32% of access line growth in 1995 was due to the sales of additional access lines to existing residential customers. Vertical services revenues also increased in 1995.

Wireless revenues relate to Mobile Systems operations and increased in 1996 and 1995 due primarily to the growth in the number of Mobile Systems' cellular customers of 20.7% and 22.7%. These increases were partially offset by slight declines in average revenue per customer. Beginning in 1997, wireless revenues will also reflect personal communications services (PCS) operations in California and Nevada.

Mobile Systems had 4,398,000 customers in areas in which they were one of the two incumbent providers and 35,000 resale customers at December 31, 1996. These customer amounts were 3,659,000 and 13,000, respectively, at December 31, 1995.

Network Access Interstate network access revenues increased in 1996 and 1995 due largely to increases in demand for access services by interexchange carriers. Growth in revenues from end user charges, attributable to an increasing access line base, also contributed to the increases in both years. Net rate reductions under the FCC's revised price cap plan, which were effective August 1, 1995, partially offset these increases by approximately $115 in both 1996 and 1995.

Intrastate network access revenues increased in 1996 and 1995 due primarily to increases in demand, including usage by alternative intraLATA toll carriers. The increase in 1995 was partially offset by the decrease in prices due to the introduction of competition for long-distance services in California.

Long-Distance Service In 1996 and 1995 PAC provided approximately 55% - 60% of SBC's long-distance revenues. Overall, long-distance revenues increased in 1996 due principally to increases in demand resulting from California's growing economy and growth in Mobile Systems' long-distance revenues, including interLATA service that began in February 1996. Additionally, long-distance service revenues increased due to the inclusion in 1995 of SWBell intraLATA toll pool settlement payments and accruals for rate reductions relating to an appealed 1992 rate order in Oklahoma. The settlement of the appeals in October 1995 eliminated the need to continue these accruals. Absent these accruals and settlements, SWBell long-distance service revenues in 1996 would have decreased slightly due to the continuing impact of price competition from alternative intraLATA toll carriers. Long-distance service revenues decreased in 1995 primarily due to an approximate 40% reduction in intraLATA long-distance prices in California resulting from the introduction of competition for those services and the related regulatory price rebalancing. Additionally, SWBell long-distance services revenues experienced decreases, reflecting competition-related decreases in residential message volumes and the impact of optional calling plans and extended area service plans.

Directory Advertising revenues were relatively unchanged in 1996 as increased yellow pages revenues from Southwestern Bell Yellow Pages, Inc. (Yellow Pages) and Pacific Bell Directory (PBDirectory) were offset by the decrease resulting from the January 1996 sale of SBC's publishing contracts for GTE Corporation's service areas to GTE Directories. Excluding the impact of this sale, revenues increased 5.1% in 1996. Results for 1995 reflect growth in yellow pages revenues, partially offset by the impact of increased competition.

Other operating revenues in 1996 and 1995 reflect the increased demand for voice-messaging services, Caller ID equipment, computer network services, computer programming services and videoconferencing services. Other increases in 1996 were attributable to revenues from new business initiatives, such as wireless cable and internet services. The increase in 1995 was partially offset by the decrease in equipment sales revenues at Mobile Systems resulting primarily from declining equipment prices.

Dollars in millions except per share amounts

Operating Expenses

Total operating expenses increased $1,058, or 6.4%, in 1996 and $536, or 3.3%, in 1995. Components of total operating expenses, including percentage changes from the prior year, are as follows:

				Percent Change	
				1996 vs.	1995 vs.
	1996	1995	1994	**1995**	1994
Cost of services and products	**$ 8,220**	$ 7,864	$ 7,917	**4.5%**	(0.7%)
Selling, general and administrative	**5,321**	4,694	4,315	**13.4**	8.8
Depreciation and amortization	**4,109**	4,034	3,824	**1.9**	5.5
	$ 17,650	$ 16,592	$ 16,056	**6.4%**	3.3%

Cost of Services and Products increased in 1996 due to increases at the Telephone Companies for network expansion and maintenance, employee compensation and demand-related increases. Other increases in 1996 reflect growth at Mobile Systems, costs incurred to prepare for local competition and PAC's new business initiatives, such as PCS, Internet access and network integration. These increases were partially offset by PAC's decreased employee benefits expenses due to changes in employee benefit plans and benefit plan assumptions (see Note 9 to the financial statements). In 1995, expenses decreased primarily due to decreased California pool settlements with other local exchange carriers, force reductions at PacBell, and decreased equipment costs at Mobile Systems. The absence of expenses associated with SBC's United Kingdom cable television operations (discussed in Other Business Matters) also contributed to the decrease in 1995. These decreases were mostly offset by increases at the Telephone Companies for network expansion and maintenance, demand-related increases for enhanced services, and employee compensation at SWBell.

Selling, General and Administrative expenses increased in 1996 primarily due to growth-related increases at Mobile Systems and the Telephone Companies, including contracted services, employee compensation and software costs. The increase in 1996 also reflects PAC's expenses incurred to prepare support systems for local competition and for new business initiatives, including long-distance. In 1995, expenses increased primarily due to growth-related increases at Mobile Systems and SWBell, including contracted services and advertising, the $139 charge for costs associated with the strategic realignment discussed in Other Business Matters, and software costs at PAC. These increases were somewhat offset by force reductions at PacBell. Also contributing to the increases in both 1996 and 1995 were increases in operating taxes at SWBell, which include the Texas Infrastructure Fund assessments.

Depreciation and Amortization increased in 1996 and 1995 due primarily to growth in plant levels and changes in plant composition, primarily at the Telephone Companies and Mobile Systems. The increase in 1995 also reflects the effect of regulatory depreciation represcription at the Telephone Companies.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

Interest Expense decreased $145, or 15.2%, in 1996 due to a change in PAC's capital structure which replaced a portion of interest expense with amounts recorded as Other Income (Expense) (see Note 7 to the financial statements), lower long-term debt levels in SBC subsidiaries other than PAC, and capitalization of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995. Under regulatory accounting, the Telephone Companies accounted for capitalization of both interest and equity costs during periods of construction as other income.

Equity in Net Income of Affiliates increased $87 in 1996 and decreased $106 in 1995. The 1996 increase reflects: increased income from Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company, due to the relative stabilization of the peso; net gains on international affiliate transactions; and improved results from SBC's investment in French cellular operations, reflecting lower level of losses in its second year. Results for 1995 include losses on SBC's United Kingdom cable television operations, which were accounted for under the equity method prior to October 1995, and exchange losses on the non-peso denominated debt of Telmex. Results for 1996 and 1995 also reflect reductions in the translated amount of U.S. dollar earnings from Telmex's operations. Operational growth at Telmex in both years somewhat offset these declines. The 1995 decrease was also attributable to SBC's investment in French cellular operations and PAC's video-related joint venture.

SBC's future earnings from Telmex will continue to be sensitive to changes in the value of the peso. SBC's investment in Telmex has been recorded under U.S. generally accepted accounting principles (GAAP), which exclude inflation adjustments and include adjustments for the purchase method of accounting. Beginning in 1997, SBC will use the U.S. dollar, instead of the peso, as the functional currency for its investment in Telmex due to the Mexican economy becoming highly inflationary as defined by GAAP. Earnings in 1997 will reflect SBC's reduced ownership percentage in Telmex as discussed in Note 5 to the financial statements. These changes are each expected to have a slightly negative impact on Equity in Net Income from Telmex.

Other Income (Expense) - Net decreased $276 in 1996 and increased $210 in 1995. In 1995, SBC recognized a gain from the merger of SBC's United Kingdom cable television operations into TeleWest (see Note 13 to the financial statements) and interest income from tax refunds. The increase was somewhat offset by expenses associated with the refinancing of long-term debt by the Telephone Companies (see Note 6 to the financial statements). Results for 1996 reflect the inclusion in 1995 of these items and decreases due to the reclassification of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995 as well as distributions paid on Trust Originated Preferred Securities (TOPrS), as noted in the discussion of Interest Expense (see Note 7 to the financial statements).

Income Tax expense increased $441, or 29.0%, in 1996 and $71, or 4.9%, in 1995, primarily due to higher income before income taxes. In 1995, tax refunds received at PAC somewhat offset the increase. The elimination of excess deferred taxes and the reduction in the amortization of investment tax credits resulting from the discontinuance of regulatory accounting, as described in Note 2 to the financial statements, also contributed to the increases in both years.

Extraordinary Loss In 1995, SBC recorded an extraordinary loss of $6 billion from the discontinuance of regulatory accounting. The loss included a reduction in the net carrying value of telephone plant and the elimination of net regulatory assets of SWBell and PacBell (see Note 2 to the financial statements).

Dollars in millions except per share amounts

Cumulative Effect of Accounting Change As discussed in note 1 to the financial statements, PBDirectory changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. The cumulative after-tax effect of applying the new method to prior years is recognized as of January 1, 1996 as a one-time, non-cash gain applicable to continuing operations of $90, or $0.10 per share. The gain is net of deferred taxes of $53. Management believes this change to the issue basis method is preferable because it is the method generally followed in the publishing industry, including Yellow Pages, and better reflects the operating activity of the business. This accounting change is not expected to have a significant net income effect on future periods.

Operating Environment and Trends of the Business

Regulatory Environment

The Telephone Companies' telecommunications operations are subject to regulation by each of the seven states in which they operate for intrastate services and by the FCC for interstate services. The Telephone Companies operate under incentive regulation, or price caps, for various services provided by the Telephone Companies. Under price cap regulation, the Telephone Companies are permitted to establish and modify prices, not to exceed the price caps, subject to expedited approval by the governing jurisdiction. Prices for some other services not specifically covered by price caps are also subject to regulatory approval.

The FCC adopted revised interim price cap rules effective August 1, 1995 that govern the prices that the larger Local Exchange Carriers (LECs), including the Telephone Companies, charge interexchange carriers for access to local telephone networks. Price caps set by the FCC are adjusted annually for inflation, a productivity offset and certain other changes in costs. The productivity offset is a fixed percentage used to reduce price caps and is designed to encourage increased productivity. The revised rules allow a choice of three productivity offsets, two of which provide for a sharing of profits with consumers above certain earnings levels and the third of which has no sharing. Through 1996, the Telephone Companies elected the 5.3% productivity offset with no sharing.

The revised FCC price cap plan was intended to be an interim plan that would be revised in 1996. However, with the passage of the Telecommunications Act of 1996 (the Telecom Act), the FCC is conducting further proceedings to address various pricing and productivity issues, and is performing a broader review of price cap regulation in a competitive environment. Additionally, the FCC has stated it will examine universal service and access charge rules during 1997. The Telecom Act and FCC actions taken to implement provisions of the Telecom Act are discussed further under the heading "Competition."

The states' regulatory bodies set intrastate price caps on various services for various periods, depending upon the state. The price cap plans in California and Nevada included sharing mechanisms; however, beginning in 1997, Nevada implemented a new price cap plan which eliminated the sharing mechanism.

Following is a summary of significant state regulatory developments.

California The CPUC's form of price caps requires PacBell to submit an annual price cap filing to determine prices for categories of services for each new year. The price cap plan includes a sharing mechanism that requires PacBell to share its earnings with customers at certain earnings levels. Price adjustments reflect the effects of any change in inflation less productivity as well as adjustments for certain exogenous cost changes. In December 1995, the CPUC issued an order in its review of the regulatory framework in California that suspended use of the "inflation minus productivity" component of the price cap formula for 1996 through 1998. This action freezes the price caps on most of PacBell's regulated services for the years 1996 through 1998 except for adjustments due to exogenous costs or price changes approved through the CPUC's price cap filing process. In December 1996, the CPUC adjusted PacBell's rates due to various exogenous cost changes by an annual revenue reduction of approximately $66 annually, effective January 1, 1997.

The CPUC issued its final decision on universal service on October 25, 1996, establishing an annual California universal service fund of approximately $352 that will subsidize high cost service. Customers of all telecommunications providers will contribute to the universal service fund via a 2.87% surcharge on all bills for telecommunications services provided in California. Effective February 1, 1997, the universal service fund will subsidize the provision of service in high cost areas. In order to ensure revenue neutrality, PacBell must reduce its rates dollar for dollar for amounts received from the fund via an across the board surcredit on all products and services (except residential basic exchange services) or permanent price reductions for those services that previously subsidized universal service. The fund was intended to allow PacBell to eliminate high cost subsidies from its prices, positioning PacBell for competition. Initially, PacBell expects to receive $305 annually from the fund based on CPUC estimates of the cost of providing universal service. Management believes the new program underestimates the cost of providing universal service. PacBell estimates that the average cost of providing service is up to 33% higher per line per month than the CPUC estimate, which could result in high cost area subsidies remaining in prices for competitive services. If this continues, it would place PacBell at a competitive disadvantage.

In 1992, the CPUC issued a decision adopting, with modification, Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions" (FAS 106), for regulatory accounting purposes. Annual price cap decisions by the CPUC granted PacBell approximately $100 in each of the years 1993-1996 for partial recovery of higher costs under FAS 106. In October 1994 the CPUC reopened the proceeding to determine the criteria for exogenous cost treatment and whether PacBell should continue to recover these costs. The CPUC's order also held that related revenues collected after October 12, 1994, were subject to refund plus interest pending further proceedings. On April 9, 1997, the CPUC completed these proceedings and reaffirmed that postretirement benefits costs are appropriately recoverable in PacBell's price cap filings.

The FCC adopted new separations rules effective May 1, 1997 that shift recovery of substantial other billing and collections costs to the interstate jurisdiction. This rule change could reduce PacBell's revenues by about $30 in 1997 and about $45 in each subsequent year. Management is evaluating options to mitigate this effect on net income.

In 1992, a settlement agreement was reached between the State Board of Equalization, all California counties, the State Attorney General, and 28 utilities, including PacBell, on a specific methodology for valuing utility property for property tax purposes for a period of eight years. The CPUC opened an investigation to determine if any resulting property tax savings should be returned to customers. Intervenors have asserted that as much as $20 of annual property tax savings should be treated as an exogenous cost reduction in PacBell's annual price cap filings. These intervenors have also asserted that past property tax savings totaling as much as approximately $70 as of December 31, 1996, plus interest should be returned to customers. Management believes that, under the CPUC's regulatory framework, any property tax savings should be treated only as a component of the calculation of shareable earnings and not as an exogenous cost. In an Interim Opinion issued in June 1995, the CPUC decided to defer a final decision on this matter pending resolution of the criteria for exogenous cost treatment under its regulatory framework.

Texas The Public Utility Regulatory Act, which became effective in May 1995 (PURA), allows SWBell and other LECs to elect to move from rate of return regulation to price regulation with elimination of earnings sharing. In September 1995, SWBell notified the Texas Public Utility Commission (TPUC) that it elected incentive regulation under the new law. Basic local service rates are capped at existing levels for four years following the election. The TPUC is prohibited from reducing switched access rates charged by LECs to interexchange carriers while rates are capped.

LECs electing price regulation must commit to network and infrastructure improvement goals, including expansion of digital switching and advanced high-speed services to qualifying public institutions, such as schools, libraries and hospitals, requesting the services. PURA also established an infrastructure grant fund for use by public institutions in upgrading their communications and computer technology. PURA provided for a total fund assessment of $150 annually on all telecommunications providers in Texas for a ten-year period, half of which would be paid by the cellular and wireless industry. The provisions establishing different assessment rates for landline and cellular and wireless service providers were ruled unconstitutional under the Texas constitution in January 1996, and the lower rate was ordered to be applied to both categories of service providers, resulting in less than a $150 annual assessment. Based on this order, SBC's total annual payment is estimated to be approximately $35 to $45. The 1997 Texas legislative session is considering this issue with the stated goal of restoring the assessment to its original $150 annual amount. As a result, SBC's annual payment could increase.

PURA establishes local exchange competition by allowing other companies that desire to provide local exchange services to apply for certification by the TPUC, subject to certain build-out requirements, resale restrictions and minimum service requirements. PURA provides that SWBell will remain the default carrier of "1 plus" intraLATA long-distance traffic until SWBell is allowed to carry interLATA long-distance.

In 1996, MCI Communications Corporation (MCI) and AT&T Corp. (AT&T) sued the state of Texas, alleging that PURA violates the Texas state constitution, and claiming that PURA establishes anticompetitive barriers designed to prevent MCI, AT&T and Sprint Corporation (Sprint) from providing local services within Texas. SBC is unable to predict the outcome of this proceeding. During 1996, the TPUC approved the application of Sprint for a certificate of authority to provide local service, waiving the build-out requirements specified under state law for facilities-based certificates of authority. TPUC has also requested the FCC issue an expedited ruling on whether PURA's build-out requirements are lawful under the Telecom Act. AT&T and MCI have also filed petitions with the FCC arguing the build-out requirements should be preempted; they have also requested TPUC grant them similar treatment as Sprint. In a preliminary ruling, the TPUC has waived build-out requirements for them.

More than 100 applications to provide competitive local service certification have been approved by the TPUC, with over 30 more applications pending approval. As a result, SWBell expects competition to continue to develop for local service, but the specific financial impacts of this competition cannot be reasonably estimated until all required tariff filings are approved by the TPUC for SWBell and other companies intending to provide local service.

Missouri During 1996, the 1995 Cole County Circuit Court ruling which overturned the August 1994 settlement agreement reached among SWBell, the Missouri Public Service Commission (MPSC) and the Office of Public Counsel (OPC) was upheld on appeal. The practical effect of this decision is to eliminate the prospective commitments under the settlement agreement, including a rate review moratorium and capital investment commitments. The decision has no immediate impact on SWBell's current rates because they were approved by the MPSC in separate proceedings, which were not appealed.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

Oklahoma On October 30, 1995, the Oklahoma Corporation Commission (OCC) approved a settlement that resolved pending court appeals of a 1992 rate order. Under the terms of the settlement, SWBell paid a cash settlement of $170 to business and residential customers, and offered discounts with a retail value of $268 for certain SWBell services. Previously ordered rate reductions of $100 were lowered to $84, of which $57 had already been implemented. The settlement allowed the remaining $27 in rate reductions to be deferred, with approximately $9 becoming effective in 1996 and the remainder during 1997. The settlement also provides that no overearnings complaint can be filed against SWBell until January 1, 1998. SWBell began accruing for the order in 1992, and the settlement and associated costs had been fully accrued as of the end of the third quarter of 1995.

Competitive Environment

Competition continues to increase in the telecommunications industry. Recent changes in legislation and regulation have increased the opportunities for alternative service providers offering telecommunications services. Technological advances have expanded the types and uses of services and products available. Accordingly, SBC faces increasing competition in significant portions of its business.

Domestic

On February 8, 1996, the Telecom Act was enacted into law. The Telecom Act is intended to address various aspects of competition within, and regulation of, the telecommunications industry. The Telecom Act provides that all post-enactment conduct or activities which were subject to the consent decree, referred to as the Modification of Final Judgment (MFJ), issued at the time of AT&T's divestiture of the Regional Holding Companies (RHCs) are now subject to the provisions of the Telecom Act. In April 1996, the United States District Court for the District of Columbia issued its Opinion and Order terminating the MFJ and dismissing all pending motions related to the MFJ as moot. This ruling effectively ended 13 years of RHC regulation under the MFJ. Among other things, the Telecom Act also defines conditions SBC must comply with before being permitted to offer interLATA long-distance service within California, Texas, Missouri, Kansas, Oklahoma, Arkansas, and Nevada (regulated operating areas) and establishes certain terms and conditions intended to promote competition for the Telephone Companies' local exchange services.

Under terms of the Telecom Act, SBC may immediately offer interLATA long-distance outside the regulated operating areas and over its wireless network both inside and outside the regulated operating areas. Before being permitted to offer landline interLATA long-distance service in any state within the regulated operating areas, SBC must apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves consultation with the United States Department of Justice, requires favorable determinations that the Telephone Companies have entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" with predominantly facilities based carrier(s) that serve residential and business customers or, alternatively, that the Telephone Companies have a statement of terms and conditions effective in that state under which it offers the "competitive checklist" items. The FCC must also make favorable public interest and structural separation determinations. The Telecom Act directed the FCC to establish rules and regulations to implement the Telecom Act, and to preempt specific state law provisions under certain circumstances. The Telecom Act also allows RHCs to provide cable services over their own networks, but sets limits on RHCs acquiring interests in cable television operations in their regulated operating areas.

In August 1996, the FCC issued rules by which competitors could connect with LECs' networks, including those of the Telephone Companies. Among other things, the rules addressed unbundling of network elements, pricing for interconnection and unbundled elements (Pricing Provisions), and resale of network services. The FCC rules were appealed by numerous parties, including SBC, other LECs, various state regulatory commissions and the National Association of Regulatory Utility Commissioners.

On October 15, 1996, the United States Court of Appeals for the Eighth Circuit (Eighth Circuit) issued an order to stay the FCC's Pricing Provisions and its rules permitting new entrants to "pick and choose" among the terms and conditions of approved interconnection agreements. The stay provides that it will remain in effect while the Eighth Circuit considers the validity of the rules. Other provisions of rules adopted by the FCC to implement the Telecom Act remain in effect.

The effects of the FCC rules are dependent on many factors including, but not limited to: the ultimate resolution of the pending appeals; the number and nature of competitors requesting interconnection, unbundling or resale; and the results of the state regulatory commissions' review and handling of related matters within their jurisdictions. Accordingly, SBC is not able to assess the impact of the FCC rules.

Landline Local Service

Recent state legislative and regulatory developments also allow increased competition for local exchange services. Companies wishing to provide competitive local service have filed numerous applications with state commissions throughout the Telephone Companies' regulated operating areas, and the commissions of each state have begun approving these applications. Under the Telecom Act, companies seeking to interconnect to the Telephone Companies' network and exchange local calls must enter into interconnection agreements with the Telephone Companies, which are then subject to approval by the appropriate state commission. There have been approximately 190 companies approved by state commissions to provide local telephone service throughout the Telephone Companies' regulated operating areas, most of them in Texas and California. There are approximately 70 more applications pending approval before the state commissions. Several companies who have failed to agree on all interconnection terms have filed for arbitration before the state commissions.

The CPUC authorized facilities-based local services competition effective January 1996 and resale competition effective March 1996. Several issues still need to be resolved before the CPUC issues final rules for local competition. These issues include final rates for resale, presubscription, implementation of number portability and LEC provisioning and pricing of essential network functions to competitors. In order to provide services to resellers, PacBell uses established operating support systems, and has implemented electronic ordering systems and a customer care/billing center. Costs to implement local competition, especially number portability, will be material and it is uncertain whether regulators will allow for recovery of these costs. The CPUC expects to issue final rules on presubscription in early 1997 and final rates and rules for all other issues in late 1997. It is anticipated that competition will be targeted mainly to high-density areas, where higher margins may be achieved. Many of these competitors have placed facilities in service and begun extensive advertising campaigns.

In October 1996, in a consolidated arbitration hearing between SWBell and AT&T, MCI, MFS Communications Company, Inc. (MFS), Teleport Communications Group, and American Communications Services, Inc., the TPUC approved interconnection rates to be charged by SWBell as well as certain other terms of interconnection between the parties. SWBell also filed revised cost support for the establishment of rates with the TPUC which may be subject to further hearings. SWBell, AT&T and MCI filed suit in state and federal court maintaining that, for various reasons, the arbitration award is unlawful. SWBell has TPUC-approved interconnection agreements with 26 local service providers, with 17 pending approvals as of April 15.

Dollars in millions except per share amounts

In Missouri, the MPSC issued orders on a consolidated arbitration hearing with AT&T and MCI and on selected items with MFS. Among other terms, the orders established discount rates for resale of SWBell services and prices for unbundled network elements. SWBell has filed suit in federal court appealing the orders as unlawful.

As a result of the Telecom Act and conforming interconnection agreements, the Telephone Companies expect in 1997 they will experience local exchange competition from multiple providers in various markets. Management is unable to assess the effect of competition on the industry as a whole, or financially on SBC, but expects both losses of market share in local service and gains resulting from new business initiatives, vertical services and new service areas. SBC intends to use approved agreements in support of its application to the FCC to provide interLATA long-distance service in the Telephone Companies' regulated operating areas.

The Telephone Companies also face competition from various local service providers that bypass the local exchange network. Some of these providers have built fiber optic "rings" throughout large metropolitan areas to provide transport services (generally high-speed data) for large business customers and interexchange carriers. Others provide high-usage customers, particularly large businesses, alternative telecommunications links for voice and data, such as private network systems, shared tenant services or private branch exchange (PBX) systems (which are customer-owned and provide internal switching functions without using a telephone company's central office facilities). The extent of the economic incentive to bypass the local exchange network depends upon local exchange prices, access charges, regulatory policy and other factors. End user charges previously ordered by the FCC are designed in part to mitigate the effect of system bypass.

Wireless Local Service

In 1993, the FCC adopted an order allocating radio spectrum and licenses for PCS. PCS utilizes wireless telecommunications digital technology at a higher frequency radio spectrum than cellular. Like cellular, it is designed to permit access to a variety of communications services regardless of subscriber location. In an FCC auction, which concluded in March 1995, PCS licenses were awarded in 51 major markets. SBC acquired PCS licenses in the Major Trading Areas (MTAs) of Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. The California licenses cover all of California and Nevada. SBC is currently in the build out phase of PCS in most of its California-Nevada markets and Tulsa, Oklahoma. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee and Little Rock, Arkansas and other consideration.

In November 1996, Pacific Bell Mobile Services (PBMS) conducted an extensive PCS trial in San Diego, California. Service was formally launched in San Diego in January 1997, in February 1997 in Las Vegas, Nevada, and in March 1997 in Sacramento, California. The network will incorporate the Global System for Mobile Communications ("GSM") standard which is widely used in Europe. PBMS is selling PCS as an off-the-shelf product in approximately 100 retail stores across San Diego County, about 60 retail stores in Las Vegas and about 80 retail stores in Sacramento. PBMS plans to offer PCS service in San Francisco and Los Angeles in the second quarter of 1997. Management expects a widespread offering of PCS service in most of California and Nevada by mid-1997. Management anticipates significant competition, particularly from the two established cellular companies in each market. However, a high quality product with PacBell's service reputation should enable PBMS to establish a significant presence in these markets.

In an FCC auction which concluded January 1997, SBC acquired eight additional PCS licenses for Basic Trading Areas (BTAs) that are within the five-state area. SBC plans to build out the new BTAs as part of its strategy to be a full service telecommunications provider (expected completion 1999). Including these new BTAs with existing cellular and PCS services, SBC will be able to offer wireless services to approximately 85% of its landline local service customers in the five-state area.

Companies granted licenses in MTAs and BTAs where SBC also provides service include subsidiaries and affiliates of AT&T, Sprint and other RHCs. The degree of competition which SBC will encounter in its cellular markets will depend, in part, on the timing and extent of the build out of PCS services.

Long-distance

Competition continues to intensify in the Telephone Companies' intraLATA long-distance markets. Principal competitors are interexchange carriers, bypass service interexchange carriers which are assigned an access code (e.g., "10XXX") used by their customers to route intraLATA calls through the interexchange carrier's network, and resellers, which sell long-distance services obtained at bulk rates. Effective January 1, 1995, the CPUC authorized intraLATA long-distance services competition in California. In April 1995, the CPUC also ordered PacBell to offer expanded interconnection to competitive access providers. These competitors are allowed to carry the intrastate portion of long-distance and intraLATA long-distance calls between PacBell's central offices and long distance carriers. Competitors may choose to locate their transmission facilities within or near PacBell's central offices. It is estimated that PacBell now serves less than 50% of the business intraLATA long-distance customers in its service areas. On April 11, 1997, SBC filed an application with the FCC for the provision of interLATA long-distance services in Oklahoma under the provisions of the Telecom Act. The OCC has approved SBC's application.

Other

In the future, it is likely that additional competitors will emerge in the telecommunications industry. Cable television companies and electric utilities have expressed an interest in, or already are, providing telecommunications services. As a result of recent and prospective mergers and acquisitions within the industry, SBC may face competition from entities offering both cable TV and telephone services in the Telephone Companies' regulated operating areas. Interexchange carriers have been certified to provide local service, and a number of other major carriers have publicly announced their intent to provide local service in certain markets, some of which are in the Telephone Companies' regulated operating areas.

SBC is aggressively representing its interests regarding competition before federal and state regulatory bodies, courts, Congress and state legislatures. SBC will continue to evaluate the increasingly competitive nature of its business, and to develop appropriate competitive, legislative and regulatory strategies.

International

Telmex was granted a concession in 1990, which expired in August 1996, as the sole provider of long-distance services in Mexico. In 1995, the Mexican Senate and Chamber of Deputies passed legislation encompassing a series of rules for the introduction of competition into the Mexican long-distance market previously issued by the Mexican Secretary of Communication and Transportation. Those rules specified that there would be an unlimited number of long-distance concessions and that Telmex was required to provide 60 interconnection points by January 1, 1997, and more than 200 interconnection points by the year 2000. Several large competitors have received licenses to compete with Telmex and begun operations, including a joint venture between AT&T and Alfa, a Mexican consortium, and Avantel, S.A., a joint venture between MCI and Grupo Financiero Banamex-Accival, Mexico's largest financial group. Balloting for presubscription of long-distance service is currently occurring among Telmex's customers in selected areas.

Dollars in millions except per share amounts

Other Business Matters

Merger Agreement On April 1, 1997, SBC and PAC completed the merger of an SBC subsidiary with PAC, in a transaction in which each share of PAC common stock was exchanged for 0.73145 of a share of SBC common stock. With the merger, PAC became a wholly-owned subsidiary of SBC. The transaction has been accounted for as a pooling of interests and a tax-free reorganization. Accordingly, the financial statements for the periods presented have been restated to include the accounts of PAC (see Note 3 to the financial statements for more information).

Restructuring Reserve In December 1993, a reserve was established to record the incremental cost of force reductions associated with restructuring PacBell's business processes through 1997. This restructuring was expected to allow PacBell to eliminate approximately 10,000 employee positions through 1997, net of approximately 4,000 new positions expected to be created. Net force reductions were 1,926 for 1996 and 9,168 for the three-year period 1994 through 1996. The pace of net force loss moderated in 1996 due to strong volume growth at PacBell.

This table sets forth the status and activity of this reserve.

	1996	1995	1994
Balance - beginning of year	$ 228	$ 819	$ 1,097
Additions	-	-	-
Charges: cash outlays	(195)	(372)	(216)
non-cash	64	(219)	(62)
Balance - end of year	$ 97	$ 228	$ 819

Charges to the restructuring reserve in 1996 totaled $131, including cash outlays of $195 and a $64 non-cash charge reversal described below. In 1995, PacBell charged $219 to the restructuring reserve for the non-cash cost through 1997 of enhanced retirement benefits negotiated in the 1995 union contracts, to be paid from pension fund assets. Based on its experience, in 1996 PacBell revised its estimate of these retirement costs. Consequently, $64 of these 1995 non-cash charges were reversed in 1996. There was no effect on net income from either the 1995 charge or the 1996 change in this estimate. Management expects to use the remaining reserve balance during 1997.

Effective with the merger, SBC has begun a complete review of all of its subsidiaries, including subsidiaries of PAC. Approximately 50 review teams are examining operational functions within the companies and evaluating all strategic initiatives. The teams will identify synergies between the companies, establish uniform system requirements and redirect strategic efforts. SBC cannot currently estimate the amount of future savings to be derived from this process or the amount of current and future costs associated with reorganizing functions and reevaluating strategies that SBC will incur; however, significant changes in strategic initiatives or combinations of common functions would result in material charges to SBC's 1997 results of operations. SBC anticipates the review teams will complete the evaluation phase by the end of the second quarter.

Acquisitions and Dispositions In addition to the acquisitions, dispositions and the merger of SBC's United Kingdom cable television operations discussed in Note 13 to the financial statements, SBC has made several acquisitions and dispositions since 1994.

In October 1994, SBC sold an additional 25% of its United Kingdom cable television operations to Cox Cable Communications, accounting for the remaining investment under the equity method of accounting until the 1995 merger of these operations.

In 1995, SBC made the following acquisitions: a wireless system serving Watertown, New York, and 100% of the stock of Cross Country Wireless (CCW), a wireless cable television operator providing service to 40,000 customers in Riverside, California and with licenses to provide service in Los Angeles, Orange County and San Diego. The CCW acquisition involved the exchange of approximately $120 of stock and assumption of $55 in debt. Additionally, SBC made the following equity investments in 1995: a $317 investment for 40% of VTR S.A. (VTR), a privately owned Chilean telecommunications holding company which is 51% owned by Grupo Luksic, a large Chilean conglomerate and an investment in a South African wireless company.

In 1996, SBC made the following additional investments: an investment to maintain its indirect 10% ownership in a French cellular company to offset dilution of its interest resulting from other equity sales, and an increase in its holding in VTR to 49% through the purchase of shares from another minority shareholder. Also in 1996, SBC and the other RHC's reached an agreement to sell Bell Communications Research (Bellcore) in a transaction expected to close in 1997.

In March 1997, the consortium of SBC and Telekom Malaysia Berhad, which is 60% owned by SBC, finalized an agreement to purchase 30% of Telkom South Africa (Telkom), the state-owned telecommunications company of South Africa. Under the agreement, SBC is committed to invest approximately $750, approximately $600 of which will remain in Telkom. The transaction is expected to close in the second quarter of 1997.

None of these transactions had a material effect on SBC's financial results in 1996, 1995 or 1994, nor does management expect them to have a material effect on SBC's financial position or results of operations in 1997.

Strategic Realignment In July 1995, SBC announced a strategic realignment which positions the company to be a single-source provider of telecommunications services. All of SBC's operations within the five-state area report to one management group, while international operations and domestic operations outside the five-state area report to a separate management group.

In connection with this realignment of functions, in 1995 SBC recognized $139 in selling, general and administrative expenses. These expenses include postemployment benefits for approximately 2,400 employees arising from the future consolidation of operations within the five-state area, streamlining support and administrative functions and integrating financial systems. Implementation of the realignment has been delayed due to the merger with PAC. The charge reduced net income for 1995 by approximately $88.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

Liquidity and Capital Resources

Capital Expenditures and Other Commitments

To provide high-quality communications services to its customers, SBC, particularly the Telephone Companies, Mobile Systems and SBC's PCS operations must make significant investments in property, plant and equipment. The amount of capital investment is influenced by demand for services and products, continued growth and regulatory commitments.

SBC's capital expenditures totaled $5,481, $4,338 and $3,981 for 1996, 1995 and 1994. The Telephone Companies' capital expenditures increased 29% in 1996 and 11% in 1995 due primarily to demand-related growth, network upgrades, customer-contracted requirements, ISDN projects, PCS build-out and SWBell's regulatory commitments. SBC's capital expenditures increase in 1995 was also due to PAC's expenditures for the PCS network. Mobile Systems expenditures increased 10% in 1996 and 6% in 1995 due to continued growth.

In 1997, management expects total capital spending to increase from 1996, to between $5,800 and $6,000. Capital expenditures in 1997 will relate primarily to the continued evolution of the Telephone Companies' networks, including amounts agreed to under regulation plans at SWBell, and continued build out of Mobile Systems' markets and PAC's PCS. SBC expects to fund ongoing capital expenditures with cash provided by operations.

SWBell continues to make additional network and infrastructure improvements over periods ranging through 2001 to satisfy regulatory commitments. Total capital expenditures under these commitments will vary based on actual demand of potential end users. SWBell anticipates spending approximately $150 to $200 in 1997 associated with these commitments.

PacBell has purchase commitments of approximately $208 remaining in connection with its previously announced program for deploying an all-digital switching platform with ISDN and SS-7 capabilities.

In December 1994, PacBell contracted for the purchase of up to $2,000 in Advanced Communications Network (ACN) facilities, which incorporated new technologies. During 1995, the ability to deploy the facilities outstripped the ACN vendor's ability to deliver necessary products and software. Accordingly, management decided to suspend construction at certain sites, which reduced the expected cost to less than $700. If ACN facilities meet certain quality and performance criteria (the Network Test), PacBell is committed to purchase the ACN facilities in 1998. If ACN facilities are acquired, due to competition or other factors affecting PacBell's ability to recover its investment in these facilities, their value to PacBell could be materially impaired. If ACN facilities fail the Network Test, PacBell will not be committed to buy the ACN facilities but might be liable to reimburse the principal ACN vendor for some construction costs up to $300, which would also result in a material charge.

As discussed in Other Business Matters, SBC has committed to invest approximately $750 under its agreement to purchase a stake in Telkom South Africa. The transaction is expected to be completed in the second quarter of 1997.

Over the next few years, SBC is expecting to incur significant software expenditures for interconnection and customer number portability. The extent and timing of these expenditures will vary depending on the timing and nature of regulatory actions and corresponding or compensating network improvements, but are likely to be material.

Management's Discussion and Analysis, continued

Dollars in millions except per share amounts

Dividends Declared

Dividends declared by the Board of Directors of SBC were $1.72 per share in 1996, $1.65 per share in 1995, and $1.58 per share in 1994. These per share amounts do not include dividends declared and paid by PAC prior to the merger. Including those PAC dividends, total dividends paid were $1,680 in 1996, $1,933 in 1995 and $1,878 in 1994. Pursuant to the terms of the merger agreement, PAC reduced its 1996 second, third and fourth quarter dividends. The lower second and third quarter dividends paid in 1996 improved 1996 cash flow by approximately $195. Management's dividend policy considers both the expectations and requirements of shareowners, internal requirements of SBC and long-term growth opportunities.

Cash, Lines of Credit and Cash Flows

SBC had $314 of cash and cash equivalents available at December 31, 1996. Commercial paper borrowings as of December 31, 1996, totaled $1,848. SBC has entered into agreements with several banks for lines of credit totaling $3,550 all of which may be used to support commercial paper borrowings (see Note 6 to the Financial Statements). SBC had no borrowings outstanding under these lines of credit as of December 31, 1996.

During 1996, as in 1995 and 1994, SBC's primary source of funds continued to be cash generated from operations, as shown in the Consolidated Statements of Cash Flows. Net cash provided by operating activities exceeded SBC's construction and capital expenditures during 1996, as in 1995 and 1994; this excess is referred to as free cash flow, a supplemental measure of liquidity. SBC generated free cash flow of $1,935, $2,452 and $2,952 in 1996, 1995 and 1994.

During 1996 PAC issued $1,000 of TOPrS, $500 at 7.56% in January 1996 and $500 at 8.5% in June 1996 (see Note 7 to the financial statements). The proceeds were used to retire outstanding short-term debt, primarily commercial paper which had increased significantly during 1995.

During 1996 and 1995, the Telephone Companies refinanced long-term debt with an aggregate principal amount of $964.

Total Capital

SBC's total capital consists of debt (long-term debt and debt maturing within one year), TOPrS and shareowners' equity. Total capital increased $1,844 in 1996 and decreased $4,006 in 1995. The increase in 1996 was due to PAC's increased financing requirements and the reinvestment of earnings, partially offset by the acquisition of treasury shares. The decrease in 1995 was due to the effects of the discontinuance of regulatory accounting. Absent this extraordinary charge, total capital increased by $2,016 in 1995 due primarily to the reinvestment of earnings and increased commercial paper borrowings, partially offset by foreign currency translation adjustments resulting from the decline in the value of the Mexican peso.

Debt Ratio

SBC's debt ratio was 55.5%, 61.7% and 48.6% at December 31, 1996, 1995 and 1994. The debt ratio is affected by the same factors that affect total capital. For 1995, the decrease in equity caused by the discontinuance of regulatory accounting increased the debt ratio by 13.2 percentage points.

Share Repurchases

See Note 12 to the financial statements.

Employee Stock Ownership Plans

See Note 10 to the financial statements.

Report of Independent Auditors

The Board of Directors and Shareowners
SBC Communications Inc.

We have audited the accompanying supplemental consolidated balance sheets of SBC Communications Inc. (formed as a result of the consolidation of SBC Communications Inc. (SBC) and Pacific Telesis Group (PAC)) as of December 31, 1996 and 1995, and the related supplemental consolidated statements of income, shareowners' equity and cash flows for each of the three years in the period ended December 31, 1996. The supplemental consolidated financial statements give retroactive effect to the merger of SBC and PAC on April 1, 1997, which has been accounted for using the pooling of interests method as described in the notes to the supplemental consolidated financial statements. These supplemental consolidated financial statements are the responsibility of SBC's management. Our responsibility is to express an opinion on these supplemental consolidated financial statements based on our audits. We did not audit the financial statements of PAC which statements reflect total assets constituting 42% for 1996 and 43% for 1995 of the related supplemental consolidated financial statement totals, and which reflect total operating revenues constituting approximately 41%, 42% and 44% of the related supplemental consolidated financial statement totals for the years ended December 31, 1996, 1995 and 1994. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for PAC, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards 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. 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 and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the supplemental consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of SBC Communications Inc. at December 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, after giving retroactive effect to the merger of PAC, as described in Note 3 to the supplemental consolidated financial statements, in conformity with generally accepted accounting principles.

As discussed in Note 3, the supplemental consolidated financial statements include the effects of changes applied retroactively to conform accounting methodologies between PAC and SBC. As discussed in Note 1 to the supplemental consolidated financial statements, Pacific Bell, a subsidiary of PAC, changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. As discussed in Note 2 to the supplemental consolidated financial statements, SBC discontinued its application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" in 1995.

ERNST & YOUNG LLP

San Antonio, Texas
February 14, 1997,
except for Note 3, as to which the date is
April 1, 1997

SBC Communications Inc.
Consolidated Statements of Income

Dollars in millions except per share amounts

	1996	1995	1994
Operating Revenues			
Local service	$ 11,430	$ 10,365	$ 9,243
Network access	5,831	5,514	5,204
Long-distance service	2,240	2,072	2,923
Directory advertising	1,985	1,984	1,950
Other	2,000	1,777	1,686
Total operating revenues	23,486	21,712	21,006
Operating Expenses			
Cost of services and products	8,220	7,864	7,917
Selling, general and administrative	5,321	4,694	4,315
Depreciation and amortization	4,109	4,034	3,824
Total operating expenses	17,650	16,592	16,056
Operating Income	5,836	5,120	4,950
Other Income (Expense)			
Interest expense	(812)	(957)	(935)
Equity in net income of affiliates	207	120	226
Other income (expense) - net	(82)	194	(16)
Total other income (expense)	(687)	(643)	(725)
Income From Continuing Operations Before Income Taxes, Extraordinary Loss and Cumulative Effect of Accounting Change	5,149	4,477	4,225
Income taxes	1,960	1,519	1,448
Income from Continuing Operations	3,189	2,958	2,777
Income from spun-off operations, net of tax	-	-	23
Income Before Extraordinary Loss and Cumulative Effect of Accounting Change	3,189	2,958	2,800
Extraordinary Loss from Discontinuance of Regulatory Accounting, net of tax	-	(6,022)	-
Cumulative Effect of Accounting Change, net of tax	90	-	-
Net Income (Loss)	$ 3,279	$ (3,064)	$ 2,800
Earnings Per Common Share:			
Income from Continuing Operations	$ 3.46	$ 3.22	$ 3.04
Income from spun-off operations	-	-	.03
Income Before Extraordinary Loss and Cumulative Effect of Accounting Change	3.46	3.22	3.07
Extraordinary Loss	-	(6.55)	-
Cumulative Effect of Accounting Change	.10	-	-
Net Income (Loss)	$ 3.56	$ (3.33)	$ 3.07
Weighted Average Number of Common Shares Outstanding (in millions)	921	920	912

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

SBC Communications Inc.
Consolidated Balance Sheets

Dollars in millions except per share amounts

	December 31,	
	1996	1995
Assets		
Current Assets		
Cash and cash equivalents	**$ 314**	$ 566
Short-term cash investments	**432**	243
Accounts receivable - net of allowances for uncollectibles of $311 and $266	**4,684**	3,995
Prepaid expenses	**287**	198
Deferred charges	**102**	369
Other current assets	**452**	666
Total current assets	**6,271**	6,037
Property, Plant and Equipment - Net	**26,080**	24,374
Intangible Assets - Net of Accumulated Amortization of $611 and $543	**3,589**	3,635
Investments in Equity Affiliates	**1,964**	1,616
Other Assets	**1,581**	1,450
Total Assets	**$ 39,485**	$ 37,112

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

SBC Communications Inc.
Consolidated Balance Sheets

Dollars in millions except per share amounts

	December 31, 1996	1995
Liabilities and Shareowners' Equity		
Current Liabilities		
Debt maturing within one year	**$ 2,335**	$ 3,210
Accounts payable and accrued liabilities	**6,584**	6,026
Dividends payable	**393**	484
Total current liabilities	**9,312**	9,720
Long-Term Debt	**10,930**	10,409
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	**853**	447
Postemployment benefit obligation	**5,070**	5,202
Unamortized investment tax credits	**498**	578
Other noncurrent liabilities	**2,181**	2,313
Total deferred credits and other noncurrent liabilities	**8,602**	8,540
Commitments and contingencies		
Corporation-obligated mandatorily redeemable preferred securities of subsidiary trusts*	**1,000**	-
Shareowners' Equity		
Preferred shares ($1 par value, 10,000,000 authorized: none issued)	**-**	-
Common shares ($1 par value, 2,200,000,000 authorized: issued 933,772,624 at December 31, 1996 and 933,861,842 at December 31, 1995)	**934**	934
Capital in excess of par value	**9,422**	9,398
Retained earnings (deficit)	**1,297**	(316)
Guaranteed obligations of employee stock ownership plans	**(229)**	(272)
Deferred Compensation - LESOP trust	**(161)**	(242)
Foreign currency translation adjustment	**(637)**	(578)
Treasury shares (20,616,939 at December 31, 1996 and 11,122,981 at December 31, 1995, at cost)	**(985)**	(481)
Total shareowners' equity	**9,641**	8,443
Total Liabilities and Shareowners' Equity	**$ 39,485**	$ 37,112

* The trusts contain assets of $1,030 in principal amount of the Subordinated Debentures of Pacific Telesis Group.

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

SBC Communications Inc.
Consolidated Statements of Cash Flows

Dollars in millions, increase (decrease) in cash and cash equivalents

	1996	1995	1994
Operating Activities			
Net income (loss)	$ 3,279	$ (3,064)	$ 2,800
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	4,109	4,034	3,824
Undistributed earnings from investments in equity affiliates	(138)	(58)	(134)
Provision for uncollectible accounts	395	346	305
Amortization of investment tax credits	(80)	(95)	(124)
Deferred income tax expense	626	609	(20)
Extraordinary loss, net of tax	-	6,022	-
Cumulative effect of accounting change, net of tax	(90)	-	-
Spun-off operations	-	-	(23)
Changes in operating assets and liabilities:			
Accounts receivable	(765)	(463)	(493)
Other current assets	(50)	77	(97)
Accounts payable and accrued liabilities	632	(76)	556
Other - net	(502)	(542)	321
Total adjustments	4,137	9,854	4,115
Net Cash Provided by Continuing Operations	7,416	6,790	6,915
Net Cash Provided by Spun-off Operations	-	-	18
Net Cash Provided by Operating Activities	7,416	6,790	6,933
Investing Activities			
Construction and capital expenditures	(5,481)	(4,338)	(3,981)
Investments in affiliates	(74)	(54)	(25)
Purchase of short-term investments	(1,005)	(704)	(325)
Proceeds from short-term investments	816	587	390
Dispositions	96	14	296
Acquisitions	(442)	(1,186)	(1,238)
Net investment in spun-off operations	-	-	33
Net Cash Used in Continuing Operations	(6,090)	(5,681)	(4,850)
Net Cash used in spun-off operations	-	-	(332)
Net Cash Used in Investing Activities	(6,090)	(5,681)	(5,182)

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

SBC Communications Inc.
Consolidated Statements of Cash Flows
Dollars in millions, increase (decrease) in cash and cash equivalents

	1996	1995	1994
Financing Activities			
Net change in short-term borrowings with original maturities of three months or less	(977)	1,402	(129)
Issuance of other short-term borrowings	209	91	36
Repayment of other short-term borrowings	(134)	(91)	(41)
Issuance of long-term debt	989	981	355
Repayment of long-term debt	(408)	(1,086)	(462)
Early extinguishment of debt and related call premiums	-	(465)	-
Issuance of trust originated preferred securities	1,000	-	-
Issuance of common shares	111	74	180
Purchase of treasury shares	(650)	(216)	(447)
Issuance of treasury shares	52	82	18
Dividends paid	(1,664)	(1,814)	(1,744)
Other	(106)	-	(18)
Net Cash Used in Continuing Operations	(1,578)	(1,042)	(2,252)
Net cash provided by spun-off operations	-	-	39
Net Cash Used in Financing Activities	(1,578)	(1,042)	(2,213)
Net Cash Provided by (Used in) all Activities	(252)	67	(462)
Less spun-off operations	-	-	(275)
Net increase (decrease) in cash and cash equivalents	(252)	67	(187)
Cash and cash equivalents beginning of year	566	499	686
Cash and Cash Equivalents End of Year	$ 314	$ 566	$ 499

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

SBC Communications Inc.

Consolidated Statements of Shareowners' Equity

Dollars in millions except per share amounts

	Common Shares Shares	Common Shares Amount	Capital in Excess of Par Value	Retained Earnings (Deficit)	Guaranteed Obligations of Employee Stock Ownership Plans	Deferred Compensation Leveraged Employee Stock Ownership Trust	Foreign Currency Translation Adjustment	Treasury Shares Shares	Treasury Shares Amount	Total
Balance, December 31, 1993	912,191,021	$912	$11,400	$3,757	$(353)	$(386)	$(39)	(2,510,404)	$(110)	$15,181
Net income for the year ($3.07 per share)	-	-	-	2,800	-	-	-	-	-	
Dividends to shareowners ($1.58 per share)	-	-	-	(1,878)	-	-	-	-	-	
Spun-off stock distribution	-	-	(2,901)	-	-	-	-	-	-	
Reduction of debt associated with Employee Stock Ownership Plans	-	-	-	-	38	-	-	-	-	
Cost of LESOP trust shares allocated to employee accounts	-	-	-	-	-	80	-	-	-	
Foreign currency translation adjustment, net of income tax benefit of $197	-	-	-	-	-	-	(324)	-	-	
Issuance of common shares:										
Dividend Reinvestment Plan	3,334,668	4	134	-	-	-	-	-	-	
Other issuances	15,140,077	15	621	-	-	-	-	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(11,301,550)	(447)	
Issuance of treasury shares	-	-	4	-	-	-	-	2,410,326	94	
Other	-	-	-	(14)	-	-	-	-	-	
Balance, December 31, 1994	930,665,766	931	9,258	4,665	(315)	(306)	(363)	(11,401,628)	(463)	13,407
Net income (loss) for the year ($(3.33) per share)	-	-	-	(3,064)	-	-	-	-	-	
Dividends to shareowners ($1.65 per share)	-	-	-	(1,933)	-	-	-	-	-	
Reduction of debt associated with Employee Stock Ownership Plans	-	-	-	-	43	-	-	-	-	
Cost of LESOP trust shares allocated to employee accounts	-	-	-	-	-	64	-	-	-	
Foreign currency translation adjustment, net of income tax benefit of $116	-	-	-	-	-	-	(215)	-	-	
Issuances of common shares	3,196,076	3	129	-	-	-	-	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(4,610,713)	(216)	
Issuance of treasury shares:										
Dividend Reinvestment Plan	-	-	19	-	-	-	-	2,730,666	111	
Other issuances	-	-	(8)	-	-	-	-	2,158,694	87	
Other	-	-	-	16	-	-	-	-	-	
Balance, December 31, 1995	933,861,842	934	9,398	(316)	(272)	(242)	(578)	(11,122,981)	(481)	8,443
Net income for the year ($3.56 per share)	-	-	-	3,279	-	-	-	-	-	
Dividends to shareowners ($1.72 per share)	-	-	-	(1,680)	-	-	-	-	-	
Reduction of debt associated with Employee Stock Ownership Plans	-	-	-	-	43	-	-	-	-	
Cost of LESOP trust shares allocated to employee accounts	-	-	-	-	-	81	-	-	-	
Foreign currency translation adjustment, net of income tax benefit of $28	-	-	-	-	-	-	(59)	-	-	
Purchases of common shares	(89,218)	-	-	-	-	-	-	-	-	
Purchase of treasury shares	-	-	-	-	-	-	-	(13,099,709)	(650)	
Issuance of treasury shares:										
Dividend Reinvestment Plan	-	-	26	-	-	-	-	2,667,752	109	
Other issuances	-	-	(5)	-	-	-	-	937,999	37	
Other	-	-	3	14	-	-	-	-	-	
Balance, December 31, 1996	**933,772,624**	**$934**	**$9,422**	**$1,297**	**$(229)**	**$(161)**	**$(637)**	**(20,616,939)**	**$(985)**	**$9,641**

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

Notes to Consolidated Financial Statements

Dollars in millions except per share amounts

1. Summary of Significant Accounting Policies

Basis of Presentation - The consolidated financial statements include the accounts of SBC Communications Inc. and its majority-owned subsidiaries (SBC). SBC's subsidiaries and affiliates operate predominantly in the communications services industry, providing landline and wireless telecommunications services and equipment, directory advertising and cable television services both domestically and worldwide.

SBC's largest subsidiaries are Southwestern Bell Telephone Company (SWBell) providing telecommunications services in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area), and Pacific Telesis Group (PAC), providing telecommunications services in California and Nevada. PAC's subsidiaries include Pacific Bell (PacBell, which also includes its subsidiaries) and Nevada Bell. (SWBell, PacBell and Nevada Bell are collectively referred to as the Telephone Companies.)

All significant intercompany transactions are eliminated in the consolidation process. Investments in partnerships, joint ventures and less than majority-owned subsidiaries are principally accounted for under the equity method. Earnings from certain foreign investments accounted for under the equity method are included for periods ended within three months of SBC's year end.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Income Taxes - Deferred income taxes are provided for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

Investment tax credits earned prior to their repeal by the Tax Reform Act of 1986 are amortized as reductions in income tax expense over the lives of the assets which gave rise to the credits.

Cash Equivalents - Cash equivalents include all highly liquid investments with original maturities of three months or less.

Deferred Charges - Directory advertising costs are deferred until the directory is published and advertising revenues related to these costs are recognized.

Cumulative Effect of Accounting Change - Prior to January 1, 1996, Pacific Bell Directory (a subsidiary of PacBell) recognized revenues and expenses related to publishing directories in California using the "amortization" method, under which revenues and expenses were recognized over the lives of the directories, generally one year. The change in methodology was made because it is the method generally followed in the publishing industry, including Southwestern Bell Yellow Pages, and better reflects the operating activity of the business.

The cumulative after-tax effect of applying the change in method to prior years is recognized as of January 1, 1996 as a one-time, non-cash gain applicable to continuing operations of $90, or $0.10 per share. The gain is net of deferred taxes of $53. Had the current method been applied during 1995 and 1994, income before extraordinary loss and accounting change would not have been materially affected.

Dollars in millions except per share amounts

Property, Plant and Equipment - Property, plant and equipment is stated at cost. The cost of additions and substantial betterments of property, plant and equipment is capitalized. The cost of maintenance and repairs of property, plant and equipment is charged to operating expenses. Property, plant and equipment is depreciated using straight-line methods over their estimated economic lives, generally ranging from 3 to 50 years. Prior to the discontinuance of regulatory accounting in the third quarter of 1995, SWBell and PacBell computed depreciation using certain straight-line methods and rates as prescribed by regulators. In accordance with composite group depreciation methodology, when a portion of the Telephone Companies' depreciable property, plant and equipment is retired in the ordinary course of business, the gross book value is charged to accumulated depreciation; no gain or loss is recognized on the disposition of this plant.

Intangible Assets - Intangible assets consist primarily of wireless cellular, PCS and television licenses, cable television licenses, customer lists and the excess of consideration paid over net assets acquired in business combinations. These assets are being amortized using the straight-line method, over periods generally ranging from 5 to 40 years. At December 31, 1996 and 1995, amounts included in net intangible assets for licenses were $2,695 and $2,692. Management periodically reviews the carrying value and lives of all intangible assets based on expected future cash flows.

Software Costs - The costs of computer software purchased or developed for internal use are expensed as incurred. However, initial operating system software costs are capitalized and amortized over the lives of the associated hardware.

Advertising Costs - Costs for advertising products and services or corporate image are expensed as incurred.

Foreign Currency Translation - Local currencies are generally considered the functional currency for SBC's share of foreign operations, except in countries considered highly inflationary. SBC translates its share of foreign assets and liabilities at current exchange rates. Revenues and expenses are translated using average rates during the year. The ensuing foreign currency translation adjustments are recorded as a separate component of Shareowners' Equity. Other transaction gains and losses resulting from exchange rate changes on transactions denominated in a currency other than the local currency are included in earnings as incurred.

Earnings Per Common Share - The earnings per common share computation uses the weighted average number of common shares outstanding, including shares held by employee stock ownership plans. Common stock equivalents outstanding are not considered dilutive.

2. Discontinuance of Regulatory Accounting

In the third quarter of 1995, SWBell and PacBell discontinued their application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (FAS 71). FAS 71 requires depreciation of telephone plant using lives set by regulators which are generally longer than those established by unregulated companies, and deferral of certain costs and obligations based on regulatory actions (regulatory assets and liabilities). As a result of the adoption of price-based regulation for most of SWBell's revenues and the acceleration of competition in the California and five-state area telecommunications markets, management determined that SWBell and PacBell no longer met the criteria for application of FAS 71.

Dollars in millions except per share amounts

Upon discontinuance of FAS 71 by SWBell and PacBell, SBC recorded a non-cash, extraordinary charge to net income of $6,022 (after a net deferred tax benefit of $4,037). This charge was comprised of an after-tax charge of $5,739 to reduce the net carrying value of telephone plant, and an after-tax charge of $283 for the elimination of net regulatory assets. The components of the charge were as follows:

	Pre-tax	After-tax
Increase telephone plant accumulated depreciation	$ 9,476	$ 5,739
Elimination of net regulatory assets	583	283
Total	$ 10,059	$ 6,022

The increase in accumulated depreciation of $9,476 reflected the effects of adopting depreciable lives for SWBell's and PacBell's plant categories which more closely reflect the economic and technological lives of the plant. The adjustment was supported by discounted cash flow analyses which estimated amounts of telephone plant that may not be recoverable from discounted future cash flows. These analyses included consideration of the effects of anticipated competition and technological changes on plant lives and revenues.

Following is a comparison of new lives to those prescribed by regulators for selected plant categories:

	Average Lives (in Years)	
	Regulator-Prescribed	Estimated Economic
Digital switch	17	10-11
Digital circuit	10-12	7-8
Copper cable	19-26	14-18
Fiber cable	27-30	20
Conduit	57-59	50

The increase in accumulated depreciation at SWBell also included an adjustment of approximately $450 to fully depreciate analog switching equipment scheduled for replacement. Remaining analog switching equipment is being depreciated using an average remaining life of four years.

The discontinuance of FAS 71 for external financial reporting purposes also required the elimination of net regulatory assets of $583. Regulatory assets and liabilities are related primarily to accounting policies used by regulators in the ratemaking process which are different from those used by non-regulated companies. The differences arose predominantly in the accounting for income taxes, deferred compensated absences, and, in California, pension costs and debt redemption costs. These items are required to be eliminated with the discontinuance of accounting under FAS 71. SWBell and PacBell accounting and reporting for regulatory purposes are not affected by the discontinuance of FAS 71 for external financial reporting purposes.

With the discontinuance of FAS 71, SWBell and PacBell began accounting for interest on funds borrowed to finance construction as an increase in property, plant and equipment and a reduction of interest expense. Under the provisions of FAS 71, both companies capitalized both interest and equity costs allowed by regulators during periods of construction as other income and as an addition to the cost of plant constructed. Additionally, PacBell began accounting for pension costs under Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions," (FAS 87) and Statement of Financial Accounting Standards No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" (FAS 88).

Dollars in millions except per share amounts

3. Merger Agreement

On April 1, 1997, SBC and PAC completed the merger of an SBC subsidiary with PAC, in a transaction in which each share of PAC common stock was exchanged for 0.73145 of a share of SBC common stock (equivalent to approximately 313 million shares). With the merger, PAC became a wholly-owned subsidiary of SBC. The transaction has been accounted for as a pooling of interests and a tax-free reorganization. Accordingly, the financial statements for the periods presented have been restated to include the accounts of PAC. These are supplemental consolidated financial statements which will become the historical consolidated financial statements of SBC upon issuance of financial statements for the quarter ending June 30, 1997.

Operating revenues, income before extraordinary loss and cumulative effect of accounting change and net income (loss) of the separate companies for the last three years were as follows:

Year Ended December 31,	1996	1995	1994
Operating revenues:			
SBC	$ 13,898	$ 12,670	11,772
PAC	9,588	9,042	9,234
Combined	$ 23,486	$ 21,712	$ 21,006
Income before extraordinary loss and cumulative effect of accounting change:			
SBC	$ 2,101	$ 1,889	$ 1,649
PAC	1,057	1,048	1,159
Adjustments	31	21	(8)
Combined	$ 3,189	$ 2,958	$ 2,800
Net income (loss):			
SBC	$ 2,101	$ (930)	$ 1,649
PAC	1,142	(2,312)	1,159
Adjustments	36	178	(8)
Combined	$ 3,279	$ (3,064)	$ 2,800

The combined results include the effect of changes applied retroactively to conform accounting methodologies between PAC and SBC for, among other items, pensions, postretirement benefits, sales commissions and merger transaction costs as well as certain deferred tax adjustments resulting from the merger. In each case, SBC believes the new methods are more prevalent and better reflect the operations of the business. Transaction costs and one-time charges relating to the closing of the merger were $359 ($215 net of tax) including, among other items, the present value of amounts to be returned to California ratepayers as a condition of the merger and expenses for investment banker and professional fees. Of this amount, $72 is included in expenses in 1996. The remainder will be reflected in 1997 expenses.

Effective with the merger, SBC has begun a complete review of all of its subsidiaries, including subsidiaries of PAC. Approximately 50 review teams are examining operational functions within the companies and evaluating all strategic initiatives. The teams will identify synergies between the companies, establish uniform system requirements and redirect strategic efforts. SBC cannot currently estimate the amount of future savings to be derived from this process or the amount of current and future costs associated with reorganizing functions and reevaluating strategies that SBC will incur; however, significant changes in strategic initiatives or combinations of common functions would result in material charges to SBC's 1997 results of operations. SBC anticipates the review teams will complete the evaluation phase by the end of the second quarter.