RICHARDSON ELECTRONICS LTD/DE
Form DEF 14A
August 22, 2014

SCHEDULE 14A INFORMATION
Proxy Statement Pursuant to Section 14(a) of the Securities
Exchange Act of 1934 (Amendment No.)

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RICHARDSON ELECTRONICS, LTD.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than Registrant)

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RICHARDSON ELECTRONICS, LTD.
40W267 Keslinger Road
P.O. Box 393
LaFox, Illinois 60147-0393

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON OCTOBER 7, 2014

Dear Stockholders:

On behalf of the Board of Directors and Management of Richardson Electronics, Ltd., I cordially invite you to attend the 2014 Annual Meeting of Stockholders. The Annual Meeting will be held on Tuesday, October 7, 2014, at 2:00 p.m. Central Time, at our corporate headquarters at 40W267 Keslinger Road, LaFox, Illinois.
The purpose of the Annual Meeting is to consider and vote on the following matters:

1. The election of six directors nominated by Richardson's Board of Directors for a term expiring at the 2015 Annual Meeting (Proposal 1);

2. To ratify the selection of Ernst & Young LLP as the Company's independent registered public accounting firm for fiscal year 2015 (Proposal 2);

3. To approve, on an advisory basis, the compensation of our Named Executive Officers (Proposal 3);

4. To approve an amendment to the 2011 Long-Term Incentive Plan to increase the number of shares available under the plan (Proposal 4);

5. To approve the Amended and Restated Certificate of Incorporation to reduce the number of authorized shares (Proposal 5); and

6. To act upon any other business that may properly come before the meeting or at any adjournment or postponement thereof.

We currently are not aware of any other matters scheduled to come before the Annual Meeting. All stockholders are cordially invited to attend the meeting, although only stockholders of record at the close of business as of August 14, 2014, are entitled to notice of, and to vote at, the Annual Meeting or at any adjournment or postponement thereof.

You are cordially invited to attend the meeting. Whether or not you plan to attend the Annual Meeting, it is important that your shares be represented and voted. You may vote via the Internet, telephone or by mail before the Annual Meeting or in person at the Annual Meeting. For specific instructions, please refer to the accompanying proxy card.

This year we are again taking advantage of Securities and Exchange Commission rules that allow us to furnish proxy materials to stockholders via the Internet. We sent notices of Internet availability of proxy materials to holders of our common stock as of the record date on or about August 28, 2014. The notice describes how you can access our proxy materials beginning on August 28, 2014.

By Order of the Board of Directors,
EDWARD J. RICHARDSON

Chairman of the Board, Chief Executive Officer and President

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RICHARDSON ELECTRONICS, LTD.

PROXY STATEMENT

ANNUAL MEETING INFORMATION

General

The Board of Directors of Richardson Electronics, Ltd. (the “Company,” “we,” “our” or “us”) is soliciting your proxy for the Annual Meeting of Stockholders to be held at our corporate headquarters located at 40W267 Keslinger Road, LaFox, Illinois 60147-0393, on Tuesday, October 7, 2014, at 2:00 p.m. Central Time, and at any and all adjourned or postponed sessions of the Annual Meeting. On or about August 28, 2014, we mailed our stockholders of record a notice of Internet availability of proxy materials, including this proxy statement and our Annual Report on Form 10-K for the fiscal year ended May 31, 2014. All stockholders receiving the notice will have the ability to access the proxy materials over the Internet and to request a paper copy by mail by following the instructions in the notice.

Record Date and Quorum

Stockholders of record at the close of business on August 14, 2014, the record date, are entitled to notice of and to vote their shares at the Annual Meeting. At the record date, 11,806,173 shares of our common stock, and 2,190,644 shares of our Class B common stock were issued and outstanding. The common stock is listed for trading on the NASDAQ Global Market under the symbol RELL. The presence in person or by proxy of the holders of record of a majority of the combined voting power of the outstanding shares of common stock and Class B common stock entitled to vote is required to constitute a quorum for the transaction of business at the Annual Meeting. Abstentions and broker non-votes (which occur when a broker indicates on a proxy card that it is not voting on a matter) are considered as shares present at the Annual Meeting for the purpose of determining a quorum.

How to Vote

Stockholders can simplify their voting and reduce Company expenses by voting by telephone or via the Internet. If you vote by telephone or Internet, you do not need to mail back your proxy card. Telephone and Internet voting information is provided on your proxy card. A control number located on the proxy card is designed to verify your identity, allow you to vote your shares and confirm that your voting instructions have been properly recorded.

If your shares are held in the name of a bank or broker, you should follow the voting instructions you receive from the bank or broker. The availability of telephone or Internet voting will depend on your bank or broker’s voting process. If you choose not to vote by telephone or Internet, please return your proxy card properly signed, and the shares represented will be voted in accordance with your directions. You can specify your choices by marking the appropriate boxes on the proxy card.

The election of directors (Proposal 1); the non-binding advisory vote on executive compensation (Proposal 3); the approval of the amendment to the 2011 Long-Term Incentive Plan (Proposal 4); and the approval of the Amended and Restated Certificate of Incorporation (Proposal 5) are “non-discretionary” matters. Therefore, your broker may not vote your shares with respect to these items unless it receives your voting instructions, and if it does not, those votes will be counted as “broker non-votes.” “Broker non-votes” are shares that are held in street name by a bank or broker that indicates on its proxy that it does not have or did not exercise discretionary authority to vote on a particular matter.

If your proxy card is signed and returned without specifying choices, the persons named as proxies will vote in accordance with the recommendations of the Board of Directors. The Board’s recommendation is set forth together with the description of each matter in this Proxy Statement.

The Board of Directors recommends that you vote:

- FOR the election of each director nominee (Proposal 1);
- FOR the ratification of the selection of Ernst & Young LLP as our independent registered public accounting firm for fiscal year 2015 (Proposal 2);
- FOR the approval, on an advisory basis, of the compensation of our Named Executive Officers (Proposal 3);
- FOR the approval of an amendment to the 2011 Long-Term Incentive Plan (Proposal 4); and
- FOR the approval of the Amended and Restated Certificate of Incorporation (Proposal 5).

The Company knows of no other matters scheduled to come before the meeting. If any other matters properly come before the meeting, the proxies solicited hereby will be voted on such matters at the discretion of the persons named as proxies, except proxies that are marked to deny discretionary authority.

We encourage you to vote your shares in advance of the Annual Meeting date even if you plan on attending the Annual Meeting.

Vote Required, Abstentions and Broker Non-Votes

Holders of common stock are entitled to one vote for each share of common stock held on the record date, and holders of the Class B common stock are entitled to ten votes for each share of Class B common stock held on the record date.

If a quorum is present at the Annual Meeting, the six candidates for director who receive the highest number of affirmative votes will be elected. A proxy marked to withhold authority for the election of one or more directors will not be voted with respect to the director or directors indicated. Stockholders are not entitled to cumulate votes for the election of directors.

The affirmative vote of shares representing a majority in voting power of the Company’s common stock present in person or represented by proxy at the meeting and entitled to vote is necessary for approval of proxy Proposals 1, 2, 3, and 4. The affirmative vote of shares representing: (1) a majority in voting power of the Company’s common stock entitled to vote thereon, voting as a single class; (2) a majority of the issued and outstanding shares of common stock, voting as a separate class; and (3) a majority of the issued and outstanding shares of Class B common stock, voting as a separate class, is necessary for approval of proxy Proposal 5. Proxy cards marked as abstentions on Proposal 1, 2, 3, 4, and 5 will not be voted and will have the effect of a negative vote. Please note that a broker or other nominee will not be permitted to vote your shares on Proposals 1 (election of directors); or 3 (approval of executive compensation); 4 (approval of amendment to the Long-Term Incentive Plan) and 5 (approval of the Amended and Restated Certificate of Incorporation); absent specific instructions from you. Broker non-votes on Proposals 1, 3, and 4 will have no effect on the proposals, but broker non-votes on Proposal 5 will have the effect of a negative vote. Because Proposal 2 is a routine proposal on which a broker or other nominee generally has discretionary authority to vote, we do not expect any broker non-votes on Proposal 2.

Revocability of Proxies

You may revoke your proxy at any time before it is voted (in the case of proxy cards) by giving notice to the Secretary of the Company or by executing and mailing a later-dated proxy. To revoke a proxy given or change your vote cast, by telephone or the Internet, you must do so by telephone or the Internet, respectively (following the directions on your proxy card), by 11:59 p.m. Eastern Standard Time on October 6, 2014.

Proxy Solicitation

We will bear the expense of soliciting proxies. Our officers and certain other employees, without additional remuneration, may also solicit proxies personally or by telephone, e-mail or other means.

PROPOSAL 1 - ELECTION OF DIRECTORS

At the Annual Meeting, stockholders will elect six directors to serve on our Board of Directors until the next annual meeting, or until their successors are elected and shall have qualified, subject to their earlier death, resignation or removal as permitted by law. Directors will be elected by a plurality of the votes cast at the meeting by the holders of shares represented in person or by proxy. Thus, assuming a quorum is present, the six persons receiving the greatest number of votes will be elected as directors and votes that are withheld will have no effect.

Our Board of Directors, acting through our Nominating Committee, is responsible for nominating a slate of directors that collectively have the complementary experience, qualifications, skills and attributes to guide the Company and function effectively as a Board.

The Nominating Committee has recommended Edward Richardson, Jacques Belin, James Benham, Kenneth Halverson, Scott Hodes and Paul Plante, as nominees for election at the Annual Meeting.

We believe that each of our nominees has professional experience in areas relevant to our strategy and operations. All of our directors have managerial experience and are accustomed to dealing with complex problems. We also believe each of our nominees has other attributes necessary to create an effective Board, including high personal and professional ethics, the willingness to engage management and each other in a constructive and collaborative fashion, the ability to devote significant time to serve on our Board and its committees, and a commitment to representing the long-term interests of all our stockholders. In addition to these attributes, in each individual's biography set forth below, we have highlighted specific experience, qualifications, and skills that led the Nominating Committee and the Board to conclude that each individual should be nominated to serve as a director of the Company.

Jacques Belin, age 63, served as Managing Director of Thales Components and Subsystems from 2000 to 2011. He retired in 2011. Prior to that he served in multiple capacities including Quality and Production Engineer, Operations Manager and Factories Manager. In addition, Mr. Belin was heavily involved at Thales in areas including strategy, sales and marketing, and administration. Mr. Belin holds an engineering degree from Ecole Centrale in Paris. His entire career has been devoted to the electron tube and subsystems business. We believe Mr. Belin's vast experience in the industry and knowledge of other advanced power generation, microwave, and detection technologies will be highly beneficial to the Company.

James Benham, age 69, has served as a Technical and Marketing Consultant to the Night Vision and Microwave Devices Industries since March, 2013. He retired in March, 2013 after 46 years in Defense Electronics. Prior to his retirement, Mr. Benham was the President of L-3 Communications Narda West Division in Folsom, CA from 2011 to 2013. For the previous 16 years, he was President of the Electron Devices Division of L-3 Communications. Mr. Benham received his BS in Chemistry from the State University of New York, and an MBA from Lynchburg College in Lynchburg, Virginia. He has also completed executive development programs at The Wharton School of the University of Pennsylvania, Harvard Business School and Stanford University. Additionally, Mr. Benham holds a patent in the night vision field. We believe Mr. Benham's 45+ years of technology development, engineering and management experience will be a major asset to the future of the Company.

Kenneth Halverson, age 63, is currently a consultant with Halverson Consulting, LLC since 2009. Previously, he was Senior Vice President from 1999 to 2009 with MedAssets, Inc., one of the largest Group Purchasing Organizations in the country. MedAssets provides service to thousands of hospitals helping them to reduce their overall expenses. Mr. Halverson was with Comdisco Inc. from 1984 to 1999, acting as Senior Vice President and President of the Healthcare Group, which leased imaging and clinical equipment as well as refurbished and remarketed imaging equipment. Mr. Halverson holds an MBA in Finance from Northwestern University's Kellogg School of Management and has held various executive positions with technology and healthcare companies throughout his career. We believe Mr. Halverson's extensive experience with healthcare companies as well as his background in technology and finance will enable him to provide valuable insight into the Company's strategy.

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Scott Hodes, age 77, has been a director of the Company since 1983 and has served as our lead director since 2011. Mr. Hodes is Senior Counsel at Bryan Cave LLP where he was a partner from January 2004 to March 2009. From 1992 until 2004, Mr. Hodes was a partner with the law firm of McGuire Woods Ross & Hardies LLP and its predecessor firm Ross & Hardies LLP. Among his numerous leadership positions in business and community organizations, he is currently a director of the Better Government Association. We believe Mr. Hodes' qualifications to serve on our Board of Directors include his experience gained as legal counsel for numerous publicly traded and private companies as a practicing lawyer for more than 50 years.

Paul J. Plante, age 56, has provided business consulting services to the electronics industry since 2008 and has been a director since 2011. Prior to that time he was Vice President, Medical Industry Solutions, for the Kimball Electronics Group from February 2007 until May 2008, after the purchase by Kimball Electronics of Reptron Electronics, Inc. From February 2004 to February 2007, Mr. Plante was President and Chief Executive Officer and a member of the Board of Directors of Reptron Electronics, Inc., a publicly held provider of electronics manufacturing services with a focus on the medical industry. From 1994 until 2004 he served as the President and Chief Operating Officer of Reptron. Mr. Plante negotiated and led Reptron Electronics, Inc. through a successful pre-arranged Chapter 11 reorganization period that strengthened the company's balance sheet and liquidity with no significant loss of customers, employees, or suppliers. Prior to 1994, he was the Chief Financial Officer at Reptron and at K-Byte, Inc., a Michigan based software developer and electronics manufacturer. Mr. Plante has a degree in accounting and has been a licensed certified public accountant. We believe Mr. Plante is financially literate and qualifies as an "audit committee financial expert" under SEC rules. Mr. Plante's qualifications to serve on our Board of Directors include his significant experience in the electronics industry, his experience managing electronics manufacturing companies and his extensive financial knowledge. Mr. Plante also serves as a director of Sigmatron International.

Edward J. Richardson, age 72, has been a director of the Company since 1965. He is currently the Chairman of the Board, Chief Executive Officer, President and Chief Operating Officer of the Company. Mr. Richardson has been employed by the Company in various capacities since 1961. We believe Mr. Richardson's qualifications to serve on our Board of Directors include his position as our Chief Executive Officer for over 37 years and his unique ability to bring historic knowledge and continuity to the Board.

The Company knows of no reason why any of the nominees for director would be unable to serve. In the event, however, that any nominee named should, prior to the election, become unable to serve as a director, your proxy (unless designated to the contrary) will be voted for such other person or persons as the Board of Directors may recommend.

Our Board of Directors recommends that you vote "FOR" the election of each director nominee.

CORPORATE GOVERNANCE

Independence of Directors

The Board of Directors has determined that Messrs. Benham, Halverson, Hodes, and Plante, are independent as defined by NASDAQ listing standards. All members of the Audit, Compensation & Governance, and Nominating Committees, are independent in accordance with applicable laws and NASDAQ rules for members of such committees.

Board Leadership Structure

The Company has no fixed policy on whether the roles of Chairman of the Board and Chief Executive Officer should be separate or combined, with this decision being made based on the best interests of the Company and its stockholders considering the circumstances at the time. Currently, these roles are combined with Mr. Richardson serving as both the Chairman of the Board and the Chief Executive Officer. Mr. Richardson possesses detailed and in-depth knowledge of the issues, opportunities and challenges facing the Company and its business, and is responsible for the day-to-day operations of the Company. Therefore, the Board believes that Mr. Richardson is best positioned to efficiently develop agendas that ensure that the Board's time and attention are focused on the most critical matters and to execute strategic plans effectively, especially given the relatively small size of the Company's Board.

At the selection of the Board, Mr. Hodes, who is an independent director, has served as lead director since 2011. The lead director acts as a key liaison with the Chief Executive Officer, assists the Chairman of the Board in setting the Board agenda, chairs executive sessions of the Board, and communicates Board member feedback to the Chief Executive Officer. In addition, the Company's non-management directors meet in regularly scheduled executive sessions without any members of management present. The purpose of these executive sessions is to promote open and candid discussion among the non-management directors. The Board believes this approach appropriately and effectively complements the combined role of Chairman of the Board and Chief Executive Officer.

Board and Committee Information

During our last fiscal year, the Board of Directors held five meetings, of which two were teleconference meetings. Each director attended at least 75% of the aggregate number of such meetings and meetings of the committees on which he served. Although we have no formal policy about attendance at the Annual Meeting of Stockholders by our directors, it is encouraged. Last year, all directors attended the Annual Meeting.

During our last fiscal year, the Board of Directors had four standing committees: the Audit Committee, Compensation & Governance Committee, Executive Committee, and Nominating Committee.

During our last fiscal year, the members and chair of each committee were as follows:

Director	Audit	Compensation	Executive	Nominating
Kenneth Halverson	a	a		a
Scott Hodes	a	a	a	a(Chair)
Paul Plante	a(Chair)	a(Chair)		a
Edward Richardson			a(Chair)	

Executive Committee. The Executive Committee did not meet during the last fiscal year. This committee may exercise all authority of the Board of Directors in the management of the Company during the interval between meetings of the Board of Directors, except as otherwise provided in our by-laws or by applicable law.

Audit Committee. The Audit Committee held four meetings during the last fiscal year. This committee meets for the purpose of engaging and discharging the independent auditors (or recommending such actions), directing and supervising special investigations, reviewing with the independent auditors the plan and results of the auditing engagement, reviewing the scope and results of our procedures for internal auditing, approving each professional service provided by the independent auditors prior to the performance of such services, reviewing the independence of the independent auditors, considering the range of audit and non-audit fees for the independent auditors and reviewing the adequacy of the issuer's system of internal accounting controls and such other matters relating to our financial affairs and accounts as required by law or regulation or as it deems desirable or as the Board of Directors may assign to it. The Board of Directors has determined that the composition and functioning of the committee complies with the rules of the SEC and NASDAQ, including that each of its members is independent, as that term is defined in NASDAQ rules, and that one of its members, Mr. Plante, qualifies as an "Audit Committee Financial Expert," as that term is defined in SEC rules. The Audit Committee has adopted a written charter approved by the Board of Directors. A copy of the charter is available on our website at www.rell.com.

The Audit Committee's report begins on page 13.

Compensation & Governance Committee. The Compensation & Governance Committee (the "Compensation Committee") held ten meetings in the last fiscal year. The committee is comprised of three independent directors, and the Board of Directors has determined that the composition and functioning of this committee complies with the applicable NASDAQ and SEC requirements.

The committee's responsibilities include:

- Establishing, reviewing, and approving the base salary, non-equity incentive compensation, perquisites, and any other forms of non-equity compensation for our Chairman and Chief Executive Officer and for our executive officers;
- Reviewing and monitoring our incentive compensation and retirement plans and performing the duties imposed on the Committee by the terms of those plans;
- Administering our incentive compensation plans, including determining the employees to whom stock options and stock awards are granted, the number of shares subject to each option or award, and the date or dates upon which each option or award may be exercised;
- Developing and reviewing the Company's Corporate Governance Guidelines; and
- Performing other duties deemed appropriate by the Board of Directors.

The Compensation Committee chairman reports the committee's recommendations on executive compensation to the Board of Directors. Our Human Resources Department supports the committee and is delegated authority to fulfill certain administrative duties regarding compensation programs. The Compensation Committee has authority to retain, approve fees for, and terminate consultants as it deems necessary to assist in the fulfillment of its duties and responsibilities. The committee has adopted a written charter which is available on our website at www.rell.com.

The Compensation Committee report is on page 20.

Nominating Committee. The Nominating Committee met once during the last fiscal year. In considering whether to recommend any particular candidate for inclusion on the Board of Directors' slate of recommended director nominees, the Nominating Committee applies the criteria set forth in our corporate governance guidelines. These criteria include the candidate's integrity, business acumen, knowledge of our business and industry, experience, diligence, and the ability to act in the interests of all stockholders. The committee does not assign specific weights to particular criteria and no particular criterion is a prerequisite for each prospective nominee. The committee believes that the background and qualifications of our directors, considered as a group, should provide a composite mix of experience, knowledge, and abilities that will best allow the Board of Directors to fulfill its responsibilities.

Management and the Directors submit candidates for nomination for election to the Board of Directors and for committee consideration. With respect to the election of director nominees at the Annual Meeting, the Nominating Committee recommended the Board nominate each of the six directors currently serving on the Board.

The Company does not have a policy regarding the consideration of diversity in identifying director nominees. The committee has not adopted a written charter. The Company is utilizing the "Controlled Company" exemption pursuant to Nasdaq Rule 5615(c) for purposes of the Nominating Committee Charter Requirement. The determination is based on the fact that Mr. Richardson has over 60% of the voting rights.

Stockholders may also submit names of candidates for consideration by the Nominating Committee, provided that such submissions must be received by the Board of Directors no later than the July 1st immediately preceding the annual meeting of stockholders. Stockholders may also nominate a candidate or candidates for election as a director at the annual meeting at which directors are elected.

Board Role in Risk Oversight

Non-management Directors meet regularly in executive sessions without management. Executive sessions are held during each regularly scheduled meeting and the Company's lead director presides over these sessions.

The Board and each of the Audit, Nominating, and Compensation Committees conduct annual self-evaluations, as contemplated by the Company's Governance Principles and the charters of such Board Committees.

While the Company's management is responsible for day-to-day management of various risks facing the Company, the Board of Directors is responsible for evaluating the Company's exposure to risk and to monitor the steps management has taken to assess and control risk. In addition, the Board has delegated oversight of certain categories of risk to the Audit and Compensation Committees. The Audit Committee oversees risks related to the integrity of the Company's financial statements and financial reporting, and the Compensation Committee oversees risks related to the Company's compensation plans and practices. In performing their oversight responsibilities, the Board receives periodic reports from the Chief Executive Officer and other members of senior management on areas of risk facing the Company. The Audit and Compensation Committees report to the Board regularly on matters relating to the specific areas of risk the committees oversee.

Compensation of Directors

Non-employee directors receive a quarterly retainer of $4,500 and meeting fees of $1,000 for each Audit Committee meeting and $750 for other Board and committee meetings. The Chairman of the Audit Committee receives an additional quarterly retainer of $1,500.

Upon joining the Board, new directors receive a grant of 25,000 stock options that vest over five years. After the five-year period, directors receive an annual grant of 5,000 stock options that are fully vested on the date of grant.

Employee directors receive no additional compensation related to their service on our Board of Directors.

COMPENSATION OF DIRECTORS
Director Compensation Table

Name of Director	Fees Earned or Paid in Cash ($)	Option Awards ($) (1)(2)	All Other Compensation ($)	Total ($)
Edward J. Richardson	—	—	—	—
Jacques Belin	15,000	14,693	—	29,693
James Benham	15,000	14,693	—	29,693
Kenneth Halverson	19,250	14,693	—	33,943
Scott Hodes	31,250	17,900	—	49,150
Paul Plante	37,750	31,212	—	68,962

(1) Amounts represent the dollar amount recognized for financial statement reporting purposes with respect to fiscal 2014 for the fair value of stock options granted to each director in fiscal 2014, in accordance with Financial Accounting Standards Board Accounting Standards Codification (ASC) 718, and do not correspond to the actual value that will be recognized by each director. For the relevant assumptions used in determining the fair value of stock option awards, refer to Note 4, Significant Accounting Policies - Share-Based Compensation, in the Notes to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2014, filed with the SEC on July 25, 2014.

(2)

The aggregate number of options granted in fiscal 2014 to directors was 80,000 and all were outstanding at fiscal year end.

EXECUTIVE OFFICERS

The following are our executive officers as of August 19, 2014:

Name	Age	Position
Edward J. Richardson	72	Chairman, Chief Executive Officer, Chief Operating Officer and President
Wendy S. Diddell	49	Executive Vice President, Corporate Development & General Manager, Canvys
Kathleen S. Dvorak	57	Executive Vice President, Chief Financial Officer and Chief Strategy Officer
James M. Dudek, Jr.	42	Corporate Controller and Chief Accounting Officer
Kathleen M. McNally	54	Senior Vice President, Global Supply Chain

Mr. Richardson has been employed by the Company since 1961, holding several positions during this time. He was Chairman of the Board, Chief Executive Officer and President from September 1989 until November 1996. Since that time, Mr. Richardson has continued to hold the offices of Chairman of the Board and Chief Executive Officer. In April 2006, he also became President and Chief Operating Officer, and in June 2009 he also became the General Manager of the Electron Device Group.

Ms. Diddell has been Executive Vice President, Corporate Development since June 2007. In June 2009, she also assumed the role of General Manager of our Canvys business. Prior to June 2007, Ms. Diddell was Executive Vice President and General Manager of our Security Systems Division since February 2006. Prior to that, Ms. Diddell was employed as a management consultant for the Security Systems Division since July 2003 and Vice President and General Manager of the Security Systems Division since June 2004.

Ms. Dvorak has been Executive Vice President, Chief Financial Officer and Chief Strategy Officer since November 2007. Ms. Dvorak has since assumed responsibility for Information Systems, Legal and Human Resources. Prior to joining us, Ms. Dvorak was employed by United Stationers Inc. as Senior Vice President and Chief Financial Officer from 2001 to 2007, Senior Vice President Investor Relations and Financial Administration from 2000 to 2001.

Mr. Dudek has been Controller and Chief Accounting Officer since December 2007. Prior to that, Mr. Dudek was Senior Director, Financial Reporting with Career Education Corporation from September 2006 to November 2007 and Director of Accounting from February 2004 to August 2006. Prior to that, Mr. Dudek was with ConAgra Refrigerated Foods Group from September 1999 to February 2004, serving as Retail Sales Controller from May 2002 to February 2004, and prior to that he held various positions within the Corporate Financial Planning department from September 1999 to September 2002.

Ms. McNally has been Senior Vice President, Global Supply Chain, since 2009. Previously she served as Senior Vice President of Marketing Operations and Customer Support from 2000 to 2009 and as Vice President and Corporate Officer of Marketing Operations from 1989 until 2000. Prior to that, she held various positions within the marketing department since joining the Company in 1979.

Executive officers are elected annually by the Board of Directors at the time of the annual stockholders meeting and serve until their earlier resignation, death or removal.

PRINCIPAL STOCKHOLDERS

The following table shows the number of shares of common stock and Class B common stock beneficially owned by (1) each director, (2) each of our Named Executive Officers, (3) all directors and executive officers of the Company as a group, and (4) each other person who is known by us to beneficially own more than 5% of our common shares. Percent of Class and Percent of Total Voting Rights are based on 13,996,817 shares outstanding as of August 14, 2014.

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	Shares of Common Stock (1)		Percent of Class	Shares of Class B Common Stock (2)	Percent of Class B Common Stock	Percent of Total Voting Rights
Directors:						
Jacques Belin	5,000	(3)	*	—	*	*
James Benham	5,000	(4)	*	—	*	*
Kenneth Halverson	5,000	(5)	*	—	*	*
Scott Hodes	103,424	(6)	*	3,712	*	*
Paul J. Plante	15,000	(7)	*	—	*	*
Edward J. Richardson	2,212,966	(8)	15.8 %	2,162,966	98.7 %	64.2 %
Non-Director Named Executive Officers:						
Wendy S. Diddell	58,000	(9)	*	—	*	*
Kathleen S. Dvorak	83,000	(10)	*	—	*	*
Kathleen M. McNally	48,656	(11)	*	—	*	*
James M. Dudek, Jr.	13,603	(12)	*	—	*	*
All Executive Officers and Directors as a Group (10 persons)	2,549,649	(13)	18.2 %	2,166,678	98.9 %	64.5 %
Other Beneficial Owners:						
Gates Capital Management, Inc.	2,852,186	(14)	20.4 %	—	—	8.5 %
RGM Capital	1,165,131	(15)	8.3 %	—	—	3.5 %
Dimensional Fund Advisors LP	1,162,355	(16)	8.3 %	—	—	3.4 %
Royce & Associates LLC	1,000,649	(17)	7.1 %	—	—	3.0 %

* Less than 1%.

(1) Except as noted, beneficial ownership of each of the shares listed is comprised of both sole investment and sole voting power, or investment power and voting power that is shared with the spouse of the director or officer.

(2) Common stock is entitled to one vote per share, and Class B common stock is entitled to ten votes per share.

(3) Includes 5,000 shares of common stock to which Mr. Belin holds stock options exercisable within 60 days

(4) Includes 5,000 shares of common stock to which Mr. Benham holds stock options exercisable within 60 days

(5) Includes 5,000 shares of common stock to which Mr. Halverson holds stock options exercisable within 60 days

(6) Includes 3,712 shares of common stock which would be issued upon conversion of Mr. Hodes' Class B common stock and 50,000 shares of common stock to which Mr. Hodes holds stock options exercisable within 60 days.

(7) Includes 15,000 shares of common stock to which Mr. Plante holds stock options exercisable within 60 days.

(8) Includes 2,162,966 shares of common stock which would be issued upon conversion of Mr. Richardson's Class B common stock and 50,000 shares of common stock to which Mr. Richardson holds stock options exercisable within 60 days. Mr. Richardson has pledged 491,000 of his shares of Class B common stock as security to JP Morgan Chase Bank to secure a personal loan. The full Board evaluated the risk of significant pledging of stock. As this is a small percentage of his total holdings, the Board did not deem this to be material or represent a risk to the Company.

(9) Includes 58,000 shares of common stock to which Ms. Diddell holds stock options exercisable within 60 days.

(10) Includes 73,000 shares of common stock to which Ms. Dvorak holds stock options exercisable within 60 days.

(11) Includes 41,500 shares of common stock to which Ms. McNally holds stock options exercisable within 60 days.

(12) Includes 12,600 shares of common stock to which Mr. Dudek holds stock options exercisable within 60 days.

(13) Includes 2,162,966 shares of common stock issuable on conversion of Class B common stock and 365,100 shares of common stock issuable upon options exercisable within 60 days.

(14)

Information disclosed in this table is as of June 30, 2014, and was obtained from a Form 13F filed with the SEC. The address for Gates Capital Management, Inc. is 1177 Avenue of the Americas, 46th Floor, New York, NY 10036.

(15) Information disclosed in this table is as of June 30, 2014, and was obtained from a Form 13F filed with the SEC. The address for RGM Capital is 9010 Strada Stell Court, Suite 105, Naples, FL 34109.

(16) Information disclosed in this table is as of June 30, 2014, and was obtained from a Form 13F filed with the SEC. The address for Dimensional Fund Advisors LP is 6300 Bee Cave Road, Building One, Austin, Texas, 78746.

(17) Information disclosed in this table is as of June 30, 2014 and was obtained from a Form 13F filed with the SEC. The address for Royce & Associates LLC is 745 Fifth Avenue, New York, NY, 10151.

PROPOSAL 2 - RATIFICATION OF THE SELECTION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee expects to engage Ernst & Young LLP to serve as our independent registered public accounting firm for the fiscal year ending May 30, 2015.

Although the Audit Committee is not required to do so, it is submitting its expected selection of our independent registered public accounting firm for ratification at the Annual Meeting in order to ascertain the views of our stockholders. The Audit Committee will not be bound by the vote of the stockholders; however, if the proposed selection is not ratified, the Audit Committee would reconsider its selection.

One or more representatives of Ernst & Young LLP are expected to be present at the Annual Meeting. The representatives will have an opportunity to make a statement if they desire and will be available to respond to questions from stockholders.

Our Board of Directors recommends that you vote “FOR” the selection of Ernst & Young LLP as our independent registered public accounting firm for fiscal 2015.

AUDIT MATTERS

Audit Committee Report

The Audit Committee of the Board of Directors is comprised of directors that are “independent” as defined under the current NASDAQ listing standards and Rule 10A-3 under the Exchange Act. The Audit Committee has a written charter that has been approved by the Board of Directors. A copy of the charter is available on our website at www.rell.com.

The Audit Committee’s members are not professionally engaged in the practice of accounting or auditing, and they necessarily rely on the work and assurances of the Company’s management and the independent registered public accounting firm. Management has the primary responsibility for the financial statements and the reporting process, including the process of internal control over financial reporting. The independent registered public accounting firm of Ernst & Young LLP (“EY”) is responsible for performing an independent audit of the Company’s consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”) and expressing an opinion on the conformity of such audited financial statements with United States generally accepted accounting principles. In addition, the Company’s independent registered public accounting firm is responsible for auditing as well as expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. The Audit Committee has reviewed and discussed with management the audited financial statements of the Company for the fiscal year ended May 31, 2014 (the “Audited Financial Statements”). In addition, the Audit Committee has discussed with EY the matters required to be discussed by PCAOB Auditing Standard No. 16.

The Audit Committee has received the written disclosures and the letter from EY required by applicable requirements of the Public Company Accounting Oversight Board, regarding communications concerning independence and has discussed with EY its independence from the Company. The Audit Committee further considered whether the provision of non-audit related services by EY to the Company is compatible with maintaining the independence of EY with the Company. The Audit Committee has also discussed with management of the Company and EY such other matters and received assurances from them as it deemed appropriate.

The Company’s internal auditors and EY discussed with the Audit Committee the overall scope and plans for their respective audits. The Audit Committee meets regularly with the internal auditors and EY, with and without management present, to discuss the results of their reviews, the evaluation of the Company’s internal control over financial reporting, and the overall quality of the Company’s accounting.

Based on the above review and discussions, the Audit Committee recommended to the Board of Directors, and the Board approved, that the Audited Financial Statements of the Company be included in the Annual Report on Form 10-K for the fiscal year ended May 31, 2014, for filing with the SEC.

Audit Committee of the Board of Directors

Paul Plante, Chairman
Kenneth Halverson
Scott Hodes

Independent Auditor's Fees

The following table sets forth the aggregate fees billed for each of the last two years for professional services rendered by our principal registered public accounting firm for the respective years.

	2014	2013
Audit Fees [1]	$869,000	$843,177
Audit-Related Fees	—	—
Tax Fees[2]	—	75,000
All Other Fees	—	—
Total	$869,000	$918,177

(1) Audit Fees were for professional services rendered for the audits of our annual financial statements included in our Forms 10-K for the fiscal years ended May 31, 2014 and June 1, 2013. The reviews of the financial statements included in our quarterly reports on Forms 10-Q during such fiscal years, statutory audits for certain of our non-U.S. subsidiaries, and audit of our internal controls over financial reporting.

(2) Tax Fees of $75,000 in 2013 were for tax consulting services.

Audit Fees are reviewed and specifically approved by the Audit Committee on an annual basis. The Audit Committee has established formal policies and procedures for the pre-approval of audit-related, tax and other fees. These procedures include a review and pre-approval of an annual budget covering the nature of an amount to be expended for auditor services by specific categories of services to be provided. The Audit Committee pre-approved all Tax Fees shown above pursuant to its established policies and procedures.

RELATED PARTY TRANSACTIONS

Pursuant to our Code of Conduct, related party transactions involving directors, executive officers or their immediate family members must be reviewed and approved by our Board of Directors prior to the Company entering into such transactions. Our Code of Conduct generally describes a prohibited related party transaction as one that would adversely influence an employee or director in the performance of his or her duties to the Company or one that is inconsistent with or opposed to the best interests of the Company. The Code of Conduct contains many standards and examples of potentially prohibited related party transactions, but the Board of Directors retains the discretion to determine whether each potential transaction is consistent with the standards described in the Code of Conduct. Other than the broad standards outlined in the Code of Conduct, we do not have written standards for reviewing and evaluating potential related party transactions. However, Directors may consider any factors that they deem consistent with their fiduciary duties to stockholders.

During fiscal 2014, there were no related party transactions between the Company and our directors, executive officers, or their immediate family members.

COMPENSATION DISCUSSION AND ANALYSIS

We believe that the performance and contribution of our executive officers are critical to the success of the Company. To attract, retain and motivate our executives to accomplish our business strategies, we have implemented executive compensation programs providing executives with the opportunity to earn compensation that reward strong performance and creation of stockholder value.

Objectives

The fundamental objectives of our executive compensation programs are to:

- Attract and retain highly qualified executives by providing total compensation that is internally equitable and externally competitive;
- Motivate executives by providing performance-based incentives to achieve our annual financial goals and long-term business strategies; and
- Align the interests of executives with those of stockholders by rewarding our executives for individual and corporate performance measured against our goals and plans and by granting stock options and other equity-based compensation.

To achieve our compensation objectives, we use both annual cash compensation, which includes a base salary and an annual cash incentive plan, and time-based equity awards. When making compensation decisions, the various elements of compensation are evaluated together, and the level of compensation opportunity provided for one element may impact the level and design of other elements. We attempt to balance the total executive compensation program to promote the achievement of both current and long-term performance goals.

The Compensation Committee reviews and analyzes our executive compensation policies, programs, and practices regularly in light of these objectives and our financial performance to ensure that our compensation practices are appropriately configured to achieve these objectives.

Say on Pay Feedback from Stockholders

A primary focus of our Compensation Committee is whether the Company's executive compensation program serves the best interests of the Company's stockholders. As part of its ongoing review of our executive compensation program, the Compensation Committee considered the affirmative stockholder advisory vote on executive compensation ("say on pay") at the Company's 2013 Annual Meeting, where a significant majority of our stockholders approved the compensation program described in the proxy statement for that meeting. The Compensation Committee determined that the Company's executive compensation philosophy, objectives and elements continue to be appropriate. In 2014, the Company aligned its CEO and executive management team on a single incentive plan with four defined metrics.

Named Executive Officers

For fiscal 2014, our Named Executive Officers were as follows:

Executive Name	Title
Edward J. Richardson	Chairman, Chief Executive Officer and President
Wendy S. Diddell	Executive Vice President, Corporate Development & General Manager, Canvys
Kathleen S. Dvorak	Executive Vice President, Chief Financial Officer, and Chief Strategy Officer
James M. Dudek, Jr.	Corporate Controller and Chief Accounting Officer
Kathleen M. McNally	Senior Vice President, Global Supply Chain

Establishing Executive Compensation

Role of the Compensation Committee. The Compensation Committee is responsible for discharging the responsibilities of the Board of Directors with respect to executive compensation. Its role is to review and approve the Company's compensation programs, policies and practices with respect to its executive officers. The Compensation Committee assists the Board in evaluating the performance of the Chief Executive Officer, which is generally conducted during executive sessions of the Board. The committee also reviews the Chief Executive Officer's evaluation of the performance of the other executive officers in order to determine the base compensation and annual cash bonus opportunities for the executive officers.

The committee also administers the Company's incentive compensation plans and, in such capacity, determines equity compensation for its executive officers in the form of awards of stock, restricted stock, and stock options to support the objectives of its compensation programs. The Compensation Committee did not retain a compensation consultant during fiscal 2014.

Role of Management. The Chief Executive Officer (CEO) assists the Compensation Committee in reaching compensation decisions by developing recommended compensation for the executive officers. The CEO also develops performance objectives for each executive officer. The CEO meets with each executive officer formally on an annual basis to review past performance and to discuss performance objectives for the following year.

The Company's Chief Financial Officer (CFO) also serves as its Chief Human Resources Officer. In connection with the structure and amount of the Company's executive officer compensation, the CFO advises the CEO regarding the Company's financial performance and, in her capacity as Chief Human Resources Officer, the compensation for its non-executive officer employees. The Compensation Committee consults with the CEO to ensure that executive officer compensation will achieve the Company's annual financial goals and long-term business plans.

During fiscal 2014, the committee did not analyze executive compensation at any group of peer companies as a 3% merit increase was given to all Named Executive Officers except for Ms. Diddell, who received an increase of 19.3% reflecting an internal equity adjustment.

Role of Employment Agreements. The Company considers employment agreements to be an important part of recruiting and retaining qualified executive officers. All of the Named Executive Officers, other than Mr. Richardson and Ms. McNally, have entered into employment agreements. The employment agreements with each of the Named Executive Officers establish initial base compensation and ongoing annual cash bonus opportunity as a percentage of base compensation. These employment agreements are described in further detail on page 25. Due to his substantial equity stake in the Company, the Compensation Committee does not believe that an employment agreement with Mr. Richardson is necessary to achieve the retention goals served by employment agreements with most of the other Named Executive Officers.

Role of Compensation Benchmarking. One of the fundamental objectives of the Company's compensation program is that total compensation be externally competitive. To achieve this objective, from time to time the Company obtains data to compare its executive compensation against executive compensation at other companies. In fiscal years when such data is not obtained, the CEO and the Compensation Committee rely on publicly available information related to competitive compensation, internal equity, and general market trends in executive compensation.

Generally, the Compensation Committee uses data from public sources to determine whether the market for executive compensation has changed significantly. If the Compensation Committee believed the market had changed significantly, then it would instruct the CEO to commission a study of executive compensation at certain comparable companies for purposes of evaluating the Company's compensation arrangements. If the Compensation Committee does not believe the market has changed significantly, then the Committee recommends a fixed percentage merit increase for executives. The Committee's evaluation of competitive compensation and market trends is based on publicly available information. The Committee generally does not independently analyze executive compensation at any group of peer companies except when recruiting for new executives.

Role of Compensation Consultants. The Compensation Committee has the authority under its charter to retain compensation consultants to assist in the evaluation of executive officer compensation and benefits and approve the consultants' fees and other retention terms. However, the Company and the Compensation Committee has not historically engaged compensation consultants in determining Named Executive Officer compensation. Instead, the Compensation Committee utilizes publicly available information and informal surveys from professional human resource organizations to determine executive compensation.

Elements of Executive Compensation

Most of the Company's compensation elements fulfill one or more of its compensation objectives. The elements of total compensation for its Named Executive Officers are:

- base compensation;
- annual cash bonus compensation;
- equity-based compensation;
- profit sharing/401(k) plan; and
- perquisites.

Base Compensation. The Compensation Committee alone determines the CEO's base compensation. This amount was equal to the budgeted increase in compensation for U.S. employees and was based on generally available market data with respect to annual wage increases in the United States. In fiscal 2012, the Committee approved increases for Mr.

Richardson and the other executive officers of 3.0%. Based upon this approval, Mr. Richardson's base compensation in 2012 was $573,169. In fiscal 2013, the Committee felt that in light of the challenges facing the business and the highly demanding nature of pursuing and evaluating global acquisition opportunities that it would be appropriate to increase the base compensation of Mr. Richardson by $100,000 effective October 15, 2012. This decision was made based on the fact that equity compensation is typically a large component of total compensation for most CEOs. In the case of Mr. Richardson, the Committee felt that additional equity was not warranted to align Mr. Richardson's interests with those of the other stockholders. As a result, they determined that adjusting Mr. Richardson's base compensation was more appropriate. In fiscal 2013, the Compensation Committee approved a 3% increase for all executive officers. In fiscal 2014, the Compensation

Committee approved a 3% increase in base compensation for all employees including Mr. Richardson and the other executive officers except for Ms. Diddell whose base compensation was increased by 19.3% on December 18, 2013. Based on internal equity and the travel requirements of Ms. Diddell's position, her base compensation was increased to $335,000 in 2014. Mr. Richardson's base compensation at the end of fiscal 2014 was $693,364.

The amount of base compensation for each of the other Named Executive Officers is initially set upon the commencement of his or her employment as an executive officer with the Company and is stated in the Named Executive Officer's employment agreement if the Company has an employment agreement with the Named Executive Officer. This initial amount is established with a goal of attracting talented executive officers to the Company and is recommended by the CEO and approved by the Compensation Committee. Thereafter, each of the Named Executive Officers' base compensation is reviewed annually by the CEO and the Compensation Committee.

In determining appropriate levels of base compensation for executive officers, the CEO considers the executive officer's individual performance, the financial performance of the Company, and a base compensation that is internally equitable and externally competitive. The Compensation Committee annually reviews the base compensation of the executive officers set by the CEO. The Compensation Committee reports its findings and opinions with respect to base compensation to the Board for further discussion so that the Board may provide feedback to the CEO regarding its perception of how well the base compensation of the executive officers achieves the Company's compensation objectives.

Annual Cash Bonus Compensation. During fiscal 2012, the Compensation Committee recommended and the Board and stockholders approved a payment under the Edward J. Richardson Incentive Compensation Plan.

Under the plan, Mr. Richardson was eligible for an annual cash bonus equal to 2% of the Company's annual net income after taxes each fiscal year, subject to the Compensation Committee's right, in its sole and exclusive discretion, to reduce the bonus, including a reduction to zero. This plan formalized a historical annual cash bonus arrangement for the CEO established by the Board of Directors in 1983. In fiscal 2012, Mr. Richardson earned a cash bonus of $172,080 based upon a calculation of 2% of the Company's annual net income after tax.

In October 2012, the Compensation Committee recommended and the Board and stockholders approved the Amended and Restated Edward J. Richardson Incentive Compensation Plan whereby Mr. Richardson would be eligible to receive bonus compensation based on the greater of 2% of annual net income after tax or a bonus based upon achieving pre-established financial objectives that support the Company's profitability. Mr. Richardson's incentive payment under the 2% plan for FY13 would have been approximately $25,000.

Pursuant to the terms of the Edward J. Richardson Incentive Compensation Plan, Mr. Richardson is entitled to the greater of 2% of annual net income or a bonus of up to 70% of base compensation based upon levels of achievement of his goals. The Compensation Committee evaluated Mr. Richardson's performance relative to measurement criteria for fiscal 2013 based on the level of achievement of the established goals.

Based upon the assessment of his goals, the Committee determined that Mr. Richardson earned a bonus payment for Fiscal 2013 of $167,805. The basis for the payout was creating long-term shareholder value as measured by the Five-year Cumulative Total Return Graph included in the Company's 10-K for Fiscal 2013 and the completion of an acquisition that was accretive to earnings. The targets for the operating expense ratio and working capital efficiency goals were not met.

The Company relies on performance-based cash bonuses under the Company's annual incentive compensation plan to reward Company employees, including executive officers, for achievement of specific financial goals related to our annual operating plan and budget. The Compensation Committee believes tying annual cash bonus compensation for executive officers primarily to financial metrics provides the appropriate incentive to the executive officers to contribute to our financial success. For the Named Executive Officers, the annual incentive plans also included a substantial portion related to achievement of personal performance goals in fiscal 2013 and for the first quarter of fiscal 2014.

On an annual basis, management presents specific recommendations to the Compensation Committee regarding the financial metrics and other components to be included in the annual incentive plan, which are those metrics and components that management believes will provide the best incentive to achieve desired operating results. These recommendations were developed in light of achievement under prior plans and through consultation with the CEO. The Compensation Committee considers management's recommendation and then determines the final components and structure of our incentive compensation plans based on the objectives of our compensation program.

The target bonus opportunity for Mr. Richardson is equal to 70% of his base compensation, which excludes car allowance, bonus, equity award and perquisites. Target bonus opportunities for Ms. Diddell, Ms. Dvorak, and Ms. McNally are equal to 50% of their base compensation, which excludes car allowance, bonus, equity awards and perquisites. The target bonus opportunity for Mr. Dudek is 35% of his base compensation, which excludes car allowance, bonus, equity awards and perquisites. The target bonus percentages were initially set by the Compensation Committee with a goal of attracting talented executive officers to the Company, and are stated in the Named Executive Officers' employment agreement, if we have an employment agreement with the named executive officer. If we do not have an employment agreement with the named executive officer, then the target bonus percentage is recommended by the CEO and approved by the Compensation Committee on an annual basis.

For the first quarter of fiscal 2014, the Named Executive Officers except for Mr. Richardson and Ms. Diddell, were eligible for cash bonuses based on income from continuing operations, operating income, working capital efficiency and personal performance. For the last three quarters, the Compensation Committee placed the Named Executive Officers on the Executive Incentive Plan which included Mr. Richardson and Ms. Diddell. Mr. Richardson (for all of FY14) and the Named Executive Officers (for Q2 through Q4 of FY14) were eligible for annual cash bonuses based on the following metrics:

Fiscal 2014 Incentive Metrics

	Richardson		Diddell		Dvorak		Dudek		McNally	
Acquisitions	30.0	%	30.0	%	30.0	%	30.0	%	30.0	%
Continue to Drive Long-Term Shareholder Value	30.0	%	30.0	%	30.0	%	30.0	%	30.0	%
Drive Companywide Process Improvement Initiatives	20.0	%	20.0	%	20.0	%	20.0	%	20.0	%
Generate Positive Cash Flow	20.0	%	20.0	%	20.0	%	20.0	%	20.0	%
Total	100.0	%	100.0	%	100.0	%	100.0	%	100.0	%

Targets for each of the financial metrics are established by the Compensation Committee for each fiscal year and correspond with the annual financial plan for the Company approved by the Board of Directors.

Payments on the financial metrics incentive targets are capped at 100% achievement for each of the Company's first three fiscal quarters and are capped at 150% achievement for the final annual calculation.

The table below sets forth the bonus targets and percentage achievement for each of the Named Executive Officers for fiscal 2014.

Fiscal 2014 Incentive Actual Performance

	Richardson[1]		Diddell		Dvorak		Dudek		McNally	
Personal Performance (Q1)										
% Achievement			100.00	%	94.66	%	94.66	%	94.66	%
Eligible			$34,956		49,432		18,290		24,749	
Earned			$34,956		46,793		17,314		23,428	
Acquisitions (Q2 - Q4) [2]										
% Achievement	100.00	%	100.00	%	100.00	%	100.00	%	100.00	%
Eligible	$141,365		31,461		44,488		16,461		22,274	
Earned	$141,365		31,461		44,488		16,461		22,274	
Shareholder Value (Q2 - Q4) [3]										
% Achievement	100.00	%	100.00	%	100.00	%	100.00	%	100.00	%
Eligible	$141,365		31,461		44,488		16,461		22,274	
Earned	$141,365		31,461		44,488		16,461		22,274	
Process Improvement (Q2 - Q4) [4]										
% Achievement	86.70	%	86.70	%	86.70	%	86.70	%	86.70	%
Eligible	$94,244		20,974		29,659		10,974		14,849	
Earned	$81,709		18,184		25,714		9,514		12,874	
Positive Cash Flows										

Switched access lines (thousands)	6,908	7,359	(451)	(6.1)%
Switched access minutes of use (millions)	30,893	34,331	(3,438)	(10)%
High-speed Internet subscribers (thousands)	1,017	693	324	47%
Wireless subscribers (thousands)	48	-	48	NM

Net Operating Revenues

Net operating revenues increased $66 million, or 1%, in 2007 and $142 million, or 2%, in 2006. Variances in individual categories of revenue are discussed below.

Voice

Voice revenues include monthly recurring fees for local service, enhanced calling features and long distance. Additionally, voice revenues include access and other wholesale services to other carriers to enable connectivity to our network as well as USF receipts and customer surcharges. Voice revenues declined $108 million in 2007 and increased $81 million in 2006.

The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	2006 vs. 2005
	(millions)	
Transfer of long distance customers from Sprint Nextel	$ 160	$ 286
Decline in voice revenues primarily due to access line losses	(211)	(179)
Discontinuance of USF surcharges on high-speed Internet services	(14)	(12)
Decline in access revenues primarily associated with lower access minutes of use	(14)	(43)
Significant billing dispute settled in 2006	(34)	34
Other	5	(5)
Total increase (decrease)	$ (108)	$ 81

As the transfer of long distance customers will no longer impact our annual comparisons, we expect that the rate of decline of total voice revenues will increase in 2008 due to previously discussed access line loss trends.

Data

Data revenues represent data network services sold to business customers and special access services sold to other carriers. Data revenues increased $59 million in 2007 and $49 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	2006 vs. 2005
	(millions)	
Special access revenue	$ 31	$ 21
Transfer of dedicated IP customers from Sprint Nextel	10	16
Ethernet and other business data services	19	9
Other	(1)	3
Total increase	$ 59	$ 49

We expect continued growth in special access and business data services in 2008.

High-speed Internet

High-speed Internet revenues increased $96 million in 2007 and $83 million in 2006. These increases are due to a 26% increase in subscribers in 2007 and a 47% increase in 2006. On an ongoing basis, we expect that high-speed Internet revenue will continue to increase, but at a lower growth rate, as our base grows.

Wireless

During the second quarter 2006, we began offering wireless communication services. The $44 million increase in 2007 and $7 million increase in 2006 was attributed to the increase in wireless subscribers. As of December 31, 2007, we had approximately 112 thousand subscribers to our wireless service as compared to 48 thousand subscribers a year ago.

See Overview-Operations for further discussion of actions to reduce earnings dilution with respect to our wireless offerings. These actions could result in reduced wireless revenue in 2008.

Other Service

Other service revenues mainly includes professional services, intelligent network database services, billing and collection services and sales of products and services through various sales agency relationships, including our video service offering. Other service revenues declined $27 million in 2007 and $64 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	2006 vs. 2005
	(millions)	
Transfer of professional services customers to Sprint Nextel	$ (4)	$ (3)
Elimination of billing, collection and sales agency revenues due to customer transfers from Sprint Nextel	(19)	(40)
Professional services and database	(8)	(10)
Video sales agency	3	7
Wireless sales agency	-	(13)
Other	1	(5)
Total decrease	$ (27)	$ (64)

Product Revenues

Product revenues are derived mainly from sales of customer premises equipment, or CPE, which is communications equipment that resides at a business customer s location for the management of voice and data networks and applications. Sales of high-speed Internet equipment and wireless handsets to our customers also are reflected in product revenues. Product revenues increased $2 million in 2007 and decreased $14 million in 2006. The 2006 decrease in revenue was due in part to the transfer of certain large CPE customers to Sprint Nextel as part of the spin-off.

Costs of Services

Costs of services include costs to operate and maintain the local network including employee-related costs directly supporting our network, costs directly associated with various service offerings, intercarrier compensation (such as access payments and reciprocal compensation), federal and state USF assessments and various operating taxes. Cost of services increased $42 million in 2007 and $178 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	2006 vs. 2005
	(millions)	
Transfer of long distance customers from Sprint Nextel	$ 85	$ 168
Long distance costs (primarily rate driven)	(15)	-
Reciprocal compensation (impacted by $18 million of favorable settlements in 2006, and $7 million favorable settlement in 2005)	11	(9)
Discontinuance of USF requirements on high-speed Internet services	(14)	(12)
Network severance charges	17	20
Network labor and benefits	(35)	9
Hurricane related costs	-	(11)
Other costs	(7)	13
Total increase (decrease)	$ 42	$ 178

Costs of Products

Costs of products increased $27 million in 2007 and decreased $1 million in 2006. The 2007 cost increase is related to higher product costs associated with wireless handsets and other telecommunications equipment. Our

cost of products related to wireless handsets will likely decrease in 2008 due to actions taken or to be taken to reduce earnings dilution with respect to our wireless offerings.

Selling, General and Administrative

Selling, general and administrative (SGA) costs, includes costs associated with selling and marketing, customer service, information technology, bad debt expense, general corporate costs and all other employee-related costs. These costs increased $19 million in 2007 and $29 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	**2006 vs. 2005**
	(millions)	
Transfer of long distance customers from Sprint Nextel	$ 25	$ 50
Elimination of allocated charges associated with the spin-off	(51)	(108)
Other allocated cost reductions	-	(46)
Spin-off related charges	(85)	85
Severance charges	33	10
Increased costs of corporate support functions, net of subsequent employee reductions	17	39
Effect of 2007 postretirement benefit plan amendment	(21)	-
Stock compensation and other benefits costs	36	(11)
Bad debt expense	42	2
Systems and process improvement initiatives	25	3
Gain on sale of exchanges	12	(12)
Other	(14)	17
Total increase	$ 19	$ 29

SGA costs include charges for estimated bad debt expense. The reserve for bad debt requires management s judgment and is based on many factors. Bad debt expense increased to approximately 1.5% of net operating revenues in 2007 from 0.9% in 2006. The increase is partially due to additional bad debt expense associated with long distance customers transferred from Sprint Nextel at spin, additional expense associated with our wireless offering, as well as current economic factors.

Depreciation

Depreciation expense increased $32 million in 2007 and $49 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	**2006 vs. 2005**
	(millions)	
Transfer of shared assets from Sprint Nextel	$ 38	$ 53
Depreciation rate reductions	(48)	(27)
Plant growth	36	23
Incremental depreciation resulting from capitalized sales and use tax assessments	6	-
Total increase	$ 32	$ 49

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Asset Impairment

In 2005, we recorded $80 million in asset impairment charges. This was primarily due to the terminated development and deployment of a network management software application, which resulted in approximately $77 million in allocated impairment charges. Sprint Nextel, in conjunction with our management, terminated this project after evaluating business strategies and determining that the project would not provide the cost structure, flexibility or operational functionality we would need once the spin-off was complete.

Segmental Results of Operations Logistics

Through our Logistics segment, we procure, configure, service and distribute equipment, materials and supplies to the communications industry. The products that we offer include outside plant, telephones and accessories and network access equipment from leading manufacturers.

	For the Years Ended December 31,				Difference	
(millions)	**2007**	**% of Revenues**	**2006**	**% of Revenues**	**$**	**Percent**
Net operating revenues	$ 466	100 %	$ 530	100 %	$ (64)	(12)%
Operating expenses						
Costs of products and services	418	90 %	483	91 %	(65)	(13)%
Selling, general and administrative	41	9 %	52	10 %	(11)	(21)%
Depreciation and amortization	9	2 %	11	2 %	(2)	(18)%
Total operating expenses	468	101 %	546	103 %	(78)	(14)%
Operating loss	$ (2)	(1)%	$ (16)	(3)%	$ 14	88 %
Capital expenditures	$ 2		$ 2		$ -	- %

	For the Years Ended December 31,				Difference	
(millions)	**2006**	**% of Revenues**	**2005**	**% of Revenues**	**$**	**Percent**
Net operating revenues	$ 530	100 %	$ 563	100 %	$ (33)	(6)%
Operating expenses						
Costs of products and services	483	91 %	517	92 %	(34)	(7)%
Selling, general and administrative	52	10 %	75	13 %	(23)	(31)%
Depreciation and amortization	11	2 %	12	2 %	(1)	(8)%
Total operating expenses	546	103 %	604	107 %	(58)	(10)%
Operating loss	$ (16)	(3)%	$ (41)	(7)%	$ 25	(61)%
Capital expenditures	$ 2		$ 5		$ (3)	(60)%

Net Operating Revenues

Revenues from the Logistics segment decreased $64 million in 2007 and $33 million in 2006. The following table lists the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	**2006 vs. 2005**
	(millions)	
Significant new supply contracts	$ 10	$ 74
Exit of enterprise and wireless markets	(21)	(116)

Loss of significant supply contracts	(50)	-
Other	(3)	9
Total decrease	$ (64)	$ (33)

Cost of Products and Services

Cost of products and services includes costs of equipment sold and other operating taxes. These costs decreased $65 million in 2007 and $34 million in 2006. The drivers of these changes are directly associated with the revenue factors noted above, as well as a reduction of inventory reserves related to previously exited markets and a 2006 third quarter charge associated with certain in-process inventory.

Selling, General and Administrative

Selling, general and administrative expense decreased $11 million in 2007 and $23 million in 2006. The 2007 decrease in costs was driven by a decrease in spin-off costs, a decrease in severance charges as well as favorable bad debt experience. The 2006 comparison benefited from reductions in workforce associated with the exit of the unprofitable enterprise and wireless markets initiated in late 2005 and completed in 2006, and the integration of certain support functions with those established by us at spin-off. These benefits were somewhat offset by severance charges and spin-off costs attributed to the Logistics business.

Consolidated Non-operating Items

	For the Years Ended December 31,		
	2007	**2006**	**2005**
		(millions)	
Interest expense	$ 432	$ 324	$ 83
Other (income) expense, net	(3)	(14)	(3)
Income tax expense	392	450	578
Cumulative effect of change in accounting principles, net	-	-	16

Interest Expense

Interest expense increased $108 million in 2007 and $241 million in 2006. These increases are primarily due to the full year impact of the issuance of the long-term debt associated with spin-off partially offset by the reduction of debt outstanding and elimination of notes previously payable to Sprint Nextel.

Our effective interest rate on long-term debt was 7.2% for 2007 and 7.1% for 2006. The slightly higher effective interest rate is primarily due to the pay down of spin-off related debt bearing lower effective interest rates. Interest costs on pre-spin-off short-term borrowings from Sprint Nextel have been excluded so as not to distort the effective interest rate on long-term debt. See Liquidity and Capital Resources below for more information on our financing activities.

Other (Income) Expense, Net

Other (income) expense decreased $11 million in 2007 and increased $11 million in 2006. These variances were primarily due to a $5 million gain related to the 2006 liquidation of our holdings in the Rural Telephone Bank and a $3 million gain resulting from the re-designation of a derivative instrument, also recorded in 2006.

Income Tax Expense

Income tax expense decreased $58 million in 2007 and $128 million in 2006. Our effective tax rates were 36.5% in 2007 and 2006 while the 2005 rate was 39.3%. In 2007, the effective tax rate was impacted by modifications in our legal entity structure and a favorable state tax ruling. The decrease in effective tax rate from 2005 to 2006 was the result of enacted state legislation, adjustments to deferred taxes to properly reflect our deferred tax income tax liabilities and the benefit of consolidated, combined, or unitary methodologies on state income taxes. See Note 5, Income Taxes, of the Notes to the Consolidated Financial Statements, for additional information.

Cumulative Effect of Change in Accounting Principles, Net

Embarq adopted FIN 47, *Accounting for Conditional Asset Retirement Obligations*, in 2005, which clarified that an entity is required to recognize a liability for the fair value of an Asset Retirement Obligation if the amount can be reasonably estimated. The adoption resulted in a cumulative effect of change in accounting principles, net of tax, of $16 million.

LIQUIDITY AND CAPITAL RESOURCES

We manage our liquidity and capital resource needs primarily through managing the use of capital and the timing and amount of capital expenditures.

Cash Flows

The following table summarizes the components of our increase (decrease) in cash and equivalents for the years ended December 31, 2007, 2006 and 2005:

	For the Years Ended December 31, 2007	2006	2005
		(millions)	
Operating activities	$ 1,624	$ 2,053	$ 1,898
Investing activities	(794)	(880)	(811)
Financing activities	(814)	(1,223)	(1,097)
Increase (decrease) in cash and equivalents	$ 16	$ (50)	$ (10)

Operating Activities

Net cash provided by operating activities decreased $429 million in 2007 from 2006 and increased $155 million in 2006 from 2005. These changes were based on the following:

	Increase (Decrease) 2007 vs. 2006	2006 vs. 2005
	(millions)	
Collections from customers	$ (38)	$ 152
Payments to employees and suppliers	(85)	(51)
Contributions to the defined benefit pension plan	(75)	79
Interest payments	(147)	(204)
Income tax payments, net	(101)	201
Other	17	(22)
Total increase (decrease) in cash from operating activities	$ (429)	$ 155

The changes in cash from operating activities as detailed in the table above were impacted by the drivers discussed in Results of Operations, as well as the timing of certain working capital, employee benefit plan and income tax requirements.

Investing Activities

Net cash used by investing activities decreased $86 million in 2007 compared to 2006 and increased $69 million in 2006 compared to 2005.

Capital expenditures account for the majority of our investing activities. Our capital expenditures primarily fund new service addresses and network capacity increases; regulatory mandates; internal infrastructure; new capabilities; sales success based expenditures primarily related to growth in high-speed Internet and data services; and spin-off related expenditures. Capital expenditures of $829 million in 2007 decreased $94 million from $923 million in 2006, which increased $95 million from $828 million in 2005. The following table shows the major drivers of these changes:

	Increase (Decrease)	
	2007 vs. 2006	**2006 vs. 2005**
	(millions)	
Network buildout and mandates	$ (81)	$ (75)
Internal infrastructure	21	(5)
New capabilities	(19)	21
Sales success based	2	125
Spin-off capital expenditures	(17)	29
Total increase (decrease) in capital expenditures	$ (94)	$ 95

During 2007, capital requirements associated with new service addresses declined in part due to the downturn in residential construction and development in our service territories. This trend in the housing market could affect capital requirements in the future.

In 2006, the company sold a total of 25 rural telephone exchanges in north central Kansas. Cash proceeds of $15 million were received in 2006. An additional $15 million of cash proceeds from the fourth quarter 2006 sale were received in the 2007 first quarter. Also, in 2006, we received proceeds of $9 million from the liquidation of our investment in the Rural Telephone Bank.

Financing Activities

Net cash used by financing activities decreased $409 million in 2007 from 2006 and increased $126 million in 2006 from 2005.

In 2007, we made net cash payments on our long-term debt of $577 million. In connection with the spin-off in 2006, we borrowed $2.1 billion under our credit agreement and paid Sprint Nextel a net amount of $2.2 billion in cash. In addition to us remitting the proceeds from the borrowing to Sprint Nextel, our $308 million advance receivable balance, which was classified as cash, was settled, and Sprint Nextel transferred $200 million of cash to us. Between the spin-off and the end of 2006, we made net payments of $790 million on our outstanding credit agreement.

In 2007, dividends totaling $367 million were paid to shareholders. In 2006, we paid $194 million in dividends to Sprint Nextel before the spin-off and $150 million in dividends to shareholders in the third and fourth quarters of 2006. Dividends of $983 million were paid to Sprint Nextel in 2005.

Net proceeds from common and treasury stock issued in connection with stock based compensation plans were $109 million in 2007 compared to $20 million in the post-spin period of 2006. In 2007, the company recognized excess tax benefits related to stock-based compensation expense of $25 million, an increase over the $2 million excess tax benefit in 2006.

Capital Requirements

We currently expect capital expenditures for 2008 to be approximately $800 million. We continue to review capital expenditure requirements and will adjust spending and capital investment in response to operational needs and customer demand.

Liquidity

We expect that cash from operations will fully fund our capital requirements.

Our total indebtedness at December 31, 2007, was $5.9 billion, consisting of $4.5 billion in senior notes, $770 million in direct borrowings under our credit agreement and approximately $623 million of other debt. As of December 31, 2007, we had $410 million in direct borrowings under our revolving credit facility with available letters of credit of approximately $29 million, leaving approximately $1.1 billion of availability under the revolving credit facility. Current debt maturities as of December 31, 2007, were $99 million. We are in compliance with all applicable financial covenants associated with our borrowings.

We may also incur additional indebtedness from time to time for general corporate purposes, including working capital requirements and capital expenditures. Regulatory restrictions and the terms of our indebtedness, however, limit our ability to incur additional indebtedness, raise capital through our subsidiaries, pledge the stock of our subsidiaries, encumber our assets or the assets of our subsidiaries, or cause our subsidiaries to guarantee our indebtedness.

We expect to pay regular quarterly dividends. Our ability to fund a regular quarterly dividend will be impacted by our ability to generate cash from operations. The declaration, amount and timing of future dividends will be at the discretion of our board of directors, and will depend upon many factors, including our financial condition, results of operations, growth prospects, funding requirements, applicable law and other factors our board of directors deems relevant. On January 9, 2008, we announced that our board of directors declared an increased dividend of $0.6875 per share on our common stock. The dividend is payable on March 31, 2008, to stockholders of record on March 10, 2008.

Also, on January 9, 2008, our board of directors authorized a program for the repurchase of our common stock for an aggregate purchase price of up to $500 million until June 30, 2009. We anticipate purchasing shares either in the open market or through private transactions, depending on market conditions and other factors, in accordance with applicable securities laws.

In connection with the spin-off, we established our own pension and other postretirement benefit plans. Our pension plans are funded in excess of current federal minimum requirements. Contributions to our pension plans during 2008 are expected to be approximately $75 million based on projected plan asset and liability levels.

As discussed in Note 6, Employee Benefit Plans, of the Notes to the Consolidated Financial Statements, amendments to certain of our other postretirement benefit plans were approved in 2007 and are fully effective January 1, 2008. We now expect a reduction of approximately $10 million in benefit payments in 2008 compared to 2007 related to these amendments (which is lower than previously disclosed estimates due to better than expected 2007 claims experience). Consequently, contributions to our other postretirement benefit plans, including medical and life insurance benefits, are expected to be approximately $30 million in 2008.

In December 2007, a group of retirees filed a putative class action lawsuit in Kansas federal court, challenging this decision. See Note 3, Commitments and Contingencies, of the Notes to the Consolidated Financial Statements, for additional information.

Future Contractual Obligations

The following table represents our future contractual obligations as of December 31, 2007:

	Total	2008	2009	2010	2011	2012	After 2012
				(millions)			
Long-term debt	$ 5,878	$ 99	$ 2	$ 2	$ 770	$ -	$ 5,005
Interest on long-term debt [(1)]	5,604	422	415	415	386	370	3,596
Operating leases	139	37	32	24	18	11	17
Purchase obligations and other	244	130	42	27	25	20	-
Total	$ 11,865	$ 688	$ 491	$ 468	$ 1,199	$ 401	$ 8,618

(1) *Estimated interest on the bank credit agreement assumes payment schedule based upon the outstanding balances and interest rates as of December 31, 2007, and excludes any additional prepayment or drawdown under the revolving credit facility.*

Our adoption of FIN 48 resulted in the recognition of a liability for uncertain tax positions of $96 million as of December 31, 2007. The liability has not been assigned to any particular year due to the inherent uncertainty regarding the timing of future cash outflows.

Off-Balance Sheet Arrangements

We do not participate in, secure or finance any unconsolidated, special purpose entities.

Financial Strategies

Derivatives

We manage exposure to interest rate risk by regularly monitoring our mix of floating and fixed-rate debt. We may enter into interest rate swap agreements or other derivative transactions to manage this exposure. As of December 31, 2007, there were no outstanding derivative instruments.

During the 2005 fourth quarter, we entered into swaption derivative contracts for a cumulative notional amount of $600 million. These swaption contracts were intended to mitigate the interest rate variability of the first ten years semi-annual interest payments on the first $600 million of our debt issuance in connection with the spin-off.

Additionally, in the 2005 fourth quarter we entered into Treasury collars for a cumulative notional amount of $2.4 billion. These treasury collars were intended to mitigate the interest rate variability of the first ten years semi-annual interest payments on the next $2.4 billion of our debt issuance. The Treasury collars were accounted for as cash flow hedges.

On May 12, 2006, the swaption contracts and treasury collars entered into in 2005 were terminated. The accumulated other comprehensive income associated with these transactions of $51 million ($30 million net of tax) will be amortized using the effective interest method and reclassified to interest expense as a yield adjustment of the hedged semi-annual interest payment for ten years.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are susceptible to market risks related to changes in interest rates and do not purchase or hold any derivative financial instruments for trading purposes.

We are subject to interest rate risk primarily associated with our borrowings under our credit agreement. From time to time, we may consider entering into swap and other agreements to manage our exposure to interest rate changes on our debt.

Approximately 87% of our outstanding debt at December 31, 2007, is fixed-rate debt. While changes in interest rates impact the fair value of this debt, there is no impact on earnings and cash flows because we do not intend to prepay these obligations.

We perform interest rate sensitivity analyses on our variable-rate debt. These analyses indicate that a 1% change in interest rates would have an annual pre-tax impact of $8 million on the Consolidated Statements of Operations and Comprehensive Income and Consolidated Statements of Cash Flows at December 31, 2007. While earnings and cash flows are impacted as interest rates change, our variable-rate debt is not subject to changes in fair values.

We also perform a sensitivity analysis on the fair market value of our outstanding debt. A 10% decrease in market interest rates would cause an increase of approximately $167 million in fair market value of our outstanding debt at December 31, 2007.

Item 8. Financial Statements and Supplementary Data

The consolidated financial statements required by this item begin on page F-1 of this annual report on Form 10-K and are incorporated herein by reference. The financial statement schedule required under SEC Regulation S-X is filed pursuant to Item 15 of this annual report on Form 10-K and is incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable

Item 9A. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act, and in connection with the preparation of this annual report on Form 10-K, our management, including the Interim Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the design and operation of our disclosure controls and procedures. Based on this evaluation, the Interim Chief Executive Officer and Chief Financial Officer each concluded that the design and operation of the disclosure controls and procedures were effective as of December 31, 2007, in providing assurance that information required to be disclosed in reports we file or submit is accumulated and communicated to management, including the Interim Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure and in providing reasonable assurance that the information is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

During 2007, there have been no changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

(b) Management s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to our management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

Our management conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2007. This assessment was based on the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, in Internal Control Integrated Framework. Based on this assessment, management believes that our internal control over financial reporting was effective as of December 31, 2007.

The effectiveness of our internal control over financial reporting as of December 31, 2007, has been audited by KPMG LLP, our independent registered public accounting firm, as stated in its report that appears on page F-2.

Item 9B. Other Information

None.

Part III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item regarding our executive officers is incorporated by reference to Part I of this report under the caption Executive Officers of the Registrant. All other information required by this item, other than the code of ethics information below, is incorporated herein by reference to the information set forth in the proxy statement relating to our 2008 Annual Meeting of Shareholders, which will be filed with the SEC.

We have adopted a code of ethics, which we refer to as the Embarq Code of Conduct, which applies to all our employees, including our executive officers, and directors. The Embarq Code of Conduct is publicly available on our website at www.embarq.com/governance/ethics/ and you may also obtain a copy free of charge by writing to: Corporate Secretary, Embarq Corporation, 5454 W. 110th St., Overland Park, KS 66211. If a provision of the Embarq Code of Conduct is amended, other than by a technical, administrative or other non-substantive amendment, or a waiver of the Embarq Code of Conduct is granted to a director or executive officer, the notice of such amendment or waiver will be posted on our website. Also, we may elect to disclose the amendment or waiver in a report on Form 8-K filed with the SEC.

Item 11. Executive Compensation

The information required by this item is incorporated by reference to the information set forth in our proxy statement relating to our 2008 Annual Meeting of Shareholders, which will be filed with the SEC.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated by reference to the information set forth in our proxy statement relating to our 2008 Annual Meeting of Shareholders, which will be filed with the SEC.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is incorporated by reference to the information set forth in our proxy statement relating to our 2008 Annual Meeting of Shareholders, which will be filed with the SEC.

Item 14. Principal Accountant Fees and Services

The information required by this item is incorporated by reference to the information set forth in the proxy statement relating to our 2008 Annual Meeting of Shareholders, which will be filed with the SEC.

Part IV

Item 15. Exhibits and Financial Statement Schedules

(a) 1. The consolidated financial statements of Embarq filed as part of this report are listed in the Index to Consolidated Financial Statements.
2. The consolidated financial statement schedule of Embarq filed as part of this report is listed in the Index to Consolidated Financial Statements. All other financial statement schedules are not required under the related instructions, or are inapplicable and therefore have been omitted.

3. The following exhibits are filed as part of this report:

Exhibit Number	Description
2.1*	Separation and Distribution Agreement (Incorporated by reference to Exhibit 2.1 to Amendment No. 4 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on May 2, 2006).
2.2*	Transition Services Agreement between Embarq Corporation (receiver) and Sprint Nextel Corporation (provider) dated as of January 20, 2006 (Incorporated by reference to Exhibit 2.2 to Amendment No. 3 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on April 28, 2006).
2.3*	Transition Services Agreement between Embarq Corporation (provider) and Sprint Nextel Corporation (receiver) dated as of January 20, 2006 (Incorporated by reference to Exhibit 2.3 to Amendment No. 3 to the Registration Statement on Form 10 (File No. 0001-32732), filed with the Securities and Exchange Commission on April 28, 2006.
2.4*	Tax Sharing Agreement dated as of May 17, 2006 by and among Sprint Nextel Corporation, Embarq Corporation and certain Embarq subsidiaries (Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
2.5*	Employee Matters Agreement dated as of May 17, 2006 between Sprint Nextel Corporation and Embarq Corporation (Incorporated by reference to Exhibit 2.2 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
2.6*	Patent Agreement dated as of May 17, 2006 by and between Sprint Nextel Corporation and Embarq Corporation (Incorporated by reference to Exhibit 2.5 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
2.7*	Trademark Assignment and License Agreement dated as of May 17, 2006, by and among Sprint Nextel Corporation, Embarq Corporation and certain Embarq subsidiaries (Incorporated by reference to Exhibit 2.3 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
2.8*	Software and Proprietary Information Agreement dated as of May 17, 2006 by and between Embarq Corporation and Sprint Nextel Corporation (Incorporated by reference to Exhibit 2.4 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
3.1	Amended and Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to Amendment No. 4 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on May 2, 2006).

Exhibit Number	Description
3.2	Amended and Restated Bylaws, as amended (Incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on July 25, 2006).
4.1	Indenture, dated as of May 17, 2006, by and between Embarq Corporation and J.P. Morgan Trust Company, National Association, a national banking association, as trustee (Incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 18, 2006).
4.2	6.738% Global Note due 2013 (Incorporated by reference to Exhibit 4.2 to the Registrant s Annual Report on Form 10-K (File No. 001-32372), filed with the Securities and Exchange Commission on March 9, 2007).
4.3	7.082% Global Note due 2016 (Incorporated by reference to Exhibit 4.3 to the Registrant s Annual Report on Form 10-K (File No. 001-32372), filed with the Securities and Exchange Commission on March 9, 2007).
4.4	7.995% Global Note due 2036 (Incorporated by reference to Exhibit 4.4 to the Registrant s Annual Report on Form 10-K (File No. 001-32372), filed with the Securities and Exchange Commission on March 9, 2007).
4.5	Credit Agreement, dated May 10, 2006, by and among Embarq Corporation (borrower), the banks, financial institutions and other institutional lenders (initial lenders) and issuers of letters of credit (initial issuing banks) and Citibank, N.A., as administrative agent (Incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 11, 2006).
10.1**	Agreement Regarding Special Compensation and Post Employment Restrictive Covenants, dated as of December 12, 1995, by and between Sprint Corporation and Gene M. Betts (Incorporated by reference to Exhibit 10.5 to the registrant s Amendment No. 1 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on March 14, 2006).
10.2**	Special Compensation and Non-Compete Agreement, dated as of August 12, 1996, by and between Sprint Corporation and William R. Blessing (Incorporated by reference to Exhibit 10.6 to the registrant s Amendment No. 1 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on March 14, 2006).
10.3**	Employment Agreement, dated as of December 3, 2003, by and among Sprint Corporation, Sprint/United Management Company and Thomas A. Gerke (Incorporated by reference to Exhibit 10.10 to the registrant s Amendment No. 1 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on March 14, 2006).
10.4**	Waiver with respect to Employment Agreement of Mr. Gerke, dated as of December 16, 2007.
10.5**	Employment Agreement, dated as of June 7, 2005, by and among Sprint Corporation, Sprint/United Management Company and Daniel R. Hesse (Incorporated by reference to Exhibit 10.11 to the registrant s Amendment No. 1 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on March 14, 2006).
10.6**	Special Compensation and Non-Compete Agreement, dated as of December 9, 1997, by and between Sprint Corporation and Thomas J. McEvoy (Incorporated by reference to Exhibit 10.12 to the registrant s Amendment No. 1 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on March 14, 2006).

Exhibit Number	Description
10.7**	Embarq Corporation 2006 Equity Incentive Plan, as amended and restated (Incorporated by reference to Exhibit 10.1 to the registrant s Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on December 13, 2006).
10.8**	Embarq Corporation 2006 Short-Term Incentive Plan (Incorporated by reference to Exhibit 10.14 to the registrant s Amendment No. 4 to the Registration Statement on Form 10 (File No. 001-32732), filed with the Securities and Exchange Commission on May 2, 2006).
10.9**	Form of Indemnification Agreement entered into between Embarq Corporation and each of its directors and each of the following officers: Gene M. Betts, William R. Blessing, Harrison S. Campbell, William E. Cheek, Thomas A. Gerke, Richard B. Green, E.J. Holland, Jr., Thomas J. McEvoy and Claudia S. Toussaint (Incorporated by reference to Exhibit 10.1 to the registrant s Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 5, 2006).
10.10**	Embarq Corporation Amended and Restated Supplemental Executive Retirement Plan (Incorporated by reference to Exhibit 10.11 to the registrant s Annual Report on Form 10-K (File No. 001-32732), filed with the Securities and Exchange Commission on March 9, 2007).
10.11**	Embarq Corporation Key Management Benefit Plan (Incorporated by reference to Exhibit 10.2 to the registrant s Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on May 11, 2006).
10.12**	Embarq Corporation Non-Employee Director Compensation Program (Incorporated by reference to Exhibit 10.13 to the registrant s Annual Report on Form 10-K (File No. 001-32732), filed with the Securities and Exchange Commission on March 9, 2007).
10.13**	Form of Special Equity Award Agreement for Individuals with Employment or Severance Agreements (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on July 25, 2006).
10.14**	Form of Special Equity Award Agreement for Individuals without Employment or Severance Agreements (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on July 25, 2006).
10.15**	Form of 2006 Annual Equity Award for Executive Officers other than Mr. Hesse (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on August 1, 2006).
10.16**	Form of 2006 Annual Equity Award for Daniel R. Hesse (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on August 1, 2006).
10.17**	Form of Award Agreement for Outside Directors (Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on August 1, 2006).
10.18**	Summary of Embarq Corporation 2007 Short-Term Incentive Program (Incorporated by reference to Exhibit 10.1 of the Current Report on Form 8-K (File No. 001-32372), filed with the Securities and Exchange Commission on February 27, 2007).
10.19**	Form of 2007 Award Agreement for Executive Officers other than Mr. Hesse (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K (File No. 001-32372), filed with the Securities and Exchange Commission on February 27, 2007.

Exhibit Number	Description
10.20**	Form of 2007 Award Agreement for Daniel R. Hesse (Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K (File No. 001-32372), filed with the Securities and Exchange Commission on February 27, 2007).
10.21**	Executive Severance Plan, including Form of Participation Agreement entered into between Embarq Corporation and the following executive officers: Harrison S. Campbell, William E. Cheek, Richard B. Green, E.J. Holland, Jr. and Claudia S. Toussaint (Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on April 30, 2007.
10.22**	Form of 2007 Award Agreement for Non-Employee Directors (Incorporated by reference to Exhibit 10.2 to the Registrant s Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on April 30, 2007).
10.23**	Agreement dated as of December 17, 2007 by and among Sprint Nextel Corporation, Embarq Corporation and certain other entities (Incorporated by reference to Exhibit 10.1 of the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on December 18, 2007).
10.24**	Voluntary Termination of Employment Letter Agreement between Embarq Corporation and Daniel R. Hesse dated December 17, 2007 (Incorporated by reference to the Current Report on Form 8-K (File No. 001-32732), filed with the Securities and Exchange Commission on December 18, 2007)
21.1	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP.
31.1	Certification of Chief Executive Officer Pursuant to Securities Exchange Act of 1934 Rule 13a-14(a).
31.2	Certification of Chief Financial Officer Pursuant to Securities Exchange Act of 1934 Rule 13a-14(a).
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Our company will furnish to the Securities and Exchange Commission, upon request, a copy of the instruments defining the rights of holders of long-term debt that does not exceed 10% of the total assets of our company.

* Schedules and/or exhibits not filed will be furnished supplementally to the Securities and Exchange Commission upon request.
** Management contracts or compensatory plan or arrangement

SIGNATURES

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

EMBARQ CORPORATION

(Registrant)

By /s/ Thomas A. Gerke

Thomas A. Gerke
Interim President and Chief Executive Officer

Dated: February 29, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities indicated on the 29th day of February 2008.

/s/ Thomas A. Gerke

Thomas A. Gerke
Interim President and Chief Executive Officer
(Principal Executive Officer)

/s/ Gene M. Betts

Gene M. Betts
Chief Financial Officer
(Principal Financial Officer)

/s/ Richard B. Green

Richard B. Green
Vice President and Controller
(Chief Accounting Officer)

SIGNATURES

EMBARQ CORPORATION

(Registrant)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities indicated on the 29th day of February 2008.

/s/ Peter C. Brown
Peter C. Brown
Director

/s/ Steven A. Davis
Steven A. Davis
Director

/s/ Richard A. Gephardt
Richard A. Gephardt
Director

/s/ John P. Mullen
John P. Mullen
Director

/s/ William A. Owens
William A. Owens
Director

/s/ Dinesh C. Paliwal
Dinesh C. Paliwal
Director

/s/ Stephanie M. Shern
Stephanie M. Shern
Director

/s/ Laurie A. Siegel
Laurie A. Siegel
Director

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EMBARQ CORPORATION

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Embarq Corporation:

We have audited the accompanying consolidated balance sheets of Embarq Corporation and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations and comprehensive income, cash flows, and stockholders equity for each of the years in the three-year period ended December 31, 2007. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule, Schedule II Consolidated Valuation and Qualifying Accounts. We also have audited the Company s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these consolidated financial statements and related financial statement schedule, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control Over Financial Reporting (Item 9A(b)). Our responsibility is to express an opinion on these consolidated financial statements and related financial statement schedule and an opinion on the Company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Embarq Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth there in. Additionally in our opinion, Embarq Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As discussed in Note 1 to the consolidated financial statements, the Company adopted the provisions of FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, as of December 31, 2005. Also, as discussed in Note 6 to the consolidated financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R),* as of December 31, 2006. Lastly, as discussed in Note 5 to the consolidated financial statements, the Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes- an Interpretation of FASB Statement No. 109*, as of January 1, 2007.

/s/ KPMG LLP

Kansas City, Missouri

February 28, 2008

EMBARQ CORPORATION

CONSOLIDATED BALANCE SHEETS

(millions, except per share data)

	As of December 31,	
	2007	**2006**
Assets		
Current assets		
Cash and equivalents	$ 69	$ 53
Accounts receivable, net of allowance for doubtful accounts of $60 and $53	616	660
Inventories, net	138	179
Deferred income taxes	76	73
Prepaid expenses and other current assets	87	86
Total current assets	986	1,051
Gross property, plant and equipment	20,802	20,470
Accumulated depreciation	(13,054)	(12,482)
Net property, plant and equipment	7,748	7,988
Goodwill	27	27
Prepaid pension asset	108	-
Other assets	32	53
Total	$ 8,901	$ 9,119
Liabilities and Stockholders Equity		
Current liabilities		
Current maturities of long-term debt	$ 99	$ 37
Accounts payable	387	503
Payroll and employee benefits	208	198
Accrued income taxes	27	68
Accrued operating taxes	97	96
Deferred revenue	202	211
Accrued interest	56	52
Other current liabilities	122	99
Total current liabilities	1,198	1,264
Noncurrent liabilities		
Long-term debt	5,779	6,421
Deferred income taxes	1,130	1,067
Benefit plan obligations	320	685
Other noncurrent liabilities	210	150
Total noncurrent liabilities	7,439	8,323
Stockholders equity		
Preferred stock, $.01 par value; 200 shares authorized; no shares issued and outstanding	-	-
Common stock, $.01 par value; 1,250 shares authorized; 153.1 and 149.7 shares issued and outstanding	2	1
Paid-in capital	(231)	(414)
Retained earnings	623	308

Accumulated other comprehensive income (loss)	(130)	(363)
Total stockholders equity	264	(468)
Total	$ 8,901	$ 9,119

See accompanying Notes to Consolidated Financial Statements.

EMBARQ CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(millions, except per share data)

	For the Years Ended December 31,		
	2007	**2006**	**2005**
Net Operating Revenues			
Service revenues	$ 5,786	$ 5,722	$ 5,566
Product revenues	579	641	688
Total net operating revenue	6,365	6,363	6,254
Operating Expenses			
Cost of services	1,637	1,594	1,417
Cost of products	559	598	632
Selling, general and administrative	1,608	1,600	1,594
Depreciation	1,057	1,027	979
Asset impairment	-	-	80
Total operating expenses	4,861	4,819	4,702
Operating Income	1,504	1,544	1,552
Interest expense	432	324	83
Other (income) expense, net	(3)	(14)	(3)
Income Before Income Taxes	1,075	1,234	1,472
Income tax expense	392	450	578
Income Before Cumulative Effect of Change in Accounting Principle, Net	683	784	894
Cumulative effect of change in accounting principle, net	-	-	16
Net Income	$ 683	$ 784	$ 878
Amendments to and remeasurements of employee benefit plans, net of tax	(232)	-	-
Amortization of employee benefit plans prior service cost and actuarial losses, net of tax	(5)	-	-
Unrealized holding gains on cash flow derivatives, net of tax	-	(39)	9
Amortization of cash flow derivatives, net of tax	4	1	-
Net minimum pension liability adjustment, net of tax	-	-	(6)
Comprehensive Income, Net of Tax	$ 916	$ 822	$ 875
		(Pro forma)	
Earnings per common share			
Basic	$ 4.50	$ 5.26	
Diluted	$ 4.44	$ 5.21	
Weighted average common shares outstanding			

Basic	151.9	149.2
Potentially dilutive shares under equity incentive plans	2.0	1.2
Diluted	153.9	150.4

See accompanying Notes to Consolidated Financial Statements.

EMBARQ CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(millions)

	For the Years Ended December 31,		
	2007	**2006**	**2005**
Operating Activities			
Net income	$ 683	$ 784	$ 878
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of change in accounting principle	-	-	16
Depreciation	1,057	1,027	979
Provision for losses on accounts receivable	94	55	54
Deferred and noncurrent income taxes	(43)	(69)	33
Stock-based compensation expense	50	31	-
Net losses (gains) on sales of assets	(7)	(17)	1
Other, net	45	39	17
Changes in assets and liabilities:			
Accounts receivable	(75)	(35)	(78)
Inventories and other current assets	(4)	29	(14)
Accounts payable and other current liabilities	(98)	235	93
Noncurrent assets and liabilities, net	(78)	(26)	(81)
Net cash provided by operating activities	1,624	2,053	1,898
Investing Activities			
Capital expenditures	(829)	(923)	(828)
Proceeds from construction reimbursements	10	10	9
Proceeds from sales of assets	25	33	8
Net cash used by investing activities	(794)	(880)	(811)
Financing Activities			
Issuance of long-term debt	-	1,600	-
Principal payments on long-term debt	(787)	(492)	(115)
Borrowings under revolving credit agreement	1,430	920	-
Repayments under revolving credit agreement	(1,220)	(720)	-
Net cash paid to Sprint Nextel associated with the spin-off	-	(2,208)	-
Proceeds from common stock issued	109	20	-
Purchase of treasury shares	(2)	-	-
Dividends paid to stockholders	(367)	(150)	-
Dividends paid to Sprint Nextel	-	(194)	(983)
Excess tax benefits from stock-based compensation	25	2	-
Other, net	(2)	(1)	1
Net cash used by financing activities	(814)	(1,223)	(1,097)
Increase (Decrease) in Cash and Equivalents	16	(50)	(10)
Cash and Equivalents at Beginning of Period	53	103	113
Cash and Equivalents at End of Period	$ 69	$ 53	$ 103

See accompanying Notes to Consolidated Financial Statements.

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EMBARQ CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(millions, except per share data)

	Preferred Stock	Common Stock	Treasury Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Business Equity	Total Stockholders Equity
January 1, 2005 balance	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ (522)**	**$ 5,482**	**$ 4,960**
Net income	-	-	-	-	-	-	878	878
Dividends paid to Sprint Nextel	-	-	-	-	-	-	(983)	(983)
Cash flow derivatives, net of tax	-	-	-	-	-	(9)	-	(9)
Net minimum pension liability adjustment, net of tax	-	-	-	-	-	6	-	6
December 31, 2005 balance	**-**	**-**	**-**	**-**	**-**	**(525)**	**5,377**	**4,852**
Net income	-	-	-	-	-	-	326	326
Dividends paid to Sprint Nextel	-	-	-	-	-	-	(194)	(194)
Cash flow derivatives, net of tax	-	-	-	-	-	39	-	39
Net transfer to Sprint Nextel	-	1	-	(467)	-	516	(5,509)	(5,459)
May 17, 2006 balance	**-**	**1**	**-**	**(467)**	**-**	**30**	**-**	**(436)**
Net income	-	-	-	-	458	-	-	458
Dividends paid to shareholders ($1.00 per share)	-	-	-	-	(150)	-	-	(150)
Common stock issued	-	-	-	20	-	-	-	20
Stock-based compensation expense	-	-	-	31	-	-	-	31
Excess tax benefits from stock-based compensation	-	-	-	2	-	-	-	2
Amortization of cash flow derivative, net of tax	-	-	-	-	-	(1)	-	(1)
Adoption of SFAS No. 158, net of tax	-	-	-	-	-	(392)	-	(392)
December 31, 2006 balance	**-**	**1**	**-**	**(414)**	**308**	**(363)**	**-**	**(468)**
Cumulative effect of adoption of FIN 48, net of tax	-	-	-	-	1	-	-	1
January 1, 2007 Balance	**-**	**1**	**-**	**(414)**	**309**	**(363)**	**-**	**(467)**
Net income	-	-	-	-	683	-	-	683
Dividends to shareholders ($2.375 per share)	-	-	-	-	(369)	-	-	(369)
Common stock issued, net	-	1	-	106	-	-	-	107
Purchase of treasury stock	-	-	(2)	-	-	-	-	(2)
Issuance of treasury stock	-	-	2	-	-	-	-	2
Stock-based compensation expense	-	-	-	49	-	-	-	49
Excess tax benefits from stock-based compensation	-	-	-	25	-	-	-	25
Amendments to and remeasurements of employee benefit plans (net of tax)	-	-	-	-	-	232	-	232

Amortization of (net of tax):								
Employee benefit plans prior service cost and actuarial losses	-	-	-	-	-	5	-	5
Cash flow derivative	-	-	-	-	-	(4)	-	(4)
Adjustment of net transfer to Sprint Nextel	-	-	-	3	-	-	-	3
December 31, 2007 Balance	**$ -**	**$ 2**	**$ -**	**$ (231)**	**$ 623**	**$ (130)**	**$ -**	**$ 264**

Common Shares Outstanding	
Shares issued at spin-off	149.1
Shares issued under equity incentive plans	0.6
Shares outstanding as of December 31, 2006	149.7
Shares issued under equity incentive plans	3.4
Shares outstanding as of December 31, 2007	153.1

See accompanying Notes to Consolidated Financial Statements.

EMBARQ CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Background, Basis of Presentation and Significant Accounting Policies

Background

Embarq was incorporated in 2005 under the laws of Delaware and was formerly a wholly owned subsidiary of Sprint Nextel. On May 17, 2006, Sprint Nextel spun-off its local communications business and product distribution operations, thereby establishing Embarq as a separate, stand-alone company.

Embarq provides, both directly and through its wholesale and sales agency relationships, a suite of communications services, consisting of local and long distance voice, data, high-speed Internet, satellite video, wireless and other communications-related products and services to consumer and business customers primarily in local service territories in 18 states. Embarq also provides access to its local network and other wholesale communications services for customers, including other carriers. Through its Logistics segment, Embarq engages in wholesale product distribution, logistics and configuration services.

Embarq has a significant presence in Florida, North Carolina, Nevada and Ohio (these four states represent nearly two-thirds of all of Embarq s access lines). The remaining states (in order of number of access lines) are: Virginia, Pennsylvania, Texas, Indiana, Missouri, Tennessee, New Jersey, Minnesota, Kansas, South Carolina, Washington, Oregon, Nebraska and Wyoming. As the incumbent local exchange carrier, or ILEC, Embarq is generally the carrier of last resort in these local service territories and receives funding under universal service programs in certain of these territories.

As of December 31, 2007, Embarq had approximately 18 thousand active employees. Approximately 35% of these employees were represented by unions subject to collective bargaining agreements. Of the union-represented employees, approximately 32% have collective bargaining agreements that will expire within one year. There were no material changes related to employee collective bargaining agreements during the year ended December 31, 2007.

Basis of Presentation

The accompanying consolidated financial statements reflect all the accounts of Embarq, and its wholly owned subsidiaries. All intercompany transactions have been eliminated. The consolidated financial statements reflect Embarq s consolidated operations as a separate, stand-alone entity following the spin-off, together with the combined historical operations of the entities that comprised the local communications business and product distribution operations of Sprint Nextel before the spin-off.

The accompanying consolidated financial statements were prepared using accounting principles generally accepted in the United States. These principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates.

Certain prior year amounts have been reclassified to conform to the current year presentation. The reported amounts of gross property, plant and equipment and accumulated depreciation as of December 31, 2006, have been reduced by approximately $335 million related to fully depreciated assets at that date. These reclassifications and revisions had no effect on the results of operations or stockholders equity, as previously reported.

Significant Accounting Policies

Cash and Equivalents

Cash and equivalents include cash and highly liquid investments with original maturities of three months or less.

Revenue & Accounts Receivable

Total net operating revenue is comprised of revenue generated from voice, data, high-speed Internet, wireless service and product sales. Embarq recognizes operating revenues as services are rendered or as products are sold in accordance with SAB No. 104, *Revenue Recognition*. Certain service activation and installation fees are deferred and amortized over the average life of the customer. In addition, revenue with multiple deliverables, primarily related to wireless revenue, is recorded in compliance with EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Embarq also records revenue in accordance with EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus net as an Agent*.

During 2006, Embarq adopted EITF Issue No. 06-03, *How Sales Taxes Collected From Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation).* Embarq records federal and state USF surcharges on a gross basis. The total amount of surcharges recorded in net operating revenue was as follows:

	For the Years Ended December 31,		
	2007	**2006**	**2005**
		(millions)	
Federal and state USF surcharges	$ 92	$ 98	$ 87

Revenue reserves are established for access disputes with CLECs and long distance carriers, billing errors and customer disputes, and returns on product sales.

Allowance for doubtful accounts represents the estimate of accounts receivables that are deemed to be uncollectible, with specific allowances for accounts with known collection risks. These reserves require management s judgment based on historical trending, contractual terms, industry norms and recognition of current market indicators.

Inventories

Inventories are stated at the lower of cost or market and consisted of materials, supplies and equipment held for resale and internal use. Cost is principally determined on a first-in first-out method.

Embarq s inventory aggregated by class was as follows:

	As of December 31,	
	2007	**2006**
	(millions)	
Resale inventory, net of allowance of $10 and $15	$ 83	$ 105
Other inventory held for internal use	55	74
Total inventory, net	$ 138	$ 179

Property, Plant and Equipment

Embarq records property, plant and equipment at historical cost. Repair and maintenance costs are expensed as incurred. Embarq capitalizes software in accordance with American Institute of Certified Public Accountants Statement of Position 98-1 *Accounting for the Costs of Computer Software developed or obtained for Internal Use* and EITF Issue No. 97-13 *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project that Combines Business Process Reengineering and Information Technology Transformation*.

Embarq categorizes its property, plant and equipment into three main categories: network assets; buildings and improvements; and administrative and other. Network assets principally consist of metallic cable and wire facilities, fiber optic cable facilities, switching equipment, conduit, poles and other central office equipment. Buildings and improvements principally consist of owned general office facilities and leasehold improvements. Administrative and other assets principally consist of land, furniture, information technology equipment and vehicles.

The costs of homogeneous units of property, plant and equipment are aggregated to form groups of assets that are depreciated on a straight-line basis over the estimated remaining useful life established for each specific group. Estimates and assumptions used in establishing the depreciation rates associated with each group are based on internal studies of use, industry data on lives, recognition of technological advancements and understanding of business strategy. Assumptions are evaluated annually. Generally, changes in depreciation rates are effected through changes in the remaining depreciable lives of the applicable group assets and are considered an accounting estimate in accordance with SFAS No. 154, *Accounting Changes and Error Corrections.*

Ordinary asset retirements are generally charged against accumulated depreciation with no gain or loss recognized. Ordinary asset retirements totaled $493 million in 2007 and $468 million in 2006. Embarq recognizes gains and losses on unusual or unanticipated asset retirements. See Note 11, Sale of Exchanges, for additional information.

Embarq s gross property, plant and equipment and associated range of estimated useful lives by category were as follows:

	Range of Estimated Useful Lives	As of December 31, 2007	2006
	(years)	*(millions)*	
Network assets	3 to 35	$ 18,900	$ 18,503
Buildings and improvements	5 to 30	1,038	1,006
Administrative and other assets	3 to 15	864	961
Gross property, plant and equipment		$ 20,802	$ 20,470

Embarq evaluates property, plant and equipment for impairment whenever indicators of impairment exist. Accounting standards require that if an impairment indicator is present, Embarq must assess whether the carrying amount of the asset is recoverable by estimating the sum of the future undiscounted cash flows, excluding interest costs, expected to result from the asset. If the carrying amount is more than the recoverable amount, an impairment charge must be recognized based on the fair value of the asset. Although no impairments occurred during 2007 or 2006, Embarq s telecommunications segment recorded $80 million in allocated asset impairments in 2005, of which, $77 million resulted from the abandonment of a network monitoring software application.

On an annual basis, Embarq performs an analysis of the remaining life depreciation rates. In 2007, 2006 and 2005, depreciation rates for various digital switching equipment and digital loop carrier equipment were adjusted, which resulted in the following:

	For the Years Ended December 31,		
	2007	**2006(1)**	**2005**
Depreciation (increase) decrease (millions)	$ 48	$ 27	$ (10)
Increase in basic and diluted earnings per share (dollars)	0.20	0.11	NA

(1) Pro forma earnings per share information. See Earnings Per Common Share below, for additional information.

Goodwill

Embarq accounts for goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Goodwill represents the excess of the purchase price over the fair value of the net assets acquired in business combinations accounted for as purchases. The book value of goodwill was $27 million at December 31, 2007 and 2006 with $12 million related to United Telephone Southeast LLC and $11 million related to acquisitions completed by Centel, both subsidiaries of Embarq. The remaining $4 million was related to various other Embarq businesses.

Embarq evaluates goodwill for impairment on an annual basis and whenever events or circumstances indicate these assets may be impaired. Embarq determines impairment by comparing net assets of the reporting unit to its respective fair value. In the event the unit s net assets exceed its fair value, an implied fair value of goodwill must be determined by assigning the unit s fair value to each asset and liability of the unit. The excess of the fair value of the reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. An impairment loss is measured by the difference between the goodwill carrying value and the implied fair value.

Derivatives

Embarq recognizes derivative instruments as either assets or liabilities in the Consolidated Balance Sheets and measures those instruments at fair value in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities as Amended.* Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income (loss) depending on the use of the derivative and whether it qualifies for hedge accounting.

Embarq uses derivative instruments only for hedging and risk management purposes. Hedging activity may be done for the purpose of mitigating the risks associated with an asset, liability, committed transaction or probable forecasted transaction. Embarq is primarily exposed to the market risk associated with unfavorable movements in interest rates. Embarq does not enter into derivative transactions for speculative or trading purposes.

At inception and on an on-going basis, Embarq assesses whether each derivative that qualifies for hedge accounting continues to be highly effective in offsetting changes in the cash flows of the hedged item. If and when a derivative instrument is no longer expected to be highly effective, hedge accounting is discontinued. Hedge ineffectiveness, if any, is included in current period earnings.

Severance Liabilities

Embarq provides severance benefits for involuntarily terminated employees. Such benefits are recorded in accordance with SFAS No. 112, *Employers Accounting for Postemployment Benefits*. Voluntary offers for separation or other contractual separation benefits are recorded in accordance with SFAS No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination.* Other one-time benefit arrangements or exit costs that are part of an organized restructuring plan are recorded in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*.

At various times in recent years, Embarq has taken steps, including both voluntary and involuntary reductions in its workforce in order to better align organizational resources with Embarq s business needs as well as to improve its overall cost structure. Related to these reductions, Embarq recognized the following severance charges:

	For the Years Ended December 31,		
	2007	**2006**	**2005**
		(millions)	
Cost of services			
Telecommunications segment	$ 34	$ 20	$ -
Selling, general and administrative			
Telecommunications segment	43	10	-
Logistics segment	3	4	-
Subtotal	46	14	-
Total severance charges	$ 80	$ 34	$ -

Legal and Other Contingent Liabilities

Embarq accrues loss contingencies for legal, environmental and other contingent liabilities in accordance with SFAS No. 5, *Accounting for Contingencies*. See Note 3, Commitment and Contingencies, for additional information.

Leases

Embarq accounts for capital and operating leases in accordance with SFAS No. 13, *Accounting for Leases*. See Note 3, Commitments and Contingencies, for additional information.

Advertising

Embarq recognizes advertising expenses as incurred. This includes production, media and other promotional and sponsorship costs. Total advertising expense was as follows:

	For the Years Ended December 31,		
	2007	**2006**	**2005**
		(millions)	
Advertising expense	$ 94	$ 103	$ 78

Income Taxes

Embarq accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Before spin-off, Embarq s operations were included in the consolidated federal income tax return and certain combined or consolidated state income tax returns of Sprint Nextel. In accordance with Sprint Nextel s tax sharing arrangement, income tax expense was recorded and charged to Embarq on the basis of filing separate returns in each taxing jurisdiction. After spin-off, Embarq was subject to income taxes as a stand alone entity.

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As of January 1, 2007, Embarq adopted FIN 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As prescribed by the interpretation, the cumulative effect of applying these provisions was reported as an adjustment to the opening balance of retained earnings.

Embarq records interest associated with these liabilities as interest expense. Associated penalties are recorded as income tax expense. The total amount of interest and penalties recognized as of December 31, 2007, were as follows:

	Interest	Penalties
	(millions)	
Recognized in the Consolidated Balance Sheet	$ 4	$ 2
Recognized in the Consolidated Statement of Operations and Comprehensive Income	3	2

Asset Retirement Obligations

Embarq recognizes Asset Retirement Obligations, or ARO, in accordance with SFAS No. 143, *Accounting for Asset Retirement Obligations*. In 2005, FIN 47, *Accounting for Conditional Asset Retirement Obligations,* was issued which clarifies that an entity is required to recognize a liability for the fair value of an ARO if the amount can be reasonably estimated. The adoption of this interpretation in 2005 resulted in an ARO liability of $28 million, an ARO asset of $4 million and a cumulative change in accounting principle, net, of $16 million.

Embarq recognized an ARO related to the removal and disposal of the asbestos in company buildings, removal and environmental cleanup of fuel storage tanks used in standby power supply systems and decommissioning of leased building spaces. The fair value of the assets legally restricted to settle the ARO and the corresponding liability as of December 31, 2007 and 2006, was as follows:

	As of December 31,	
	2007	2006
	(millions)	
ARO assets	$ 4	$ 4
ARO liability	32	29

In addition, an ARO liability exists, but was not recognized, in situations where Embarq has been granted easements and rights-of-way by the United States government, municipalities and private landowners to route its cable facilities. Most cable facilities are buried, however, some metallic and fiber cable are above-ground on company-owned poles. In addition, Embarq contracts with other utilities to connect cable and wire to their poles. As of December 31, 2007, an estimated settlement date for these obligations was indeterminate.

Stock-based Compensation

Effective January 1, 2006, Sprint Nextel adopted SFAS No. 123R, *Share-Based Payment,* utilizing the modified prospective method. The revised standard requires the recognition of compensation cost of unvested share-based awards granted to employees before January 1, 2003, which were outstanding as of January 1, 2006. The allocated impact of the adoption of this standard was immaterial to Embarq because Sprint Nextel had previously accounted for share-based awards in accordance with SFAS No. 123, *Accounting for Stock Compensation*, as amended by SFAS No. 148, *Accounting for Stock Compensation Transition and Disclosure*, as of January 1, 2003, using the prospective method. Following the spin-off, Embarq implemented the provisions of SFAS No. 123R related to the options, nonvested stock and nonvested stock units held by its employees. Embarq recognizes compensation expense related to share-based awards with graded vesting that only have a service condition on a straight line basis over the requisite service period for the entire award. See Note 7, Stock-Based Compensation, for additional information.

As SFAS No. 123R was adopted using the modified prospective method, no retrospective application of net income was required for awards granted prior to January 1, 2003, that were vested in prior years. The pro forma effect, net of tax, had such awards been expensed under the fair value recognition provisions of SFAS No. 123R would have resulted in an approximately $4 million reduction to net income in 2005.

Earnings per Common Share

Embarq calculates basic and diluted earnings per share in accordance with SFAS No. 128, *Earnings per Share.* For purposes of calculating pro forma basic and diluted earnings per share for the year ended December 31, 2006, Embarq assumed that the total common shares issued at spin-off, as well as its related potential dilutive securities, were outstanding for the period from January 1, 2006, through May 17, 2006.

The dilution effect for 2007 and 2006 was primarily related to outstanding stock options and restricted stock units. Approximately 2.1 million stock options in 2007 and 3.3 million stock options in 2006 had an exercise price that was above the average annual market price of Embarq stock. As such, these amounts were not included in the computation of diluted earnings per share.

Note 2. Spin-off from Sprint Nextel

In December 2004, Sprint Nextel announced its intention to spin-off its local communications business and product distribution operations from its other businesses in a tax-free transaction. On May 17, 2006, the date of the spin-off, in exchange for, and as a condition to, the transfer of assets and the assumption of liabilities described below, Embarq (1) issued to Sprint Nextel 149.1 million shares of company common stock and (2) issued to Sprint Nextel $4.5 billion of Embarq senior notes and transferred to Sprint Nextel $2.1 billion in cash. In exchange for, and contemporaneously with, the issuance of Embarq s common stock and transfer of debt and cash, Sprint Nextel transferred the Embarq assets, consisting of Sprint Nextel s local communications operations, wholesale product distribution operations and consumer and certain business long distance customers located in its local service territories; and Embarq assumed certain liabilities related to its business. The spin-off was completed through a pro rata distribution to Sprint Nextel shareholders consisting of one share of Embarq common stock for every 20 shares of Sprint Nextel voting and non-voting shares owned by Sprint Nextel s shareholders as of the close of business on May 8, 2006, the record date for the distribution.

The impacts of the spin-off have been reflected in the consolidated financial statements for periods after the spin-off. Accordingly, the revenues and related expenses from the transferred long distance customers and the interest expense associated with the spin-related borrowings are reflected only in periods after the spin-off. Additionally, while management believes these consolidated financial statements include all historical costs; periods before the spin-off do not include all the expenses that would have been incurred had Embarq been a separate, stand-alone entity. Thus, Embarq s results of operations and cash flows before the spin-off are not fully comparable to those after the spin-off.

Relationship with Sprint Nextel

Before the spin-off, Embarq provided to and received from Sprint Nextel a variety of services that were considered related party transactions. Revenues and expenses resulting from these activities were as follows:

	For the Years Ended December 31,	
	2006	**2005**
	(millions)	
Related party revenues	$ 138	$ 428
Related party expenses	488	1,253

Services provided to Sprint Nextel that make up related party revenues included, but were not limited to, voice, access, data and telecommunications equipment, as well as billing and collection and lease of network facilities. Services Sprint Nextel provided to Embarq that make up related party expenses included charges for facilities, information services, marketing and certain corporate and administrative services. Sprint Nextel directly assigned, where possible, related costs based on Embarq s use of these services. Where direct assignment was not possible, or practical, Sprint Nextel used indirect methods, including time studies and headcounts, to allocate shared service costs to Embarq. The services provided by Sprint Nextel were generally accounted for based on fully distributed costs, which Embarq believes approximated fair value.

In connection with Embarq s spin-off, Embarq entered into certain agreements with Sprint Nextel. The key terms of the principal agreements that continue to be operative are summarized below:

Separation and Distribution Agreement. Embarq entered into a separation and distribution agreement that generally requires Embarq and Sprint Nextel to indemnify each other and each other s representatives and affiliates against certain liabilities. The separation and distribution agreement also contains the terms of the spin-off and certain covenants regarding cooperation to effect the transactions contemplated by the spin-off. The agreement also governs rights both Embarq and Sprint Nextel have to access certain of each other s information following the spin-off. As of December 31, 2007, all material provisions of this agreement have been satisfied. As an ancillary agreement to the separation and distribution agreement, Embarq also entered into an employee matters agreement relating to certain compensation and employee benefit obligations with respect to Embarq s current and former employees.

Tax Sharing Agreement. In connection with the spin-off, Embarq entered into a tax sharing agreement with Sprint Nextel. The tax sharing agreement covers, among other things, Embarq s and Sprint Nextel s rights and obligations with respect to taxes for both the pre- and post-spin-off periods. As of December 31, 2007, settlement of the parties rights and obligations relating to certain pre-spin-off periods is still pending. Embarq has reflected the estimated amounts that may be due from or to Sprint Nextel, pursuant to this agreement in the Consolidated Balance Sheets. These estimates are based on preliminary calculations, which are still subject to further adjustment based on the agreed-upon processes to resolve these matters, including arbitration.

Under the tax sharing agreement, in order to preserve the tax-free treatment to Sprint Nextel of the spin-off, for specified periods of up to 30 months following the spin-off, Embarq may be prohibited, except in specified circumstances, from

- Issuing, redeeming or being involved in other acquisitions of our equity securities;
- Transferring significant amounts of our assets;
- Amending our certificate of incorporation or bylaws;

- Failing to comply with the IRS requirement for a spin-off that we engage in the active conduct of a trade or business after the spin-off; or

- Engaging in other actions or transactions that could jeopardize the tax-free status of the spin-off.

A private letter ruling issued by the IRS after the spin-off provides Embarq with the flexibility to pursue open market repurchases of Embarq s common stock without adversely affecting the tax-free status of Embarq s spin-off from Sprint Nextel.

Embarq has an obligation to indemnify Sprint Nextel for taxes resulting from the spin-off if that tax results from (1) an issuance of our equity securities, a redemption of our equity securities or our involvement in other acquisitions of our equity securities, (2) other actions or failures to act by us (such as those described above) or (3) any of our representations or undertakings referred to in the tax sharing agreement being incorrect or violated.

Embarq currently does not believe these prohibitions impose a significant constraint on Embarq s flexibility to execute its existing strategy.

Intellectual Property Agreements. In connection with the spin-off, Embarq entered into a patent agreement, software and proprietary information agreement and a trademark assignment and license agreement with Sprint Nextel. These agreements govern Embarq s relationship with Sprint Nextel with respect to ownership of and use of intellectual property.

Transition Services Agreements. Embarq entered into transition services agreements with Sprint Nextel under which both parties agreed to provide certain specified services to one another for up to two years following the spin-off. At December 31, 2007, Embarq has exited the majority of these agreements and it is expected that Embarq will exit the remaining agreements according to their terms.

Commercial Service Agreements. Embarq and Sprint Nextel entered into commercial service agreements pursuant to which each company obtains services from one another. The principal agreements are described below:

- Embarq entered into a non-exclusive wholesale agreement, which Embarq refers to as the MVNO agreement, with Sprint Nextel. Under this agreement, for a period of 7 years, Embarq is able to resell certain CDMA-based wireless voice and data services in Embarq s local service territories.

- Under a 5 year wholesale master services agreement with Sprint Nextel, which Embarq refers to as the long distance agreement, Embarq has the ability to market and sell our own branded wireline long distance voice and data services to consumer and small business customers. Under this agreement, Embarq must purchase a minimum of 95% of certain categories of our domestic and international long distance voice and data services from Sprint Nextel.

In addition to the MVNO agreement and long distance agreement, Embarq also entered into a sales agency agreement with Sprint Nextel to sell certain Sprint Nextel-branded wireless and wireline voice and data services to business customers and a teleservices agreement where Embarq purchases payphone and private branch exchange repair and refurbishing and reverse logistics services from Sprint Nextel. Embarq also entered into certain agreements with Sprint Nextel where Embarq is providing certain services to Sprint Nextel, including calling name database services, toll free rehome services and special access services.

Note 3. Commitments and Contingencies

Litigation, Claims and Assessments

Seven former manufactured gas plant sites have been identified that may have been owned or operated by entities acquired by Embarq s subsidiary, Centel, before that company was acquired by Sprint Nextel. These sites are not currently owned or operated by either Sprint Nextel or Embarq. On three sites, Embarq and the current landowners are working with the EPA pursuant to administrative consent orders. Expenditures pursuant to the orders are not expected to be material. On five sites, including the three sites where the EPA is involved, Centel has entered into agreements with other potentially responsible parties to share costs. Further, Sprint Nextel has agreed to indemnify Embarq for most of any eventual liability arising from all seven of these sites.

In December 2007, a group of retirees filed a putative class action lawsuit in Kansas federal court, challenging the decision to make certain modifications to Embarq s retiree benefits programs effective January 1, 2008. See Note 6, Employee Benefit Plans, for additional information. Defendants include Embarq Corporation, certain of its benefits plans, its Compensation Committee, and its plan administrator. Additional defendants include Sprint Nextel and certain of its benefits plans. In addition, complaints have been filed with the EEOC, asserting that the benefits plan changes are discriminatory. Embarq and other defendants intend to vigorously contest these claims and charges.

Various lawsuits, including putative class actions, regulatory proceedings against Embarq and other claims typical for a business enterprise are pending against or would otherwise impact the entities comprising Embarq. While it is not possible to determine the ultimate disposition of each of these proceedings and whether they will be resolved consistent with Embarq s expectations, Embarq expects that the outcome of these proceedings, individually or in the aggregate, will not have a material adverse effect on its financial condition or results of operations.

Purchase Commitments

Embarq has minimum purchase commitments with various vendors through 2013. These outstanding commitments represent non-cancelable commitments to purchase goods and services, consisting primarily of network maintenance and equipment, information technology services, customer support provided by third parties and other expenses related to normal business operations. As of December 31, 2007, outstanding minimum fixed purchase commitments to be paid in future years were as follows:

	(millions)
2008	$ 130
2009	42
2010	27
2011	25
2012	20
Thereafter	-

Amounts actually paid will likely be higher due to variable components of certain agreements which include hours contracted, subscribers and other factors. The total amounts of purchase commitments paid for the years ended December 31, 2007, 2006 and 2005 that had an original term in excess of one year were as follows:

	2007	**2006**	**2005**
		(millions)	
Purchase commitments paid	$ 51	$ 17	$ 33

Leases

Embarq leases various equipment, office facilities, retail outlets, switching facilities, and other network sites. These leases, with few exceptions, provide for automatic renewal options and escalations that are either fixed or based on the consumer price index. Any rent abatements, along with rent escalations, are included in the computation of rent expense calculated on a straight-line basis over the lease term. The lease term for most leases includes the initial non-cancelable term plus at least one renewal period, as the exercise of the related renewal option or options is reasonably assured.

Embarq s gross rental expense amounts for the years ended December 31, 2007, 2006 and 2005 were as follows:

	2007	2006	2005
		(millions)	
Gross rental expense	$ 114	$ 108	$ 82

As of December 31, 2007, our minimum rental commitments for operating leases were as follows:

	(millions)
2008	$ 37
2009	32
2010	24
2011	18
2012	11
Thereafter	17

Note 4. Long-term Debt and Financial Instruments

The following table summarizes Embarq s long-term debt:

	Interest Rate	Maturing	As of December 31, 2007	2006
			(millions)	
Senior notes				
Notes due 2013	6.7%	2013	$ 1,000	$ 1,000
Notes due 2016	7.1%	2016	2,000	2,000
Notes due 2036	8.0%	2036	1,485	1,485
Term credit facility	5.5% and 5.9%	2011	360	1,110
Revolving credit facility	5.4% and 5.9%	2011	410	200
Other	6.8% to 9.8%	2008 to 2025	623	663
Total debt			$ 5,878	$ 6,458
Current maturities			(99)	(37)
Total long-term debt			$ 5,779	$ 6,421

In connection with the spin-off, Embarq issued senior notes in an aggregate amount of $4.5 billion. The senior notes will mature in three tranches, with the earliest maturity in 2013. In addition to the senior notes issued, Embarq entered into a credit agreement with certain financial institutions. The credit agreement expires in May 2011 and originally consisted of a $1.6 billion term facility and a $1.5 billion revolving credit facility, with a $200 million sub-limit for letters of credit. The credit agreement provides for interest rates equal to a base rate

of London Interbank Offered Rate (LIBOR), plus an applicable margin. The applicable margin is based on Embarq s non-credit enhanced long-term senior unsecured debt rating. The credit agreement includes customary covenants that, among other things, require Embarq to maintain certain financial ratios and restrict its ability to incur additional indebtedness.

Various subsidiaries of Embarq have outstanding first mortgage bonds or unsecured debentures. This debt is included in Other in the above table. Each issue of first mortgage bonds is secured by substantially all of the property, plant and equipment of the issuing subsidiary. In the aggregate, approximately 55% of Embarq s property, plant and equipment is pledged to secure one or more issues of first mortgage bonds. As of December 31, 2007, approximately $423 million of first mortgage bonds were outstanding.

Embarq was in compliance with all applicable financial covenants associated with Embarq s borrowings. As of December 31, 2007, Embarq had letters of credit available under the revolving credit facility of approximately $29 million.

The following table represents scheduled principal payments of Embarq s long-term debt as of December 31, 2007:

	(millions)
2008	$ 99
2009	2
2010	2
2011	770
2012	-
Thereafter	5,005

In anticipation of issuing its senior notes at the time of spin-off, Embarq took steps in the 2005 fourth quarter to limit its interest rate risk by entering into hedge transactions. On May 12, 2006, the hedge instruments entered into in 2005 were terminated. The accumulated other comprehensive income (loss) associated with these hedges was $51 million, or $30 million net of tax, and was amortized using the effective interest method and reclassified to interest expense as a yield adjustment of the hedged semi-annual interest payment for ten years. As of December 31, 2007 and 2006, Embarq reclassified approximately $5 million and $3 million as a reduction of interest expense. At December 31, 2007, there were no outstanding derivatives.

Fair Value of Financial Instruments

The estimated fair value of long-term debt was $6.1 billion as of December 31, 2007, and was $6.6 billion as of December 31, 2006. These amounts reflect the present value of estimated future cash flows using a discount rate based on the risks involved. The carrying value of Embarq s other financial instruments, primarily cash and equivalents, accounts receivable and accounts payable, approximate fair value as of December 31, 2007 and 2006, due to their short-term nature. Embarq has no significant concentrations of credit risk related to its accounts receivable. See Note 6, Employee Benefit Plans, and Note 7, Stock-based Compensation, for additional information related to fair value.

Note 5. Income Taxes

Embarq s income tax expense (benefit) consisted of the following:

	For the Years Ended December 31,		
	2007	2006	2005
		(millions)	
Current income tax expense			
Federal	$ 386	$ 441	$ 461
State	49	78	84
Total current	435	519	545
Deferred and non-current income tax expense (benefit)			
Federal	(14)	(60)	25
State	(29)	(9)	8
Total deferred and non-current income tax expense (benefit)	(43)	(69)	33
Total	$ 392	$ 450	$ 578

The differences that caused Embarq s effective income tax rates to vary from the 35% federal statutory rate for income taxes related to continuing operations were as follows:

	For the Years Ended December 31,		
	2007	2006	2005
		(millions)	
Income tax expense at the federal statutory rate	$ 376	$ 432	$ 515
Effect of:			
State income taxes, net of federal income tax effect	26	46	60
Nonrecurring federal and state deferred tax adjustments, net	(12)	(16)	-
Other, net	2	(12)	3
Income tax expense	$ 392	$ 450	$ 578
Effective income tax rate	36.5%	36.5%	39.3%

In 2007, Embarq s modified its legal entity structure, which resulted in state income tax expense being reduced by $14 million and a nonrecurring deferred tax adjustment of $6 million. Also, a favorable state ruling in 2007 resulted in a nonrecurring deferred tax adjustment of $6 million. In 2006, nonrecurring deferred tax adjustments of approximately $16 million were required to properly reflect our deferred income tax liabilities. In addition, other, net in 2006 included $7 million in favorable deferred tax adjustments stemming from enacted state legislation.

Income tax expense (benefit) allocated to other items was as follows:

For the Years Ended December 31,

	2007	2006	2005
		(millions)	
Amortization of employee benefit plans prior service costs and actuarial loss [1]	$ 4	$ -	$ -
Amendments to and remeasurements of employee benefit plans [1]	150	-	-
Cumulative effect of change in accounting principle	-	-	(10)
Additional minimum pension liability [1]	-	321	9
SFAS No. 158 adoption [1]	-	(248)	-
Unrealized holding gains on cash flow derivatives [1]	-	27	(6)
Amortization of cash flow derivatives [1]	(1)	(2)	-

(1) These amounts have been recorded directly in accumulated other comprehensive income (loss).

Embarq recognizes deferred income taxes for the temporary differences between the carrying amounts of its assets and liabilities for financial statement purposes and their tax bases. The sources of the differences that give rise to deferred income tax assets and liabilities, along with the income tax effect of each, were as follows:

	As of December 31,			
	2007		2006	
	Current	Noncurrent	Current	Noncurrent
	(millions)			
Deferred Tax Assets				
Benefit plan obligations	$ -	$ 79	$ -	$ 261
Accruals and other liabilities	73	11	70	19
Stock based compensation	-	33	-	26
Net operating loss carryforward	-	35	-	8
Intangibles	-	29	-	33
Other, net	3	16	3	7
Total deferred tax assets before valuation allowance	76	203	73	354
Valuation allowance	-	(10)	-	(7)
Total deferred tax assets	76	193	73	347
Deferred Tax Liabilities				
Property, plant and equipment	-	1,323	-	1,414
Total deferred tax liabilities	-	1,323	-	1,414
Current Deferred Tax Asset	$ 76	$ -	$ 73	$ -
Noncurrent Deferred Tax Liability	$ -	$ 1,130	$ -	$ 1,067

In conjunction with the spin-off, Sprint Nextel transferred to Embarq certain assets and liabilities, which resulted in the transfer or establishment of a net deferred tax liability of $53 million. This amount includes a deferred tax asset of $268 million related to the transfer from Sprint Nextel of property, plant, and equipment, customer transfers, postretirement obligations and other liabilities, offset by a $321 million deferred tax liability related to the elimination of the additional minimum pension liability.

At December 31, 2007, Embarq did not have any federal net operating loss carryforwards. However, Embarq had state net operating loss carryforwards of approximately $545 million. Related to these loss carryforwards are state tax benefits of $35 million before consideration of valuation allowance. The loss carryforwards expire in varying amounts through 2026.

Management believes it is more likely than not that these deferred income tax assets, net of the valuation allowance, will be realized based on current income tax laws and expectations of future taxable income stemming from the reversal of existing deferred tax liabilities or ordinary operations. Uncertainties surrounding income tax law changes, shifts in operations between state taxing jurisdictions and future operating income levels may, however, affect the ultimate realization of all or some of these deferred income tax assets. When Embarq evaluated these and other qualitative factors and uncertainties concerning its industry, it was determined that they provide continuing evidence requiring the valuation allowance, which we recognize related to the realization of the tax benefit of the net operating loss carryforwards as of December 31, 2007.

FIN 48

As of January 1, 2007, Embarq adopted FIN 48 by analyzing uncertain tax positions for tax periods prior and subsequent to spin-off. The total amount of unrecognized tax benefits related to these positions was $301 million, primarily related to the classification of USF receipts as taxable income. While the ultimate recognition

of USF receipts is highly certain, there is uncertainty about the timing of such recognition. Of the $301 million, approximately $55 million represented uncertain tax positions that could result in a potential future obligation. The remaining $246 million represents refund claims. Due to the uncertainty of these refund claims, Embarq has not recognized the impact to current or deferred taxes in its consolidated financial statements.

As of December 31, 2007, the total liability for uncertain tax positions was $96 million. The total amount of unrecognized tax benefit changes through 2007 was as follows:

		(millions)
Unrecognized tax benefits as of January 1, 2007	$	301
Increase (decrease) as a result of tax positions taken in prior years		33
Increase (decrease) as result of tax positions taken during the current year		14
Decrease related to settlements with taxing authorities		(8)
Unrecognized tax benefits as of December 31, 2007	$	340

Embarq expects it is reasonably possible the liability for uncertain tax positions related to USF will increase by $10 million to $15 million in 2008.

It is reasonably possible that settlements will be made with various tax authorities related to tax positions taken on prior year returns. These positions relate to tax accounting methods and consolidated state income tax return positions. Embarq expects that the negotiated settlement of these matters will result in a $35 million to $40 million reduction of the unrecognized tax benefit in 2008.

Additionally, Embarq has unrecognized tax benefits related to various other tax positions that are not individually significant. Embarq believes that it is reasonably possible that these items may be settled during 2008 resulting in a reduction of the unrecognized tax benefit up to $7 million.

For years before 1990, Embarq is generally no longer subject to examination by U.S. federal, state, and local tax authorities, either as a component of Sprint Nextel s income tax returns or on a stand-alone basis.

The total amount of unrecognized tax benefit that, if recognized, would impact the effective tax rate was $23 million for these tax positions.

Note 6. Employee Benefit Plans

Assets and liabilities recognized in the Consolidated Balance Sheets relating to Embarq s various employee benefit plans were as follows:

	As of December 31,			
	2007		2006	
	(millions)			
Prepaid pension asset	$	108	$	-
Benefit plan obligations				
Defined benefit pension liability	$	32	$	59
Postretirement benefit liability		219		557
Other benefit obligations		69		69
Total	$	320	$	685

Embarq s Defined Benefit Pension Plans

Concurrent with the spin-off, Embarq established a noncontributory defined benefit pension plan. Pension benefits for plan participants represented by a collective bargaining agreement are based on negotiated schedules. All other participants pension benefits are based on each individual participant s years of service and compensation. Embarq also established certain other nonqualified defined benefit plans to provide supplemental benefits to certain executives. Embarq uses a December 31 measurement date for the plans.

Embarq initially measured the plans at May 17, 2006, based on actual plan assets and their respective accrued benefit obligations transferred from Sprint Nextel. Upon the final measurements, an additional $326 million in pension obligation was transferred to Embarq from Sprint Nextel, which was recognized through paid-in capital. In addition, Embarq s pension plan assets exceeded the accumulated benefit obligation and required the elimination of the additional minimum pension liability of $917 million that was recorded as of December 31, 2005.

The following table presents information related to Embarq s defined benefit pension plans since their initial measurements:

(millions)	Expense	Projected Benefit Obligation	Plan Assets	Funded Status	Unrecognized Net Loss (1)	Unrecognized Prior Service Cost (1)	Unamortized Transition Asset (1)	Accumulated Other Comp. Income Recognized (1)
May 17, 2006	$ -	$ (3,148)	$ 3,089	$ (59)	$ 742	$ 74	$ (1)	$ 815
Service cost	31	(31)	-	(31)	-	-	-	-
Interest cost	121	(121)	-	(121)	-	-	-	-
Expected return on assets	(166)	-	-	-	166	-	-	166
Amortization of actuarial losses	24	-	-	-	(24)	-	-	(24)
Amortization of prior service cost	10	-	-	-	-	(10)	-	(10)
Actuarial losses	-	(84)	-	(84)	84	-	-	84
Plan amendments (2)	-	(15)	-	(15)	-	15	-	15
Actual return on assets	-	-	249	249	(249)	-	-	(249)
Benefit payments	-	106	(106)	-	-	-	-	-
Employer contributions	-	-	2	2	-	-	-	-
December 31, 2006 (3)	20	(3,293)	3,234	(59)	719	79	(1)	797
Service cost	55	(55)	-	(55)	-	-	-	-
Interest cost	199	(199)	-	(199)	-	-	-	-
Expected return on assets	(263)	-	-	-	263	-	-	263
Amortization of actuarial losses	46	-	-	-	(46)	-	-	(46)
Amortization of prior service cost	16	-	-	-	-	(16)	-	(16)
Actuarial gains	-	10	-	10	(10)	-	-	(10)
Plan amendments (2)	-	(12)	-	(12)	-	12	-	12
Actual return on assets	-	-	314	314	(314)	-	-	(314)
Benefit payments	-	207	(207)	-	-	-	-	-
Employer contributions	-	-	77	77	-	-	-	-
December 31, 2007 (4)	$ 53	$ (3,342)	$ 3,418	$ 76	$ 612	$ 75	$ (1)	$ 686

(1) The adoption of SFAS No. 158 on December 31, 2006, required the pension obligation recognized to equal the funded status of the plans as measured by the difference between the projected benefit obligations and the plans asset values. This resulted in an increase in the obligation of $797 million. In combination with the associated deferred tax impact of $307 million, this adjustment reduced stockholder s equity by $490 million.

(2) Plan amendments were a result of collective bargaining agreement renewals, which impacted certain union employee benefit schedules.

(3) The accumulated benefit obligation was $3,179 million at December 31, 2006.

(4) The accumulated benefit obligation was $3,228 million at December 31, 2007.

Plan Asset Allocations	Actual	Targeted	Expected Future Benefit Payments	
				(millions)
Equity securities	57%	50% to 65%	2008	$ 196
Debt securities	23%	15% to 30%	2009	201
Real estate	10%	5% to 15%	2010	209
Other	10%	5% to 15%	2011	219
Total	100%	100%	2012	230
			2013-2017	1,320

Embarq s investment strategy is to maintain a diversified asset portfolio in order to provide a nominal long-term rate of return. The expected rate of return on plan assets was determined through evaluation of information obtained from investment advisors corroborated with peer data for reasonableness.

Embarq is planning to contribute approximately $75 million to its defined benefit pension plans in 2008.

Embarq s Postretirement Benefit Plans

Concurrent with spin-off, Embarq established its own postretirement benefit plans that provide postretirement benefits, principally medical and life insurance, to its eligible former employees. The plans allow eligible employees retiring before certain dates to benefits at no or reduced cost. Employees retiring after certain dates are eligible for benefits on a shared cost basis. Embarq generally funds and expects to continue funding its postretirement obligations as benefits are paid. Embarq uses a December 31 measurement date for the plans.

Embarq initially measured the plans at May 17, 2006, based on actual plan assets and their respective accrued benefit obligations transferred from Sprint Nextel. Upon final measurements, an additional postretirement liability of $16 million was transferred to Embarq from Sprint Nextel, which was recognized through paid-in capital.

During the second quarter of 2007, Embarq amended its other postretirement medical and life insurance plans. Effective January 1, 2008, Embarq eliminated medical coverage and Medicare premium subsidies for Medicare-eligible retirees and Medicare-eligible beneficiaries and capped the maximum amount of life insurance benefits through the company-sponsored plan for qualified retirees at $10 thousand. In addition, effective September 1, 2007, Embarq eliminated company-provided life insurance coverage for retirees who also have benefits through a separate subsidiary company-sponsored plan. In December 2007, a group of retirees filed a putative class action lawsuit in Kansas federal court, challenging this decision. See Note 3, Commitments and Contingencies, for additional information.

The amendment caused Embarq to remeasure these postretirement benefit plans as of June 30, 2007. The accumulated postretirement benefit obligations were reduced by $301 million with a corresponding increase in accumulated other comprehensive income (loss), net of tax. The reduction in the obligation will be amortized to other postretirement benefit cost over the remaining average life of retirees.

The following table presents information related to the Embarq s postretirement benefit plans since their initial measurements:

(millions)	Expense	Accumulated Projected Benefit Obligation	Plan Assets	Funded Status	Unrecognized Net Loss (1)	Unrecognized Prior Service Cost (1)	Unamortized Transition Asset (1)	Accumulated Other Comp. Income Recognized (1)
May 17, 2006	$ -	$ (601)	$ 43	$ (558)	$ 173	$ (350)	$ (6)	$ (183)
Service cost	5	(5)	-	(5)	-	-	-	-
Interest cost	23	(23)	-	(23)	-	-	-	-
Expected return on assets	(2)	-	-	-	2	-	-	2
Amortization of actuarial losses	11	-	-	-	(11)	-	-	(11)
Amortization of prior service cost	(37)	-	-	-	-	37	-	37
Employer contributions	-	-	27	27	-	-	-	-
Benefit payments	-	28	(28)	-	-	-	-	-
Actual return on assets		-	4	4	(4)	-	-	(4)
Actuarial gains or losses	-	(2)	-	(2)	2	-	-	2
December 31, 2006	-	(603)	46	(557)	162	(313)	(6)	(157)
Service cost	8	(8)	-	(8)	-	-	-	-
Interest cost	26	(26)	-	(26)	-	-	-	-
Expected return on assets	(3)	-	-	-	3	-	-	3
Amortization of prior service cost	(68)	-	-	-	-	68	-	68
Amortization of actuarial losses	15	-	-	-	(15)	-	-	(15)
Amortization of transition asset	(1)	-	-	-	-	-	1	1
Employer contributions	-	-	37	37	-	-	-	-
Benefit payments	-	39	(39)	-	-	-	-	-
Plan amendments	-	301	-	301	-	(301)	-	(301)
Actual return on assets	-	-	3	3	(3)	-	-	(3)
Actuarial gains or losses	-	31	-	31	(31)	-	-	(31)
December 31, 2007	$ (23)	$ (266)	$ 47	$ (219)	$ 116	$ (546)	$ (5)	$ (435)

(1) The adoption of SFAS No. 158 as of December 31, 2006, required the post-retirement benefit obligation recognized to equal the funded status of the plans as measured by the difference between the accumulated projected benefit obligation and the plan asset value. This resulted in a decrease in the obligation of $157 million. In combination with the associated deferred tax impact of $59 million, this adjustment increased stockholder s equity by $98 million.

Plan Asset Allocations	Actual	Expected Future Benefit Payments	(millions)
Equity securities	67%	2008	$ 32
Debt securities	33%	2009	27
Total	100%	2010	24
		2011	23
		2012	20
		2013-2017	104

Embarq is planning to contribute approximately $30 million to their postretirement benefit plans in 2008.

Assumptions and Other Information

Accounting for long term obligations such as defined benefit pension and postretirement benefit obligations requires the use of certain assumptions. Embarq developed assumptions used to calculate the discount rate based on a hypothetical portfolio of bonds rated AA- or better that produced a cash flow matching the projected benefit payments of the plan. The expected rate of future pay raises was based on a weighted-average of past experience and industry peer group survey data. The expected long-term return on plan assets was determined by considering forward-looking estimates of the expected long-term returns for a portfolio invested according to the pension trust s target investment policy. Health care costs increases and assumed health care cost trends were developed per review of surveys of employers expectations of medical cost increases and to a spot survey of the retiree medical inflation assumptions expected to be used by other plan sponsors.

The following weighted average assumptions were used to determine the benefit obligation and net benefit costs related to the defined benefit pension plans and postretirement benefit plans:

	2007	2006
Benefit obligation assumptions		
Discount rate	6.3%	6.1%
Rate of compensation increase	4.0%	4.0%
Health care cost increases in the following year	7.9%	8.6%
Net benefit cost assumptions		
Discount rate (1)	6.1%	6.4%
Rate of compensation increase	4.0%	4.3%
Long-term expected return on plan assets	8.5%	8.8%
Health care cost increases in the current year	8.6%	9.3%

(1) The June 30, 2007, remeasurement of the other postretirement benefit expense used a discount rate of 6.4%

The ultimate assumed health care trend rate used in calculating the benefit obligation and net benefit costs for 2007 and 2006 was 5% and is expected to be reached in 2012.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost trend rates would have the following effects:

	2007	2006
	(millions)	
Health Care Cost Trend Rate Sensitivity:		
Effect on service and interest cost 1% increase	$ 1	$ 1
Effect on service and interest cost 1% decrease	(1)	(1)
Effect on APBO 1% increase	4	30

Effect on APBO	1% decrease	(4)	(26)

Subsequent to the adoption of SFAS No. 158, the amount recognized in accumulated other comprehensive income (loss) related to Embarq s defined benefit pension plans and postretirement benefit plans was equivalent to the unrecognized net loss, unrecognized prior service cost (credit) and the unamortized transition asset for each respective plan at December 31, 2007. The total amount of amortization related to these items that are expected to be recognized into net periodic benefit cost in 2008 is as follows:

	Defined Benefit Pension Plan	Postretirement Benefits
	(millions)	
Amortization of net losses	$ 25	$ 12
Amortization of prior service cost (credit)	17	(53)
Amortization of net transition asset	-	(1)

Defined Contribution Plans

Embarq has defined contribution employee savings plans. Participants may contribute portions of their pay to the plans. Embarq matched contributions for non-union employees and union-represented employees in cash. For certain other union-represented employees, Embarq matched contributions in company stock. Embarq may, at the discretion of the Employee Benefits Committee, and subject to a respective collective bargaining agreement provide matching contributions based on the performance of Embarq stock compared to the Dow Jones US Telecommunications Total Return Index. The matching contribution was equal to 25% of participants contributions, up to 6% of their pay, in 2007 and was equal to 28% of participants contributions, up to 6% of their pay, in 2006. Embarq recognized expense of $10 million for 2007 and $8 million for 2006 related to these plans.

Allocated Benefit Plan Costs

Before spin-off, a substantial number of Embarq employees were covered as part of Sprint Nextel s noncontributory defined benefit pension plan and postretirement benefit plans. Embarq was allocated plan assets, benefit obligations and net periodic benefit costs from Sprint Nextel related to individuals that could be identified as supporting Embarq s operations. The following table summarizes the total benefit plan costs reflected in Embarq s Consolidated Statements of Operations and Comprehensive Income.

	For the Years Ended December 31, 2006	2005
	(millions)	
Allocated defined benefit pension cost	$ 20	$ 64
Allocated postretirement benefit cost	2	16

Before spin-off, certain Embarq employees participated in Sprint Nextel s defined contribution plan, which had similar matching contributions to Embarq s plan. Prior to 2006, Sprint Nextel matched participants contributions in Sprint Nextel stock. Embarq recognized allocated contribution charges of $5 million for the pre-spin-off 2006 period and $15 million in 2005.

Other Benefit Obligations

Other benefit obligations recognized in the Consolidated Balance Sheets, mainly represent certain long-term disability obligations recognized in accordance with SFAS No. 112, *Employers Accounting for Postemployment Benefits*.

Note 7. Stock-based Compensation

Share-based Payment Plans

Under the Embarq Corporation 2006 Equity Incentive Plan, Embarq can grant a wide range of awards related to Embarq common stock, including stock options, nonvested stock and stock units, otherwise referred to as restricted stock and stock units, stock appreciation right awards, performance share awards and performance unit awards to Embarq s directors and employees. Under the 2006 Plan, 24.5 million common shares were reserved for issuance, of which approximately 12.3 million common shares remained available at December 31, 2007. The Compensation Committee of the Board of Directors of Embarq (the Compensation Committee) may award options to purchase common stock and set all the terms and conditions of the options, except that the option exercise price per share shall be no less than the fair market value of a share of common stock on the date of grant. In addition, the Compensation Committee has discretion to set the vesting schedule for the options which can have a term not to exceed ten years and may establish the terms and conditions of the awards including the satisfaction of performance and market goals.

Beginning in the fourth quarter of 2006, Embarq began offering an Employee Stock Purchase Plan, which allows eligible employees to deduct up to 20% of eligible compensation to purchase common shares of stock at a price equal to 90% of its market value on the last trading day of each quarter. The aggregate number of shares an employee may purchase cannot exceed 15 thousand shares or the equivalent of $25 thousand in any calendar year, subject to limitations imposed by Section 423 of the Internal Revenue Code. Under this plan, 0.9 million common shares were reserved for issuance, of which approximately 0.7 million remained available at December 31, 2007.

Stock Options

Embarq uses the Black-Scholes-Merton model to estimate the fair value of stock options. The risk-free interest rate was determined using the yield available on the option grant date for a zero-coupon U.S. Treasury security with a term equivalent to the expected life of the option. The dividend yield was determined based upon estimated annual dividends and the fair value and shares outstanding of Embarq s stock on the option grant date. Due to Embarq s relatively short life as an independent company, the expected volatility was based on a blend of the historic and implied volatility of Embarq s peer group. The expected life for options granted during the year was determined by applying the simplified method as described by SAB No. 107, *Share-Based Payment*.

The weighted average grant date fair value was $12.02 in 2007 and $13.62 in 2006 for all options converted or granted. These fair values were based on the following weighted average assumptions:

	2007	**2006**
Risk-free interest rate	4.7%	5.0%
Expected dividend yield	3.5%	4.4%
Expected volatility	24.4%	22.5%
Expected term (years)	6.0	4.7

A summary of the activity related to Embarq s stock options for 2007 is presented below:

	Options	**Weighted Average Exercise Price**
	(millions)	
Beginning balance outstanding	9.2	$ 51.04
Granted	0.9	56.46
Exercised	2.8	38.63
Forfeited/expired	0.9	56.44
Ending balance outstanding	6.4	$ 56.51

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The total amount of options exercisable and expected to vest, net of expected forfeitures, at December 31, 2007, was:

	Options	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Term	Weighted Average Exercise Price
		(millions)		
Exercisable	4.5	$ 24.1	3.4	$ 60.24
Expected to vest, net of expected forfeitures	1.9	$ 7.4	8.1	$ 47.72

The consolidated financial statement impact related to stock options exercised was as follows:

	For the Years Ended December 31,	
	2007	2006
	(millions)	
Cash received	$ 109	$ 21
Tax benefit realized	22	3
Intrinsic value	60	8

During 2007, approximately 1.0 million stock options with a weighted average fair value of $11.62 became fully vested. During 2006, approximately 0.1 million stock options with a weighted average fair value of $18.93 became fully vested. As of December 31, 2007, there was $11 million of total unrecognized compensation cost related to unvested stock options that is expected to be recognized over a weighted-average period of 0.7 years.

Restricted Stock Units

Prior to 2007, the fair value for restricted stock units where vesting was dependent only on service was calculated using the average of the high and low price of Embarq stock on the day of grant. Beginning in 2007, the fair value of such awards was calculated using the closing stock price on the day of grant. During 2007, Embarq granted restricted stock units that contained market conditions that affect factors other than vesting. The fair value of these awards was determined based on their expected outcome as of the grant date.

The weighted average grant date fair value for restricted stock units granted in 2007 was $55.41 and $43.86 in 2006. A summary of the activity related to the restricted stock units 2007 was as follows:

	Unit Award	Weighted Average Fair Value
	(millions)	
Beginning balance nonvested	2.0	$ 43.85
Granted	0.8	55.41
Vested	0.7	47.54
Forfeited	0.5	47.83
Ending balance nonvested	1.6	$ 46.87

In February 2007, Embarq granted 0.5 million restricted stock units that had performance and market provisions which could result in the initial number of awards granted being increased up to 200% or decreased to zero. The conversion ratios related to these awards are equally weighted to the performance and market conditions for the two and three year performance periods ended December 31, 2008 and 2009.

As of December 31, 2007, there was $20 million of total unrecognized compensation cost related to restricted stock units that is expected to be recognized over a weighted-average period of 0.9 years.

The total intrinsic value of restricted stock units vested during 2007 was $8 million and $1 million in 2006.

Compensation Expense

After the spin-off, stock-based compensation expense was calculated on the direct method based on each employee s individual grant. Before the spin-off, stock-based compensation expense was allocated to Embarq by Sprint Nextel based on the total Embarq employee headcount as a percentage of Sprint Nextel s total employees.

A summary of the total expense and income tax benefit related to our equity plans for the years ended December 31, 2007, 2006 and 2005 were as follows:

	For the Years Ended December 31,		
	2007	**2006**	**2005**
		(millions)	
Compensation Expense			
Pre spin-off allocated expense	$ -	$ 22	$ 49
Post spin-off direct expense	50	31	-
Total	$ 50	$ 53	$ 49
Income Tax Benefit			
Pre spin-off allocated expense	$ -	$ 8	$ 18
Post spin-off direct expense	18	11	-
Total	$ 18	$ 19	$ 18

Resignation of Chief Executive Officer (CEO)

In December 2007, Embarq s CEO resigned resulting in the forfeiture of 0.6 million stock options and 0.4 million restricted stock units. These forfeitures resulted in the reversal of $12 million in compensation expense recognized in 2007 and prior years and reduced unearned compensation expense by $11 million as of December 31, 2007.

Resignation of Chief Operating Officer (COO)

On December 19, 2006, Embarq entered into a general release and agreement with the COO, which eliminated that position. Embarq recognized $8 million of stock-based compensation expense associated with this event.

The general release and agreement provided that Embarq will vest those portions of the former COO s equity grants that remain unvested at the end of his 18 month severance period, which included 43,043 stock option awards and 63,045 restricted stock unit awards. This was considered to be a modification of vesting terms requiring a revaluation of the modified awards. The fair value for the modified stock options was $11.37 per option and $51.22 per unit for the restricted stock units. Of the total $8 million stock compensation charge recognized related to this event, approximately $4 million was the value associated with the modified awards.

Spin-off from Sprint Nextel

The employee matters agreement provided that at spin-off, Sprint Nextel options held by Embarq employees would be converted into options to purchase shares of Embarq common stock. At spin-off, Embarq employees held approximately 15 million Sprint Nextel stock options which were converted into approximately 8 million Embarq stock options. These options had substantially the same terms and conditions as the terms and conditions of the underlying Sprint Nextel options. Additionally, a special equity award of Embarq restricted stock units was granted to Embarq employees who had their Sprint Nextel options converted into Embarq options. These awards vest over a three year service period and were valued at the closing market value of Embarq stock on the first business day following the grant date. No incremental compensation expense resulted from this modification event.

Pursuant to the employee matters agreement, Sprint Nextel and Embarq employees retained any restricted stock and restricted stock units issued by Sprint Nextel. To compensate for the loss in value of these units related to the spin-off, the holders of these awards were issued pro rata one Embarq award for every 20 Sprint Nextel awards held. The terms and conditions of the Embarq awards were substantially the same as the terms and conditions of the corresponding Sprint Nextel awards and vest over the remaining term of the Sprint Nextel awards. Embarq will recognize the minimal incremental compensation cost related to this modification event over the remaining vesting period of the awards.

Note 8. Business Segment Information

Embarq has two segments, Telecommunications and Logistics. The Telecommunications segment provides, both directly and through wholesale and sales agency relationships, local and long distance voice, data, high-speed Internet, satellite video, wireless and other communications-related products and services to consumer and business customers primarily within Embarq s local service territories in 18 states. The Telecommunications segment also provides access to Embarq s local network and other wholesale communications services to customers, including other carriers. The Logistics segment engages in wholesale product distribution, logistics and configuration services to third parties.

Embarq manages its segments to the operating income level. Items such as interest, other income and expense, or income taxes are managed at the consolidated level. The reconciliation for operating income to net income is shown on the face of the accompanying Consolidated Statements of Operations and Comprehensive Income.

The financial information by operating segment as of and for the years ended December 31, 2007, 2006 and 2005, were as follows:

	Telecommunications	Logistics	Consolidated
		(millions)	
2007			
Service revenues			
Voice	$ 4,238	$ -	$ 4,238
Data	765	-	765
High-speed Internet	489	-	489
Wireless	51	-	51
Other	243	-	243
Total service revenues	5,786	-	5,786
Product revenues	113	466	579
Total net operating revenues	5,899	466	6,365
Depreciation	1,048	9	1,057
Operating expenses	4,393	468	4,861
Operating income (loss)	1,506	(2)	1,504
Operating margin	26%	-%	24%
Capital expenditures	827	2	829
Total assets	8,792	109	8,901

	Telecommunications	Logistics	Consolidated
		(millions)	
2006			
Service revenues			
Voice	$ 4,346	$ -	$ 4,346
Data	706	-	706
High-speed Internet	393	-	393
Wireless	7	-	7
Other	270	-	270
Total service revenues	5,722	-	5,722
Product revenues	111	530	641
Total net operating revenues	5,833	530	6,363
Related party revenues	124	14	138
Depreciation	1,016	11	1,027
Operating expenses	4,273	546	4,819
Operating income (loss)	1,560	(16)	1,544
Operating margin	27%	(3)%	24%
Capital expenditures	921	2	923
Total assets	8,924	195	9,119

	Telecommunications	Logistics	Consolidated
		(millions)	
2005			
Service revenues			
Voice	$ 4,265	$ -	$ 4,265
Data	657	-	657
High-speed Internet	310	-	310
Other	334	-	334
Total Service revenues	5,566	-	5,566
Product revenues	125	563	688
Total net operating revenues	5,691	563	6,254
Related party revenues	374	54	428
Depreciation	967	12	979
Operating expenses	4,098	604	4,702
Operating income (loss)	1,593	(41)	1,552
Operating margin	28%	(7)%	25%
Capital expenditures	823	5	828
Total assets	9,009	212	9,221

Note 9. Supplemental Cash Flow Information and Non-Cash Activities

Embarq s supplemental cash flow information and non-cash activities were as follows:

	2007	2006	2005
		(millions)	
Supplemental Cash Flow Information			
Cash paid for interest, net of amounts capitalized	$ 437	$ 290	$ 86
Cash paid for income taxes	449	348	549
Non-Cash Activities			
Capital expenditure accrual	$ 1	$ 3	$ -
Dividend accrual	2	-	-
Extinguishment of debt	3	-	-
Issuance of treasury stock to the Employee Stock Purchase Plan	2	-	-
Transactions with Sprint Nextel associated with spin-off:			
Distribution of senior notes	-	(4,485)	-
Transfer of notes receivable	-	460	-
Transfer and subsequent adjustment of property, plant and equipment, net	4	313	-
Transfer of post-retirement and other benefit obligations	-	(358)	-
Elimination of additional minimum pension liability and pension intangible	-	837	-
Transfer and subsequent adjustment of other assets and liabilities, net	(2)	35	-
Deferred taxes related to assets and liabilities transferred and subsequently adjusted	1	(53)	-

Note 10. Recently Issued Accounting Pronouncements

SFAS No. 157, *Fair Value Measurements* this standard provides enhanced guidance for using fair value to measure assets and liabilities on the balance sheet by clarifying the definition of fair value and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. This standard is effective for fiscal years beginning after November 15, 2007, for assets and liabilities measured at fair value on a recurring basis and for fiscal years beginning after November 15, 2008, for assets and liabilities that are not required or permitted to be measured on a recurring basis. The adoption of this standard is not expected to have a material effect on Embarq s financial condition or results of operations.

Note 11. Sale of Exchanges

In the 2006 first quarter, Embarq finalized the sale of 13 exchanges including approximately 5,200 access lines in north central Kansas for approximately $18 million in cash. This sale resulted in a pre-tax gain of approximately $6 million and was reflected as a reduction of selling, general and administrative expense in the Consolidated Statements of Operations and Comprehensive Income.

In the 2006 fourth quarter, Embarq finalized the sale of 12 exchanges in north central Kansas, serving approximately 5,400 access lines. Proceeds from this sale were approximately $17 million, which generated a pre-tax gain of $6 million. This gain was reflected as a reduction of selling, general and administrative expense in the Consolidated Statements of Operations and Comprehensive Income.

Note 12. Quarterly Financial Data (Unaudited)

	2007 Quarters			
	1st	2nd	3rd	4th
	(millions, except per share data)			
Net operating revenue	$ 1,589	$ 1,605	$ 1,594	$ 1,577
Operating income	371	400	363	370
Net income	160	176	157	190
Basic earnings per share	1.07	1.16	1.02	1.24
Diluted earnings per share	1.05	1.15	1.01	1.23

	2006 Quarters			
	1st (1)	2nd (1)	3rd	4th
	(millions, except per share data)			
Net operating revenue	$ 1,561	$ 1,579	$ 1,606	$ 1,617
Operating income	366	406	366	406
Net income	214	216	160	194
Basic earnings per share	1.44	1.45	1.07	1.30
Diluted earnings per share	1.42	1.44	1.06	1.28

(1) Pro forma earnings per share information. See Note 1, Background, Basis of Presentation and Significant Accounting Policies, for additional information.

Note 13. Subsequent Events

Dividend Declaration

In January 2008, Embarq declared a dividend of $0.6875 per share payable on March 31, 2008, to stockholders of record on March 10, 2008. The declaration and payment of future dividends to holders of Embarq common stock is at the discretion of Embarq s board of directors, and depends upon many factors, including Embarq s financial condition, results of operations, growth prospects, funding requirements, applicable law and other factors the board of directors deems relevant.

Repurchase of Common Stock

In January 2008, Embarq s board of directors authorized a program for the repurchase of common stock for an aggregate purchase price of up to $500 million that will expire on June 30, 2009. Embarq anticipates purchasing shares either in the open market or through private transactions, depending on market conditions and other factors, in accordance with applicable securities laws.

Stock-based Compensation

On February 27, 2008, Embarq s Compensation Committee approved the grant of 0.4 million restricted stock units related to the 2007 short-term incentive program to certain non-executive employees. These grants vest in December 2008 and are expected to result in Embarq recognizing approximately $17 million in compensation expense during 2008.

EMBARQ CORPORATION

SCHEDULE II CONSOLIDATED VALUATION AND QUALIFYING ACCOUNTS

For the Years Ended December 31, 2007, 2006 and 2005

	Balance Beginning of Period	Charged to income	Other Deductions(1)	Balance End of Period
			(millions)	
December 31, 2007				
Allowance for doubtful accounts	$ 53	$ 94	$ 87	$ 60
Revenue reserve	28	92	59	61
Valuation allowance Deferred tax asset	7	3	-	10
December 31, 2006				
Allowance for doubtful accounts	$ 57	$ 55	$ 59	$ 53
Revenue reserve	24	36	32	28
Valuation allowance Deferred tax asset	2	5	-	7
December 31, 2005				
Allowance for doubtful accounts	$ 61	$ 54	$ 58	$ 57
Revenue reserve	48	60	84	24
Valuation allowance Deferred tax asset	2	-	-	2

(1) Accounts written off and billing disputes resolved, net of recoveries.