 consist of $125 in cash severance payments and $25 for adjustments to the accrual due to

estimated demographics being different than actual demographics of employees that separated from the company. Deductions from the accrual for other exit costs consist primarily of cash payments of $18 settling liabilities for early contract terminations.

Note K Employee Benefit Plans

PENSION AND OTHER POSTRETIREMENT BENEFIT PLANS

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

Pension Plans

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

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

Other Benefits

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

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

In determining the accumulated benefit obligation of the management health care plan, we anticipate cost sharing adjustments for eligible employees who retire after December 31, 1991. The written plan provides for an annual dollar value cap for the purpose of determining contributions required from retirees. However, because of past practice, some level of cost sharing of medical trend inflation above the caps is considered in the valuation.

For our non-management labor contracts that contain an annual dollar value cap for the purpose of determining contributions required from retirees, we have waived the cap during the current contract periods and thus not collected contributions from those non-management retirees. The caps are set at each bargaining cycle in connection with the negotiation of the overall contract. In accordance with the provisions of SFAS No. 106, we account for non-management retiree health benefits based on the terms of the contract.

Medicare Prescription Drug, Improvement and Modernization Act of 2003

Other postretirement benefit amounts include the estimated impact of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), which was signed into law on December 8, 2003. A plan sponsor s eligibility for the federal subsidy depends on whether the plan s prescription drug benefit is at least actuarially equivalent to the Medicare Part D benefit. To determine actuarial equivalence, we compared the Medicare Part D standard drug coverage to BellSouth s retiree prescription drug coverage. We calculated the actuarial values based on nationwide statistics published in a standardized rating manual, and adjusted for

historical utilization by BellSouth retirees. After taking retiree premiums and cost sharing provisions of each plan into consideration, the BellSouth plan still provides a more valuable benefit to retirees. Thus we believe that BellSouth should be eligible for subsidies into the foreseeable future.

We remeasured our obligation as of December 1, 2003 to incorporate the impact of the Act which resulted in a reduction to the accumulated benefit obligation by $572. The remeasurement resulted in a reduction of net postretirement benefit cost of $26 in 2003. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require BellSouth to change its estimated impact on 2004 results.

Key assumptions included in the calculation of the decrease in the obligation included:

Federal subsidy of $690 per participant beginning in 2006, increasing with the assumed health care cost trend rate after 2006;

receipt of reimbursements from Medicare in the same year that we pay our drug claims;

estimated changes in retiree participation rates and

no adjustment for taxation of the subsidy.

In December 2003, the FASB revised SFAS No. 132, Employers Disclosures about Pensions and Other Postretirement Benefits. It requires additional disclosures to those in the original SFAS No. 132 about the plan assets, benefit obligations, cash flows, and net periodic benefit cost of defined benefit plans and other postretirement benefit plans. The requirements of this statement are presented below.

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

	Pension Benefits		Other Benefits	
	2002	**2003**	**2002**	**2003**
Change in benefit obligation:				
Benefit obligation at the beginning of the year	$11,928	**$11,386**	$ 6,315	**$ 7,387**
Service cost	177	**181**	51	**50**
Interest cost	809	**742**	453	**478**
Amendments				**(572)**
Actuarial (gain) loss	437	**803**	916	**293**
Benefits and lump sums paid	(2,000)	**(1,492)**	(400)	**(480)**
Curtailment	34		39	
Special termination benefits	1		13	
Benefit obligation at the end of the year	$11,386	**$11,620**	$ 7,387	**$ 7,156**
Change in plan assets:				
Fair value of plan assets at the beginning of the year	$16,617	**$13,338**	$ 3,163	**$ 2,820**
Actual return (loss) on plan assets	(1,279)	**2,759**	(461)	**761**
Employer contribution			493	**563**
Plan participants contributions			25	**29**
Benefits and lump sums paid	(2,000)	**(1,492)**	(400)	**(480)**
Fair value of plan assets at the end of year	$13,338	**$14,605**	$ 2,820	**$ 3,693**
Funded status:				
As of the end of the year	$ 1,952	**$ 2,985**	$ (4,567)	**$ (3,463)**
Unrecognized prior service cost	(472)	**(432)**	335	**(49)**
Unrecognized net (gain) loss	1,535	**942**	3,213	**2,923**
Unrecognized net (asset) obligation	(5)		365	**(38)**
Prepaid (accrued) benefit cost	$ 3,010	**$ 3,495**	$ (654)	**$ (627)**
Amounts recognized in the consolidated balance sheets at December 31:				
Prepaid benefit cost	$ 3,088	**$ 3,572**	$ 269	**$ 279**
Accrued benefit cost	(78)	**(77)**	(923)	**(906)**
Net amount recognized	$ 3,010	**$ 3,495**	$ (654)	**$ (627)**

Weighted-average assumptions used to determine benefit obligations at December 31:				
Discount rate	6.75%	**6.25%**	6.75%	**6.25%**
Rate of compensation increase	5.10%	**5.10%**	4.80%	**4.80%**
Health care cost trend rate assumed for next year (Pre-age 65)			10.00%	**9.00%**
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) Pre-65			5.50%	**5.00%**
Year that the rate reaches the ultimate trend rate Pre-65			2012	**2010**
Health care cost trend rate assumed for next year (Post-age 65)			12.00%	**13.00%**
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) Post-65			5.50%	**5.00%**
Year that the rate reaches the ultimate trend rate Post-65			2013	**2010**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. A one-percentage point change in assumed health care cost trend rates would have the following effects as of December 31, 2003:

	1-Percentage Point Increase	**1-Percentage Point Decrease**
Effect on total service and interest cost components	$ 45	$ (32)
Effect on other postretirement benefit obligation	$487	$(411)

In contrast to the projected benefit obligation, the accumulated benefit obligation represents the actuarial present value of benefits based on employee service and compensation as of a certain date and does not include an assumption about future compensation levels. The accumulated benefit obligation for the qualified defined benefit pension plans was $10,741 and $11,164 at December 31, 2002 and 2003 respectively.

The Other benefits funded status above of $(4,567) and $(3,463) includes a plan with a positive funded status. For the remaining plans the unfunded status was $(4,740) and $(3,754).

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	Pension Benefits			Other Benefits		
	2001	2002	2003	2001	2002	2003
Components of net periodic benefit cost:						
Service cost	$ 209	$ 177	**$ 181**	$ 42	$ 51	**$ 50**
Interest cost	919	809	**742**	428	453	**478**
Expected return on plan assets	(1,655)	(1,598)	**(1,386)**	(299)	(323)	**(315)**
Amortization of prior service cost	(31)	(50)	**(39)**	65	164	**149**
Amortization of actuarial (gain) loss	(220)	(145)	**(28)**	31	34	**108**
Amortization of transition (asset) obligation	(19)	(19)	**(5)**	79	75	**66**
Net periodic benefit cost	$ (797)	$ (826)	**$ (535)**	$ 346	$ 454	**$ 536**
Curtailment (gain) loss		(21)		97	66	
Settlement (gain) loss		181	**49**			
Special termination benefits					13	
Net periodic benefit cost with adjustments	$ (797)	$ (666)	**$ (486)**	$ 443	$ 533	**$ 536**
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:						
Discount rate	7.75%	7.25%	**6.75%**	7.75%	7.25%	**6.75%**
Expected return on plan assets	9.00%	9.00%	**8.50%**	8.25%	8.25%	**8.00%**
Rate of compensation increase	5.30%	5.10%	**5.10%**	4.80%	4.80%	**4.80%**
Health care cost trend rate pre-age 65				8.50%	8.00%	**10.00%**
Health care cost trend rate post-age 65				11.10%	10.50%	**12.00%**

Curtailments and Settlements

In 2001, we recognized curtailment losses of $97 related to other postretirement benefits: $72 related to accelerated recognition of prior service cost in excess of the decrease in our postretirement benefit obligation for the wireless employees that are covered under Cingular s postretirement benefit plans, and $25 related to work force reduction activity. Work force reduction activity in 2002 resulted in that year s curtailment gain for pensions and the curtailment and special termination benefits charges for other postretirement benefits.

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

Expected Return on Assets Assumption

As of December 2003 the 5-year average return on BellSouth pension assets was 5.9%, the 10-year average return was 9.4%, and the average return since inception was 10.9%. Our asset returns for 2003 were in excess of 22%. The expected return on plan assets reflects asset allocations, investments strategy and the views of investment managers and other large pension plan sponsors as well as historical returns. The postretirement benefits rate is slightly lower than the pension rate due to the use of a taxable postretirement benefits trust.

Plan Assets

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

	Pension			Other Benefits		
		At December 31			At December 31	
Asset Category	**Target**	**2002**	**2003**	**Target**	**2002**	**2003**
Equity securities	45-75%	56%	**57%**	50-85%	75%	**78%**
Debt securities	10-25	20	**19**	0-10	7	**5**
Real estate	5-15	10	**10**	5-15	5	**4**
Other	5-15	14	**14**	15-25	13	**13**
Total		100%	**100%**		100%	**100%**

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

Ensure that funds are available to pay benefits as they become due

maximize the trusts total return subject to prudent risk taking

and preserve and/or improve the funded status of the trusts over time.

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

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

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Cash Flows

Due to the funded status of our plans, we do not expect to make contributions to the pension plans in 2004. Consistent with prior years, we expect to contribute cash to the VEBA trusts to fund benefit payments. Contributions for 2004 are estimated to be in the range of $475 to $525.

Supplemental Executive Retirement Plan

The pension amounts reported above do not include the supplemental executive retirement plan (SERP), which is an unfunded nonqualified plan. The net periodic benefit cost associated with this plan was $55 in 2001, $58 in 2002 and $53 in 2003. Additional information for the plan, which has an accumulated benefit obligation in excess of plan assets, is:

	December 31	
	2002	**2003**
Projected benefit obligation	$ 443	**$ 473**
Accumulated benefit obligation (net amount recognized pre-tax)	374	**429**
Fair value of plan assets	0	**0**
Amounts recognized in the consolidated balance sheets at December 31:		
Amount recognized as accrued benefit cost	(265)	**(293)**
Additional minimum liability recognized in other comprehensive income (pre-tax)	(109)	**(136)**

DEFINED CONTRIBUTION PLANS

We maintain several contributory savings plans that cover substantially all employees. The BellSouth Retirement Savings Plan and the BellSouth Savings and Security Plan (collectively, the Savings Plans) are tax-qualified defined contribution plans. Assets of the plans are held by two trusts (the Trusts), which, in turn, are part of the BellSouth Master Savings Trust.

In 1990, we incorporated a leveraged Employee Stock Ownership Plan (ESOP) into the Savings Plans. The Trusts borrowed $850 by issuing amortizing notes that were guaranteed by BellSouth. The Trusts used the loan proceeds to purchase shares of BellSouth common stock in the open market. These shares were held in suspense accounts in the Trusts; a scheduled number of shares were released for allocation to participants as each semiannual loan payment was made. The Trusts serviced the debt with contributions from us and with dividends paid on the shares held by the Trusts. None of the shares held by the Trusts are subject to repurchase.

We match a portion of employees eligible contributions to the Savings Plans at rates determined annually by the Board of Directors. Our matching obligation is fulfilled with shares released from the suspense accounts semiannually for allocation to participants. The number of shares allocated to each participant s account is based on the market price of the shares at the time of allocation. If shares released for allocation do not fulfill our matching obligation, we will make further contributions to the Trusts to fund the purchase of additional shares in the open market to fulfill the remaining obligation.

During 2003, the final debt service payments were made on the loans to the Trusts and all remaining shares held by the leveraged ESOP were allocated to participants, thus terminating the leveraged ESOP

arrangement. Future contributions by participants will be matched at approved rates in cash.

We recognized expense using the shares allocated accounting method, which combines the cost of the shares allocated for the period plus interest incurred, reduced by the dividends used to service the ESOP debt. Dividends on all ESOP shares are recorded as a reduction to retained earnings, and all ESOP shares are included in the computation of earnings per share.

	2001	**2002**	**2003**
Compensation cost	$ 37	$ 38	**$ 55**
Interest expense	$ 15	$ 9	**$ 2**
Actual interest on ESOP Notes	$ 22	$ 12	**$ 2**
Cash contributions, excluding dividends paid to the trusts	$ 79	$ 84	**$ 86**
Dividends paid to the trusts, used for debt service	$ 39	$ 34	**$ 14**
Shares allocated to participants (millions)	53.4	58.6	**63.5**
Shares unallocated (millions)	10.1	4.9	**0.0**

Note L Financial Instruments

The recorded amounts of cash and cash equivalents, temporary cash investments, bank loans and commercial paper approximate fair value due to the short-term nature of these instruments. The fair value for BST s long-term debt is estimated based on the closing market prices for each issue at December 31, 2002 and 2003. Fair value estimates for the Guarantee of ESOP Debt, BellSouth Corporation long-term debt, foreign exchange contracts, foreign currency swaps and interest rate swaps are based on quotes from dealers. Since judgment is required to develop the estimates, the estimated amounts presented herein may not be indicative of the amounts that we could realize in a current market exchange.

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

	2002	
	Recorded Amount	**Estimated Fair Value**
Debt:		
Issued by BST	$ 6,439	$ 6,738
Issued by BellSouth Corporation	9,231	10,047
Issue by Latin America entities	1,634	1,198
Other debt and discounts	(15)	(15)
Guarantee of ESOP debt	108	108
	$17,397	$18,076
Interest rate swaps, net liability	$ 111	$ 111
Foreign currency swaps, net liability	$ 263	$ 263

	2003	
	Recorded Amount	**Estimated Fair Value**
Debt:		
Issued by BST	**$ 4,713**	**$ 4,950**
Issued by BellSouth Corporation	**8,822**	**9,528**
Issue by Latin America entities	**1,556**	**1,458**
Other debt and discounts	**(111)**	**(111)**
	$14,980	**$15,825**
Interest rate swaps, net liability	**$ 75**	**$ 75**

DERIVATIVE FINANCIAL INSTRUMENTS

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

INTEREST RATE SWAPS

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

	2002	2003

Pay fixed/receive variable (cash flow hedge):		
Notional amount	$ 1,144	**$ 1,120**
Rate paid	5.84%	**5.75%**
Rate received	1.79%	**1.22%**
Pay variable/receive fixed (fair value hedge):		
Notional amount	$ 230	**$ 125**
Rate paid	0.93%	**1.09%**
Rate received	2.75%	**2.22%**

The change in fair market value for derivatives designated as hedging the exposure to variable cash flows of a forecasted transaction is recognized as a component of other comprehensive income, net of tax impacts. As of December 31, 2003, there are unrecognized losses of $56 recorded in other comprehensive income. The change in fair market value for derivatives designated as hedging the exposure to changes in the fair value of a recognized asset or liability, is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. During 2003, the change in value of our fair value hedges of $5 was completely offset by the change in the fair value of the hedged items, resulting in no impact to net income. The cash flow swaps mature in 2005 and the fair value swaps mature in 2008.

FOREIGN CURRENCY SWAPS

In March 2002 we entered into three foreign currency swap contracts, which qualify as cash flow hedges, to mitigate foreign currency risk on loans we extended to KPN for approximately 2,154. As a result of the early repayment of the KPN advances in April 2003, we settled these currency swaps and recorded a gain of $20, or $13 net of tax.

CONCENTRATIONS OF CREDIT RISK

Financial instruments that potentially subject us to credit risk consist principally of trade accounts receivable. Concentrations of credit risk with respect to these receivables, other than those from long distance carriers, are limited due to the composition of the customer base, which includes a large number of individuals and businesses. Accounts receivable from long distance carriers totaled $165 at December 31, 2003 and $275 at December 31, 2002.

Note M Shareholders Equity

COMMON STOCK AUTHORIZED

Our articles of incorporation authorize the issuance of 8,650,000,000 shares of common stock, par value $1 per share. Our Board of Directors is authorized to create from the unissued common stock one or more series, and, prior

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to the issuance of any shares in any particular series, to fix the voting powers, preferences, designations, rights, qualifications, limitations or restrictions of such series. The Board has not created any series of common stock.

PREFERRED STOCK AUTHORIZED

Our articles of incorporation authorize 100 million shares of cumulative first preferred stock having a par value of $1 per share, of which 30 million shares have been reserved and designated series B for possible issuance under a shareholder rights plan. As of December 31, 2003, no preferred shares had been issued. The series A first preferred stock was created for a previous shareholder rights plan which has expired.

SHAREHOLDER RIGHTS PLAN

In 1999, we adopted a shareholder rights plan by declaring a dividend of one right for each share of common stock then outstanding and to be issued thereafter. Each right entitles shareholders to buy one one-thousandth of a share of series B first preferred stock for $200.00 per share. The rights may be exercised only if a person or group acquires 10% of the common stock of BellSouth without the prior approval of the Board of Directors or announces a tender or exchange offer that would result in ownership of 10% or more of the common stock. If a person or group acquires 10% of BellSouth s stock without prior Board approval, other shareholders are then allowed to purchase BellSouth common stock, or units of preferred stock with the same voting and economic characteristics, at half price. The rights currently trade with BellSouth common stock and may be redeemed by the Board of Directors for one cent per right until they become exercisable, and thereafter under certain circumstances. The rights expire in December 2009.

SHARES HELD IN TRUST AND TREASURY

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

	2002		2003	
	Shares (in millions)	**Amount**	**Shares (in millions)**	**Amount**
Shares held in treasury	123	$4,757	**153**	**$5,333**
Shares held by grantor trust	37	615	**37**	**659**
Shares held in trust and treasury	160	$5,372	**190**	**$5,992**

Treasury Shares

Shares held in trust and treasury include treasury share purchases made by the company primarily in open market transactions under repurchase plans and to satisfy shares issued in connection with employee and director share plans. In July 2002, we announced our intention to purchase up to $2 billion of our outstanding common stock through December 31, 2003. Purchases under that program were as follows:

	Number of shares	**Aggregate**	**Average**

	purchased (in millions)	purchase price	price per share
2002	14.8	$ 356	$24.13
2003	**35.0**	**$ 858**	**$24.50**
Total	49.8	$1,214	$24.39

In addition, we purchased 7.6 million shares for an aggregate of $235 prior to the commencement of the $2 billion program. We reissued 4.9 million shares in 2002 and 4.5 million shares in 2003 in connection with various employee and director benefit plans.

Grantor Trusts

We have grantor trusts that are designed to provide funding for the benefits payable under certain nonqualified benefit plans. The trusts are funded with shares of BellSouth stock and marketable securities. The trusts are irrevocable, and assets contributed to the trusts can only be used to pay such benefits with certain exceptions. These trusts are wholly owned by BellSouth and its subsidiaries and are consolidated in our financial statements. Accordingly, the shares of BellSouth stock held by the trusts have been classified as a reduction to shareholders equity in the consolidated balance sheets and are not considered in the computation of shares outstanding for financial reporting purposes.

GUARANTEE OF ESOP DEBT

The amount equivalent to the guarantee of the amortizing notes issued by our ESOP trusts is presented as a reduction to shareholders equity. The amount recorded as a decrease in shareholders equity represents the cost of unallocated BellSouth common stock purchased with the proceeds of the amortizing notes and the timing difference resulting from the shares allocated accounting method. See Note K for further information.

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OTHER COMPREHENSIVE INCOME

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

	2002	2003
Cumulative foreign currency translation adjustment	$(609)	**$(444)**
Minimum pension liability adjustment	(71)	**(89)**
Net unrealized losses on derivatives	(57)	**(56)**
Net unrealized gains (losses) on securities	(3)	**4**
	$(740)	**$(585)**

Note N Stock Compensation Plans

Effective January 1, 2003, we adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for stock-based employee compensation by retroactive restatement of all periods presented. As a result, stock-based compensation cost related to stock options of $203 ($123 net of tax or $0.07 per share) for 2001, $159 ($100 net of tax or $0.05 per share) for 2002 and $114 ($72 net of tax or $0.04 per share) for 2003 is included in our results of operations. Net income and earnings per share for 2001, 2002, and 2003 were decreased by the net amounts shown above. The balances for retained earnings for all periods presented have been adjusted for the effect (net of income taxes) of applying retroactively the fair value method of accounting for stock-based compensation.

At December 31, 2003, we have stock options outstanding under several stock-based compensation plans. The BellSouth Corporation Stock Plan (the Stock Plan) provides for grants to key employees of stock options and various other stock-based awards. One share of BellSouth common stock is the underlying security for any award. The number of shares available for future grant under the BellSouth Corporation Stock Plan (as amended on December 5, 2000) is equal to 1.25% of total BellSouth shares outstanding at the time of grant, plus, for each prior calendar year since the effective date of the plan, the excess of shares available for grant in that calendar year over the number of shares granted in that calendar year. Prior to adoption of the Stock Plan, stock options were granted under the BellSouth Corporation Stock Option Plan. Stock options granted under both plans entitle an optionee to purchase shares of BellSouth common stock within prescribed periods at a price either equal to, or in excess of, the fair market value on the date of grant. Options granted under these plans generally become exercisable at the end of three to five years and have a term of 10 years.

	2001	2002	2003
Options outstanding at January 1	84,814,050	93,467,300	**106,328,465**
Options granted	16,361,471	19,376,330	**14,374,127**
Options exercised	(5,344,850)	(3,757,663)	**(4,495,974)**
Options forfeited	(2,363,371)	(2,757,502)	**(3,365,745)**
Options outstanding at December 31	93,467,300	106,328,465	**112,840,873**
Weighted-average option prices per common share:			
Outstanding at January 1	$33.09	$35.10	**$35.68**
Granted at fair market value	$42.10	$35.98	**$21.96**
Exercised	$21.02	$17.55	**$17.94**
Forfeited	$44.25	$42.44	**$38.85**
Outstanding at December 31	$35.10	$35.68	**$34.52**
Weighted-average fair value of options granted at fair market value during the year	$10.99	$ 9.39	**$ 4.20**

Options exercisable at December 31	53,116,756	64,431,978	**70,615,852**
Shares available for grant at December 31	46,102,961	48,345,455	**54,881,922**

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

	2001	2002	2003
Expected life (years)	5	5	**5**
Dividend yield	1.81%	2.19%	**3.87%**
Expected volatility	26.0%	29.0%	**29.0%**
Risk-free interest rate	4.74%	4.03%	**2.65%**

The following table summarizes information about stock options outstanding at December 31, 2003:

	Outstanding			Exercisable	
Exercise Price Range	**Options (millions)**	**Average Life[(a)]**	**Average Exercise Price**	**Options (millions)**	**Average Exercise Price**
$14.77 - $20.67	4,316,331	1.11	$16.58	4,302,031	$16.58
$20.91 - $22.19	28,212,879	5.78	$21.76	14,729,529	$21.78
$22.20 - $30.91	17,977,203	5.58	$29.83	12,780,781	$30.66
$31.03 - $41.00	16,856,941	7.77	$38.95	4,527,913	$38.49
$41.26 - $51.78	45,477,519	6.22	$44.37	34,275,598	$44.99
$14.77 - $51.78	112,840,873	6.04	$34.52	70,615,852	$35.40

(a) Average contractual life remaining in years.

Note O Segment Information

We have four reportable operating segments: (1) Communications Group; (2) Domestic Wireless; (3) Latin America Group; and (4) Advertising and Publishing Group.

We own an approximate 40% economic interest in Cingular Wireless, and share joint control of the venture with SBC Communications, Inc. We account for the investment under the equity method. For management purposes

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we evaluate our domestic wireless segment based on our proportionate share of Cingular s results. Accordingly, results for our domestic wireless segment reflect the proportional consolidation of 40% of Cingular s results.

The following table provides information for each operating segment:

	2001	2002	2003
Communications Group			
External revenues	$18,927	$18,334	$18,255
Intersegment revenues	144	155	193
Total segment revenues	19,071	18,489	18,448
Depreciation and amortization	4,114	4,161	3,771
Segment operating income	5,611	4,916	4,843
Interest expense	597	498	407
Income taxes	1,838	1,671	1,645
Segment net income	$ 3,208	$ 2,751	$ 2,829
Segment assets	$32,525	$31,925	$32,354
Capital expenditures	$ 5,125	$ 3,337	$ 2,824
Domestic Wireless			
External revenues	$ 5,707	$ 5,961	$ 6,193
Intersegment revenues			
Total segment revenues	5,707	5,961	6,193
Depreciation and amortization	767	740	835
Segment operating income	1,020	1,086	915
Interest expense	328	364	343
Net earnings (losses) of equity affiliates	(29)	(106)	(129)
Income taxes	251	224	159
Segment net income	$ 425	$ 357	$ 261
Segment assets	$ 9,012	$ 9,649	$10,210
Capital expenditures	$ 1,262	$ 1,234	$ 1,094
Latin America Group			
External revenues	$ 2,910	$ 2,233	$ 2,294
Intersegment revenues	25	5	4
Total segment revenues	2,935	2,238	2,298
Depreciation and amortization	605	440	367
Segment operating income	268	279	329
Interest expense	195	138	121
Interest income	36	23	30
Net earnings (losses) of equity affiliates	(36)	(10)	18
Income tax expense (benefit)	66	(28)	27
Segment net income (loss)	$ (46)	$ 108	$ 161
Segment assets	$ 6,574	$ 3,717	$ 3,895
Equity method investments	127	108	119
Capital expenditures	$ 500	$ 247	$ 268
Advertising and Publishing Group			
External revenues	$ 2,072	$ 2,134	$ 2,033
Intersegment revenues	18	23	17
Total segment revenues	2,090	2,157	2,050
Depreciation and amortization	29	29	26
Segment operating income	982	898	973
Interest expense	16	12	7

Income taxes	374	340	**368**
Segment net income	$ 596	$ 545	**$ 600**
Segment assets	$ 1,843	$ 1,703	**$ 1,002**
Capital expenditures	$ 63	$ 29	**$ 28**

RECONCILIATION TO

CONSOLIDATED FINANCIAL INFORMATION

	2001	2002	2003
Operating revenues			
Total reportable segments	$29,803	$28,845	**$28,989**
Cingular proportional consolidation	(5,707)	(5,961)	**(6,193)**
Advertising and publishing accounting change	1	(49)	
Unbilled receivable adjustment		(163)	
Refund of customer late fees in Florida		(108)	
Corporate, eliminations and other	33	(124)	**(161)**
Total consolidated	$24,130	$22,440	**$22,635**
Operating income			
Total reportable segments	$ 7,881	$ 7,179	**$ 7,060**
Cingular proportional consolidation	(1,020)	(1,086)	**(915)**
Advertising and publishing accounting change	41	1	
Unbilled receivable adjustment		(163)	
Restructuring charge and asset impairment	(431)	(914)	**(162)**
Pension settlement loss		(167)	**(47)**
Adjustment to ISP accrual	(143)		
Refund of customer late fees in Florida		(108)	
Corporate, eliminations and other	(190)	4	**(30)**
Total consolidated	$ 6,138	$ 4,746	**$ 5,906**
Net Income			
Total reportable segments	$ 4,183	$ 3,761	**$ 3,851**
Advertising and publishing accounting change	27	1	
Unbilled receivable adjustment		(101)	
Restructuring charge and asset impairments	(274)	(589)	**(99)**
Pension settlement loss		(100)	**(29)**
Adjustment to ISP accrual	(88)		
Refund of customer late fees in Florida		(70)	
Foreign currency transaction gains (losses)	(230)	(597)	**110**
Brazil loan impairments		(263)	
Net gain (loss) on ownership transactions	28	806	**(234)**
Net gains (losses) on sale or impairment of securities	(1,263)	(274)	**22**
Cumulative effect of changes in accounting principle		(1,285)	**315**
Early extinguishment of debt		(22)	
Corporate, eliminations and other	64	56	**(32)**
Total consolidated	$ 2,447	$ 1,323	**$ 3,904**

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

Reconciling items are transactions or events that are included in reported consolidated results but are excluded from segment results due to their nonrecurring or nonoperational nature. Net gain (loss) on ownership transactions include: for 2001, gains from the sale of investments in SkyCell and BellSouth International Wireless Services; in 2002, a gain from the conversion of our ownership interest in E-Plus and a loss associated with the disposal of one of our Brazilian advertising and publishing companies; and for 2003, losses from the sale of two Brazilian wireless companies.

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

	United States	International	Total
2001:			
Revenues	$21,220	$2,910	$24,130
Long-lived assets	39,936	5,255	45,191
2002:			
Revenues	$20,207	$2,233	$22,440
Long-lived assets	39,106	2,511	41,617
2003:			
Revenues	**$20,341**	**$2,294**	**$22,635**
Long-lived assets	**38,537**	**2,316**	**40,853**

Note P Foreign Currency

Argentina

In Argentina, we own an 86.7% interest in CRM, a wireless communications company, which we consolidate in our financial statements. In January 2002, the Argentine government announced economic reforms, including a devaluation of its national currency, the Argentine Peso. The Argentine Peso lost over 71% of its value as compared to the US Dollar in 2002. Based on the net monetary position of CRM, we recorded foreign currency transaction losses of $683 during 2002. We are recording a valuation allowance on the net operating losses, deferring recognition of the tax benefits generated by these losses due to the potentially limited tax carry forward period in Argentina. The value of the Argentine Peso as compared to the US Dollar slightly recovered during 2003 resulting in the recognition of foreign currency transaction gains of $104 during 2003.

Venezuela

In Venezuela, we own a 78.2% interest in Telcel, a wireless communications company, which we also consolidate in our financial statements. In February 2002, the Venezuelan government let the Bolivar float freely. The Bolivar subsequently devalued approximately 44% since the beginning of our fiscal period 2002. Based on Telcel s net monetary position, we recorded foreign currency transaction gains of $89 in 2002 and $5 in 2003. In addition, Venezuela is no longer considered a hyper inflationary economy, which resulted in a change in the functional currency from the US Dollar to the Bolivar. As a result, remeasurement of non-monetary assets and liabilities is reflected as a foreign currency translation adjustment in the other comprehensive income portion of shareholders equity.

During February 2003, the Venezuelan government announced a new foreign exchange control regime and set a fixed exchange rate of 1,600 Bolivars to the US Dollar. There are currently currency restrictions in place in Venezuela that limit our ability to physically convert local currency to US Dollars. Because of the currency controls, we are accumulating significant balances in Bolivars held in local banks. We are currently analyzing available alternatives in order to convert the currency into US Dollars. During February 2004, the official exchange rate was adjusted by the government to 1,920 Bolivars to the US Dollar, but the currency exchange restrictions were not lifted. This devaluation will result in a reduction to revenues and net income

of our Venezuelan operation beginning in the first quarter of 2004. The government has established procedures for the conversion of Bolivars into US Dollars for the import of a limited number of goods and services. Our local operation has been able to make limited purchases of dollars for the import of cellular handsets used in its business.

Due to the currency controls, there is no free market currency exchange rate. Therefore, in preparing our consolidated financial statements, we used the exchange rate established by the Venezuelan government of 1,600 Bolivars to the US Dollar to translate the local currency financial statements into our reporting currency, the US Dollar. When the Bolivar resumes trading on the open market, the exchange rate may be different than the rate set by the government. A significant devaluation of the local currency would result in a decline in revenues and, to a lesser extent, operating expenses when reported in the US Dollar. To the extent permissible by regulatory and market conditions, a portion of the effect of a devaluation could be offset by local rate increases. As an example, a devaluation in the Venezuelan currency from the 1,600 rate used in our financial statements to 3,000 Bolivars to the US Dollar would equate to a decrease in revenues of approximately $421 for 2003, not taking into consideration any potential impacts from offsetting local rate increases. Such a change in the exchange rate would also result in a reduction in the company s net assets of approximately $339, which would be reported as a reduction in shareholder s equity through the cumulative foreign currency translation adjustment. Because certain expenses are settled in US Dollars, determination of the net income impact of such a devaluation is not practicable.

We are monitoring the situation, but continue to believe it is temporary in nature. Therefore, we have continued to consolidate the financial statements of this operation in accordance with SFAS No. 94. In the event the currency restrictions are deemed other-than-temporary, we would cease to consolidate this operation and would reflect the investment using the cost method of accounting.

Note Q Commitments and Contingencies

LEASES

We have entered into operating leases for facilities and equipment used in operations. Rental expense under operating leases was $319 for 2001, $329 for 2002, and $345 for 2003. Capital leases currently in effect are not significant. The following table summarizes the approximate future minimum rentals under noncancelable operating leases in effect at December 31, 2003:

	Minimum Rentals
2004	$ 160
2005	139
2006	119
2007	104
2008	90
Thereafter	376
Total	$ 988

OUTSIDE PLANT

We currently self-insure all of our outside plant against casualty losses. Such outside plant, located in the nine southeastern states served by BST, is susceptible to damage from severe weather conditions and other perils. The net book value of outside plant was $7,308 at December 31, 2002 and $8,527 at December 31, 2003.

GUARANTEES

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

PURCHASE OBLIGATIONS

As of December 31, 2003, we have contracts in place to outsource certain services, principally information technology. We also have several significant commitments with large vendors to purchase telecommunications equipment, software and services.

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

	Payments Due by Period				
	Total	Less than 1 year	2005-2007	2008-2010	After 2010
Unconditional purchase obligations[1]	$3,563	$807	$2,156	$600	

(1) The total unconditional purchase obligation includes $323 related to agreements with Qwest and Accenture that do not stipulate annual minimum purchases. The agreement with Qwest expires in 2006 and the Accenture agreement expires in 2007. These amounts are included in the 2005-2007 column above.

PUT-CALL PROVISIONS

Venezuela

We own a 78.2% interest in Telcel, our Venezuelan operation. Telcel s other major shareholder holds an indirect 21% interest in Telcel. Under a Stock Purchase Agreement, that shareholder has the right to initiate a process that could require us to purchase (the puts), and we have the right to initiate a process that could require that shareholder to sell (the calls) to us, the shareholder s interest in Telcel. Notice of the initiation of the process with respect to approximately half of that shareholder s interest was to be given in 2000 and notice with respect to the remaining balance was to be given in 2002. If we exercise our call right, we would purchase that shareholder s interest at between 100% and 120% of its appraised fair value. If we are required to purchase the interest, we would do so at between 80% and 100% of its appraised fair value.

In 2000, the shareholder initiated a process for appraising the value of approximately half of its interest in Telcel, but the process was not completed. The shareholder also has sent a letter purporting to exercise the balance of the puts under the Stock Purchase Agreement. We are currently in arbitration with the shareholder over alleged breaches by BellSouth and the shareholder of the Stock Purchase Agreement, including the timing of the valuation and whether the process was properly initiated in 2000. The arbitration does not directly involve the valuation of the balance of the puts. The shareholder is seeking damages and specific performance, and BellSouth is seeking, among other things, unspecified damages and a ruling that it has not breached the Stock Purchase Agreement in any respect. The arbitration also related to an alleged oral agreement to buy out the shareholder s entire interest in Telcel, which we argue does not exist. The first stage of the hearing on these matters occurred in early 2004, with additional hearings scheduled for the second quarter of 2004. If the arbitration panel rules against BellSouth, it is possible that the appraised fair value of the shareholder s interest in Telcel could be substantially in excess of current value. At this time, the likely outcome of this arbitration cannot be predicted, nor can a reasonable estimate of the amount of loss, if any, be made.

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Colombia

We own approximately 66% of BellSouth Colombia. Our principal partner holds approximately 34%. We have agreed with our partner to a series of related put and call agreements whereby we can acquire, or could be compelled by our partner to acquire, additional shares of the Colombian operation currently held by our partner for a price equal to the appraised fair value. During the first put/call period, we have the right, but not the obligation, to call and our partner has the right, but not the obligation, to put to us approximately one-third of our partner s holding in the Colombian operation. In February 2004, we exercised our call right with respect to the first put/call provision. As a result, we agreed to purchase 11.6% of the Colombian operation from our partner. The purchase price for the additional interest is $32 and will be funded from cash on hand. Under a second put/call option, the remaining balances of our partner s shares (100% of the partner s shares if the first put/call expires unexercised) can be called by us or put to us beginning in 2006 until 2009. We cannot predict if either party will exercise its rights under the second put/call option provision.

RECIPROCAL COMPENSATION

Following the enactment of the Telecommunications Act of 1996, our telephone company subsidiary, BellSouth Telecommunications, Inc. (BST), and various competitive local exchange carriers entered into interconnection agreements providing for, among other things, the payment of reciprocal compensation for local calls initiated by the customers of one carrier that are completed on the network of the other carrier. These agreements were the subject of litigation before various regulatory commissions. After an FCC ruling in April 2001 prescribing new rates, BellSouth settled its claims with competitors for traffic occurring through mid-June 2001, and entered into agreements that contained the FCC rates for traffic occurring from mid-June 2001 forward. The District of Columbia Circuit Court of Appeals, in the second quarter of 2002, remanded the ruling to the FCC to implement a rate methodology consistent with the Court s opinion. The FCC s previous rules and rates remain in effect while it reconsiders them. A change in the rules or rates could increase our expenses.

REGULATORY MATTERS

Beginning in 1996, we operated under a price regulation plan approved by the South Carolina Public Service Commission (PSC) under existing state laws. In April 1999, however, the South Carolina Supreme Court invalidated this price regulation plan. In July 1999, we elected to be regulated under a new state statute, adopted subsequent to the PSC s approval of the earlier plan. The new statute allows telephone companies in South Carolina to operate under price regulation without obtaining approval from the PSC. The election became effective during August 1999. The South Carolina Consumer Advocate petitioned the PSC seeking review of the level of our earnings during the 1996-1998 period when we operated under the subsequently invalidated price regulation plan. The PSC dismissed the petition in November 1999 and issued orders confirming the vote in February and June of 2000. In July 2000, the Consumer Advocate appealed the PSC s dismissal of the petition. In January 2004, the court hearing the appeal affirmed the PSC s decision. An appeal of this decision to the South Carolina Supreme Court is probable. If the Consumer Advocate prevails, the case could be remanded to the PSC, which could, after considering evidence, order refunds to customers in South Carolina, which in the aggregate may be material to the company. At this time, we are unable to predict the outcome of this appeal and, therefore, cannot determine the impact, if any, this matter may have on future earnings.

LEGAL PROCEEDINGS

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

estimate of the amount of loss, if any, be made.

From August through October 2002 several individual shareholders filed substantially identical class action lawsuits against BellSouth and three of its senior officers alleging violations of the federal securities laws. The cases have been consolidated in the United States District Court for the Northern District of Georgia and are captioned In re BellSouth Securities Litigation. Pursuant to the provisions of the Private Securities Litigation Reform Act of 1995, the court has appointed a Lead Plaintiff. The Lead Plaintiff filed a Consolidated and Amended Class Action Complaint on or about July 15, 2003 and named four outside directors as additional defendants. The Consolidated and Amended Class Action Complaint alleges that during the period November 7, 2000 through February 19, 2003, the Company (1) overstated the unbilled receivables balance of its advertising and publishing subsidiary; (2) failed to properly implement SAB 101 with regard to its recognition of advertising and publishing revenues; (3) improperly billed competitive local exchange carriers (CLEC) to

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inflate revenues; (4) failed to take a reserve for refunds that ultimately came due following litigation over late payment charges; and (5) failed to properly write down goodwill of its Latin American operations. The plaintiffs are seeking an unspecified amount of damages, as well as attorneys fees and costs. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

In February 2003, a similar complaint was filed in the Superior Court of Fulton County, Georgia on behalf of participants in BellSouth s Direct Investment Plan alleging violations of Section 11 of the Securities Act. Defendants removed this action to federal court pursuant to the provisions of the Securities Litigation Uniform Standards Act of 1998. On or about July 3, 2003, the federal court issued a ruling that the case should be remanded to Fulton County Superior Court. The plaintiffs are seeking an unspecified amount of damages, as well as attorneys fees and costs. At this time, the likely outcome of the case cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

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

In October 2002, a number of antitrust class action lawsuits were filed against BellSouth in federal district courts in Atlanta, Georgia and Ft. Lauderdale, Florida. The plaintiffs purport to represent putative classes consisting of all BellSouth local telephone service subscribers and/or all subscribers of competitive local exchange carriers in nine southeastern states since 1996. The plaintiffs allege that BellSouth engaged in unlawful anticompetitive conduct in violation of state and federal antitrust laws by, among other things, (1) denying competitors access to certain essential facilities necessary for competitors to provide local telephone service; (2) using its monopoly power in the wholesale market for local telephone service as leverage to maintain a monopoly in the retail market; and (3) failing to provide the same quality of service, access and billing to competitors that it provides its own retail customers. The plaintiffs are seeking an unspecified amount of treble damages, injunctive relief, as well as attorneys fees and costs. At this time, the likely outcome of the cases cannot be predicted, nor can a reasonable estimate of loss, if any, be made.

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

OTHER CLAIMS

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

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

Note R Related Party Transactions

In addition to the advances to affiliates discussed in Note D and activity related to Cingular discussed in Note K, other significant transactions with related parties are summarized in the succeeding paragraphs. We generated revenues of approximately $304 in 2001, $386 in 2002, and $426 in 2003 from the provision of local interconnect and long distance services to Cingular and agent commissions from Cingular.

In October 2000, we entered into a transition services agreement with Cingular, pursuant to which we provide transition services and products for a limited period of time. The services we provided included government and regulatory affairs, finance, compensation and benefit accounting, human resources, internal audit, risk management, legal, security and tax. Provided services terminated prior to December 31, 2002. The fees were determined based

on the cost of providing the level of service expected to be provided at the time we entered into the agreements.

Also in October 2000, we transferred our wireless employees and all related obligations and liabilities to two subsidiary leasing companies. We entered into a leasing agreement with Cingular, whereby our leasing companies agreed to lease all of their current employees to Cingular through December 2001. Between October 2000 and December 2001, the wireless employees were solely employed by our leasing subsidiaries and participated in BellSouth benefit plans. During this period, Cingular reimbursed us monthly for all payroll related obligations for these wireless employees. These billings to Cingular were recorded as contra expenses, and the net earnings of the leasing subsidiaries were zero during this period. In December 2001 we transferred our leasing companies and substantially all related liabilities to Cingular. The net liabilities transferred to Cingular approximated $36.

Note S Subsidiary Financial Information

We have fully and unconditionally guaranteed all of the outstanding debt securities of BellSouth Telecommunications, Inc. (BST), which is a 100% owned subsidiary of BellSouth. In accordance with SEC rules, BST is no longer subject to the reporting requirements of the Securities Exchange Act of 1934, and we are providing the following condensed consolidating financial information. BST is listed separately because it has debt securities, registered with the SEC, that we have guaranteed. We revised the condensed consolidating financial information as of December 31, 2002 and December 31, 2001 and for the years then ended to reflect the application by BST and BellSouth (Parent) of the equity method of accounting for investments in their subsidiaries. The Other column represents all other wholly owned subsidiaries excluding BST and BST subsidiaries. The Adjustments column includes the necessary amounts to eliminate the intercompany balances and transactions between BST, Other and Parent and to consolidate wholly owned subsidiaries to reconcile to our consolidated financial information.

The revisions described above had no effect on the consolidated financial statements. Further, the revisions had no effect on the revenues or net income in the BST column. The primary impact of these revisions on the December 31, 2002 consolidating information was an approximate $19 billion increase in Parent Shareholders Equity (of which $17 billion was an increase in Investments in Subsidiaries) and a reclassification of approximately $3 billion between Accounts Receivable and Investments in the BST column. Additionally, there were reclassifications between Operating Expenses, Equity in Earnings and Income Taxes. These changes resulted in increases in Operating Expenses, Cash Flows, and Equity in Earnings, and decreases in Income Taxes in the BST column, which were offset by changes within the Adjustments column. We do not believe any of these revisions are material.

CONDENSED CONSOLIDATING STATEMENTS OF INCOME

	For the Year Ended December 31, 2001				
	BST	Other	Parent	Adjust-ments	Total
Total operating revenues	$18,267	$8,659	$	$(2,796)	$24,130
Total operating expenses	15,307	6,912	125	(4,352)	17,992
Operating income	2,960	1,747	(125)	1,556	6,138
Interest expense	853	434	632	(604)	1,315
Net earnings (losses) of equity affiliates	1,160	478	3,680	(4,853)	465
Other income (expense), net	15	(5)	(1,173)	(311)	(1,474)
Income before income taxes and cumulative effect of changes in accounting principle	3,282	1,786	1,750	(3,004)	3,814
Provision (benefit) for income taxes	749	647	(697)	668	1,367

Income before cumulative effect of changes in accounting principle	2,533	1,139	2,447	(3,672)	2,447
Cumulative effect of changes in accounting principle					
Net income (losses)	$ 2,533	$ 1,139	$ 2,447	$ (3,672)	$ 2,447

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	For the Year Ended December 31, 2002				
	BST	Other	Parent	Adjust-ments	Total
Total operating revenues	$17,515	$ 7,423	$	$(2,498)	$22,440
Total operating expenses	15,292	6,263	114	(3,975)	17,694
Operating income	2,223	1,160	(114)	1,477	4,746
Interest expense	617	343	610	(382)	1,188
Net earnings (losses) of equity affiliates	1,015	86	2,899	(3,920)	80
Other income (expense), net	(46)	881	184	(241)	778
Income before income taxes and cumulative effect of changes in accounting principle	2,575	1,784	2,359	(2,302)	4,416
Provision (benefit) for income taxes	582	882	(249)	593	1,808
Income before cumulative effect of changes in accounting principle	1,993	902	2,608	(2,895)	2,608
Cumulative effect of changes in accounting principle		(1,285)	(1,285)	1,285	(1,285)
Net income (losses)	$ 1,993	$ (383)	$ 1,323	$(1,610)	$ 1,323

	For the Year Ended December 31, 2003				
	BST	Other	Parent	Adjust-ments	Total
Total operating revenues	$17,400	$7,989	$	$(2,754)	$22,635
Total operating expenses	14,838	6,114	25	(4,248)	16,729
Operating income	2,562	1,875	(25)	1,494	5,906
Interest expense	537	174	580	(243)	1,048
Net earnings (losses) of equity affiliates	1,067	511	3,900	(5,013)	465
Other income (expense), net	(10)	190	111	(14)	277
Income before income taxes and cumulative effect of changes in accounting principle	3,082	2,402	3,406	(3,290)	5,600
Provision (benefit) for income taxes	730	845	(183)	619	2,011
Income before cumulative effect of changes in accounting principle	2,352	1,557	3,589	(3,909)	3,589
Cumulative effect of changes in accounting principle	816	(501)	315	(315)	315

Net income (losses)	$ 3,168	$ 1,056	$ 3,904	$ (4,224)	$ 3,904

CONDENSED CONSOLIDATING BALANCE SHEETS

	December 31, 2002					December 31, 2003				
	BST	Other	Parent	Adjust-ments	Total	BST	Other	Parent	Adjust-ments	Total
ASSETS										
Current assets:										
Cash and cash equivalents	$	$ 752	$ 1,643	$ 87	$ 2,482	$ 5	$ 1,190	$ 3,227	$ 134	$ 4,556
Accounts receivable, net	53	1,901	2,807	(632)	4,129	68	1,201	3,204	(1,545)	2,928
Other current assets	367	695	81	108	1,251	393	773	81	118	1,365
Total current assets	420	3,348	4,531	(437)	7,862	466	3,164	6,512	(1,293)	8,849
Investments and advances	3,331	6,924	23,340	(23,854)	9,741	3,464	7,913	22,609	(25,434)	8,552
Property, plant and equipment, net	21,352	2,037	5	51	23,445	21,818	1,947	4	38	23,807
Deferred charges and other assets	4,892	329	124	381	5,726	5,029	287	72	467	5,855
Intangible assets, net	1,071	1,477	3	154	2,705	1,036	1,460	5	138	2,639
Total assets	$ 31,066	$ 14,115	$ 28,003	$ (23,705)	$ 49,479	$ 31,813	$ 14,771	$ 29,202	$ (26,084)	$ 49,702
LIABILITIES AND SHAREHOLDERS EQUITY										
Current liabilities:										
Debt maturing within one year	$ 2,844	$ 1,120	$ 2,991	$ (1,841)	$ 5,114	$ 2,454	$ 920	$ 2,470	$ (2,353)	$ 3,491
Other current liabilities	3,415	1,563	743	(1,252)	4,469	3,942	1,724	916	(1,615)	4,967
Total current liabilities	6,259	2,683	3,734	(3,093)	9,583	6,396	2,644	3,386	(3,968)	8,458
Long-term debt	5,371	3,344	6,294	(2,726)	12,283	4,970	845	6,301	(627)	11,489
Noncurrent liabilities:										
Deferred income taxes	3,507	1,508	(733)	170	4,452	4,408	1,519	(751)	173	5,349
Other noncurrent liabilities	3,258	1,147	802	48	5,255	2,991	1,074	554	75	4,694
Total noncurrent liabilities	6,765	2,655	69	218	9,707	7,399	2,593	(197)	248	10,043
Shareholders equity	12,671	5,433	17,906	(18,104)	17,906	13,048	8,689	19,712	(21,737)	19,712
Total liabilities and shareholders equity	$ 31,066	$ 14,115	$ 28,003	$ (23,705)	$ 49,479	$ 31,813	$ 14,771	$ 29,202	$ (26,084)	$ 49,702

CONDENSED CONSOLIDATING CASH FLOW STATEMENTS

	For the Year Ended December 31, 2001				
	BST	Other	Parent	Adjustments	Total
Cash flows from operating activities	$ 6,308	$ 1,896	$ 3,559	$ (3,765)	$ 7,998
Cash flows from investing activities	(4,962)	(1,183)	(3,320)	2,426	(7,039)
Cash flows from financing activities	(1,347)	(1,156)	(239)	1,314	(1,428)
Net (decrease) increase in cash	$ (1)	$ (443)	$	$ (25)	$ (469)

	For the Year Ended December 31, 2002				
	BST	Other	Parent	Adjustments	Total
Cash flows from operating activities	$ 6,174	$ 1,362	$ 3,434	$ (2,724)	$ 8,246
Cash flows from investing activities	(3,166)	(479)	1,480	458	(1,707)
Cash flows from financing activities	(3,008)	(731)	(3,271)	2,361	(4,649)
Net (decrease) increase in cash	$	$ 152	$ 1,643	$ 95	$ 1,890

	For the Year Ended December 31, 2003				
	BST	Other	Parent	Adjustments	Total
Cash flows from operating activities	**$ 7,654**	**$ 2,283**	**$ 4,038**	**$ (5,446)**	**$ 8,529**
Cash flows from investing activities	**(2,918)**	**(685)**	**371**	**1,534**	**(1,698)**
Cash flows from financing activities	**(4,731)**	**(1,160)**	**(2,825)**	**3,959**	**(4,757)**
Net (decrease) increase in cash	**$ 5**	**$ 438**	**$ 1,584**	**$ 47**	**$ 2,074**

Note T Quarterly Financial Information (Unaudited)

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

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2002				
Operating Revenues	$5,534	$5,780	$5,434	$5,692
Operating Income	1,369	1,199	1,042	1,136
Income Before Effect of Change in Accounting Principle	1,131	263	640	574
Net Income (Loss)	(154)	263	640	574
Basic Earnings Per Share[a]:				
Income Before Effect of Change in Accounting Principle	$ .60	$ .14	$ .34	$ .31
Net Income (Loss)	$ (.08)	$ .14	$ .34	$ .31
Diluted Earnings Per Share[a]:				
Income Before Effect of Change in Accounting Principle	$ .60	$ .14	$ .34	$ .31
Net Income (Loss)	$ (.08)	$ .14	$ .34	$ .31
2003				
Operating Revenues	**$5,523**	**$5,642**	**$5,728**	**$5,742**
Operating Income	**1,379**	**1,435**	**1,554**	**1,538**
Income Before Effect of Change in Accounting Principle	**915**	**951**	**936**	**787**
Net Income (Loss)	**1,230**	**951**	**936**	**787**
Basic Earnings Per Share[a]:				
Income Before Effect of Change in Accounting Principle	**$ .49**	**$ .51**	**$ .51**	**$ .43**
Net Income (Loss)	**$ .66**	**$ .51**	**$ .51**	**$ .43**
Diluted Earnings Per Share[a]:				
Income Before Effect of Change in Accounting Principle	**$ .49**	**$ .51**	**$ .51**	**$ .43**
Net Income (Loss)	**$ .66**	**$ .51**	**$ .51**	**$ .43**

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

The quarters shown were affected by the following:

2002

During 2002, we recorded foreign currency losses, net of tax, of $204, or $0.11 per share, in first quarter, $355, or $0.19 per share, in second quarter, $13, or $0.01 per share, in third quarter and $26, or $0.01 per share, in fourth quarter.
We recorded losses as a result of selling shares of Qwest common stock, which reduced net income by $60, or $0.03 per share, during first quarter and $23, or $0.01 per share, during second quarter.

We recorded losses related to the write-down of our investments in equity securities, which reduced net income by $101, or $0.05 per share, in first quarter and $33, or $0.02 per share, in second quarter.
We recorded losses related to our workforce reduction of approximately 5,000 positions, which reduced net income by $225, or $0.12 per share, in second quarter and $202, or $0.11 per share, in third quarter, and $262, or $0.14 per share in fourth quarter.
First quarter also includes a gain related to the conversion of our ownership interest in E-Plus into KPN stock, a loss on the subsequent sale of the KPN stock, and a gain from the settlement of forward contracts associated with advances to E-Plus, all of which increased net income by $857, or $0.45 per share. In addition, first quarter includes recognition of an impairment on shareholder loans to our Brazilian equity investments, as well as the recognition of a guarantee on a portion of those operations debt, which resulted in a decrease to net income of $263, or $0.14 per share. Also during first quarter, we recorded a reduction to our advertising and publishing revenues, which reduced net income by $101, or $0.05 per share.
Third quarter also includes a charge for the refund of certain late payment fees to customers in Florida, which reduced net income by $70, or $0.04 per share.
Fourth quarter also includes a loss related to the sale of our remaining Brazilian yellow pages operation, which reduced net income by $51, or $0.03 per share.

2003

During 2003, we recorded foreign currency gains and (losses), net of tax, of $48, or $0.03 per share, in first quarter, $65, or $0.04 per share, in second quarter, $(12), or $(0.01) per share, in third quarter and $9, or $0.00 per share, in fourth quarter.
We recorded losses related to our workforce reduction of approximately 3,400 positions, which reduced net income by $74, or $0.04 per share, in first quarter and $12, or $0.01 per share, in second quarter, and $10, or $0.01 per share in fourth quarter.
Second quarter also includes a charge for the sale of one of our Brazilian equity-method investments, which reduced net income by $73, or $0.04 per share.
Third quarter also includes a charge for an asset impairment, which reduced net income by $32, or $0.02 per share.
Fourth quarter also includes a charge for the sale of one of our Brazilian equity-method investments, which reduced net income by $161, or $0.09 per share, and a gain related to the sale of Tele Cento Oeste common stock, which increased net income by $27, or $0.01 per share.

Note U   Subsequent Events

SONOFON

On February 12, 2004, we closed on a previously announced agreement to sell our interest in Danish wireless provider, Sonofon, for 3.68 billion Danish Kroner (currently equaling approximately US$600) to Telenor ASA. We received 3.05 billion Danish Kroner for our 46.5% equity stake and 630 Danish Kroner for our shareholder loan and accrued interest. Telenor, the incumbent local exchange carrier in Norway, currently owns 53.5 percent of Sonofon and shares joint control of the company with BellSouth.

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We will record an after-tax gain of approximately $300 in the first quarter of 2004.

AT&T WIRELESS

On February 17, 2004, Cingular announced an agreement to acquire AT&T Wireless Services, Inc. in an all cash transaction. Under the terms of the agreement, which were approved by our board of directors and the boards of directors of SBC and Cingular as well as AT&T Wireless, shareholders of AT&T Wireless will receive $15 cash per common share or approximately $41 billion. The acquisition, which is subject to the approvals of AT&T Wireless shareholders and federal regulatory authorities, and to other customary closing conditions, is expected to be completed in the fourth quarter of 2004.

We have committed to funding our proportionate share of the all cash transaction. We expect our funding requirement will be approximately $16 billion. Funding will be achieved through a combination of existing cash on hand, cash generated from our operations prior to closing and potential asset sales. We plan to access the public debt markets for the remainder. At the time of closing, we currently anticipate our likely external funding needs to be in the $9.5 to $10.5 billion range.

Cingular expects to achieve significant operating and capital synergies through this acquisition by consolidating networks, distribution, billing, procurement, marketing, advertising and other functions. Due to the impacts of purchase accounting at Cingular, integration costs and additional financing costs of indebtedness we expect to incur to satisfy our funding commitment to the transaction, we expect some dilution to GAAP earnings per share in the first few years subsequent to the closing of the transaction.

SBC s and BellSouth s proportionate equity stake in Cingular will remain unchanged following the transaction, with SBC holding 60 percent and BellSouth 40 percent. SBC and BellSouth will continue to have equal management control.

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EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

BELLSOUTH CORPORATION

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH AUDITORS ON ACCOUNTING AND FINANCIAL DISCLOSURE

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

ITEM 9a. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to the management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management necessarily applied its judgment in assessing the costs and benefits of such controls and procedures, which, by their nature, can provide only reasonable assurance regarding management s control objectives. We also have investments in certain unconsolidated entities. As we do not control or manage these entities, our disclosure controls and procedures with respect to such entities are necessarily more limited than those we maintain with respect to our consolidated subsidiaries.

The Company s management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls can prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. There are inherent limitations in all control systems, including the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of one or more persons. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and, while our disclosure controls and procedures are designed to be effective under circumstances where they should reasonably be expected to operate effectively, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in any control system, misstatements due to error or fraud may occur and not be detected.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer along with the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rules 13a-15(b) and 15d-15(b). Based upon the foregoing, the Chief Executive Officer along with the Chief Financial Officer concluded that our disclosure controls and procedures are effective at providing reasonable assurance that all material information relating to BellSouth (including consolidated subsidiaries) required to be included in our Exchange Act reports is reported in a timely manner. In addition, based on such evaluation we have identified no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART III

ITEMS 10 THROUGH 13.

Information regarding executive officers required by Item 401 of Regulation S-K is furnished in a separate disclosure on page 20 in Part I of this report since the registrant did not furnish such information in its definitive proxy statement prepared in accordance with Schedule 14A. Information regarding our Code of

Ethics, as required by Item 10 below, is included under the caption Website Access on page 20 of this Form 10-K.

The additional information required by these items will be included in the registrant s definitive proxy statement dated March 10, 2004 as follows, and is herein incorporated by reference pursuant to General Instruction G(3):

Item	Description	Page(s) in Definitive Proxy Statement
10.	Directors and Executive Officers of the Registrant	7 to 8; 40 to 41[a]
11.	Executive Compensation	13 to 14[b]; 18[c]; 33 to 39[d]
12.	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	19; 37[e]
13.	Certain Relationships and Related Transactions	11 to 12[f]; 39[g]
14.	Principal Auditor Fees and Services	15[h]

(a) Only the information under the caption Section 16(a) Beneficial Ownership Reporting Compliance.
(b) Only the information under the caption Director Compensation.
(c) Only the information under the caption Compensation Committee Interlocks and Insider Participation.
(d) Excluding the information under the captions Equity Compensation Plan Information and Related Party Transactions.
(e) Only the information under the caption Equity Compensation Plan Information.
(f) Only the information under the caption Independent Directors.
(g) Only the information under the caption Related Party Transactions.
(h) Only the information under the caption Independent Auditor Fees and Services.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

		Page(s) in This Form 10-K
a.	Documents filed as a part of the report:	
(1)	Financial Statements:	
	Reports of Independent Auditors	55
	Consolidated Statements of Income	56
	Consolidated Balance Sheets	57
	Consolidated Statements of Cash Flows	58
	Consolidated Statements of Shareholders Equity and Comprehensive Income	59
	Notes to Consolidated Financial Statements	60
(2)	Financial statement schedules have been omitted because the required information is contained in the financial statements and notes thereto or because such schedules are not required or applicable.	
(3)	Exhibits: Exhibits identified in parentheses below, on file with the SEC, are incorporated herein by reference as exhibits hereto. All management contracts or compensatory plans or arrangements required to be filed as exhibits to this Form 10-K Report pursuant to Item 15(c) are filed as Exhibits 10 through 10ll inclusive.	

Exhibit Number	
3a	Amended Articles of Incorporation of BellSouth Corporation adopted December 5, 2000. (Exhibit 3a to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
3b	Amended and Restated By-laws of BellSouth Corporation adopted September 22, 2003 (Exhibit 3b to Form 10-Q for the quarter ended September 30, 2003, File No. 1-8607.)
4	BellSouth Corporation Shareholder Rights Agreement. (Exhibit 1 to Report on Form 8-A dated November 23, 1999, File No. 1-8607.)
4a	No instrument which defines the rights of holders of long and intermediate term debt of BellSouth Corporation is filed herewith pursuant to Regulation S-K, Item 601(b)(4)(iii)(A). Pursuant to this regulation, BellSouth Corporation hereby agrees to furnish a copy of any such instrument to the SEC upon request.
10a	BellSouth Corporation Officer Short Term Incentive Award Plan. (Exhibit 10y to Form 10-Q for the quarter ended September 30, 1996, File No. 1-8607.)
10c	BellSouth Corporation Executive Long Term Disability and Survivor Protection Plan as amended and restated effective January 1, 1994. (Exhibit 10c-1 to Form 10-K for the year ended December 31, 1993, File No. 1-8607.)
10d	BellSouth Corporation Executive Transfer Plan. (Exhibit 10ee to Registration Statement No. 2-87846.)
10e	BellSouth Corporation Death Benefit Program. (Exhibit 10ff to Form 10-K for the year ended December 31, 1989, File No. 1-8607.)
10f	BellSouth Corporation Plan For Non-Employee Directors Travel Accident Insurance. (Exhibit 10ii to Registration Statement No. 2-87846.)
10g	BellSouth Corporation Executive Incentive Award Deferral Plan as amended and restated effective September 23, 1996. (Exhibit 10g to Form 10-K for the year ended December 31, 1996, File No. 1-8607.)
10h	BellSouth Corporation Nonqualified Deferred Compensation Plan as amended and restated effective November 25, 1996. (Exhibit 10h to Form 10-K for the year ended December 31, 1996, File No. 1-8607.)
10i	BellSouth Corporation Supplemental Executive Retirement Plan as amended on March 23, 1998. (Exhibit 10i to Form 10-Q for the quarter ended March 31, 1998, File No. 1-8607.)

10j	BellSouth Corporation Directors Retirement Plan. (Exhibit 10qq to Form 10-K for the year ended December 31, 1986, File No. 1-8607.)
10k	BellSouth Corporation Financial Counseling Plan. (Exhibit 10r to Form 10-K for the year ended December 31, 1992, File No. 1-8607.)
10k-1	Amendment dated November 3, 1995 to the BellSouth Corporation Financial Counseling Plan for Executives. (Exhibit 10l-1 to Form 10-K for the year ended December 31, 1995, File No. 1-8607.)
10l	BellSouth Corporation Deferred Compensation Plan for Non-Employee Directors. (Exhibit 10gg to Registration Statement No. 2-87846.)
10m	BellSouth Corporation Executive Life Insurance Plan as amended and restated as the BellSouth Split-Dollar Life Insurance Plan, effective August 31, 1998. (Exhibit 10m to Form 10-K for the year ended December 31, 1998, File No. 1-8607.)
10n	BellSouth Corporation Non-Employee Director Stock Plan. (Exhibit 10z to Form 10-Q for the quarter ended March 31, 1997, File No. 1-8607.)
10p	BellSouth Non-Employee Directors Charitable Contribution Program. (Exhibit 10z to Form 10-K for the year ended December 31, 1992, File No. 1-8607.)

Exhibit Number	
10q	BellSouth Personal Retirement Account Pension Plan, as amended and restated effective January 1, 1998. (Exhibit 10q to Form 10-K for the year ended December 31, 1998, File No. 1-8607.)
10q-1	Amendment dated December 22, 1998 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-1 to Form 10-K for the year ended December 31, 1998, File No. 1-8607.)
10q-2	Amendment dated March 22, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-2 to Form 10-Q for the quarter ended March 31, 1999, File No. 1-8607.)
10q-3	Amendment dated April 7, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-3 to Form 10-Q for the quarter ended March 31, 1999, File No. 1-8607.)
10q-4	Amendment dated May 6, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-4 to Form 10-Q for the quarter ended June 30, 1999, File No. 1-8607.)
10q-5	Amendment dated May 6, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-5 to Form 10-Q for the quarter ended June 30, 1999, File No. 1-8607.)
10q-6	Amendment dated May 7, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-6 to Form 10-Q for the quarter ended June 30, 1999, File No. 1-8607.)
10q-7	Amendment dated September 13, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-7 to Form 10-Q for the quarter ended September 30, 1999, File No. 1-8607.)
10q-8	Amendment dated December 22, 1999 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-8 to Form 10-K for the year ended December 31, 1999, File No. 1-8607.)
10q-9	Amendment dated December 15, 2000 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-9 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10q-10	Amendment dated December 15, 2000 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-10 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10q-11	Amendment dated December 15, 2000 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-11 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10q-12	Amendment dated December 15, 2000 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-12 to Form 10-Q for the quarter ended September 30, 2001, File No. 1-8607.)
10q-13	Amendment dated December 18, 2001 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-13 to Form 10-K for the year ended December 31, 2001, File No. 1-8607.)
10q-14	Amendment dated December 17, 2002 to the BellSouth Personal Retirement Account Pension Plan. (Exhibit 10q-14 to Form 10-K for the year ended December 31, 2002, File No. 1-8607.)
10q-15	Amendment dated December 23, 2003 to the BellSouth Personal Retirement Account Pension Plan.
10r	BellSouth Corporation Trust Under Executive Benefit Plan(s) as amended April 28, 1995. (Exhibit 10u-1 to Form 10-Q for the quarter ended June 30, 1995, File No. 1-8607.)
10r-1	Amendment dated May 23, 1996 to the BellSouth Corporation Trust Under Executive Benefit Plan(s). (Exhibit 10s-1 to Form 10-Q for the quarter ended June 30, 1996, File No. 1-8607.)
10r-2	Second Amendment dated July 8, 2002 to the BellSouth Corporation Trust Under Executive Benefit Plan(s). (Exhibit 10r-2 to Form 10-Q for the quarter ended September 30, 2002, File No. 1-8607.)
10r-3	First Amendment dated November 1, 2003 to the BellSouth Corporation Trust Under Executive Benefit Plan(s).
10r-4	Second Amendment dated December 17, 2003 to the BellSouth Corporation Trust Under Executive Benefit Plan(s).
10s	BellSouth Telecommunications, Inc. Trust Under Executive Benefit Plan(s) as amended April 28, 1995. (Exhibit 10v-1 to Form 10-Q for the quarter ended June 30, 1995, File No. 1-8607.)

10s-1	Amendment dated May 23, 1996 to the BellSouth Telecommunications, Inc. Trust Under Executive Benefit Plan(s). (Exhibit 10t-1 to Form 10-Q for the quarter ended June 30, 1996, File No. 1-8607.)
10s-2	Second Amendment dated July 8, 2002 to the BellSouth Telecommunications, Inc. Trust Under Executive Benefit Plan(s). (Exhibit 10s-2 to Form 10-Q for the quarter ended September 30, 2002, File No. 1-8607.)
10s-3	First Amendment dated November 1, 2003 to the BellSouth Telecommunications, Inc. Trust Under Executive Benefit Plan(s).
10s-4	Second Amendment dated December 17, 2003 to the BellSouth Telecommunications, Inc. Trust Under Executive Benefit Plan(s).
10t	BellSouth Corporation Trust Under Board of Directors Benefit Plan(s) as amended April 28, 1995. (Exhibit 10w-1 to Form 10-Q for the quarter ended June 30, 1995, File No. 1- 8607.)
10t-1	Amendment dated May 23, 1996 to the BellSouth Corporation Trust Under Board Directors Benefit Plan(s). (Exhibit 10u-1 to Form 10-Q for the quarter ended June 30, 1996, File No. 1-8607.)

Exhibit Number	
10t-2	First Amendment dated November 1, 2003 to the BellSouth Corporation Trust Under Board of Directors Benefit Plan(s).
10t-3	Second Amendment dated December 17, 2003 to the BellSouth Corporation Trust Under Board of Directors Benefit Plan(s).
10u	BellSouth Telecommunications, Inc. Trust Under Board of Directors Benefit Plan(s) as amended April 28, 1995. (Exhibit 10x-1 to Form 10-Q for the quarter ended June 30, 1995, File No. 1-8607.)
10u-1	Amendment dated May 23, 1996 to the BellSouth Telecommunications, Inc. Trust Under Board of Directors Benefit Plan(s). (Exhibit 10v-1 to Form 10-Q for the quarter ended June 30, 1996, File No. 1-8607.)
10u-2	First Amendment dated November 1, 2003 to the BellSouth Telecommunications, Inc. Trust Under Board of Directors Benefit Plan(s).
10u-3	Second Amendment dated December 17, 2003 to the BellSouth Telecommunications, Inc. Trust Under Board of Directors Benefit Plan(s).
10v-1	The Amended and Restated BellSouth Corporation Stock Plan Effective April 24, 1995 As Amended (Exhibit 10v-1 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10w	BellSouth Retirement Savings Plan as amended and restated effective July 1, 2001. (Exhibit 10w to Form 10-K for the year ended December 31, 2001, File No. 1-8607.)
10w-1	First Amendment dated December 18, 2001 to the BellSouth Retirement Savings Plan. (Exhibit 10w-1 to Form 10-K for the year ended December 31, 2001, File No. 1-8607.)
10w-2	Second Amendment dated March 14, 2002 to the BellSouth Retirement Savings Plan. (Exhibit 10w-2 to Form 10-Q for the quarter ended September 30, 2002, File No. 1-8607.)
10w-3	Third Amendment to the BellSouth Retirement Savings Plan effective as of May 1, 2002 and December 10, 2002. (Exhibit 10w-3 to Form 10-K for the year ended December 31, 2002, File No. 1-8607.)
10w-4	Fourth Amendment dated December 23, 2003 to the BellSouth Retirement Savings Plan.
10x	BellSouth Corporation Officer Estate Enhancement Plan and Agreement. (Exhibit 10x to Form 10-K for the year ended December 31, 1996, File No. 1-8607.)
10y-1	BellSouth Change in Control Executive Severance Agreements (Exhibit 10y-1 to Form 10-Q for the quarter ended September 30, 2003, File No. 1-8607.)
10z	BellSouth Compensation Deferral Plan as amended and restated effective September 28, 1998. (Exhibit 10z to Form 10-Q for the quarter ended September 30, 2001, File No. 1-8607.)
10bb	BellSouth Officer Motor Vehicle Policy. (Exhibit 10bb to Form 10-Q for the quarter ended March 31, 1998, File No. 1-8607.)
10dd	Agreement with Chief Executive Officer. (Exhibit 10dd to Form 10-K for the year ended December 31, 1998, File No. 1-8607.)
10gg	Retention Agreement dated October 18, 2000 for Francis A. Dramis. (Exhibit 10gg to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10gg-1	BellSouth Corporation Stock Plan Restricted Shares Award Agreement dated October 18, 2000 for Francis A. Dramis (Exhibit 10gg-1 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10gg-2	BellSouth Corporation Stock Plan Restricted Shares Award Escrow Agreement dated October 18, 2000 for Francis A. Dramis. (Exhibit 10gg-2 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10hh-2	BellSouth Corporation Stock Plan Restricted Shares Award Agreement dated October 26, 2000 for Ronald M. Dykes (Exhibit 10hh-1 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10hh-3	BellSouth Corporation Stock Plan Restricted Shares Award Escrow Agreement dated October 26, 2000 for Ronald M. Dykes. (Exhibit 10hh-2 to Form 10-K for the year ended December 31, 2000, File No. 1-8607.)
10hh-4	Agreement dated May 19, 2003 with Ronald M. Dykes (Exhibit 10hh-4 to Form 10-Q for the quarter ended June 30, 2003, File No. 1-8607.)
10jj-2	The Amended and Restated BellSouth Officer Compensation Deferral Plan Effective April 1, 2003 As Amended (Exhibit 10jj-2 to From 10-Q for the quarter ended June 30, 2003, File No. 1-8607.)

10kk	Amended and Restated Agreement dated February 24, 2004, between BellSouth Corporation and Mark L. Feidler.
10ll	Form of Indemnity Agreement.

Exhibit Number	
10mm	Agreement and Plan of Merger by and among AT&T Wireless Services, Inc., Cingular Wireless Corporation, Cingular Wireless LLC and Links I Corporation, and, solely with respect to Sections 5.3, 6.1(b), 6.5(b) and Article IX of the Agreement and Plan of Merger, SBC Communications Inc. and BellSouth Corporation dated as of February 17, 2004 (Incorporated by reference to Exhibit 99.1 from the Current Report on Form 8-K/A of Cingular Wireless LLC dated February 17, 2004 and filed on February 18, 2004, File No. 001-31673.)
10nn	Investment Agreement dated February 17, 2004 between BellSouth Corporation and SBC Communications Inc.
11	Computation of Earnings Per Share.
12	Computation of Ratio of Earnings to Fixed Charges.
21	Subsidiaries of BellSouth.
23a	Consent of Independent Accountants.
23b	Consent of Independent Auditors.
24	Powers of Attorney.
31-a	Section 302 Certification of F. Duane Ackerman
31-b	Section 302 certification of Ronald M. Dykes
32	Statement Required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99a	Annual report on Form 11-K for BellSouth Retirement Savings Plan for the fiscal year ended December 31, 2003 (to be filed under Form 11-K within 180 days of the end of the period covered by this report).
99b	Annual report on Form 11-K for BellSouth Savings and Security ESOP Plan for the fiscal year ended December 31, 2003 (to be filed under Form 11-K within 180 days of the end of the period covered by this report).
b.	Reports on Form 8-K: Date of Event: October 22, 2003 Subject: Press release announcing financial results for third quarter 2003.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BELLSOUTH CORPORATION

/s/ W. Patrick Shannon

W. Patrick Shannon

Vice President Finance

February 24, 2004

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

PRINCIPAL EXECUTIVE OFFICER:

F. Duane Ackerman*
CHAIRMAN OF THE BOARD, PRESIDENT
AND CHIEF EXECUTIVE OFFICER

PRINCIPAL FINANCIAL OFFICER:

Ronald M. Dykes*
CHIEF FINANCIAL OFFICER

PRINCIPAL ACCOUNTING OFFICER:

W. Patrick Shannon*
Vice President Finance

DIRECTORS:

F. Duane Ackerman*
Reuben V. Anderson*
James H. Blanchard*
J. Hyatt Brown*
Armando M. Codina*
Kathleen F. Feldstein*
James P. Kelly*
Leo F. Mullin*
Eugene F. Murphy*
Robin B. Smith*
William S. Stavropoulos*

*By: /s/ W. Patrick Shannon

W. Patrick Shannon

(INDIVIDUALLY AND AS ATTORNEY-IN-FACT)

February 24, 2004