Audited Financial Statements

# Puerto Rico Telephone Company, Inc.

(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

Year Ended December 31, 2009

With Report of Independent Auditors

Eorl

Ernst & Young

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

Audited Financial Statements

Year Ended December 31, 2009

## Contents



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1001-1125646

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# Report of Independent Auditors

The Board of Directors and Shareholder of
Puerto Rico Telephone Company, Inc.

We have audited the accompanying balance sheet of Puerto Rico Telephone Company, Inc. (the Company) (a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc.) as of December 31, 2009, and the related statements of income, shareholder's equity and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Puerto Rico Telephone Company, Inc. at December 31, 2009, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

October 19, 2010

Stamp No. 2576648
affixed to
original of
this report.

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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

# Balance Sheet

December 31, 2009
*(In thousands)*

| | |
|---|---|
| **Assets** | |
| Current assets: | |
| Cash | $ 1,107 |
| Accounts receivable, net of allowance for doubtful accounts of $58,325 | 175,954 |
| Inventory and supplies, net of obsolescence reserve of $9,263 | 55,920 |
| Prepaid expenses | 42,253 |
| Deferred income taxes | 34,806 |
| Total current assets | 310,040 |
| | |
| Property, plant and equipment, net | 1,161,541 |
| Goodwill | 1,329,188 |
| Intangibles, net | 250,837 |
| Deferred income taxes | 313,617 |
| Due from parent company | 5,690 |
| Due from affiliates | 15,188 |
| Other assets | 66,334 |
| Total assets | $ 3,452,435 |
| | |
| **Liabilities and shareholder's equity** | |
| Current liabilities: | |
| Notes payable to affiliates | $ 127,000 |
| Other current liabilities | 306,650 |
| Obligation under capital lease, current portion | 7,980 |
| Pension and other post-employment benefits, current portion | 36,325 |
| Total current liabilities | 477,955 |
| | |
| Pension and other post-employment benefits | 963,800 |
| Obligation under capital lease, noncurrent portion | 69,647 |
| Other non-current liabilities | 102,945 |
| Total liabilities | 1,614,347 |
| | |
| Shareholder's equity: | |
| Common stock, $0.01 par value; authorized: 10,000,000 shares, issued 589,000 shares | 6 |
| Additional paid-in capital | 1,760,257 |
| Treasury stock, at cost; 3,254 shares | (13,847) |
| Retained earnings | 178,553 |
| Accumulated other comprehensive loss, net of taxes | (86,881) |
| Total shareholder's equity | 1,838,088 |
| Total liabilities and shareholder's equity | $ 3,452,435 |

*See accompanying notes.*

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Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Income

Year Ended December 31, 2009
*(In thousands)*

| | |
|---|---|
| Revenues: | |
| Local services | $ 435,734 |
| Access services | 168,774 |
| Long distance services | 17,198 |
| Cellular services | 394,401 |
| Directory services and other | 44,434 |
| Total revenues | 1,060,541 |
| | |
| Operating costs and expenses: | |
| Cost of services and sales | 494,588 |
| Selling, general and administrative expenses | 289,806 |
| Depreciation and amortization | 215,750 |
| Total operating costs and expenses | 1,000,144 |
| Operating income | 60,397 |
| | |
| Interest expense, net | (6,178) |
| Income before income tax expense | 54,219 |
| | |
| Income tax expense | 30,134 |
| Net income | $ 24,085 |

*See accompanying notes.*

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# Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Shareholder's Equity

*(In thousands)*

| | Common Stock | Additional Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|
| Balance at January 1, 2009 | $ 6 | $ 1,760,257 | $ (13,847) | $ 154,468 | $ (102,200) | $ 1,798,684 |
| Comprehensive income: | | | | | | |
| Net income | – | – | – | 24,085 | – | 24,085 |
| Other comprehensive loss, net of taxes: | | | | | | |
| Minimum pension liability | – | – | – | – | 15,319 | 15,319 |
| Comprehensive income | | | | | | 39,404 |
| Balance at December 31, 2009 | $ 6 | $ 1,760,257 | $ (13,847) | $ 178,553 | $ (86,881) | $ 1,838,088 |

*See accompanying notes.*

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Cash Flows

Year Ended December 31, 2009
*(In thousands)*

| | |
|---|---|
| **Cash flows from operating activities** | |
| Net income | $ 24,085 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation and amortization | 215,751 |
| Deferred income taxes | 25,498 |
| Bad debt expense | 44,729 |
| Inventory obsolescence | 4,517 |
| Employee retirement benefits expense | 55,553 |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (35,633) |
| Inventory and supplies | (4,504) |
| Prepaid expenses and other assets | (23,696) |
| Due from affiliates | (8,941) |
| Pension and other post-employment benefits | (39,946) |
| Other current and non-current liabilities | (121,471) |
| Net cash provided by operating activities | 135,942 |
| | |
| **Cash flows from investing activities** | |
| Capital expenditures, including removal costs | (88,465) |
| | |
| **Cash flows from financing activities** | |
| Repayments of notes payable to affiliates | (50,000) |
| Net cash used in financing activities | (50,000) |
| Net change in cash | (2,523) |
| | |
| Cash at beginning of year | 3,630 |
| Cash at end of year | $ 1,107 |

*See accompanying notes.*

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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

Notes to Financial Statements

December 31, 2009

*(In Thousands)*

## 1. Organization and Summary of Significant Accounting Policies

### Organization

Puerto Rico Telephone Company, Inc. (the Company or PRTC) is a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc. (TELPRI). The Company was incorporated under the laws of the Commonwealth of Puerto Rico on September 4, 1998 and is engaged in providing wireline local and intra-island long distance telephone services in Puerto Rico. Since May 1, 2004, the Company is also a facility-based operator of cellular services. Long distance service is provided by PRT Larga Distancia, Inc. (PRTLD) and its internet access service is provided by Coqui.net Corporation (Coqui.net). TELPRI is an indirectly owned subsidiary of América Móvil, S.A. de C.V. (América Móvil).

### Summary of Significant Accounting Policies

***Use of Estimates***

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

***Revenue Recognition***

Revenues are recognized when services are rendered or products are delivered to customers.

The Company operates under Price Cap Regulation for the Interstate Jurisdiction, which includes the Common Carrier Line access revenues previously included in the NECA pool. Under price cap regulation, these revenues are no longer the result of allocations of costs and investments, but the result of the quantity of lines in service to customers. Common Carrier Line revenues now consist of the subscriber line charges paid by customers, plus the Interstate Common Line Support (previously long term support) provided from the Universal Service Fund based on a capped per line amount.

**1. Organization and Summary of Significant Accounting Policies (continued)**

**Summary of Significant Accounting Policies (continued)**

***Revenue Recognition (continued)***

Revenue from prepaid cellular and long distance cards are recognized based upon usage with any residual balances recognized at the expiration date.

Customer activation fees, along with the related costs up to but not exceeding the activation fees, are deferred and amortized over the customer relationship period, which are 4 years for wireline and 2 years for wireless, as required by Staff Accounting Bulletin, SAB 104. However, customer activation fees are subject to additional consideration when wireless handsets are sold to the customers at a discount and recorded as equipment revenue under costs of services and sales in the accompanying statement of income.

Equipment sales revenue consists principally of revenues from the sale of wireless handsets and accessories to new and existing subscribers and to agents and other third-party distributors. The revenue and related expenses associated with the sale of wireless handsets and accessories through indirect sales channels are recognized when the products are delivered and accepted by the agent or third-party distributor, as this is considered to be a separate earnings process from the sale of wireless services and probability of collection is likely. Shipping and handling costs for wireless handsets sold to agents and other third-party distributors are classified as costs of services and sales.

The Company has determined that the sale of wireless services through its direct sales channels with an accompanying handset constitutes a revenue arrangement with multiple deliverables in accordance with ASC No. 605-25, *Revenue Arrangements with Multiple Deliverables*. The Company accounts for these arrangements as separate units of accounting, including the wireless service and handset. Arrangement consideration received for the handset is recognized as equipment sales when the handset is delivered and accepted by the subscriber. Arrangement consideration received for the wireless service is recognized as service revenues when earned. As the non-refundable, up-front activation fee charged to the subscriber does not meet the criteria as a separate unit of accounting, the Company allocates the additional arrangement consideration

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Revenue Recognition (continued)*

received from the activation fee to the handset (the delivered item) to the extent that the aggregate handset and activation fee proceeds do not exceed the fair value of the handset. Any activation fees not allocated to the handset are deferred upon activation and recognized as service revenue on a straight-line basis over the expected customer relationship period. The Company determined that the sale of wireless services through its indirect sales channels (agents) does not constitute a revenue arrangement with multiple deliverables. For indirect channel sales, the Company continues to defer non-refundable, up-front activation fees and associated costs to the extent of the related revenues in accordance with SAB 104. These deferred fees and costs are amortized on a straight-line basis over the estimated customer relationship period. The Company has recorded deferred revenues and deferred expenses of equal amounts in the balance sheet.

#### *Sales and Use Taxes*

The government authorities assess sales and use taxes on sale of goods and services. The Company excludes taxes collected from customers in its reported revenues; such amounts are reflected as other current liabilities until remitted to the taxing authorities.

#### *Allowance for Doubtful Accounts*

The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible losses on existing receivables that may become uncollectible based on evaluations of the collectibility of the receivables and prior loss experience. Because of uncertainties inherent in the estimation process, management's estimate of losses and the related allowance may change in the near term. The Company is not dependent on any single customer.

#### *Inventory and Supplies*

Inventory and supplies are stated at lower of cost or market. Cost is determined using average cost, net of obsolescence reserves.

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Property, Plant and Equipment***

Property, plant and equipment is stated at original cost, including interest on funds borrowed to finance the acquisition of capital additions. Depreciable property disposed of in the ordinary course of business, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Gains or losses from the sale of land are recorded in results of operations.

The Company's depreciation expense is principally based on the composite group remaining life method and straight-line composite rates. This method provides for the recognition of the cost of the remaining net investment in telephone plant, less anticipated net salvage value, over the remaining asset lives. This method also requires a periodic evaluation of the average remaining useful lives related to the expected recoverability of the carrying value of assets based on changes in technology, environmental factors, the Federal and local regulatory environment, and other competitive forces. Refer to Note 2 to the financial statements for further details.

***Goodwill and Other Intangible Assets***

<u>Goodwill</u>

Goodwill is the excess of the acquisition cost of businesses over the fair value of the identifiable net assets acquired. ASC No. 350, *Intangibles – Goodwill and Other*, no longer permits the amortization of goodwill and other indefinite-lived intangible assets acquired in a business combination. Impairment testing for goodwill is performed at least annually unless indicators of impairment exist according the ASC No. 350.

As of December 31, 2009, the Company performed its goodwill impairment test which resulted in no impairment.

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Goodwill and Other Intangible Assets (continued)***

Indefinite Life Intangible Assets

The indefinite life intangible assets are those intangibles not subject to amortization and consist of FCC cellular licenses.

A significant portion of the intangible assets are cellular licenses that provide wireless operations with the exclusive right to utilize designated radio frequency spectrum to provide cellular communication services. While licenses are issued for only a fixed time, generally ten years, such licenses are subject to renewal by the FCC. Renewals of licenses have occurred routinely and at nominal cost. Moreover, the Company has determined that there are currently no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the wireless licenses. As a result, the Company treats the wireless licenses as an indefinite-lived intangible asset under the provisions of ASC No. 350.

The Company has tested the indefinite life intangible assets for impairment at least annually unless indicators of impairment exist. The evaluation revealed no impairment exposure.

Definite Life Intangible Assets

The definite life intangible assets are those intangibles assets subject to amortization and consist principally of trade names, wireless customer base and software licenses. The Company amortizes trade names on a straight-line basis over 10 years, and wireless customer base and software licenses on a straight-line basis over 5 years.

For information related to the breakdown of the carrying amount of the major components of other intangible assets, refer to Note 3.

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Goodwill and Other Intangible Assets (continued)***

Definite Life Intangible Assets (continued)

Assets are assessed for impairment when changes in circumstances indicate that their carrying values are not recoverable in accordance with ASC No. 360, *Property, Plant, & Equipment.* Losses are recognized in circumstances where impairment exists, at the amount by which the carrying value of assets exceeds fair value.

No events occurred during the year ended December 31, 2009 that would result in an impairment of the Company's definite life intangible assets.

***Fair Value of Financial Instruments***

Carrying amounts for cash, accounts receivable, accounts payable, notes payable, obligation under capital lease, and other current liabilities approximate fair value due to their short-term duration.

***Software Costs***

The Company defers and amortizes software development project costs over a five-year period beginning at the project completion date. Amortization expense of capitalized software costs amounted to approximately $21 million for the year ended December 31, 2009.

***Advertising Costs***

The Company expenses advertising costs as incurred, and recorded advertising costs of approximately $16 million for the year ended December 31, 2009.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Repairs and Maintenance*

The Company charges the cost of repairs and maintenance as these costs are incurred.

#### *Employee Benefit Plans*

Pension and post-employment health care and life insurance benefits earned interest on projected benefit obligations are accrued currently. Prior service costs and credits resulting from changes in plan benefits are amortized over the average remaining service period of the employees expected to receive the benefits.

As required by the ASC No. 715, *Compensation – Retirement Benefits*, the Company recognizes a defined benefit postretirement plan's funded status as either an asset or liability on the balance sheet. ASC No. 715 also requires the immediate recognition of the unrecognized actuarial gains and losses and prior service costs and credits that arise during the period as a component of other accumulated comprehensive income, net of applicable income taxes. Additionally, the fair value of plan assets must be determined as of the Company's year-end.

#### *Income Taxes*

The Company uses an asset and liability approach in accounting for income taxes following the provisions of ASC No. 740, *Income Taxes.* Deferred tax assets and liabilities are established for temporary differences between the way certain income and expense items are reported for financial reporting and tax purposes. Deferred tax assets and liabilities are adjusted, to the extent necessary, to reflect tax rates expected to be in effect when the temporary differences reverse. A valuation allowance is established for deferred tax assets for which realization is more likely than not.

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***New Accounting Pronouncements***

In June 2009, the FASB established the FASB Accounting Standards Codification™ (the Codification or ASC) as the official source of authoritative GAAP (other than guidance issued by the SEC) for all non-governmental entities. The Codification, which changes the referencing of financial standards, supersedes pre-codification authoritative guidance. The Codification did not change or alter existing GAAP and did not result in a change in accounting practice for the Company upon adoption on December 31, 2009.

***Subsequent Events***

In May 2009, the FASB issued guidance, ASC 855-10, *Subsequent Events*, regarding events or transactions occurring after the balance sheet date but before the financial statements are issued. The Company adopted these requirements on March 31, 2010. The adoption of these requirements did not impact the financial statements and the required disclosures are included in Note 12.

The Company evaluates subsequent events and the evidence they provide about conditions existing at the date of the balance sheet as well as conditions that arose after the balance sheet date, but before the financial statements are issued. The effects of conditions that existed at the date of the balance sheet date are recognized in the financial statements. Events and conditions arising after the balance sheet date but before the financial statements are issued are evaluated to determine if disclosure is required to keep the financial statements from being misleading. To the extent such events and conditions exist, disclosures are made regarding the nature of events and the estimated financial effects for those events and conditions. For purposes of preparing the accompanying financial statements and the following notes to these financial statements, the Company evaluates subsequent events through the date the financial statements are available to be issued.

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## 2. Property, Plant and Equipment, Net

Property, plant and equipment, net, at December 31, 2009 consists of the following:

| | Useful life | Amount |
|---|---|---|
| Outside plant | 8.5 | $ 2,321,243 |
| Central office and transmission equipment | 3.5 | 1,498,061 |
| Equipment and other | 2.7 | 286,494 |
| Buildings | 13.5 | 358,978 |
| Land | – | 67,442 |
| Gross plant in service | | 4,532,218 |
| Less: accumulated depreciation | | 3,616,928 |
| Net plant in service | | 915,290 |
| Construction in progress | | 246,251 |
| Total | | $ 1,161,541 |

Depreciation expense amounted to approximately $176 million for the year ended December 31, 2009.

## 3. Other Intangibles, Net

Other intangibles, net at December 31, 2009, consist of the following:

| | Carrying Value |
|---|---|
| ***Indefinite Life:*** | |
| FCC Cellular licenses | $ 119,000 |

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### 3. Other Intangibles, Net (continued)

| | Cost | Accumulated Amortization | Book Value |
|---|---|---|---|
| ***Definite Life:*** | | | |
| Wireline trade name | $ 35,180 | $ 9,674 | $ 25,506 |
| Customer base | 75,864 | 41,647 | 34,217 |
| Software costs and licenses | 161,133 | 89,019 | 72,114 |
| Total Definite Life | 272,177 | 140,340 | 131,837 |
| Plus: Total Indefinite Life | 119,000 | – | 119,000 |
| Total Other Intangibles | $ 391,177 | $ 140,340 | $ 250,837 |

Intangible assets amortization expense amounted to approximately $39.5 million for the year ended December 31, 2009.

The following table presents expected amortization expense of existing intangible assets as of December 31, 2009 and for each of the following years:

| Expected amortization expense for the years ending December 31, | |
|---|---|
| 2010 | $ 39,586 |
| 2011 | 39,585 |
| 2012 | 27,438 |
| 2013 | 11,328 |
| 2014 | 5,358 |
| 2015 and thereafter | 8,542 |

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**4. Pension Plans**

The Company recognizes the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the balance sheet, with a corresponding adjustment to other comprehensive income, net of taxes, according the requirements of ASC No. 715. The adjustment to other comprehensive income represents the difference between actuarial losses and prior service costs.

The Company has noncontributory pension plans for full-time employees, which are tax qualified as they meet Employee Retirement Income Security Act of 1974 (the ERISA) requirements. The Company realizes tax deductions when contributions are made to the trusts. The trusts mainly invest in fixed income and other alternative securities to meet their benefit obligation.

The pension benefit is composed of two elements. An employee receives an annuity at retirement when they reach the rule of 85 (age plus accumulated years of service). The annuity is calculated by applying a percentage times years of service to the last three years of salary. The second element is a lump-sum benefit based on years of service, approximating nine to twelve months of salary.

There are separate trusts for the pension annuity and the lump-sum benefit with a further separation of the annuity benefit into a plan for the UIET union, for the HIETEL union and management employees. Health care and life insurance benefits are provided to retirees.

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**4. Pension Plans (continued)**

The following table sets forth the status of the plans and the amounts in the financial statements as of December 31, 2009:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Benefit obligation at end of period | $ 1,380,631 | $ 676,152 |
| Fair value of plan assets at end of period | $ 1,056,657 | $ – |
| Net pension liability | $ (323,974) | $ (676,152) |
| Net amount recognized | $ (323,974) | $ (676,152) |
| Employer contributions | $ 9,336 | $ 30,610 |
| Benefits paid | $ (108,605) | $ (33,608) |

Cont

## 4. Pension Plans (continued)

Disclosure information required by ASC No. 715:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| At December 31, | | |
| Projected benefit obligation | $ (1,380,631) | $ – |
| Accumulated benefit obligation | – | (676,152) |
| Fair value of plan assets | 1,056,657 | – |
| Net pension liability | $ (323,974) | $ (676,152) |
| | | |
| Balance sheet amounts consist of: | | |
| Current liabilities | $ (731) | $ (35,595) |
| Non-current liabilities | (323,243) | (640,557) |
| Net pension liability | $ (323,974) | $ (676,152) |
| | | |
| Amounts recognized in accumulated other comprehensive loss (pre-tax): | | |
| Net actuarial loss | $ 213,718 | $ 15,159 |
| Prior service cost (credit) | (51,086) | (35,364) |
| Accumulated other comprehensive loss (income) | $ 162,632 | $ (20,205) |

Changes in benefit obligations were caused by factors including changes in actuarial assumptions (see Assumptions).

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**4. Pension Plans (continued)**

On January 26, 2009, the Company announced to its employees that on October 1, 2009 it will change its defined benefit plan from a traditional pension plan to a cash balance plan. The Company expects a reduction in its pension expense of approximately $5 million per year.

**Net Periodic Cost**

The components of the net pension and other post-employment benefit expenses for year ended December 31, 2009, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Service cost | $ 20,830 | $ 6,118 |
| Interest cost | 84,373 | 39,483 |
| Expected return on plan assets | (89,100) | – |
| Amortization of unrecognized: | | |
| Prior service benefit | (3,332) | (2,993) |
| Actuarial loss (gain), net | 1,254 | (1,080) |
| Total | $ 14,025 | $ 41,528 |

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**4. Pension Plans (continued)**

**Assumptions**

The weighted-average assumptions used in determining benefit obligations at December 31, 2009, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 5.90% | 6.00% |
| Rate of compensation increase | 4.00% | 4.00% |

The weighted-average assumptions used in determining net periodic cost for year ended December 31, 2009, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 6.25%/7.75% | 6.25% |
| Long-term rate of return | 8.50% | – |
| Rate of compensation increase | 4.00% | 4.00% |

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## 4. Pension Plans (continued)

### Assumptions (continued)

In order to project the long-term target investment return for the total portfolio, estimates are prepared for the total return of each major asset class over the subsequent 10-year period, or longer. Those estimates are based on a combination of factors including the following: observable current market interest rates, consensus earnings expectations, historical long-term performance and value-added, and the use of conventional long-term risk premiums. To determine the aggregate return for the pension trust, the projected return of each individual asset class is then weighted according to the allocation to that investment area in the Trust's long-term asset allocation policy. The projected long-term results are then also compared to the investment return earned over the previous 10 years.

The assumed health care cost trend rates used in determining benefit obligations at December 31, 2009 follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 6.90% |
| Rate to which cost trend rate gradually declines | 4.50% |
| Year the rate reaches level it is assumed to remain thereafter | 2021 |

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## 4. Pension Plans (continued)

### Assumptions (continued)

The assumed health care cost trend rates used in determining net periodic cost for year ended December 31, 2009, follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 5.75% |
| Rate to which cost trend rate gradually declines | 5.00% |
| Year the rate reaches level it is assumed to remain thereafter | 2010 |

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

| | Increase | Decrease |
|---|---|---|
| Effect in 2009 total service and interest cost | $ 6,985 | $ (5,722) |
| Effect on post-retirement benefit obligation as of December 31, 2009 | 90,105 | (74,842) |

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## 4. Pension Plans (continued)

### Plan Assets

The weighted-average assets allocation for the pension plans assets at December 31, 2009, by category are as follows:

| | |
|---|---|
| Equity securities | 57% |
| Debt securities | 41% |
| Other | 2% |
| | 100% |

Assets are allocated according to a long-term policy neutral position and held within a relatively narrow and pre-determined range. Both active and passive management approaches are used depending on perceived market efficiencies and various other factors.

### Cash Flows

In 2009, the Company elected to apply available credit balances to satisfy the minimum contribution requirements for some of their qualified pension trusts, which decreased paid contributions to the qualified pension plans to $8.594 million. The Company contributed $748 thousand to the nonqualified pension plans and $4.160 million to the other postretirement benefit plans. The estimate of the amount and timing of required qualified pension trust contributions for 2010 is based on current regulations, including continued pension funding relief, and is approximately $47.131 million for the three qualified plans sponsored by the Company. The Company estimates approximately $761 thousand in contributions to the non-qualified pension plans and approximately $35.594 million to the other post-retirement benefit plans in 2010. The Company believes that it will have adequate liquidity resources to fund these contributions. The Company believes the sources of funds including from operations and from readily available external financing arrangements will be sufficient to meet ongoing requirements.

**4. Pension Plans (continued)**

**Estimated Future Benefit Payments**

The benefits payments, which reflect expected future service, are expected to be paid as follows:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| 2010 | $ 98,054 | $ 36,729 |
| 2011 | 97,391 | 39,532 |
| 2012 | 96,441 | 42,040 |
| 2013 | 95,612 | 44,401 |
| 2014 | 96,850 | 46,766 |
| 2015-2019 | 520,740 | 263,480 |

Medicare Prescription Drug subsidies expected to offset the future other post-retirement benefit payments noted above are as follows:

| | Post-Retirement Benefits |
|---|---|
| 2010 | $ 1,135 |
| 2011 | 1,309 |
| 2012 | 1,526 |
| 2013 | 1,766 |
| 2014 | 2,027 |
| 2015-2019 | 13,439 |

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## 5. Other Current Liabilities

Other current liabilities at December 31, 2009, consist of the following:

| | | |
|---|---|---|
| Accounts payable | $ | 140,117 |
| Accrued expenses | | 123,996 |
| Employee benefit accruals | | 30,931 |
| Bank overdraft | | 4,377 |
| Income and other taxes | | 3,460 |
| Interest | | 2,063 |
| Carrier payables | | 1,706 |
| Total | $ | 306,650 |

## 6. Other Non-Current Liabilities

Other non-current liabilities at December 31, 2009, consist of the following:

| | | |
|---|---|---|
| Deferred activation and installation revenues | $ | 26,502 |
| Customer deposits | | 20,359 |
| Other liabilities | | 56,084 |
| Total | $ | 102,945 |

Deferred activation and installation revenues are amortized on a straight-line basis over the estimated customer relationship period.

## 7. Income Taxes

The Company is subject to Puerto Rico income tax at rates ranging from 20% to 39%. The Company is covered by a tax incentives grant issued under the provisions of Act No. 135 of December 2, 1997, better known as the 1998 Tax Incentives Act, for a period of 10 years, with respect to its designated service activity of wireless and wire line telecommunications services and long distance call services to export markets. The Company is subject to income taxes on its covered designated service activity at a flat tax rate of 7% but only on the income in excess of a base period. The base period net income is subject to taxation at the regular statutory rate. Also, the Company is exempt from the payment of property and municipal license taxes at 90% and 60%, respectively.

The effective date of the exemption period is January 1, 2009 for income tax purposes, January 1, 2008 and 2009 for property taxes depending on the location of the property, and July 1, 2008 for municipal license tax purposes.

Act No. 7 of March 9, 2009, imposed a 5% temporary tax for the years 2009 through 2011. The 5% tax is computed on the tax liability for a maximum effective tax rate of 40.95%.

Income tax provision for the year ended December 31, 2009 consists of the following:

| | |
|---|---|
| Current | $ 4,636 |
| Deferred | 25,498 |
| Total | $ 30,134 |

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## 7. Income Taxes (continued)

The deferred tax assets at December 31, 2009, consists of the following:

| | | |
|---|---|---|
| Current deferred tax assets: | | |
| Allowance for doubtful accounts | $ | 22,749 |
| Reserve for inventory obsolescence | | 4,739 |
| Alternative minimum tax credits carry forward | | 7,318 |
| Total | $ | 34,806 |
| | | |
| Noncurrent deferred tax assets (liability): | | |
| Excess depreciation and amortization | $ | (108,115) |
| Reserve for contingencies | | 12,654 |
| Alternative minimum tax credits carry forward | | 26,200 |
| Employee benefit liabilities | | 382,878 |
| Total | $ | 313,617 |

Management believes that realization of the deferred income tax asset is more likely than not, based on the Company's evaluation of taxable income over the period of years that the temporary differences are expected to become tax deductions.

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## 8. Related Party Transactions

The Company has an agreement with PRTLD, an affiliate through common ownership. Under the agreement, the Company collects the fees for long distance services provided by PRTLD. PRTLD also pays the Company for the use of its access service facilities. For the year ended December 31, 2009, the Company recognized revenues under this agreement of approximately $8.9 million.

The Company has an agreement with Coqui.net. Under this agreement, the Company collects the fees for internet services provided by Coqui.net. For the year ended December 31, 2009, the Company recognized revenues for internet service of approximately $23.6 million.

Following is a summary of significant balances and transactions between the Company, TELPRI, PRTLD and Coqui.net as of December 31, 2009:

| | | |
|---|---|---|
| Due from PRTLD | $ | 38,218 |
| Due to Coqui.net | | 23,030 |
| Due from TELPRI | | 5,690 |

## 9. Notes Payable to Affiliates

At December 31, 2009, the Company had two promissory notes with affiliate entities, a $90 million balance with Distribuidora Telcel S.A. de C.V. (Distel) and other with a $37 million balance with Sercotel S.A. de C.V. (Sercotel), both bearing interest rates of 2.3775% and with maturity dates of April 30, 2010.

In 2009, the Company made payments totaling approximately $50 million, plus related interest, to decrease Distel and Sercotel's loan principal and accrued interest balances.

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## 10. Supplemental Cash Flow Information

Cash paid for interest for the year ended December 31, 2009 amounted to approximately $6.4 million. Cash payments for income taxes for the year ended December 31, 2009 amounted to approximately $20 million. Non-cash transactions related to liabilities for capital expenditures amounted to $94.9 million as of December 31, 2009.

## 11. Obligation under Capital Lease

On November 2009, the Company entered into an agreement with SES Americomm, Inc. for the lease of a telecommunication satellite that expires on 2020. The following is the book value of the leased asset included in the property and equipment as of the year ended December 31, 2009:

| | | |
|---|---|---|
| Telecommunication satellite | $ | 78,188 |
| Less: accumulated amortization | | 561 |
| Total | $ | 77,627 |

Future minimum lease payments under capital lease are as follow:

| | | |
|---|---|---|
| Year ending December 31, | | |
| 2010 | $ | 7,980 |
| 2011 | | 7,980 |
| 2012 | | 7,980 |
| 2013 | | 7,980 |
| 2014 | | 7,980 |
| Thereafter | | 45,885 |
| Total minimum lease payments | | 85,785 |
| Less: amount representing interest | | 8,158 |
| Present value of net minimum lease payments | | 77,627 |
| Less: current portion of lease obligation | | 7,980 |
| Noncurrent portion of lease obligation | $ | 69,647 |

Interest income amounted to approximately $126 for the year ended December 31, 2009.

## 12. Operating Leases

The Company has operating leases for certain facilities and equipment. Future minimum lease payments under operating leases are as follow:

| | | |
|---|---|---|
| Year ending December 31, | | |
| 2010 | $ | 25,203 |
| 2011 | | 22,245 |
| 2012 | | 16,654 |
| 2013 | | 11,701 |
| 2014 | | 7,219 |
| Thereafter | | 5,667 |
| Present value of minimum lease payments | $ | 88,689 |

Rent expense amounted to approximately $32 million for the year ended December 31, 2009.

## 13. Contingencies and Regulatory Matters

### *Regulatory and Competitive Trends*

The Company is a defendant in various legal matters arising in the ordinary course of business. Management, after consultation with legal counsel, believes at this time that the resolution of these matters will not have a material adverse effect on the Company's financial position and results of operations.

Regulatory activity at the Federal and local levels has been primarily directed at meeting challenges in maintaining support for local exchange rates of Universal Service and conducting different efforts to obtain a regulatory restructuring required by an increasingly competitive environment. Among the regulatory issues are: network interconnection and performance standards.

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## 13. Contingencies and Regulatory Matters (continued)

### *Regulatory and Competitive Trends (continued)*

The Company continues to meet the wholesale requirements of new competitors and have signed agreements with various wireless and wireline carriers. These agreements permit these carriers to purchase unbundled network elements, to resell retail services, and to interconnect their networks with the Company.

### *Toutchtone Charges*

On November 17, 2003, six residential subscribers and eight business service subscribers filed a class action suit with the Court of First Instance of Puerto Rico (the Court) under the Puerto Rico Telecommunications Act of 1996 (the Act) and the Puerto Rico Class Action Act of 1971. The plaintiffs have claimed that the Company's charges for touchtone service are not based on cost, and therefore violate the Act. The plaintiffs have requested that the Court (i) issue an order certifying the case as a class action, (ii) designate the plaintiffs as representative of the class, (iii) find that the charges are illegal, and (iv) order the Company to reimburse every subscriber for excess payments made since September 1996.

Act 138 of November 4, 2005, grants the TRB primary jurisdiction to entertain class action suits related to telecommunication services and established a maximum award of $5 million The plaintiffs challenged the legality of the Act and their case is pending a decision from the PR Supreme Court. No reserve has been established.

## 14. Subsequent Events

The Company evaluated subsequent events through October 19, 2010, the date on which these financial statements were available to be issued. There are no material subsequent events that would require further disclosure.

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# Audited Financial Statements

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)
Year Ended December 31, 2008
With Report of Independent Auditors

Ernst & Young LLP

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0901-1020261

Ernst & Young

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

Audited Financial Statements

Year Ended December 31, 2008

## Contents



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# Report of Independent Auditors

The Board of Directors and Shareholder of
Puerto Rico Telephone Company, Inc.

We have audited the accompanying balance sheet of Puerto Rico Telephone Company, Inc. (the Company) (a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc.) as of December 31, 2008, and the related statements of income, shareholder's equity and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Puerto Rico Telephone Company, Inc. at December 31, 2008, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

September 14, 2009

Stamp No. 24655105
affixed to
original of
this report.

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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

# Balance Sheet

December 31, 2008
*(In thousands)*

| | |
|---|---|
| **Assets** | |
| Current assets: | |
| Cash | $ 3,630 |
| Accounts receivable, net of allowance for doubtful accounts of $57,443 | 185,050 |
| Inventory and supplies, net of obsolescence reserve of $4,400 | 55,933 |
| Prepaid expenses | 15,205 |
| Deferred income taxes | 39,093 |
| Total current assets | 298,911 |
| Property, plant and equipment, net | 1,111,779 |
| Goodwill | 1,329,188 |
| Intangibles, net | 255,336 |
| Deferred income taxes | 343,891 |
| Due from parent company | 5,692 |
| Due from affiliates | 6,245 |
| Other assets | 70,418 |
| Total assets | $ 3,421,460 |
| **Liabilities and shareholder's equity** | |
| Current liabilities: | |
| Notes payable to affiliates | $ 37,000 |
| Other current liabilities | 320,276 |
| Pension and other post-employment benefits, current portion | 35,606 |
| Total current liabilities | 392,882 |
| Notes payable to affiliates, less current portion | 140,000 |
| Pension and other post-employment benefits | 974,026 |
| Other non-current liabilities | 115,868 |
| Total liabilities | 1,622,776 |
| Shareholder's equity: | |
| Common stock, $0.01 par value; authorized: 10,000,000 shares, issued 589,000 shares | 6 |
| Additional paid-in capital | 1,760,257 |
| Treasury stock, at cost; 3,254 shares | (13,847) |
| Retained earnings | 154,468 |
| Accumulated other comprehensive loss, net of taxes | (102,200) |
| Total shareholder's equity | 1,798,684 |
| Total liabilities and shareholder's equity | $ 3,421,460 |

*See accompanying notes.*

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0901-1020261

# Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Income

Year Ended December 31, 2008
*(In thousands)*

| | |
|---|---|
| Revenues: | |
| Local services | $ 480,732 |
| Access services | 189,514 |
| Long distance services | 21,259 |
| Cellular services | 383,445 |
| Directory services and other | 54,485 |
| Total revenues | 1,129,435 |
| | |
| Operating costs and expenses: | |
| Cost of services and sales | 481,196 |
| Selling, general and administrative expenses | 292,302 |
| Depreciation and amortization | 226,219 |
| Total operating costs and expenses | 999,717 |
| Operating income | 129,718 |
| | |
| Interest expense, net | (10,116) |
| Income before income tax expense | 119,602 |
| | |
| Income tax expense | 46,245 |
| Net income | $ 73,357 |

*See accompanying notes.*

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Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Shareholder's Equity

*(In thousands)*

| | Common Stock | Additional Paid-in Capital | Treasury Stock | Retained Earnings | Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|
| Balance at January 1, 2008 | $ 6 | $ 1,760,257 | $ (13,847) | $ 81,111 | $ (4,902) | $ 1,822,625 |
| Comprehensive loss: | | | | | | |
| Net income | – | – | – | 73,357 | – | 73,357 |
| Other comprehensive loss, net of taxes: | | | | | | |
| Net actuarial loss | – | – | – | – | (97,298) | (97,298) |
| Comprehensive loss: | | | | | | (23,941) |
| Balance at December 31, 2008 | $ 6 | $ 1,760,257 | $ (13,847) | $ 154,468 | $ (102,200) | $ 1,798,684 |

*See accompanying notes.*



0901-1020261

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Cash Flows

Year Ended December 31, 2008
*(In thousands)*

| | |
|---|---|
| **Cash flows from operating activities** | |
| Net income | $ 73,357 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation and amortization | 226,219 |
| Deferred income taxes | 24,879 |
| Employee retirement benefits expense | 52,589 |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (4,792) |
| Inventory and supplies | (31,810) |
| Prepaid expenses and other assets | (32,347) |
| Due from affiliates | 22,179 |
| Pension and other post-employment benefits | (34,058) |
| Other current and non-current liabilities | (70,411) |
| Net cash provided by operating activities | 225,805 |
| **Cash flows from investing activities** | |
| Capital expenditures, including removal costs | (134,202) |
| **Cash flows from financing activities** | |
| Decrease in due to parent company | (282,777) |
| Increase borrowings in notes payable to affiliates | 177,000 |
| Net cash used in financing activities | (105,777) |
| Net change in cash | (14,174) |
| Cash at beginning of year | 17,804 |
| Cash at end of year | $ 3,630 |

*See accompanying notes.*

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## 1. Organization and Summary of Significant Accounting Policies

### Organization

Puerto Rico Telephone Company, Inc. (the Company or PRTC) is a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc. (TELPRI). The Company was incorporated under the laws of the Commonwealth of Puerto Rico on September 4, 1998 and is engaged in providing wireline local and intra-island long distance telephone services in Puerto Rico. Since May 1, 2004, the Company is also a facility-based operator of cellular services. Long distance service is provided by PRT Larga Distancia, Inc. (PRTLD) and its internet access service is provided by Coqui.net Corporation (Coqui.net). TELPRI is an indirectly owned subsidiary of América Móvil, S.A. de C.V. (América Móvil). América Móvil is the largest wireless service provider in Latin America with more than 130 million subscribers.

### Summary of Significant Accounting Policies

#### *Use of Estimates*

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

#### *Revenue Recognition*

Revenues are recognized when services are rendered or products are delivered to customers.

Until June 30, 2008 Common Carrier Line access revenues were generated based on the participation by the Company in revenue pools with other telephone companies managed by the National Exchange Carriers Association (NECA), which are funded by access charges authorized by the Federal Communications Commission (FCC) and long-term support amounts received from the Universal Service Fund. Pooled amounts were divided among telephone companies based on allocations of costs and investments in providing interstate services. Revenues were based on preliminary allocations and cost studies and were subject to final settlement in

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Revenue Recognition (continued)***

subsequent periods. Since July 1, 2008, the Company has operated under Price Cap Regulation for the Interstate Jurisdiction, which includes the Common Carrier Line access revenues previously included in the NECA pool. Under price cap regulation, these revenues are no longer the result of allocations of costs and investments, but the result of the quantity of lines in service to customers. Common Carrier Line revenues now consist of the subscriber line charges paid by customers, plus the Interstate Common Line Support (previously long term support) provided from the Universal Service Fund based on a capped per line amount.

Revenue from prepaid cellular and long distance cards are recognized based upon usage with any residual balances recognized at the expiration date.

Customer activation fees, along with the related costs up to but not exceeding the activation fees, are deferred and amortized over the customer relationship period, which are 4 years for wireline and 2 years for wireless, as required by Staff Accounting Bulletin, SAB 104. However, customer activation fees are subject to additional consideration when wireless handsets are sold to the customers at a discount and recorded as equipment sales revenue.

Equipment sales consist principally of revenues from the sale of wireless handsets and accessories to new and existing subscribers and to agents and other third-party distributors. The revenue and related expenses associated with the sale of wireless handsets and accessories through indirect sales channels are recognized when the products are delivered and accepted by the agent or third-party distributor, as this is considered to be a separate earnings process from the sale of wireless services and probability of collection is likely. Shipping and handling costs for wireless handsets sold to agents and other third-party distributors are classified as costs of equipment sales.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Revenue Recognition (continued)***

The Company has determined that the sale of wireless services through its direct sales channels with an accompanying handset constitutes a revenue arrangement with multiple deliverables in accordance with Emerging Issues Task Force (EITF) No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. The Company accounts for these arrangements as separate units of accounting, including the wireless service and handset. Arrangement consideration received for the handset is recognized as equipment sales when the handset is delivered and accepted by the subscriber. Arrangement consideration received for the wireless service is recognized as service revenues when earned. As the non-refundable, up-front activation fee charged to the subscriber does not meet the criteria as a separate unit of accounting, the Company allocates the additional arrangement consideration received from the activation fee to the handset (the delivered item) to the extent that the aggregate handset and activation fee proceeds do not exceed the fair value of the handset. Any activation fees not allocated to the handset would be deferred upon activation and recognized as service revenue on a straight-line basis over the expected customer relationship period. The Company determined that the sale of wireless services through its indirect sales channels (agents) does not constitute a revenue arrangement with multiple deliverables. For indirect channel sales, the Company continues to defer non-refundable, up-front activation fees and associated costs to the extent of the related revenues in accordance with SAB 104. These deferred fees and costs are amortized on a straight-line basis over the estimated customer relationship period. The Company has recorded deferred revenues and deferred expenses of equal amounts in the balance sheet.

***Sales and Use Taxes***

The government authorities assess sales and use taxes on sale of goods and services. The Company excludes taxes collected from customers in its reported revenues; such amounts are reflected as accrued expenses until remitted to the taxing authorities.

## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Allowance for Doubtful Accounts*

The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible losses on existing receivables that may become uncollectible based on evaluations of the collectibility of the receivables and prior loss experience. Because of uncertainties inherent in the estimation process, management's estimate of losses and the related allowance may change in the near term. The Company is not dependent on any single customer.

#### *Inventory and Supplies*

Inventory and supplies are stated at lower of cost or market. Cost is determined using the average cost, net of obsolescence reserves.

#### *Property, Plant and Equipment*

Property, plant and equipment is stated at original cost, including interest on funds borrowed to finance the acquisition of capital additions. Depreciable property disposed of in the ordinary course of business, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Gains or losses from the sale of land are recorded in results of operations.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Property, Plant and Equipment (continued)***

The Company's depreciation expense is principally based on the composite group remaining life method and straight-line composite rates. This method provides for the recognition of the cost of the remaining net investment in telephone plant, less anticipated net salvage value, over the remaining asset lives. This method also requires a periodic evaluation of the average remaining useful lives related to the expected recoverability of the carrying value of assets based on changes in technology, environmental factors, the Federal and local regulatory environment, and other competitive forces. Refer to Note 2 to the financial statements for further details.

***Goodwill and Other Intangible Assets***

Goodwill

Goodwill is the excess of the acquisition cost of businesses over the fair value of the identifiable net assets acquired. SFAS No. 142, *Goodwill and Other Intangible Assets*, no longer permits the amortization of goodwill and other indefinite-lived intangible assets acquired in a business combination. Impairment testing for goodwill is performed at least annually unless indicators of impairment exist according the SFAS No. 142. Effective March 31, 2007, the Company recorded goodwill as a result of the acquisition of the Company interests by Sercotel, a subsidiary of América Móvil.

As of December 31, 2008, the Company performed its goodwill impairment test which resulted in no impairment.

Indefinite Life Intangible Assets

The indefinite life intangible assets are those intangibles not subject to amortization and consist of FCC cellular licenses.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

Indefinite Life Intangible Assets (continued)

A significant portion of the intangible assets are cellular licenses that provide wireless operations with the exclusive right to utilize designated radio frequency spectrum to provide cellular communication services. While licenses are issued for only a fixed time, generally ten years, such licenses are subject to renewal by the FCC. Renewals of licenses have occurred routinely and at nominal cost. Moreover, the Company has determined that there are currently no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the wireless licenses. As a result, the Company treats the wireless licenses as an indefinite-lived intangible asset under the provisions of SFAS No. 142.

The Company has tested the indefinite life intangible assets for impairment at least annually unless indicators of impairment exist. The evaluation revealed no impairment exposure.

Definite Life Intangible Assets

The definite life intangible assets are those intangibles assets subject to amortization and consist principally of trade names, wireless customer base and software licenses. The Company amortizes trade names on a straight-line basis over 10 years, and wireless customer base and software licenses on a straight-line basis over 5 years.

For information related to the breakdown of the carrying amount of the major components of other intangible assets, refer to Note 3.

Assets are assessed for impairment when changes in circumstances indicate that their carrying values are not recoverable in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Losses are recognized in circumstances where impairment exists, at the amount by which the carrying value of assets exceeds fair value.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

Definite Life Intangible Assets (continued)

No events occurred during the year ended December 31, 2008 that would result in an impairment of the Company's definite life intangible assets.

***Fair Value of Financial Instruments***

Carrying amounts for cash, accounts receivable, and accounts payable approximate fair value due to their short-term duration.

***Software Costs***

The Company defers and amortizes software development project costs over a five-year period beginning at the project completion date. Amortization expense of capitalized software costs amounted to approximately $20 million for the year ended December 31, 2008.

***Advertising Costs***

The Company expenses advertising costs as incurred, and recorded advertising costs of approximately $18 million for the year ended December 31, 2008.

***Repairs and Maintenance***

The Company charges the cost of repairs and maintenance as these costs are incurred.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Employee Benefit Plans***

Pension and post-employment health care and life insurance benefits earned interest on projected benefit obligations are accrued currently. Prior service costs and credits resulting from changes in plan benefits are amortized over the average remaining service period of the employees expected to receive the benefits.

As required by the SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (SFAS No. 158), the Company recognizes a defined benefit postretirement plan's funded status as either an asset or liability on the balance sheet. SFAS No. 158 also requires the immediate recognition of the unrecognized actuarial gains and losses and prior service costs and credits that arise during the period as a component of other accumulated comprehensive income, net of applicable income taxes. Additionally, the fair value of plan assets must be determined as of the Company's year-end.

***Income Taxes***

The Company uses an asset and liability approach in accounting for income taxes following the provisions of SFAS No. 109, *Accounting for Income Taxes*. Deferred tax assets and liabilities are established for temporary differences between the way certain income and expense items are reported for financial reporting and tax purposes. Deferred tax assets and liabilities are adjusted, to the extent necessary, to reflect tax rates expected to be in effect when the temporary differences reverse. A valuation allowance is established for deferred tax assets for which realization is more likely than not.

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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Asset Retirement Obligations***

The Company recognizes 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 in accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations.* This statement provides the accounting for the cost of legal obligations associated with the retirement of long-lived assets. The Company has determined that it does not have a material legal obligation to remove long-lived assets as described by this statement.

## 2. Property, Plant and Equipment, Net

Property, plant and equipment, net, at December 31 2008 consists of the following:

| | Useful life | Amount |
|---|---|---|
| Outside plant | 8.5 | $ 2,311,151 |
| Central office and transmission equipment | 3.5 | 1,440,488 |
| Equipment and other | 2.7 | 207,302 |
| Buildings | 13.5 | 354,133 |
| Land | – | 67,442 |
| Gross plant in service | | 4,380,516 |
| Less: accumulated depreciation | | 3,444,311 |
| Net plant in service | | 936,205 |
| Construction in progress | | 175,574 |
| Total | | $ 1,111,779 |

Depreciation expense amounted to approximately $188 million for the year ended December 31, 2008.

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## 3. Other Intangibles, Net

Other intangibles, net at December 31, 2008, consist of the following:

| | Carrying Value |
|---|---|
| ***Indefinite Life:*** | |
| FCC Cellular licenses | $ 119,000 |

| | Cost | Accumulated Amortization | Book Value |
|---|---|---|---|
| ***Definite Life:*** | | | |
| Wireline trade name | $ 35,180 | $ 6,157 | $ 29,023 |
| Customer base | 75,864 | 26,490 | 49,374 |
| Software licenses | 128,490 | 70,551 | 57,939 |
| Total Definite Life | 239,534 | 103,198 | 136,336 |
| Plus: Total Indefinite Life | 119,000 | – | 119,000 |
| Total Other Intangibles | $ 358,534 | $ 103,198 | $ 255,336 |

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### 3. Other Intangibles, Net (continued)

Intangible assets amortization expense amounted to approximately $38 million for the year ended December 31, 2008.

The following table presents expected amortization expense of existing intangible assets as of December 31, 2008 and for each of the following years:

| Expected amortization expense for the years ending December 31, | | |
|---|---|---|
| 2009 | $ | 39,701 |
| 2010 | | 39,308 |
| 2011 | | 30,852 |
| 2012 | | 10,593 |
| 2013 | | 4,449 |
| 2014 and thereafter | | 11,433 |

### 4. Pension Plans

On December 31, 2006, the Company recognized the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the end of year statement of financial position, with a corresponding adjustment to other comprehensive income, net of taxes, according the requirements of SFAS No. 158. The adjustment to other comprehensive income represents the difference between actuarial losses and prior service costs.

The Company has noncontributory pension plans for full-time employees, which are tax qualified as they meet Employee Retirement Income Security Act of 1974 (the ERISA) requirements. The Company realizes tax deductions when contributions are made to the trusts. The trusts mainly invest in fixed income and other alternative securities to meet their benefit obligation.

**4. Pension Plans (continued)**

The pension benefit is composed of two elements. An employee receives an annuity at retirement when they reach the rule of 85 (age plus years of service). The annuity is calculated by applying a percentage times years of service to the last three years of salary. The second element is a lump-sum based on years of service, approximating nine to twelve months of salary.

There are separate trusts for the pension annuity and the lump-sum benefit with a further separation of the annuity benefit into a plan for the UIET union, for the HIETEL union and management employees. Health care and life insurance benefits are provided to retirees.

The following table sets forth the status of the plans and the amounts in the financial statements as of December 31, 2008:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Benefit obligation at end of period | $ 1,387,579 | $ 733,070 |
| Fair value of plan assets at end of period | $ 1,111,017 | $ – |
| Net pension liability | $ (276,562) | $ (733,070) |
| Net amount recognized | $ (276,562) | $ (733,070) |
| Employer contributions | $ 5,107 | $ 28,951 |
| Benefits paid | $ (101,667) | $ (28,951) |

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**4. Pension Plans (continued)**

Disclosure information required by SFAS 158:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| At December 31, | | |
| Projected benefit obligation | $ (1,387,579) | $ – |
| Accumulated benefit obligation | – | (733,070) |
| Fair value of plan assets | 1,111,017 | – |
| Net pension liability | $ (276,562) | $ (733,070) |
| Balance sheet amounts consist of: | | |
| Current liabilities | $ (744) | $ (34,862) |
| Non-current liabilities | (275,818) | (698,208) |
| Net pension liability | $ (276,562) | $ (733,070) |
| Amounts recognized in accumulated other comprehensive loss (pre-tax): | | |
| Net actuarial loss | $ 119,910 | $ 61,178 |
| Prior service cost (credit) | – | (13,547) |
| Accumulated other comprehensive loss | $ 119,910 | $ 47,631 |

Changes in benefit obligations were caused by factors including changes in actuarial assumptions (see Assumptions).

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**4. Pension Plans (continued)**

On January 26, 2009, the Company announced to its employees that on October 1, 2009 it will change its defined benefit plan from a traditional pension plan to a cash balance plan. The Company expects a reduction in its pension expense of approximately $5 million per year.

**Net Periodic Cost**

The components of the net pension and other post-employment benefit expenses for year ended December 31, 2008 follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Service cost | $ 22,839 | $ 6,529 |
| Interest cost | 82,866 | 43,588 |
| Expected return on plan assets | (102,116) | – |
| Amortization of unrecognized: | | |
| Prior service cost (benefit) | – | (2,061) |
| Actuarial loss, net | – | 944 |
| Total | $ 3,589 | $ 49,000 |

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## 4. Pension Plans (continued)

### Assumptions

The weighted-average assumptions used in determining benefit obligations at December 31, 2008, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 6.25% | 6.25% |
| Rate of compensation increase | 4.00% | 4.00% |

The weighted-average assumptions used in determining net periodic cost for years ended December 31, 2008, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 6.05% | 6.15% |
| Long-term rate of return | 8.50% | 0.00% |
| Rate of compensation increase | 4.00% | 4.00% |

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**4. Pension Plans (continued)**

**Assumptions (continued)**

In order to project the long-term target investment return for the total portfolio, estimates are prepared for the total return of each major asset class over the subsequent 10-year period, or longer. Those estimates are based on a combination of factors including the following: observable current market interest rates, consensus earnings expectations, historical long-term performance and value-added, and the use of conventional long-term risk premiums. To determine the aggregate return for the pension trust, the projected return of each individual asset class is then weighted according to the allocation to that investment area in the Trust's long-term asset allocation policy. The projected long-term results are then also compared to the investment return earned over the previous 10-years.

The assumed health care cost trend rates used in determining benefit obligations at December 31, 2008 follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 7.00% |
| Rate to which cost trend rate gradually declines | 5.00% |
| Year the rate reaches level it is assumed to remain thereafter | 2010 |

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**4. Pension Plans (continued)**

**Assumptions (continued)**

The assumed health care cost trend rates used in determining net periodic cost for year ended December 31, 2008 follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 7.00% |
| Rate to which cost trend rate gradually declines | 5.00% |
| Year the rate reaches level it is assumed to remain thereafter | 2010 |

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

| | Increase | Decrease |
|---|---|---|
| Effect in 2008 total service and interest cost | $ 7,824 | $ (6,398) |
| Effect on post-retirement benefit obligation as of December 31, 2008 | 99,068 | (81,822) |

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## 4. Pension Plans (continued)

### Plan Assets

The weighted-average assets allocation for the pension plans assets at December 31, 2008, by category are as follows:

| | |
|---|---|
| Equity securities | 2% |
| Debt securities | 35% |
| Other | 63% |
| | 100% |

Assets are allocated according to a long-term policy neutral position and held within a relatively narrow and pre-determined range. Both active and passive management approaches are used depending on perceived market efficiencies and various other factors.

### Cash Flows

In 2008, the Company elected to apply available credit balances to satisfy the minimum contribution requirements for some of their qualified pension trusts, which decreased paid contributions to the qualified pension plans to $4.3 million. The Company contributed $700 thousand to the nonqualified pension plans and $29 million to the other postretirement benefit plans. The estimate of the amount and timing of required qualified pension trust contributions for 2009 is based on current regulations, including continued pension funding relief, and is approximately $4.7 million for the four qualified plans. The Company estimates approximately $744 thousand in contributions to the non-qualified pension plans and approximately $35 million to the other post-retirement benefit plans in 2009. The Company believes that it will have adequate liquidity resources to fund these contributions. The Company believes the sources of funds including from operations and from readily available external financing arrangements will be sufficient to meet ongoing requirements.

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**4. Pension Plans (continued)**

**Estimated Future Benefit Payments**

The benefits payments, which reflect expected future service, are expected to be paid as follows:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| 2009 | $ 93,373 | $ 34,861 |
| 2010 | 92,933 | 37,113 |
| 2011 | 91,774 | 39,110 |
| 2012 | 90,779 | 40,992 |
| 2013 | 89,463 | 42,550 |
| 2014-2018 | 479,263 | 238,461 |

Medicare Prescription Drug subsidies expected to offset the future other post-retirement benefit payments noted above are as follows:

| | Post-Retirement Benefits |
|---|---|
| 2009 | $ 1,531 |
| 2010 | 1,761 |
| 2011 | 1,996 |
| 2012 | 2,265 |
| 2013 | 2,597 |
| 2014-2018 | 17,833 |

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## 5. Other Current Liabilities

Other current liabilities at December 31, 2008, consist of the following:

| | | |
|---|---|---|
| Accounts payable | $ | 176,157 |
| Accrued expenses | | 105,436 |
| Employee benefit accruals | | 31,651 |
| Carrier payables | | 2,266 |
| Income and other taxes | | 561 |
| Interest | | 4,205 |
| Total | $ | 320,276 |

## 6. Other Non-Current Liabilities

Other non-current liabilities at December 31, 2008, consist of the following:

| | | |
|---|---|---|
| Deferred activation and installation revenues | $ | 32,143 |
| Customer deposits | | 22,029 |
| Other liabilities | | 61,696 |
| Total | $ | 115,868 |

Deferred activation and installation revenues are amortized on a straight-line basis over the estimated customer relationship period.

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**7. Income Taxes**

The Company is subject to Puerto Rico income tax at rates ranging from 20% to 39%. Income tax provision for the year ended December 31, 2008 consists of the following:

| | | |
|---|---|---|
| Current | $ | 21,366 |
| Deferred | | 24,879 |
| Total | $ | 46,245 |

The deferred tax assets at December 31, 2008, consists of the following:

| | | |
|---|---|---|
| Current deferred tax assets: | | |
| Allowance for doubtful accounts | $ | 22,404 |
| Reserve for inventory obsolescence | | 2,747 |
| Alternative minimum tax credits carry forward | | 13,942 |
| Total | $ | 39,093 |
| | | |
| Noncurrent deferred tax assets (liability): | | |
| Excess depreciation and amortization | $ | (95,548) |
| Reserve for contingencies | | 9,142 |
| Alternative minimum tax credits carry forward | | 26,948 |
| Employee benefit liabilities | | 403,349 |
| Total | $ | 343,891 |

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**7. Income Taxes (continued)**

Management believes that realization of the deferred income tax asset is more likely than not, based on the Company's evaluation of taxable income over the period of years that the temporary differences are expected to become tax deductions.

**8. Related Party Transactions**

The Company has an agreement with PRTLD, an affiliate through common ownership. Under the agreement, the Company collects the fees for long distance services provided by PRTLD. PRTLD also pays the Company for the use of its access service facilities. For the year ended December 31, 2008, the Company recognized an income for this agreement of approximately $9.3 million.

On June 24 and July 25, 2008, the Company entered into two loan agreements with the Coqui.net for a total of approximately $14.3 million with an interest rate of 5.885%. The loan agreements have no maturity date. Before the year ended, the Company made various payments to decrease Coqui.net principal loan balance for a total of $1.5 million, plus related interest.

The Company has an agreement with Coqui.net. Under this agreement, the Company collects the fees for internet services provided by Coqui.net. For the year ended December 31, 2008 the Company recognized income for this internet service of approximately $25 million.

Following is a summary of significant balances and transactions between the Company, TELPRI, PRTLD and Coqui.net as of December 31, 2008:

| | | |
|---|---|---|
| Due from PRTLD | $ | 20,954 |
| Due to Coqui.net | | 14,709 |
| Due from TELPRI | | 5,692 |

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## 9. Notes Payable to Affiliates

On April 25, 2008, the Company entered in two assignments and assumption agreements with TELPRI: one for a $90 million promissory note, bearing an interest of 5.7943% with Distribuidora Telcel, S.A de C.V. (Distel), and another for a $270 million promissory note, bearing an interest of 5.885% with Sercotel on June 28, 2007. As a result of these transactions, TELPRI assigned to PRTC all of its obligations, rights, titles, and interests in and to the promissory notes.

On April 30, 2008, the original promissory notes were cancelled and two new promissory notes were established: a $90 million promissory note with Distel and a $160 million promissory note with Secortel. Both notes had a maturity date of April 30, 2009, and bore an interest rate of 3.6787%. During the year, the Company made payments totaling approximately $85 million, plus related interest, to decrease Sercotel's loan principal balance.

On their due date, both promissory notes were refinanced: $90 million with Distel and $50 million with Sercotel. Both notes have maturity date of April 30, 2010 and bear an interest rate of 2.3775%.

Finally, two new promissory were issued with Sercotel during 2008 as an additional source of working capital, as follows: a $5 million promissory note (3.7343% rate) issued on August 22, 2008 and $7 million promissory note (2.5987% rate) issued on December 19, 2008. Both notes are due on August 21, 2009.

## 10. Supplemental Cash Flow Information

Cash paid for interest for the period the year ended December 31, 2008 amounted to approximately $15 million. Cash payments for income taxes by the Company for the year ended December 31, 2008 amounted to approximately $37 million. Non-cash transactions related to liabilities for capital expenditures amounted to $117 million as of December 31, 2008.

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## 11. Leases

The Company has operating leases for certain facilities and equipment. Future minimum lease payments under operating leases are as follow:

| | | |
|---|---|---|
| Year ending December 31, | | |
| 2009 | $ | 17,219 |
| 2010 | | 14,183 |
| 2011 | | 11,338 |
| 2012 | | 6,323 |
| 2013 | | 2,481 |
| Thereafter | | 3,002 |
| Present value of minimum lease payments | $ | 54,546 |

Rent expense amounted to approximately $22 million for the year ended December 31, 2008.

## 12. Contingencies and Regulatory Matters

***Regulatory and Competitive Trends***

The Company is a defendant in various legal matters arising in the ordinary course of business. Management, after consultation with legal counsel, believes at this time that the resolution of these matters will not have a material adverse effect on the Company's financial position and results of operations.

Regulatory activity at the Federal and local levels has been primarily directed at meeting challenges in maintaining support for local exchange rates Universal Service and initiated different efforts to obtain a regulatory restructuring required by an increasingly competitive environment. Among the regulatory issues are: network interconnection and performance standards.

## 12. Contingencies and Regulatory Matters (continued)

### *Regulatory and Competitive Trends (continued)*

The Company continues to meet the wholesale requirements of new competitors and have signed agreements with various wireless and wireline carriers. These agreements permit these carriers to purchase unbundled network elements, to resell retail services, and to interconnect their networks with the Company.

### *Toutchtone Charges*

On November 17, 2003, six residential subscribers and eight business service subscribers filed a class action suit with the Court of First Instance of Puerto Rico (the Court) under the Puerto Rico Telecommunications Act of 1996 (the Act) and the Puerto Rico Class Action Act of 1971. The plaintiffs have claimed that the Company's charges for touchtone service are not based on cost, and therefore violate the Act. The plaintiffs have requested that the Court (i) issue an order certifying the case as a class action, (ii) designate the plaintiffs as representative of the class, (iii) find that the charges are illegal, and (iv) order the Company to reimburse every subscriber for excess payments made since September 1996.

On November 4, 2005 Act 138 was approved. This law grants the TRB primary jurisdiction to entertain class action suits related to telecommunication services. On May 9, 2006, the Judge issued a final judgment dismissing the proceeding. The Judge acknowledged that with the enactment of Law 138, the TRB has primary jurisdiction to hear the case. On June 8, 2006, the plaintiffs filed an appeal before the Puerto Rico Court of Appeals.

On July 10, 2006, PRTC filed its corresponding opposition to the appeal. The Plaintiffs filed a request for oral hearing. On October 12, 2006, the Court of Appeals denied the plaintiffs' request for oral hearing and acknowledged the brief filed by PRTC.

On January 19, 2007, the Court of Appeals issued a decision denying the petition by the plaintiff and confirmed the decision of the First Instance Court. The plaintiff presented a writ of certiorari before the Supreme Court of Puerto Rico in February 2007. PRTC presented his opposition to the writ and the Supreme Court is considering the case.

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## 12. Contingencies and Regulatory Matters (continued)

### *Toutchtone Charges (continued)*

Under Puerto Rico law, municipalities are authorized to impose fees for the use of their rights of way and the TRB has an obligation to adopt regulations governing fees for use of municipal rights of way, consistent with local and Federal law. The TRB has not yet adopted a regulation, but a number of municipalities in Puerto Rico have sought to impose fees upon the Company for using their rights of way. The exact manner in which these fees are calculated varies, but they generally seek to collect five percent of the Company's gross revenue generated in the municipality.

The Company has challenged each of these fees in Federal court and in the Puerto Rico courts. In the leading case, PRTC v. Guayanilla, the Federal district court granted the Company's motion for summary judgment on January 28, 2005, holding that the fee proposed by the municipality violated Federal law because the municipality could not show that the fee was related to rights of way use. The municipality appealed the district court's ruling. All local court cases were stayed pending the outcome of the Guayanilla appeal. On June 7, 2006, the First Circuit issued an order affirming the District Court's grant of summary judgment in the Guayanilla case. The opinion contains an endorsement of the principle that any rights-of-way fees imposed by a municipality must bear a direct relationship to a telecommunications carrier's use of those rights-of-way and that a municipality's costs of maintaining the rights-of-way are "an essential part of the equation."

It adopts the principle that once a municipal fee is shown to be a potential barrier to providing service under Section 253(a), the burden of proof shifts to the municipality to show that the fee meets the definition of "fair and reasonable compensation" as specified in Section 253(c) of the Federal law. PRTC has filed or is in the process of filing a corresponding motion to dismiss in all pending cases based on this Opinion. So far, for the following pending cases at the Federal court, to wit, PRT v. Municipality of Caguas, PRTC v Municipality of Ponce and PRTC v. Municipality of Utuado. In all cases, the Court has declared the municipality ordinance null and void based on the Guayanilla Opinion. PRT v. Municipality of Cidra, PRT v. Municipality of Vega Baja and PRT v. Municipality of Cataño are finished.

## 12. Contingencies and Regulatory Matters (continued)

### *Toutchtone Charges (continued)*

Despite the favorable outcome in the Guayanilla case and its potential impact on the remaining right of way cases, Puerto Rico municipalities may continue to adopt ordinances intended to charge for the use of their rights of way. To the extent such fees are upheld under the newly adopted standard, PRTC will either pass the costs along to its customers, which will negatively impact its ability to compete, or absorb them, which will negatively impact its profitability.

### *HIETEL vs. PRTC*

In 1997, the "Hermandad Independiente de Empleados Telefonicos" (HIETEL) filed a complaint requesting a job functions reclassification for some maintenance technicians due to alleged change in the complexity of their functions. In 2006, a labor arbitrator resolved in favor of the HIETEL. The Company appealed the decision to the PR Appeals Court, which was later ruled unfavorable to PRTC. Subsequently, the Company filed a petition for Certiorari with the PR Supreme Court and is currently awaiting if the Supreme Court will examine the petition.

## 13. Subsequent Event

In 1997, the Company requested a Declaratory Judgment to demand the return of all amounts paid to All Systems Electronics, Inc. (ASE), a PRTC contractor, due to breach of contract. The Company based its claim on the fact that the service provider did not file tax returns and did not pay its tax liabilities as it was represented by ASE on the contract and also required by an Administrative Order from the Governor of Puerto Rico to all suppliers doing business with the Government (PRTC was part of the Government in 1997). ASE counter-veined alleging illegal contract cancellation and requested the payment of services rendered in addition to repairs for lost profits.

On August 28, 2009, the Company experienced an adverse decision from the PR Superior Court. As a result of this decision the Company was required to pay ASE an approximate amount of $14 million.

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# Audited Financial Statements

Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)
Year Ended December 31, 2010
With Report of Independent Auditors

Ernst & Young LLP

Ernst & Young

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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

Audited Financial Statements

Year Ended December 31, 2010

## Contents



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# Report of Independent Auditors

The Board of Directors and Shareholder of
Puerto Rico Telephone Company, Inc.

We have audited the accompanying balance sheet of Puerto Rico Telephone Company, Inc. (the Company) (a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc.) as of December 31, 2010, and the related statements of income, shareholder's equity and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Puerto Rico Telephone Company, Inc. at December 31, 2010, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

July 11, 2011

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affixed to
original of
this report.

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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

# Balance Sheet

December 31, 2010
*(In thousands)*

| | |
|---|---|
| **Assets** | |
| ~~Current assets:~~ | |
| Cash | $ 951 |
| Accounts receivable, net of allowance for doubtful accounts of $56,591 | 177,510 |
| Inventory and supplies, net of obsolescence reserve of $11,661 | 60,875 |
| Prepaid expenses, including prepaid income tax of $12,795 | 44,497 |
| Deferred income taxes | 33,049 |
| Total current assets | 316,882 |
| Property, plant and equipment, net | 1,174,157 |
| Goodwill | 1,329,188 |
| Intangibles, net | 267,023 |
| Deferred income taxes | 394,223 |
| Due from affiliates | 11,551 |
| Other assets | 63,131 |
| Total assets | $ 3,556,155 |
| **Liabilities and shareholder's equity** | |
| Current liabilities: | |
| Accounts payable | $ 115,315 |
| Notes payable to affiliates | 6,000 |
| Other current liabilities | 169,595 |
| Obligation under capital lease, current portion | 7,980 |
| Pension and other post-employment benefits, current portion | 34,691 |
| Total current liabilities | 333,581 |
| Notes payable to affiliates, noncurrent portion | 159,500 |
| Pension and other post-employment benefits, noncurrent portion | 1,199,774 |
| Obligation under capital lease, noncurrent portion | 62,898 |
| Due to parent company | 3,735 |
| Other non-current liabilities | 82,864 |
| Total liabilities | 1,842,352 |
| Shareholder's equity: | |
| Common stock, $0.01 par value; authorized: 10,000,000 shares, issued 589,000 shares | 6 |
| Additional paid-in capital | 1,760,257 |
| Treasury stock, at cost; 3,254 shares | (13,847) |
| Retained earnings | 202,145 |
| Accumulated other comprehensive loss, net of taxes | (234,758) |
| Total shareholder's equity | 1,713,803 |
| Total liabilities and shareholder's equity | $ 3,556,155 |

*See accompanying notes.*

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## Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Income

Year Ended December 31, 2010
*(In thousands)*

| | |
|---|---|
| Revenues: | |
| Cellular services | $ 444,869 |
| Local services | 383,744 |
| Access services | 153,112 |
| Long distance services | 14,201 |
| Video services | 1,900 |
| Directory services and other | 46,770 |
| Total revenues | 1,044,596 |
| Operating costs and expenses: | |
| Cost of services and sales | 475,117 |
| Selling, general and administrative expenses | 326,644 |
| Depreciation and amortization | 204,827 |
| Intangible asset impairment charge | 3,222 |
| Total operating costs and expenses | 1,009,810 |
| Operating income | 34,786 |
| Interest income, net | 6,458 |
| Income before income tax expense | 41,244 |
| Income tax expense | 17,652 |
| Net income | $ 23,592 |

*See accompanying notes.*

Puerto Rico Telephone Company
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

## Statement of Shareholder's Equity

*(In thousands)*

| | Common Stock | Additional Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|
| Balance at January 1, 2010 | $ 6 | $ 1,760,257 | $ (13,847) | $ 178,553 | $ (86,881) | $ 1,838,088 |
| Comprehensive income: | | | | | | |
| Net income | – | – | – | 23,592 | – | 23,592 |
| Other comprehensive loss, net of taxes: | | | | | | |
| Pension and other postretirement benefit liability adjustments, net of tax | – | – | – | – | (147,877) | (147,877) |
| Comprehensive income | | | | | | (124,285) |
| Balance at December 31, 2010 | $ 6 | $ 1,760,257 | $ (13,847) | $ 202,145 | $ (234,758) | $ 1,713,803 |

*See accompanying notes.*



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Puerto Rico Telephone Company, Inc.
(A Wholly Owned Subsidiary of Telecomunicaciones de Puerto Rico, Inc.)

# Statement of Cash Flows

Year Ended December 31, 2010
*(In thousands)*

| | |
|---|---|
| **Cash flows from operating activities** | |
| Net income | $ 23,592 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation and amortization | 204,827 |
| Loss on disposal | 1,922 |
| Intangible asset impairment charge | 3,222 |
| Deferred income taxes | 15,697 |
| Bad debt expense | 38,423 |
| Inventory obsolescence expense | 1,309 |
| Employee retirement benefits expense | 71,975 |
| Changes in operating assets and liabilities: | |
| Accounts receivable | (39,979) |
| Inventory and supplies | (6,264) |
| Prepaid expenses | (2,244) |
| Other assets | 3,203 |
| Due from/to affiliates | 10,999 |
| Accounts payable | (101,553) |
| Pension and other post-employment benefits | (80,059) |
| Other current and non-current liabilities | (14,956) |
| Net cash provided by operating activities | 130,114 |
| **Cash flows from investing activities** | |
| Capital expenditures, including removal costs | (162,021) |
| **Cash flows from financing activities** | |
| Proceeds from issuance of notes payable to affiliates | 64,500 |
| Repayments of notes payable to affiliates | (26,000) |
| Principal payments on capital lease | (6,749) |
| Net cash provided by financing activities | 31,751 |
| Net change in cash | (156) |
| Cash at beginning of year | 1,107 |
| Cash at end of year | $ 951 |

*See accompanying notes.*



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## 1. Organization and Summary of Significant Accounting Policies

### Organization

Puerto Rico Telephone Company, Inc. (the Company or PRTC) is a wholly owned subsidiary of Telecomunicaciones de Puerto Rico, Inc. (TELPRI). The Company was incorporated under the laws of the Commonwealth of Puerto Rico on September 4, 1998 and is engaged in providing wireline local and intra-island long distance telephone services in Puerto Rico. Since May 1, 2004, the Company is also a facility-based operator of cellular services. Long distance service is provided by PRT Larga Distancia, Inc. (PRTLD) and its internet access service is provided by Coqui.net Corporation (Coqui.net), which are wholly owned subsidiaries of TELPRI. TELPRI is an indirectly owned subsidiary of América Móvil, S.A. de C.V. (América Móvil).

### Summary of Significant Accounting Policies

*Use of Estimates*

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

***Revenue Recognition***

Revenues are recognized when services are rendered or products are delivered to customers.

The Company earns revenue from wireless services by providing access to and usage of its network, which includes voice and data revenue. In general, access revenue is billed one month in advance and recognized when earned. Usage revenue is generally billed in arrears recognized when is rendered.

The Company earns revenue from wireline services based upon usage of its network and facilities and contract fees. In general, fixed monthly fees for voice, video, data and certain other services are billed one moth in advance and recognized when earned. Revenue from services that are not fixed in amount and are based on usage is generally billed in arrears and recognized when such services are provided.



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Revenue Recognition (continued)***

Revenue from prepaid cellular and long distance cards are recognized based upon usage with any residual balances recognized at the expiration date. These revenues have been included in the income statement as part of cellular services revenues and long distance services revenues, respectively.

Customer activation fees, included as part of local services revenues, along with the related costs up to but not exceeding the activation fees, are deferred and amortized over the estimated customer relationship period, which are 4 years for wireline and 2 years for wireless.

Wireline equipment sales revenues, recorded as part of directory services and other revenues, consists principally as part of other revenues from the sale of small private branch exchange (PBX), large PBX, and data equipment to new and existing subscribers.

Wireless equipment sales revenue, recorded as part of cellular services revenues, consists principally of revenues from the sale of wireless handsets to new and existing subscribers and to agents and other third-party distributors. The revenue and related expenses associated with the sale of wireless handsets and accessories through indirect sales channels are recognized when the products are delivered and accepted by the agent or third-party distributor, as this is considered to be a separate earnings process from the sale of wireless services and probability of collection is likely. Shipping and handling costs for wireless handsets sold to agents and other third-party distributors are classified as costs of services and sales.

The Company has determined that the sale of wireless services through its direct sales channels with an accompanying handset constitutes a revenue arrangement with multiple deliverables in accordance with ASC No. 605-25, *Revenue Arrangements with Multiple Deliverables*. The Company accounts for these arrangements as separate units of accounting, including the wireless



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Revenue Recognition (continued)*

service and handset. Arrangement consideration received for the handset is recognized as cellular services revenues when the handset is delivered and accepted by the subscriber. Arrangement consideration received for the wireless service is recognized as service revenues when earned. As the non-refundable, up-front activation fee charged to the subscriber does not meet the criteria as a separate unit of accounting, the Company allocates the additional arrangement consideration received from the activation fee to the handset (the delivered item) to the extent that the aggregate handset and activation fee proceeds do not exceed the fair value of the handset. Any activation fees not allocated to the handset are deferred upon activation and recognized as service revenue on a straight-line basis over the expected customer relationship period. The Company determined that the sale of wireless services through its indirect sales channels (agents) does not constitute a revenue arrangement with multiple deliverables. For indirect channel sales, the Company continues to defer non-refundable, up-front activation fees and associated costs to the extent of the related revenues. These deferred fees and costs are amortized on a straight-linebasis over the estimated customer relationship period. The Company has recorded deferred revenues and deferred expenses of equal amounts in the accompanying balance sheet under other assets and other noncurrent liabilities.

The Company's access services revenues are subject to the Federal Communications Commission's (FCC) price cap regulations services. Under the price cap regulations the Company's prices are adjusted to the price cap index that reflects the overall rate of inflation in the economy, the ability of the operator to gain efficiencies relative to the average participants in the economy, and the inflation in the operator's input prices relative to the average participants in the economy.

#### *Sales and Use Taxes*

The government authorities assess sales and use taxes on sale of goods and services. The Company excludes taxes collected from customers in its reported revenues; such amounts are reflected as other current liabilities until remitted to the taxing authorities.



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Allowance for Doubtful Accounts*

The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible losses on existing receivables that may become uncollectible based on evaluations of the collectibility of the receivables and prior loss experience. Because of uncertainties inherent in the estimation process, management's estimate of losses and the related allowance may change in the near term. The Company is not dependent on any single customer.

#### *Inventory and Supplies*

Inventory and supplies are stated at the lower of cost or market. Cost is determined using average cost, net of obsolescence reserves. Management evaluates its inventory items and establishes reserves based on the age of the inventory or by specific reserves.

#### *Property, Plant and Equipment*

Property, plant and equipment is stated at cost, including interest on the funds borrowed to finance the acquisition of capital additions. Depreciable property disposed of in the ordinary course of business, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Gains or losses from the sale of land are recorded in results of operations.

The Company's depreciation expense is principally based on the composite group remaining life method and straight-line composite rates. This method provides for the recognition of the cost of the remaining net investment in telephone plant, less anticipated net salvage value, over the remaining asset lives. This method also requires a periodic evaluation of the average remaining useful lives related to the expected recoverability of the carrying value of assets based on changes in technology, environmental factors, the Federal and local regulatory environment, and other competitive forces. Refer to Note 2 to the financial statements for further details.



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

#### *Goodwill and Other Intangible Assets*

Goodwill

Goodwill is the excess of the acquisition cost of businesses over the fair value of the identifiable net assets acquired. ASC No. 350, *Intangibles – Goodwill and Other*, no longer permits the amortization of goodwill and other indefinite-lived intangible assets acquired in a business combination. Impairment testing for goodwill is performed at least annually unless indicators of impairment exist according the ASC No. 350.

The Company follows push down accounting for business combinations. As of December 31, 2010, the Company performed its goodwill impairment test which resulted in no impairment.

Indefinite Life Intangible Assets

The indefinite life intangible assets are those intangibles not subject to amortization and consist of FCC cellular licenses.

A significant portion of the intangible assets are cellular licenses that provide wireless operations with the exclusive right to utilize designated radio frequency spectrum to provide cellular communication services. While licenses are issued for only a fixed time, generally ten years, such licenses are subject to renewal by the FCC. Renewals of licenses have occurred routinely and at nominal cost. Moreover, the Company has determined that there are currently no legal, regulatory, contractual, competitive, economic or other factors that limit the useful life of the wireless licenses. As a result, the Company treats the wireless licenses as an indefinite-lived intangible asset under the provisions of ASC No. 350.

The Company has tested the indefinite life intangible assets for impairment at least annually unless indicators of impairment exist. The evaluation revealed no impairment exposure.



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Goodwill and Other Intangible Assets (continued)***

Definite Life Intangible Assets

The definite life intangible assets are those intangibles assets subject to amortization and consist principally of trade names, wireless customer base and software licenses. The Company amortizes trade names on a straight-line basis over 10 years, and wireless customer base and software licenses on a straight-line basis over 5 years.

For information related to the breakdown of the carrying amount of the major components of other intangible assets, refer to Note 3.

Assets are assessed for impairment when changes in circumstances indicate that their carrying values are not recoverable in accordance with ASC No. 360, *Property, Plant, & Equipment*. Losses are recognized in circumstances where impairment exists, at the amount by which the carrying value of assets exceeds fair value.

As explained in Note 3, the Company tested the wireline trade names for impairment and recorded an impairment charge of approximately $3.2 million to operations for the year ended December 31, 2010.

***Fair Value Measurements***

Fair value of financial and non-financial assets and liabilities is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The three-tier hierarchy for inputs used in measuring fair value, which prioritizes the inputs used in the methodologies of measuring fair value for assets and liabilities, is as follows:

*Level 1* – Quoted prices in active markets for identical assets or liabilities
*Level 2* – Observable inputs other than quoted prices in active markets for identical assets and liabilities
*Level 3* – No observable pricing inputs in the market



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Fair Value Measurements (continued)***

Financial assets and financial liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurements. Our assessment of the significance of a particular input to the fair value measurements requires judgment and may affect the valuation of the assets and liabilities being measured and their placement within the fair value hierarchy.

Carrying amounts for cash, accounts receivable, accounts payable, notes payable to affiliates, obligation under capital lease, and other current liabilities approximate fair value due to their short-term duration.

***Software Costs***

The Company defers and amortizes software development project costs over a five-year period beginning at the project completion date. Amortization expense of capitalized software costs amounted to approximately $29 million for the year ended December 31, 2010, which are included as part of the amortization expense intangible assets totaling approximately $48 million.

***Advertising Costs***

The Company expenses advertising costs as incurred, and recorded advertising costs of approximately $14 million for the year ended December 31, 2010.

***Repairs and Maintenance***

The Company charges the cost of repairs and maintenance as these costs are incurred.

***Employee Benefit Plans***

Pension and post-employment health care and life insurance benefits earned interest on projected benefit obligations are accrued currently. Prior service costs and credits resulting from changes in plan benefits are amortized over the average remaining service period of the employees expected to receive the benefits.



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## 1. Organization and Summary of Significant Accounting Policies (continued)

### Summary of Significant Accounting Policies (continued)

***Employee Benefit Plans (continued)***

As required by the ASC No. 715, *Compensation – Retirement Benefits*, the Company recognizes a defined benefit postretirement plan's funded status as either an asset or liability on the balance sheet. ASC No. 715 also requires the immediate recognition of the unrecognized actuarial gains and losses and prior service costs and credits that arise during the period as a component of other accumulated comprehensive income, net of applicable income taxes. Additionally, the fair value of plan assets must be determined as of the Company's year-end.

***Income Taxes***

The Company uses an asset and liability approach in accounting for income taxes following the provisions of ASC No. 740, *Income Taxes*. Deferred tax assets and liabilities are established for temporary differences between the way certain income and expense items are reported for financial reporting and tax purposes. Deferred tax assets and liabilities are adjusted, to the extent necessary, to reflect tax rates expected to be in effect when the temporary differences reverse. A valuation allowance is established for deferred tax assets for which realization is more likely than not.

***Subsequent Events***

The Company evaluates subsequent events and the evidence they provide about conditions existing at the date of the balance sheet as well as conditions that arose after the balance sheet date, but before the financial statements are issued. The effects of conditions that existed at the date of the balance sheet date are recognized in the financial statements. Events and conditions arising after the balance sheet date but before the financial statements are issued, are evaluated to determine if disclosure is required to keep the financial statements from being misleading. To the extent such events and conditions exist, disclosures are made regarding the nature of events and the estimated financial effects for those events and conditions. For purposes of preparing the accompanying financial statements and the following notes to these financial statements, the Company evaluates subsequent events through the date the financial statements are available to be issued.



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## 2. Property, Plant and Equipment, Net

Property, plant and equipment, net, at December 31, 2010, consists of the following:

| | Useful life | Amount |
|---|---|---|
| Outside plant | 8.5 | $ 2,394,707 |
| Central office and transmission equipment | 3.5 | 1,626,212 |
| Equipment and other | 2.7 | 221,347 |
| Buildings | 13.5 | 389,731 |
| Land | – | 67,458 |
| Gross plant in service | | 4,699,455 |
| Less: accumulated depreciation | | (3,650,674) |
| Net plant in service | | 1,048,781 |
| Construction in progress | | 125,376 |
| Total | | $ 1,174,157 |

Depreciation expense amounted to approximately $157 million for the year ended December 31, 2010, including the amortization of assets recorded under capital leases amounting to approximately $7.2 million.

## 3. Other Intangibles, Net

Other intangibles, net, at December 31, 2010, consist of the following:

| | Carrying Value |
|---|---|
| ***Indefinite Life:*** | |
| FCC Cellular licenses | $ 119,000 |

## 3. Other Intangibles, Net (continued)

| *Definite Life:* | Cost | Accumulated Amortization | Impairment Charge | Book Value |
|---|---|---|---|---|
| Wireline trade name | $ 35,180 | $ (13,192) | $ (3,222) | $ 18,766 |
| Customer base | 75,864 | (56,820) | – | 19,044 |
| Software costs and licenses | 214,716 | (104,503) | – | 110,213 |
| Total Definite Life | 325,760 | (174,515) | (3,222) | 148,023 |
| Plus: Total Indefinite Life | 119,000 | – | – | 119,000 |
| Total Other Intangibles | $ 444,760 | $ (174,515) | $ (3,222) | $ 267,023 |

The Company tests its definite life intangibles for impairment whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. In 2010, the Company consolidated its different brand names under the name "Claro" for marketing purposes. Using the "Relief from Royalty Method", the Company concluded that the carrying amount of the wireline trade name was approximately $3.2 million in excess of its respective fair value. As a result, the Company recorded a non-cash impairment charge to operations of approximately $3.2 million for the year ended December 31, 2010.

Intangible assets amortization expense amounted to approximately $48 million for the year ended December 31, 2010.

The following table presents expected amortization expense of existing intangible assets as of December 31, 2010 and for each of the following years:

| Expected amortization expense for the years ending December 31, | |
|---|---|
| 2011 | $ 48,437 |
| 2012 | 36,735 |
| 2013 | 31,220 |
| 2014 | 26,908 |
| 2015 | 3,547 |
| 2016 and thereafter | 1,176 |
| | $ 148,023 |

**4. Pension Plans**

The Company recognizes the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan in the balance sheet, with a corresponding adjustment to other comprehensive income, net of taxes, according the requirements of ASC No. 715. The adjustment to other comprehensive income represents the difference between actuarial losses and prior service costs.

The Company has noncontributory pension plans for full-time employees, which are tax qualified as they meet Employee Retirement Income Security Act of 1974 (the ERISA) requirements. The Company realizes tax deductions when contributions are made to the trusts. The trusts mainly invest in fixed income and other alternative securities to meet their benefit obligation.

The pension benefit is composed of two elements. An employee receives an annuity at retirement when they reach the rule of 85 (age plus accumulated years of service). The annuity is calculated by applying a percentage times years of service to the last three years of salary. The second element is a lump-sum benefit based on years of service, approximating nine to twelve months of salary.

There are separate trusts for the pension annuity and the lump-sum benefit with a further separation of the annuity benefit into a plan for the UIET union, for the HIETEL union and management employees. Health care and life insurance benefits are provided to retirees.



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## 4. Pension Plans (continued)

The following table sets forth the status of the plans and the amounts in the financialstatements as of December 31, 2010:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Benefit obligation at end of year | $ 1,518,486 | $ 750,689 |
| Fair value of plan assets at end of year | $ 1,034,710 | $ – |
| Net pension liability | $ (483,776) | $ (750,689) |
| Net amount recognized | $ (483,776) | $ (750,689) |
| Employer contributions | $ 52,644 | $ 27,415 |
| Benefits paid | $ (113,406) | $ (31,797) |



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**4. Pension Plans (continued)**

Disclosure information required by ASC No. 715 follows:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| At December 31, | | |
| Projected benefit obligation | $ (1,518,486) | $ – |
| Accumulated benefit obligation | – | (750,689) |
| Fair value of plan assets | 1,034,710 | – |
| Net pension liability | $ (483,776) | $ (750,689) |
| | | |
| Balance sheet amounts consist of: | | |
| Current liabilities | $ (724) | $ (33,967) |
| Non-current liabilities | (483,052) | (716,722) |
| Net pension liability | $ (483,776) | $ (750,689) |
| | | |
| Amounts recognized in accumulated other comprehensive loss (pre-tax): | | |
| Net actuarial loss | $ 387,965 | $ 87,468 |
| Prior service credit | (46,643) | (43,940) |
| Accumulated other comprehensive loss (income) | $ 341,322 | $ 43,528 |

Changes in benefit obligations were caused by factors including changes in actuarial assumptions (see Assumptions).

On January 26, 2009, the Company announced to its employees that on October 1, 2009 it will change its defined benefit plan from a traditional pension plan to a cash balance plan.



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## 4. Pension Plans (continued)

### Net Periodic Cost

The components of the net pension and other post-employment benefit expenses for the year ended December 31, 2010, are as follows:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Service cost | $ 18,841 | $ 5,887 |
| Interest cost | 80,095 | 38,488 |
| Expected return on plan assets | (77,277) | – |
| Amortization of unrecognized: | | |
| Prior service benefit | (4,442) | (7,760) |
| Actuarial loss | 9,514 | 1,603 |
| Settlement loss | 7,026 | – |
| Total | $ 33,757 | $ 38,218 |

### Assumptions

The weighted-average assumptions used in determining benefit obligations at December 31, 2010, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 5.30% | 5.45% |
| Rate of compensation increase | 4.00% | 4.00% |



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**4. Pension Plans (continued)**

**Assumptions (continued)**

The weighted-average assumptions used in determining net periodic cost for year ended December 31, 2010, follow:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| Discount rate | 5.90% | 6.00% |
| Long-term rate of return | 7.50% | N/A |
| Rate of compensation increase | 4.00% | 4.00% |

In order to project the long-term target investment return for the total portfolio, estimates are prepared for the total return of each major asset class over the subsequent 10-year period, or longer. Those estimates are based on a combination of factors including the following: observable current market interest rates, consensus earnings expectations, historical long-term performance and value-added, and the use of conventional long-term risk premiums. To determine the aggregate return for the pension trust, the projected return of each individual asset class is then weighted according to the allocation to that investment area in the Trust's long-term asset allocation policy. The projected long-term results are then also compared to the investment return earned over the previous 10 years.

The assumed health care cost trend rates used in determining benefit obligations at December 31, 2010 follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 6.70% |
| Rate to which cost trend rate gradually declines | 4.50% |
| Year the rate reaches level it is assumed to remain thereafter | 2021 |



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## 4. Pension Plans (continued)

### Assumptions (continued)

The assumed health care cost trend rates used in determining net periodic cost for year ended December 31, 2010, follow:

| | Post-Retirement Benefits |
|---|---|
| Healthcare cost trend rate assumed for next year | 6.90% |
| Rate to which cost trend rate gradually declines | 4.50% |
| Year the rate reaches level it is assumed to remain thereafter | 2021 |

Assumed health care trend rates have a significant effect on the amounts reported for the post-retirement benefits plan. A one-percentage-point change in the assumed health care cost trend rate would have the following effects:

| | Increase | Decrease |
|---|---|---|
| Effect on 2010 total service and interest cost | $ 7,092 | $ (5,776) |
| Effect on post-retirement benefit obligation as of December 31, 2010 | 99,357 | (82,142) |



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## 4. Pension Plans (continued)

### Plan Assets

The weighted-average assets allocation for the pension plans assets at December 31, 2010, by category are as follows:

| | |
|---|---|
| Cash and cash equivalents | 51% |
| Debt securities | 47% |
| Equity securities | 2% |
| | 100% |

Assets are allocated according to a long-term policy neutral position and held within a relatively narrow and pre-determined range. Both active and passive management approaches are used depending on perceived market efficiencies and various other factors.

The fair values for the pension plans by asset category as of December 31, 2010 are as follows:

| | Level 1 | Level 2 | Level 3 | Totals |
|---|---|---|---|---|
| Cash and cash equivalents | $ 531,742 | $ – | $ – | $ 531,742 |
| Debt securities | 486,963 | 502 | – | 487,465 |
| Equity securities | 719 | – | 14,784 | 15,503 |
| | $ 1,019,424 | $ 502 | $ 14,784 | $ 1,034,710 |

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## 4. Pension Plans (continued)

### Cash Flows

In 2010, the Company elected to apply available credit balances to satisfy the minimum contribution requirements for some of their qualified pension trusts which decreased paid contributions to the qualified pension plan to $51.9 million. The Company contributed $737 thousand to the nonqualified pension plan and $5 million to the other postretirement benefit plan. The estimate of the amount and timing of required qualified pension trust contributions for 2011 is based on current regulations, including continued pension funding relief, and is approximately $74.9 million for the three qualified plans sponsored by the Company. The Company estimates approximately $737 thousand in contributions to the non-qualified pension plans and approximately $66 million to the other post-retirement benefit plans in 2011. The Company believes that it will have adequate liquidity resources to fund these contributions. The Company believes the sources of funds including from operations and from readily available related parties arrangements will be sufficient to meet ongoing requirements.

### Estimated Future Benefit Payments

The benefits payments, which reflect expected future service, are expected to be paid as follows:

| | Pension and Lump-Sum Benefits | Post-Retirement Benefits |
|---|---|---|
| 2011 | $ 102,859 | $ 35,148 |
| 2012 | 101,882 | 37,371 |
| 2013 | 100,970 | 39,613 |
| 2014 | 101,504 | 41,833 |
| 2015 | 102,707 | 43,891 |
| 2016-2020 | 542,657 | 247,420 |



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## 6. Other Non-Current Liabilities

Other non-current liabilities at December 31, 2010, consist of the following:

| | | |
|---|---|---|
| Deferred activation and installation revenues | $ | 11,094 |
| Customer deposits | | 20,267 |
| Otherliabilities | | 51,503 |
| Total | $ | 82,864 |

Deferred activation and installation revenues are amortized on a straight-line basis over the estimated customer relationship period.

## 7. Income Taxes

The Company is subject to Puerto Rico income tax at rates ranging from 20% to 39%. The Company is covered by a tax incentives grant issued under the provisions of Act No. 135 of December 2, 1997, better known as the 1998 Tax Incentives Act, for a period of 10 years, with respect to its designated service activity of wireless and wire line telecommunications services and long distance call services to export markets. The Company is subject to income taxes on its covered designated service activity at a flat tax rate of 7% but only on the income in excess of a base period. The base period net income is subject to taxation at the regular statutory rate. Also, the Company is exempt from the payment of property and municipal license taxes at 90% and 60%, respectively.

The effective date of the grant and tax exemption period is January 1, 2009 for income tax purposes, January 1, 2008 and 2009 for property taxes depending on the location of the property, and July 1, 2008 for municipal license tax purposes.

Act No. 7 of March 9, 2009, imposed a 5% temporary tax for the years 2009 through 2011. The 5% tax is computed on the tax liability for a maximum statutory tax rate of 40.95%. The difference between the Company's statutory and effective tax rate is primarily due to the effect of the intangible asset impairment charges mentioned in Note 3.

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### 7. Income Taxes (continued)

Income tax expense for the year ended December 31, 2010, consists of the following:

| | |
|---|---|
| Current | $ 1,955 |
| Deferred | 15,697 |
| Total | $ 17,652 |

The Government of Puerto Rico approved a comprehensive tax reform with Act 171 of November 15, 2010, which introduced certain changes that are effective for taxable years that commenced after December 31, 2009. In general, these are the following:

- Extends the carryover period of net operating losses carryforward from 7 to 10 years. The losses that are eligible for the extended period are those incurred in taxable years that commenced after December 31, 2004 and before December 31, 2012.

- A 7% credit that is only applicable for taxable years that commenced after December 31, 2009 and before January 1, 2011. This credit will not be available to offset tax liability imposed at preferential rates or under special tax laws.

## 7. Income Taxes

The deferred tax assets(liability) at December 31, 2010, consists of the following:

| | | |
|---|---|---|
| Current deferred tax assets: | | |
| Allowance for doubtful accounts | $ | 22,071 |
| Reserve for inventory obsolescence | | 4,549 |
| Alternative minimum tax credits carry forward | | 6,429 |
| Total | $ | 33,049 |
| Noncurrent deferred tax assets (liability): | | |
| Excess depreciation and amortization | $ | (107,121) |
| Reserve for contingencies | | 14,380 |
| Alternative minimum tax credits carry forward | | 20,543 |
| Employee benefit liabilities | | 466,421 |
| Total | $ | 394,223 |

Management believes that realization of the deferred income tax asset is more likely than not, based on the Company's evaluation of taxable income over the period of years that the temporary differences are expected to become tax deductions.

## 8. Related Party Transactions

The Company has an agreement with PRTLD, an affiliate through common ownership. Under the agreement, the Company collects the fees for long distance services provided by PRTLD. PRTLD also pays the Company for the use of its access service facilities. For the year ended December 31, 2010, the Company recognized revenues for this agreement of approximately $12.4 million which are included under other revenues in the accompanying statement of income.

The Company has an agreement with Coqui.net. Under this agreement, the Company collects the fees for internet services provided by Coqui.net. For the year ended December 31, 2010, the Company recognized revenue for this internet service of approximately $22.9 million.

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## 8. Related Party Transactions (continued)

Following is a summary of significant balances and transactions between the Company, TELPRI, PRTLD, Coqui.net and other affiliates, as described above as of December 31, 2010:

| | | |
|---|---|---|
| Due to Coqui.net | $ | (32,046) |
| Due from PRTLD | | 45,010 |
| Due to other affiliates | | (1,413) |
| Total due from affiliates | $ | 11,551 |
| | | |
| Due to Parent Company | $ | (3,735) |

## 9. Notes Payable to Affiliates

At December 31, 2010, notes payable to affiliates, due to Distribuidora Telcel S.A. de C.V. (Distel) and Sercotel S.A. de C.V. (Sercotel), consisted of the following:

| | |
|---|---|
| Promissory note due to Distel, bearing interest of 1.515% with a maturity date of April 29, 2011 | $ 90,000 |
| Promissory note due to Sercotel, bearing interest of 1.515% with a maturity date of April 29, 2011 | 11,000 |
| Promissory note due to Sercotel, bearing interest of 1.515% with a maturity date of April 30, 2011 | 15,000 |
| Promissory note due to Sercotel, bearing interest of 1.5238% with a maturity date of April 29, 2011 | 11,500 |
| Promissory note due to Sercotel, bearing interest of 1.3613% with a maturity date of April 29, 2011 | 15,000 |
| Promissory note due to Sercotel, bearing interest of 1.05128% with a maturity date of April 29, 2011 | 14,000 |
| Promissory note due to Sercotel, bearing interest of .8478% with a maturity date of April 29, 2011 | 9,000 |
| Total notes payable to affiliates | 165,500 |
| Less current portion | (6,000) |
| Long-term portion | $ 159,500 |

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## 9. Notes Payable to Affiliates (continued)

In 2010, the Company made payments totaling approximately $26 million, plus related interest, to decrease notes payable principal and accrued interest balances.

As of December 31, 2010, the Company had accrued interest totaling approximately $1.4million, which has been included under as a credit in due from affiliates in the accompanying balance sheet.

Interest expense for the year ended December 31, 2010, amounted to approximately $2.4 million.

In February 2011, the Company made payments totaling approximately $6 million, plus related interest, to decrease the $15 million promissory note due to Sercotel, bearing interest of 1.515% with a maturity date of April 30, 2011. Additionally, in April 2011, the Company refinanced and issued with Sercotel and Distel new promissory notes totaling approximately $159.5 million, which are due in April 2012. Consequently, the refinanced notes have been classified as notes payable to affiliates noncurrent portion in the accompanying balance sheet.

## 10. Supplemental Cash Flow Information

Cash paid for interest for the year ended December 31, 2010 amounted to approximately $3 million. Non-cash transactions related to liabilities for capital expenditures amounted to approximately $76.8 million for the year ended December 31, 2010.

## 11. Obligation under Capital Lease

On November 2009, the Company entered into an agreement with SES Americomm, Inc. for the lease of a telecommunication satellite that expires in 2020. The following is the book value of the leased asset included in the property and equipment as of December 31, 2010:

| | |
|---|---|
| Telecommunication satellite | $ 78,188 |
| Less: accumulated amortization | (7,140) |
| Telecommunication satellite, net | $ 71,048 |

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## 11. Obligation under Capital Lease (continued)

Future minimum lease payments under the capital lease are as follow:

| | |
|---|---|
| Year ending December 31, | |
| 2011 | $ 7,980 |
| 2012 | 7,980 |
| 2013 | 7,980 |
| 2014 | 7,980 |
| 2015 | 7,980 |
| Thereafter | 37,426 |
| Total minimum lease payments | 77,326 |
| Less: amount representing interest | (6,448) |
| Present value of net minimum lease payments | 70,878 |
| Less: current portion of lease obligation | (7,980) |
| Noncurrent portion of lease obligation | $ 62,898 |

Interest expense amounted to approximately $1.4 million for the year ended December 31, 2010.

## 12. Operating Leases

The Company has operating leases for certain facilities and equipment. Future minimum lease payments under operating leases are as follow:

| | |
|---|---|
| Year ending December 31, | |
| 2011 | $ 33,384 |
| 2012 | 26,793 |
| 2013 | 21,905 |
| 2014 | 16,095 |
| 2015 | 10,013 |
| Thereafter | 6,271 |

Rent expense amounted to approximately $34.4 million for the year ended December 31, 2010.

Cont

## 13. Contingencies and Regulatory Matters

### *Regulatory and Competitive Trends*

The Company is a defendant in various legal matters arising in the ordinary course of business. As required, the Company has accrued estimates of the probable and estimable losses for the resolution of these claims. These estimates have been developed in consultation with outside counsel and are based upon an analysis of potential results, assuming a combination of litigation and settlement strategies. Although the outcome of the claims and proceedings against the Company cannot be predicted with certainty, management believes that there are no existing claims or proceedings that are likely to have a material adverse effect on the financial position, results of operations or cash flows.

Regulatory activity at the Federal and local levels has been primarily directed at meeting challenges in maintaining support for local exchange rates of Universal Service and conducting different efforts to obtain a regulatory restructuring required by an increasingly competitive environment. Significant regulatory issues include network interconnection and performance standards.

The Company continues to meet the wholesale requirements of new competitors and have signed agreements with various wireless and wireline carriers. These agreements permit these carriers to purchase unbundled network elements, to resell retail services, and to interconnect their networks with the Company.

### *Touchtone Charges*

On November 17, 2003, six residential subscribers and eight business service subscribers filed a class action suit with the Court of First Instance of Puerto Rico (the Court) under the Puerto Rico Telecommunications Act of 1996 (the Act) and the Puerto Rico Class Action Act of 1971. The plaintiffs have claimed that the Company's charges for touchtone service are not based on cost, and therefore violate the Act. The plaintiffs have requested that the Court (i) issue an order certifying the case as a class action, (ii) designate the plaintiffs as representative of the class, (iii) find that the charges are illegal, and (iv) order the Company to reimburse every subscriber for excess payments made since September 1996.

## 13. Contingencies and Regulatory Matters (continued)

### *Touchtone Charges (continued)*

Act 138 of November 4, 2005, grants the Telecommunication Regulatory Board primary jurisdiction to entertain class action suits related to telecommunication services and established a maximum award of $5 million. The plaintiffs challenged the legality of the Act and their case is pending a decision from the Puerto Rico Supreme Court. The Company believes that the class action suit is without merit and intends to vigorously defend itself against it. The outcome of this litigation is uncertain, however, and the Company cannot currently predict the manner and timing of the resolution of the suit, or an estimate of a range of possible losses or any minimum loss that could result in the event of an adverse verdict in this suit.

## 14. Subsequent Events

In connection with the preparation of the financial statements and in accordance with ASC 855, *Subsequent Events*, management has evaluated and reviewed the affairs of the Company for subsequent events that would impact the financial statements for the year ended December 31, 2010, through the opinion date of the financial statements, July 11, 2011, the date the financial statements were available to be issued.

As mentioned in Note 7, the Government of Puerto Rico worked in a comprehensive tax reform. Phase II of the tax reform was approved during the month of January 2011. Phase II of the tax reform was introduced under a new Puerto Rico Internal Revenue Code as Act 1 of January 31, 2011 and will generally be applicable to taxable years that commence after December 31, 2010. Some of the key aspects under Act 1 are the following:

- Reduction of corporate income tax rates starting in 2011.
- Changes in tax depreciation methods and useful lives.
- Changes in the alternative minimum tax (AMT) calculation.

Management is in the process of evaluating the effect these changes will have in future years, if any.



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**14. Subsequent Events (continued)**

As mentioned in Note 8, in February 2011, the Company made payments totaling approximately $6 million, plus related interest, to decrease the $15 million promissory note due to Sercotel, on April 30, 2011. Additionally, in April 2011, the Company refinanced and issued with Sercotel and Distel new promissory notes totaling approximately $159.5 million which are due in April 2012.

Other than the events mentioned above, management is not aware of any other subsequent events that could significantly impact the financial statements.



End