

## Market for the Registrant's Common Stock and Related Stockholder Matters

The Company's Common Stock has been traded on the Nasdaq National Market (Nasdaq) under the symbol "ADTN" since the Company's initial public offering of Common Stock in August 1994. Prior to the initial public offering, there was no established trading market for the Company's Common Stock. As of January 31, 1999, the Company had 647 shareholders of record and approximately 13,500 beneficial owners of shares held in street name. The following table shows the high and low sale prices per share for the Common Stock as reported by Nasdaq for the periods indicated:

| 1998 QUARTERS | HIGH     | LOW      |
|---------------|----------|----------|
| First         | \$34-3/4 | \$24     |
| Second        | \$29-3/4 | \$19-5/8 |
| Third         | \$29-1/8 | \$20-1/2 |
| Fourth        | \$28-7/8 | \$15-5/8 |

| 1997 QUARTERS | HIGH     | LOW      |
|---------------|----------|----------|
| First         | \$53-1/4 | \$22-1/2 |
| Second        | \$35-5/8 | \$20-7/8 |
| Third         | \$44     | \$23     |
| Fourth        | \$45-1/2 | \$26     |

The Company has operated with a policy of retaining earnings, presently intends to retain all future earnings for use in the development of its business and does not anticipate paying any cash dividends in the foreseeable future.

The following selected financial data concerning the Company for and as of the end of each of the years in the five year period ended December 31, 1998, are derived from the financial statements of the Company, which have been audited by PricewaterhouseCoopers LLP, independent accountants. The selected financial data are qualified in their entirety by the more detailed information and financial statements, including the notes thereto. The financial statements of the Company as of December 31, 1998 and 1997, and for each of the years in the three year period ended December 31, 1998, and the report of PricewaterhouseCoopers LLP thereon, are included elsewhere in this report.

## Selected Financial Data

Year Ended December 31,

| (in thousands, except per share data)        | 1998           | 1997           | 1996           | 1995           | 1994           |
|--|----------------|----------------|----------------|----------------|----------------|
| <b>INCOME STATEMENT DATA</b>                 |                |                |                |                |                |
| <b>Sales</b>                                 |                |                |                |                |                |
| Telco  | \$167,500      | \$171,838      | \$171,902      | \$121,311      | \$87,888       |
| CPE  | 119,059        | 93,497         | 78,219         | 60,167         | 35,552         |
| <b>Total sales</b>                           | <b>286,559</b> | <b>265,335</b> | <b>250,121</b> | <b>181,478</b> | <b>123,440</b> |
| Cost of Sales                                | 130,010        | 130,254        | 129,953        | 93,007         | 63,187         |
| <b>Gross profit</b>                          | <b>156,549</b> | <b>135,081</b> | <b>120,168</b> | <b>88,471</b>  | <b>60,253</b>  |
| Selling, general and administrative expenses | 62,061         | 44,973         | 34,308         | 27,260         | 17,347         |
| Research and development expenses            | 37,222         | 30,055         | 24,648         | 19,131         | 13,774         |
| <b>Operating income</b>                      | <b>57,266</b>  | <b>60,053</b>  | <b>61,212</b>  | <b>42,080</b>  | <b>29,132</b>  |
| Interest income                              | 5,824          | 4,175          | 2,543          | 3,205          | 440            |
| Interest expense                             | (2,287)        | (1,839)        | (895)          | (1,105)        | (448)          |
| Other Income (expense)                       | (188)          | 438            | 642            | 111            | (25)           |
| <b>Income before income taxes</b>            | <b>60,615</b>  | <b>62,827</b>  | <b>63,502</b>  | <b>44,291</b>  | <b>29,099</b>  |
| Provision for income taxes (1)               | 20,306         | 22,618         | 23,682         | 14,833         | 10,490         |
| <b>Net income (2)</b>                        | <b>40,309</b>  | <b>40,209</b>  | <b>39,820</b>  | <b>29,458</b>  | <b>18,609</b>  |
| Earnings per common share                    |                |                |                |                |                |
| assuming dilution (2)                        | 1.03           | 1.02           | 1.01           | .75            | .51            |
| Earnings per common share-basic (2)          | 1.03           | 1.03           | 1.03           | .80            | .56            |
| Weighted average shares outstanding          |                |                |                |                |                |
| assuming dilution (2)                        | 39,164         | 39,565         | 39,549         | 39,249         | 36,199         |

At December 31,

| (in thousands, except per share data) | 1998      | 1997      | 1996      | 1995      | 1994     |
|---------------------------------------|-----------|-----------|-----------|-----------|----------|
| <b>BALANCE SHEET DATA</b>             |           |           |           |           |          |
| Working Capital                       |           |           |           |           |          |
| Working Capital                       | \$150,535 | \$149,184 | \$140,510 | \$122,466 | \$66,368 |
| Total assets                          | 301,711   | 282,401   | 210,207   | 165,767   | 94,347   |
| Total debt                            | 50,000    | 50,000    | 20,000    | 20,000    | 0        |
| Stockholders' equity                  | 231,389   | 212,037   | 172,879   | 130,743   | 85,233   |

(1) Effective July 1, 1994, the Company converted from an S corporation to a C corporation for income tax purposes. As an S corporation, the Company was not subject to income taxes but paid quarterly cash distributions to fund the income tax liabilities passed through to the stockholders. As a C corporation, the Company is subject to income taxes at corporate tax rates. The provision for income taxes for 1994 includes a pro forma amount of \$4,202 for the period from January 1, 1994 to July 1, 1994.

(2) Assumes exercise of dilutive stock options calculated under the treasury stock method. See Notes 1, 9 and 13 of Notes to Financial Statements.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## OVERVIEW

The Company designs, develops, manufactures, markets and services a broad range of high-speed digital transmission products utilized by Telcos and corporate end-users to implement advanced digital data services over existing telephone networks. The Company currently sells its products to Telcos (including all of the RBOCs) and private end-users in the CPE market.

The Company's sales have increased in each year due primarily to increases in the number of units sold to both new and existing customers. These annual sales increases reflect the Company's strategy of increasing unit volume and market share through the introduction of succeeding generations of products having lower selling prices and increased functionality as compared both to the prior generation of a product and to the products of competitors. An important part of the Company's strategy is to engineer the reduction of the product cost of each succeeding product generation and then to lower the product's price based on the cost savings achieved. As a part of this strategy, the Company seeks in most instances to be a low-cost, high-quality provider of products in its markets. The Company's success to-date is attributable in large measure to its ability to initially design its products with a view to their subsequent re-design, allowing efficient enhancements of the product in each succeeding product generation. This strategy has enabled the Company to sell succeeding generations of products to existing customers as well as to increase its market share by selling these enhanced products to new customers.

While the Company has experienced increased sales in each year, the Company's operating results have fluctuated on a quarterly basis in the past, and operating results may vary significantly in future periods due to a number of factors. The Company operates with very little order backlog. A substantial majority of its sales in each quarter results from orders booked in that quarter and firm purchase orders released in that quarter by customers under agreements containing non-binding purchase commitments. Furthermore, most Telcos typically require prompt delivery of products. This results in a limited backlog of orders for these products and requires the Company to maintain sufficient inventory levels to satisfy anticipated customer demand. If near term demand for the Company's products declines or if significant potential sales in any quarter do not occur as anticipated, the Company's financial results will be adversely affected. Operating expenses are relatively fixed in the short term; therefore, a shortfall in quarterly revenues could impact the Company's financial results significantly in a given quarter. Further, maintaining sufficient inventory levels to assure prompt delivery of the Company's products increases the amount of inventory which may become obsolete and increases the risk that the obsolescence of such inventory may have an adverse effect on the Company's business and operating results. The Company's operating results may also fluctuate as a result of a number of other factors, including increased competition, customer order patterns, changes in product mix, product warranty returns and announcements of new products by the Company or its competitors. Accordingly, the Company's historical financial performance is not necessarily a meaningful indicator of future results, and, in general, management expects that the Company's financial results may vary from period to period. See Note 14 of Notes to Financial Statements.

The Company intends to retain all earnings for use in the development of its business and does not anticipate paying any cash dividends in the foreseeable future.

*This 1998 Annual Report contains "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which represent the Company's expectations or beliefs, including, but not limited to, statements concerning (i) the business and financial outlook of the Company, (ii) the Company's business, financial condition or results of operations and (iii) the Company's business strategy. When used in this 1998 Annual Report, the words "believe," "anticipate," "think," "intend," "will be," and similar expressions identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. Readers are also urged to carefully review and consider the various disclosures, including, but not limited to, the disclosures described under the captions "Management's Discussion and Analysis of Financial Condition and Results of Operation," "1998 Compared to 1997," "Liquidity and Capital Resources," and "Year 2000 Readiness Disclosure," and those discussed in the Company's filings with the Securities and Exchange Commission, as well as the general economic conditions and industry trends which could cause actual results or outcomes to differ materially from those expressed in any forward-looking statement of the Company.*

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## Results of Operations

The following table presents selected financial information derived from the Company's statements of income expressed as a percentage of sales for the years indicated.

*Years Ended December 31,*

| PERCENTAGE OF SALES                             | 1998         | 1997         | 1996         |
|---|--------------|--------------|--------------|
| <b>Sales</b>                                    |              |              |              |
| Telco   | 58.5%        | 64.8%        | 68.7%        |
| CPE   | 41.5         | 35.2         | 31.3         |
| <b>Total sales</b>                              | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> |
| Cost of sales                                   | 45.4         | 49.1         | 51.9         |
| <b>Gross profit</b>                             | <b>54.6</b>  | <b>50.9</b>  | <b>48.1</b>  |
| Selling, general and administrative expenses    | 21.7         | 17.0         | 13.7         |
| Research and development expenses               | 13.0         | 11.3         | 9.9          |
| <b>Operating income</b>                         | <b>19.9</b>  | <b>22.6</b>  | <b>24.5</b>  |
| Interest income                                 | 2.0          | 1.6          | 1.0          |
| Interest expense                                | (0.8)        | (0.7)        | (0.4)        |
| Other income (expense)                          | 0.1          | 0.2          | 0.3          |
| <b>Income before provision for income taxes</b> | <b>21.2</b>  | <b>23.7</b>  | <b>25.4</b>  |
| Provision for income taxes                      | 7.1          | 8.5          | 9.5          |
| <b>Net income</b>                               | <b>14.1%</b> | <b>15.2%</b> | <b>15.9%</b> |

# 1998 Compared to 1997

## SALES

The Company's sales increased 8% from \$265,334,768 in 1997 to \$286,558,950 in 1998. The increased sales resulted from increased sales volume to existing customers and from increased market penetration. Sales to Telcos decreased slightly from \$171,837,883 in 1997 to \$167,499,919 in 1998. Telco sales as a percentage of total sales decreased from 64.8% in 1997 to 58.5% in 1998. Sales of CPE products increased 27.3% from \$93,496,885 in 1997 to \$119,059,030 in 1998. As a percentage of total sales, CPE sales increased from 35.2% in 1997 to 41.5% in 1998. The increase in sales of CPE products is attributable to increased demand for T1 Service Unit (TSU) products and Digital Data Service (DDS) products.

## COST OF SALES

Cost of sales decreased slightly from \$130,253,531 in 1997 to \$130,009,879 in 1998, primarily as a result of the reduction in component cost. As a percentage of sales, cost of sales decreased from 49.1% in 1997 to 45.4% in 1998. This decrease was due primarily to reduction in component cost and product design enhancements. Telco cost of sales decreased from \$87,269,866 in 1997 to \$75,925,769 in 1998. Telco cost of sales as a percentage of Telco sales decreased from 50.8% in 1997 to 45.3% in 1998. CPE cost of sales increased from \$42,983,665 in 1997 to \$54,084,110 in 1998. As a percentage of CPE sales, CPE cost of sales decreased from 46.0% in 1997 to 45.4% in 1998. An important part of the Company's strategy is to reduce the product cost of each succeeding product generation and then to lower the product's price based on the cost savings achieved. This strategy sometimes results in variations in the Company's gross profit margin due to timing differences between the lowering of product selling prices and the full recognition of cost reductions. In view of the rapid pace of new product introductions by the Company, this strategy may result in variations in gross profit margins that, for any particular financial period, can be difficult to predict.

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## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses increased 38.0% from \$44,973,175 in 1997 to \$62,060,907 in 1998. The increase was due to additional sales and support expenditures necessary as a result of the Company's expanded sales base and increased dollar amounts of these expenses associated with the ongoing introduction and marketing of enhanced products, increased distribution activities associated with the CPE market, and general expansion into international markets. As a percentage of sales, selling, general and administrative expenses increased from 17.0% in 1997 to 21.7% in 1998.

## RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses increased 23.8% from \$30,055,091 in 1997 to \$37,221,780 in 1998. This increase was due to increased engineering costs associated with new product introductions and feature enhancement activities. As a percentage of sales, research and development expenses increased from 11.3% in 1997 to 13.0% in 1998. The Company continually evaluates new product opportunities and engages in intensive research and product development efforts. To date, the Company has expensed all product research and development costs as incurred. Additionally, the Company frequently invests heavily in up-front market development efforts prior to the actual commencement of sales of a major new product. As a result, the Company may incur significant research and development expenses and selling, general and administrative expenses prior to the receipt of revenues from a major new product group. The Company is presently incurring both research and development expenses and selling, general and administrative expenses in connection with its new products and its expansion into international markets.

## INTEREST EXPENSE

Interest expense increased 24.4% from \$1,838,814 in 1997 to \$2,286,821 in 1998. The Company currently pays interest on \$50,000,000 of revenue bond proceeds of which \$20,000,000 was loaned to the Company in January 1995, and \$30,000,000 was loaned to the Company in April 1997. The proceeds were used to expand the Company's facilities in Huntsville, Alabama. The increase in interest expense in 1998 was due primarily to a full year's interest being incurred in 1998 on the additional \$30,000,000 borrowed in April 1997 versus only a partial year in 1997. See also "Liquidity and Capital Resources."

## NET INCOME

As a result of the above factors, net income increased slightly from \$40,209,272 in 1997 to \$40,309,650 in 1998. As a percentage of sales, net income decreased from 15.2% in 1997 to 14.1% in 1998.

# 1997 Compared to 1996

## SALES

The Company's sales increased 6.1% from \$250,120,836 in 1996 to \$265,334,768 in 1997. The increased sales resulted from increased sales volume to existing customers and from increased market penetration. Sales to Telcos remained basically unchanged from \$171,901,851 in 1996 to \$171,837,883 in 1997. Telco sales as a percentage of total sales decreased from 68.7% in 1996 to 64.8% in 1997. Sales of CPE products increased 19.5% from \$78,218,985 in 1996 to \$93,496,885 in 1997. The increase in sales of CPE products is attributable to increased demand for T1 Service Unit (TSU) products and Integrated Services Digital Network (ISDN) products.

## COST OF SALES

Cost of sales increased 0.2% from \$129,953,371 in 1996 to \$130,253,531 in 1997, primarily as a result of the increase in sales. As a percentage of sales, cost of sales decreased from 51.9% in 1996 to 49.1% in 1997. This decrease was primarily attributable to manufacturing efficiencies and product design enhancements. Telco cost of sales decreased from \$89,277,966 in 1996 to \$87,269,866 in 1997. As a percentage of Telco sales, Telco cost of sales decreased from 51.9% in 1996 to 50.8% in 1997. CPE cost of sales increased from \$40,675,405 in 1996 to \$42,983,665 in 1997. As a percentage of CPE sales, CPE cost of sales decreased from 52.0% in 1996 to 46.0% in 1997. An important part of the Company's strategy is to reduce the product cost of each succeeding product generation and then to lower the product's price based on the cost savings achieved. This sometimes results in variations in the Company's gross profit margin due to timing differences between the lowering of product selling prices and the full recognition of cost reductions. In view of the rapid pace of new product introductions by the Company, this strategy may result in variations in gross profit margins that, for any particular financial period, can be difficult to predict.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses increased 31.1% from \$34,308,436 in 1996 to \$44,973,175 in 1997 due to additional sales and support expenditures necessary as a result of the Company's expanded sales base and increased dollar amounts of these expenses associated with the ongoing introduction and marketing of enhanced products, increased distribution activities associated with the CPE market, and general expansion into international markets. As a percentage of sales, selling, general and administrative expenses increased from 13.7% in 1996 to 17.0% in 1997.

## RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses increased 21.9% from \$24,647,425 in 1996 to \$30,055,091 in 1997. This increase was due to increased engineering costs associated with new product introductions and feature enhancement activities. As a percentage of sales, research and development expenses increased from 9.9% in 1996 to 11.3% in 1997. The Company continually evaluates new product opportunities and engages in intensive research and product development efforts. To date, the Company has expensed all product research and development costs as incurred. Additionally, the Company also frequently invests heavily in up-front market development efforts prior to the actual commencement of sales of a major new product. As a result, the Company may incur significant research and development expenses and selling, general and administrative expenses prior to the receipt of revenues from a major new product group. The Company is presently incurring both research and development expenses and selling, general and administrative expenses in connection with its new products and its expansion into international markets.

## INTEREST EXPENSE

Interest expense increased 105.5% from \$894,657 in 1996 to \$1,838,814 in 1997. This increase was due to increased borrowings during 1997. The Company currently pays interest on \$50,000,000 of revenue bond proceeds of which \$20,000,000 was loaned to the Company in January 1995, and \$30,000,000 was loaned to the Company in April 1997. The proceeds were used to expand the Company's facilities in Huntsville, Alabama. See also "Liquidity and Capital Resources."

## NET INCOME

As a result of the above factors, net income increased 1.0% from \$39,819,904 in 1996 to \$40,209,272 in 1997. As a percentage of sales, net income decreased from 15.9% in 1996 to 15.2% in 1997.

## Liquidity and Capital Resources

The Company is continuing a project to expand its facilities in Huntsville, Alabama in phases over the next three years at a cost expected to exceed \$150,000,000, of which \$56,585,000 had been incurred at December 31, 1998. Fifty million dollars of this project was approved for participation in an incentive program offered by the Alabama State Industrial Development Authority (the "Authority"). That incentive program enables participating companies such as the Company to generate Alabama corporate income tax credits that can be used to reduce the amount of Alabama corporate income taxes that would otherwise be payable. There can be no assurance that the State of Alabama will continue to make these corporate income tax credits available in the future, and the Company therefore may not realize the full benefit of these incentives. Through December 31, 1998, the Authority has issued \$50,000,000 of its taxable revenue bond pursuant to such program and loaned the proceeds from the sale of the bond to the Company. The Company is required to make payments to the Authority in amounts necessary to pay the principal of and interest on the Authority's Taxable Revenue Bond, Series 1995 (ADTRAN, Inc. Project), as amended, currently outstanding in the aggregate principal amount of \$50,000,000. Said bond matures on January 1, 2020, and bears interest at the rate of 45 basis points over the money market rate of First Union National Bank.

The Company's working capital position improved from \$149,183,578 as of December 31, 1997 to \$150,534,759 as of December 31, 1998. This improvement in the Company's working capital position was due primarily to steady earnings. The Company has used, and expects to continue to use the cash generated from operations for working capital and other general corporate purposes, including (i) product development activities to enhance its existing products and develop new products and (ii) expansion of sales and marketing activities. Inventory increased 66.9% for the fiscal year ended December 31, 1998. This increase occurred during the last six months of the period due to new business relating to Total Reach® technology and new HDSL orders anticipated from a contract awarded to the Company in October 1998. Sales were weaker than anticipated in the fourth quarter of 1998 and did not allow the Company to move the amount of inventory that was planned.

On March 31, 1997, the Board of Directors authorized the Company to re-purchase up to 1,000,000 shares of the Company's outstanding common stock. In October 1998, the Board approved the re-purchase of an additional 2,000,000 shares. As of December 31, 1998, the Company had re-purchased 1,100,081 shares of its common stock at a total cost of \$23,216,047.

Capital expenditures totaling \$23,095,854, \$18,220,850 and \$29,661,438 in 1998, 1997 and 1996, respectively, were used to expand the Company's headquarters and to purchase equipment.

At December 31, 1998, the Company's cash on hand of \$10,009,320, short-term investments of \$40,795,068 and \$10,000,000 available under a bank line of credit placed the Company's potential cash availability at \$60,804,388. The Company's \$10,000,000 bank line of credit bears interest at the rate of 87.5 basis points over the 30 day London inter-bank offered rate and expires on May 1, 1999. The Company anticipates renewing the \$10,000,000 bank line of credit upon its expiration. The Company intends to finance its operations in the future with cash flow from operations, amounts available under the bank line of credit, borrowed revenue bond proceeds and possible additional public financings. These available sources of funds are expected to be adequate to meet the Company's operating and capital needs for the foreseeable future.

## Year 2000 Readiness Disclosure

The Company conducted a year 2000 program to assess and mitigate the impact of the year 2000 issue. The Company believes that all critical information technology and non-information technology hardware and software systems are year 2000 compliant, including, but not limited to, business systems, network infrastructure, manufacturing equipment, engineering tools, customer products and plant facilities.

The Company has completed the inventory and assessment phases of its year 2000 program. The Company's operations are not dependent upon older legacy source code or mainframe computers as is often the case with systems with significant year 2000 issues. Therefore, there is little or no date-related code remediation or conversion necessary to maintain normal business activities. The primary remaining effort in the year 2000 program is to review and validate the conclusions reached by the Company's year 2000 assessment. The Company does not believe that costs associated with bringing the Company's computer systems into full compliance with the year 2000 issue will result in a material expense to the Company.

In July of 1998, the Company completed the implementation of new business software and hardware which has been determined to be year 2000 compliant. The Company is currently upgrading some secondary systems which have been identified with minor year 2000 issues. Likewise, testing and year 2000 simulations will be performed on Company systems to verify date processing capabilities. Expected completion of year 2000 simulations and testing is March 1999.

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The Company has also contacted and assessed its suppliers and subcontractors regarding the year 2000 issue and concluded that those suppliers and subcontractors which have a material relationship with the Company are not expected to cause significant business interruptions to occur as a result of the year 2000 issue. The Company's assessment of suppliers has identified those most critical to the Company's operations and a contingency plan has been drafted to handle issues in the future. The Company's primary external subcontractors are conducting their own independent internal year 2000 programs and are being assisted by the Company with their year 2000 preparations where appropriate.

The Company believes that its products are year 2000 compliant. Company engineers have confirmed product design specifications and have verified product date processing functionality. Customers are provided individual responses to product inquiries and the Company has posted detailed year 2000 information on its web site. The Company does not believe that it will have any material exposure to contingencies related to the year 2000 issue for products it has sold.

Based on information presently available, the Company does not anticipate any material impact on its financial condition or results of operations from the effect of the year 2000 issue on its internal systems or on those systems of its major suppliers and customers. However, there can be no guarantee that the systems of other companies on which the Company relies will be timely converted, or that a failure to convert by another company would not have a material adverse impact on the Company. Furthermore, despite the Company's assessments, there can be no guarantee that there will not be a year 2000 problem arising from the Company's own system that may have a material adverse impact on the Company.

As of December 31, 1998, the Company had spent approximately \$100,000 for year 2000 compliance. The Company expects to spend approximately \$60,000 in 1999. The Company does not separately track these internal costs incurred for the Y2K project. These costs, however, consist principally of the related payroll costs of its information systems group.

## Management's Responsibility for Financial Reporting

The accompanying financial statements and related notes of ADTRAN, Inc. were prepared by management, which has the primary responsibility for the integrity of the financial information therein. The statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances and include amounts which necessarily are based on management's judgment. Financial information presented elsewhere in this report is consistent with that in the financial statements.

Management maintains a comprehensive system of internal accounting controls and relies on the system to discharge its responsibility for the integrity of the financial statements. This system provides reasonable assurance that corporate assets are safeguarded, and that transactions are recorded in such a manner as to permit the preparation of reliable financial information. Reasonable assurance recognizes that the cost of a system of internal accounting controls should not exceed the related benefits. This system of internal accounting controls is augmented by written policies and procedures and the careful selection and training of qualified personnel. As of December 31, 1998, management was aware of no material weaknesses in the ADTRAN system of internal accounting controls.

The financial statements have been audited by the Company's independent certified public accountants, whose opinion is expressed on the following page. Their audit was conducted in accordance with generally accepted auditing standards, and as such, they obtained an understanding of the Company's systems of internal accounting controls and conducted such tests and related procedures as they deemed necessary to arrive at an opinion on the fairness of presentation of the financial statements.



Mark C. Smith  
Chairman and CEO



John R. Cooper  
Vice President and CFO

# Report of Independent Accountants

## TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF ADTRAN, INC.

In our opinion, the accompanying balance sheets and the related statements of income, changes in stockholders' equity and cash flows present fairly, in all material respects, the financial position of ADTRAN, Inc. (the Company) at December 31, 1998 and 1997 and the results of its operations and cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

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*PricewaterhouseCoopers LLP*

Birmingham, Alabama  
January 14, 1999

# Balance Sheets

December 31, 1998 and 1997

|   | <b>1998</b>          | <b>1997</b>          |
|---|----------------------|----------------------|
| <b>ASSETS</b>   |                      |                      |
| Current Assets:   |                      |                      |
| Cash and cash equivalents   | \$10,009,320         | \$ 45,340,961        |
| Short-term investments  | 40,795,068           | 37,833,240           |
| Accounts receivable, less allowance for doubtful accounts<br>of \$958,805 and \$893,389 in 1998 and 1997, respectively                | 46,588,319           | 40,906,887           |
| Other receivables   | 697,074              | 343,463              |
| Inventory   | 65,700,576           | 39,369,103           |
| Prepaid expenses  | 1,354,366            | 1,148,288            |
| Deferred income taxes   | 2,416,685            | 2,458,136            |
| <b>Total current assets</b>   | <b>167,561,408</b>   | <b>167,400,078</b>   |
| Property, plant and equipment, net  | 78,894,317           | 64,801,132           |
| Other assets  | 220,000              | 200,000              |
| Long-term investments   | 55,035,000           | 50,000,000           |
| <b>Total assets</b>   | <b>\$301,710,725</b> | <b>\$282,401,210</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                      |                      |
| Current liabilities:  |                      |                      |
| Accounts payable  | \$ 10,980,097        | \$9,121,270          |
| Accrued salaries  | 1,828,462            | 1,927,364            |
| Accrued income taxes  | 1,060,795            | 4,579,345            |
| Accrued taxes other than income taxes   | 252,548              | 180,611              |
| Warranty liability  | 1,519,945            | 1,435,259            |
| Compensated absences  | 1,384,802            | 972,651              |
| <b>Total current liabilities</b>  | <b>17,026,649</b>    | <b>18,216,500</b>    |
| Bonds payable   | 50,000,000           | 50,000,000           |
| Deferred income taxes   | 3,295,140            | 2,147,635            |
| <b>Total liabilities</b>  | <b>70,321,789</b>    | <b>70,364,135</b>    |
| Stockholders' equity:   |                      |                      |
| Common stock, par value \$.01 per share; 200,000,000<br>shares authorized; 39,423,479 shares issued in 1998<br>and 39,381,264 in 1997 | 394,235              | 393,813              |
| Additional paid-in capital  | 90,640,451           | 90,582,615           |
| Retained earnings   | 163,570,297          | 123,260,647          |
|   | 254,604,983          | 214,237,075          |
| Less treasury stock at cost: 1,100,081 and<br>100,000 shares in 1998 and 1997, respectively   | (23,216,047)         | (2,200,000)          |
| <b>Total stockholders' equity</b>   | <b>231,388,936</b>   | <b>212,037,075</b>   |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$301,710,725</b> | <b>\$282,401,210</b> |

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

# Statements of Income

for the years ended December 31, 1998, 1997 and 1996

|   | 1998                | 1997                | 1996                |
|---|---------------------|---------------------|---------------------|
| Sales   | \$286,558,950       | \$265,334,768       | \$250,120,836       |
| Cost of sales   | 130,009,879         | 130,253,531         | 129,953,371         |
| <b>Gross profit</b>                                       | <b>156,549,071</b>  | <b>135,081,237</b>  | <b>120,167,465</b>  |
| Selling, general and administrative expenses              | 62,060,907          | 44,973,175          | 34,308,436          |
| Research and development expenses                         | 37,221,780          | 30,055,091          | 24,647,425          |
| <b>Income from operations</b>                             | <b>57,266,384</b>   | <b>60,052,971</b>   | <b>61,211,604</b>   |
| Other income (expenses):                                  |                     |                     |                     |
| Interest income   | 5,824,223           | 4,175,032           | 2,542,417           |
| Interest expense  | (2,286,821)         | (1,838,814)         | (894,657)           |
| Other   | (188,530)           | 437,639             | 642,432             |
|   | <b>3,348,872</b>    | <b>2,773,857</b>    | <b>2,290,192</b>    |
| Income before income taxes                                | 60,615,256          | 62,826,828          | 63,501,796          |
| Provision for income taxes                                | 20,305,606          | 22,617,556          | 23,681,892          |
| <b>Net income</b>   | <b>\$40,309,650</b> | <b>\$40,209,272</b> | <b>\$39,819,904</b> |
| Weighted average shares outstanding assuming dilution (1) | 39,163,763          | 39,565,497          | 39,548,654          |
| Earnings per common share - assuming dilution (1)         | \$1.03              | \$1.02              | \$1.01              |
| Earnings per common share - basic                         | \$1.03              | \$1.03              | \$1.03              |

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

(1) Assumes exercise of dilutive stock options calculated under the treasury stock method.

# Statements of Changes in Stockholders' Equity

for the years ended December 31, 1998, 1997 and 1996

| Common Stock  |                   |   |                            |                      |                       |                            |
|---|-------------------|---|----------------------------|----------------------|-----------------------|----------------------------|
|   | Number Of Shares  | Par Value (\$. <sup>01</sup> Per Share) | Additional Paid-In Capital | Retained Earnings    | Treasury Stock        | Total Stockholders' Equity |
| <b>Balance, December 31, 1995</b>                               | <b>37,462,275</b> | <b>\$374,623</b>                        | <b>\$89,404,177</b>        | <b>\$40,964,511</b>  | <b>\$0</b>            | <b>\$130,743,311</b>       |
| Stock options exercised:  |                   |   |                            |                      |                       |                            |
| Various prices per share  | 1,307,239         | 13,072                                  | 768,686                    |                      |                       | 781,758                    |
| Income tax benefit from exercise of non-qualified stock options |                   |   |                            | 1,533,926            |                       | 1,533,926                  |
| Net income  |                   |   |                            | 39,819,904           |                       | 39,819,904                 |
| <b>Balance, December 31, 1996</b>                               | <b>38,769,514</b> | <b>387,695</b>                          | <b>90,172,863</b>          | <b>82,318,341</b>    | <b>0</b>              | <b>172,878,899</b>         |
| Stock options exercised:  |                   |   |                            |                      |                       |                            |
| Various prices per share  | 611,750           | 6,118                                   | 409,752                    |                      |                       | 415,870                    |
| Purchase of treasury stock:                                     |                   |   |                            |                      |                       |                            |
| 100,000 shares  |                   |   |                            |                      | (2,200,000)           | (2,200,000)                |
| Income tax benefit from exercise of non-qualified stock options |                   |   |                            | 733,034              |                       | 733,034                    |
| Net Income  |                   |   |                            | 40,209,272           |                       | 40,209,272                 |
| <b>Balance, December 31, 1997</b>                               | <b>39,381,264</b> | <b>393,813</b>                          | <b>90,582,615</b>          | <b>123,260,647</b>   | <b>(2,200,000)</b>    | <b>212,037,075</b>         |
| Stock options exercised:  |                   |   |                            |                      |                       |                            |
| Various prices per share  | 42,215            | 422                                     | 57,836                     |                      |                       | 58,258                     |
| Purchase of treasury stock:                                     |                   |   |                            |                      |                       |                            |
| 1,000,081 shares  |                   |   |                            |                      | (21,016,047)          | (21,016,047)               |
| Net Income  |                   |   |                            | 40,309,650           |                       | 40,309,650                 |
| <b>Balance, December 31, 1998</b>                               | <b>39,423,479</b> | <b>\$394,235</b>                        | <b>\$90,640,451</b>        | <b>\$163,570,297</b> | <b>(\$23,216,047)</b> | <b>\$231,388,936</b>       |

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

# Statements of Cash Flows

for the years ended December 31, 1998, 1997 and 1996

|   | 1998                | 1997                | 1996                |
|---|---------------------|---------------------|---------------------|
| <b>Cash flows from operating activities:</b>  |                     |                     |                     |
| Net income  | \$40,309,650        | \$40,209,272        | \$39,819,904        |
| Adjustments to reconcile net income to net cash provided by operating activities:   |                     |                     |                     |
| Depreciation  | 9,002,669           | 7,342,518           | 4,890,303           |
| Provision for warranty claims   | 1,506,432           | 1,435,259           | 2,110,614           |
| Gain (loss) on sale of property, plant, and equipment   |                     | (9,884)             | 40,572              |
| Gain (loss) on sale of short-term investments classified as available-for-sale  | 24,367              | (6,063)             | 405,789             |
| Deferred income taxes   | 1,188,956           | (313,867)           | 104,561             |
| Change in operating assets:   |                     |                     |                     |
| Accounts receivable   | (5,681,432)         | (7,081,327)         | (4,590,757)         |
| Inventory   | (26,331,473)        | 1,423,543           | 4,204,549           |
| Other assets  | (579,689)           | 932,165             | (1,083,019)         |
| Change in operating liabilities:  |                     |                     |                     |
| Accounts payable  | 1,858,827           | (228,996)           | (390,321)           |
| Other liabilities   | (4,555,110)         | 1,284,106           | (50,491)            |
| <b>Net cash provided by operating activities</b>  | <b>16,743,197</b>   | <b>44,986,726</b>   | <b>45,461,704</b>   |
| <b>Cash flows from investing activities:</b>  |                     |                     |                     |
| Expenditures for property, plant and equipment  | (23,095,854)        | (18,220,850)        | (29,661,438)        |
| Proceeds from the disposition of property, plant, and equipment   |                     | 58,297              | 4,602               |
| Purchase of long-term investments   | (5,035,000)         | (50,000,000)        |                     |
| Purchase of short-term investments classified as available-for-sale   | (2,986,195)         | (5,271,247)         | (8,309,030)         |
| <b>Net cash used in investing activities</b>  | <b>(31,117,049)</b> | <b>(73,433,800)</b> | <b>(37,965,866)</b> |
| <b>Cash flows from financing activities:</b>  |                     |                     |                     |
| Redemption of bonds payable   |                     | (20,000,000)        |                     |
| Proceeds from bond issuance   |                     | 50,000,000          |                     |
| Proceeds from issuance of common stock  | 58,258              | 415,870             | 781,758             |
| Income tax benefit from exercise of non-qualified stock options   |                     | 733,034             | 1,533,926           |
| Purchase of treasury stock  | (21,016,047)        | (2,200,000)         |                     |
| <b>Net cash (used in) provided by financing activities</b>  | <b>(20,957,789)</b> | <b>28,948,904</b>   | <b>2,315,684</b>    |
| Net (decrease) increase in cash and cash equivalents  | (35,331,641)        | 501,830             | 9,811,522           |
| Cash and cash equivalents, beginning of year  | 45,340,961          | 44,839,131          | 35,027,609          |
| <b>Cash and cash equivalents, end of year</b>   | <b>\$10,009,320</b> | <b>\$45,340,961</b> | <b>\$44,839,131</b> |
| <b>Supplemental disclosure of cash flow information:</b>  |                     |                     |                     |
| Cash paid during the year for interest, net of capitalized interest of \$35,172, \$204,153 and \$393,096 in 1998, 1997 and 1996, respectively | \$2,276,495         | \$1,844,741         | \$909,368           |
| Cash paid during the year for income taxes  | \$23,964,517        | \$20,042,644        | \$22,151,925        |

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

# Notes to Financial Statements

## 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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ADTRAN, Inc. (the "Company") designs, develops, manufactures, markets, and services a broad range of high-speed digital transmission products utilized by telephone companies ("Telcos") and corporate end-users to implement advanced digital data services over existing telephone networks. The Company also customizes many of its products for private label distribution and for original equipment manufacturers to incorporate into their own products. Most of the Company's Telco and customer premises equipment (CPE) products are connected to the local loop, which is the large existing infrastructure of the telephone network, predominantly consisting of copper wireline, which connects end-users to a Telco's Central Office. The Central Office is the Telco facility that provides local switching and distribution functions. The balance of the Company's products are used in the Telcos' Central Offices.

### **CASH AND CASH EQUIVALENTS:**

Cash and cash equivalents represent demand deposits, money market accounts, and short-term investments classified as held-to-maturity (see Note 2) with original maturities of three months or less.

### **FINANCIAL INSTRUMENTS:**

The carrying amount reported in the balance sheets for cash and cash equivalents, accounts receivable, and accounts payable approximates fair value because of the immediate or short-term maturity of these financial instruments. The carrying amount reported for the bonds payable approximates fair value because the underlying instruments are at variable rates that re-price frequently.

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Short-term investments represent re-marketed preferred stocks and municipal bonds classified as available-for-sale securities. Re-marketed preferred stocks are designed to be marketed as money market instruments. These instruments' interest rates reset on a short-term basis to maintain the price of the instruments at par. These instruments may be redeemed on the date the interest rate resets. The fair value of short-term investments is estimated based on quoted market prices (see Note 2). Realized gains or losses are computed under the specific identification method.

### **INVENTORY:**

Inventory is carried at the lower of cost or market, with cost being determined using the first-in, first-out method.

### **PROPERTY, PLANT, AND EQUIPMENT:**

Property, plant, and equipment, which is stated at cost, is depreciated using methods which approximate straight-line depreciation over the estimated useful lives of the assets. Expenditures for repairs and maintenance are charged to expense as incurred; betterments which materially prolong the lives of the assets are capitalized. The cost of assets retired or otherwise disposed of and the related accumulated depreciation are removed from the accounts and the gain or loss on such disposition is included in income.

### **LONG-LIVED ASSETS:**

The Company recognizes impairment losses on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying values. There were no such losses recognized during 1998, 1997, and 1996.

### **RESEARCH AND DEVELOPMENT COSTS:**

Research and development costs are expensed as incurred.

### **USE OF ESTIMATES:**

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

### **INCOME TAXES:**

The Company utilizes the asset and liability method of accounting for income taxes which requires the establishment of deferred tax liabilities and assets, as measured by enacted tax rates, for all temporary differences caused when the tax bases of assets and liabilities differ from those reported in the financial statements.

## **EARNINGS PER SHARE:**

Earnings per common share and earnings per common share - assuming dilution are based on the weighted average number of common and, when dilutive, common equivalent shares outstanding during the year (see Note 13).

## **RECENTLY ISSUED ACCOUNTING STANDARDS:**

In 1998, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information*, that requires the use of the management approach in identifying operating segments of the Company. Under the management approach, operating segments of an enterprise are identified in a manner consistent with how the Company makes operating decisions and assesses performance. SFAS No. 131 also requires disclosures about products and services, geographic areas, and major customers. The adoption of SFAS No. 131 did not affect results of operations or financial position but did affect the disclosure of segment information (see Note 11).

In June 1997, the Financial Accounting Standards Board (FASB) issued SFAS No. 130, *Reporting Comprehensive Income*, which requires the reporting and display of comprehensive income and its components in an entity's financial statements. The Company adopted SFAS 130 during 1998 and for the three years ending December 31, 1998, 1997 and 1996, there were no differences between net income and comprehensive income.

In June 1998, the FASB issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 133 requires all derivatives to be measured at fair value and recognized as either assets or liabilities on the balance sheet. Changes in such fair value are required to be recognized immediately in net income (loss) to the extent the derivatives are not effective as hedges. SFAS No. 133 is effective for fiscal years beginning after June 15, 1999 and is effective for interim periods in the initial year of adoption. The Company does not currently hold any derivative financial instruments.

## **2 INVESTMENTS**

At December 31, 1998 and 1997, the Company held the following securities as available-for-sale or held-to-maturity recorded at amortized cost which approximates fair value:

|  |  | <b>1998</b>         |
|--|--|---------------------|
| <b>Short-term investments, available-for-sale:</b> |  |                     |
| Municipal bonds:                                   |  | \$34,553,013        |
| Re-marketed preferred stocks:                      |  |                     |
| GE Capital preferred asset corporation A series A  |  | 5,000,000           |
| Other:   |  |                     |
| Commercial paper, US Government securities and     |  |                     |
| preferred stock                                    |  | 1,242,055           |
| <b>Total short-term investments 1998</b>           |  | <b>\$40,795,068</b> |
| <br><b>Long-term investments:</b>                  |  |                     |
| Restricted money market funds (see Note 6)         |  | \$50,000,000        |
| Other equity investments                           |  | 5,035,000           |
| <b>Total long-term investments 1998</b>            |  | <b>\$55,035,000</b> |

**Short-term investments, available-for-sale:**

|   |                     |
|---|---------------------|
| Municipal bonds                                   | \$10,333,240        |
| Re-marketed preferred stocks:                     |                     |
| GE Capital preferred asset corporation A series A | 5,000,000           |
| Muniyield Fund Auction market preferred series A  | 5,000,000           |
| VKM Investment Grade Municipal Trust preferred    | 5,000,000           |
| Nuveen Premium Income Fund preferred series M     | 2,500,000           |
| Duff & Phelps RP series C                         | 5,000,000           |
| Van Kampen Merritt Municipal Income               | 5,000,000           |
| <b>Total short-term investments 1997</b>          | <b>\$37,833,240</b> |

**Long-term investments:**

|  |                     |
|--|---------------------|
| Restricted money market funds (see Note 6) | \$50,000,000        |
| <b>Total long-term investments 1997</b>    | <b>\$50,000,000</b> |

**3 INVENTORY**

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At December 31, 1998 and 1997 inventory consisted of the following:

|                 | <b>1998</b>         | <b>1997</b>         |
|-----------------|---------------------|---------------------|
| Raw materials   | \$39,787,631        | \$24,199,720        |
| Work in process | 7,935,771           | 2,565,179           |
| Finished goods  | 17,977,174          | 12,604,204          |
|                 | <b>\$65,700,576</b> | <b>\$39,369,103</b> |

**4 PROPERTY, PLANT, AND EQUIPMENT**

Property, plant, and equipment was comprised of the following at December 31, 1998 and 1997:

|                                     | <b>1998</b>         | <b>1997</b>         |
|-------------------------------------|---------------------|---------------------|
| Land                                | \$ 4,263,104        | \$ 4,263,104        |
| Building                            | 28,684,088          | 28,673,642          |
| Construction in progress            | 12,119,342          | 3,081,702           |
| Land improvements                   | 9,499,352           | 7,963,770           |
| Office machinery and equipment      | 22,683,087          | 17,184,334          |
| Engineering machinery and equipment | 31,548,285          | 24,534,852          |
|                                     | <b>108,797,258</b>  | <b>85,701,404</b>   |
| Less accumulated depreciation       | (29,902,941)        | (20,900,272)        |
|                                     | <b>\$78,894,317</b> | <b>\$64,801,132</b> |

## 5 LINE OF CREDIT

The Company has a \$10,000,000 line of credit at a bank, which bears interest at the rate of 87.5 basis points over the 30 day London inter-bank offered rate. At December 31, 1998 and 1997, the Company had no borrowings outstanding under this line. The line of credit expires on May 1, 1999.

## 6 ALABAMA STATE INDUSTRIAL DEVELOPMENT AUTHORITY FINANCING

In conjunction with an expansion of its Huntsville, Alabama facility, the Company was approved for participation in an incentive program offered by the State of Alabama Industrial Development Authority (the "Authority"). Pursuant to such program, on January 13, 1995, the Authority issued \$20,000,000 of its taxable revenue bonds pursuant to such program and loaned the proceeds from the sale of the bonds to the Company. The bonds were originally purchased by AmSouth Bank of Alabama, Birmingham, Alabama (the "Bank"). First Union National Bank of Tennessee, Nashville, Tennessee (the "Bondholder") purchased the original bond from the Bank and made further advances to the Authority bringing the total amount outstanding to \$50,000,000. An Amended and Restated Taxable Revenue Bond (ADTRAN, Inc. Project) Series 1995, was issued and the original financing agreement was amended. The Amended and Restated Bond bears interest, payable monthly, at the rate of 45 basis points over the money market rate of the Bondholder and will mature on January 1, 2020. The Company is required to make payments to the Authority in amounts necessary to pay the principal of and interest on the Amended and Restated Bond. Included in long-term investments are \$50,000,000 which is restricted for payment of the principal amount of this bond. Construction on the project began in March 1995 and certain phases were completed by December 31, 1998.

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## 7 INCOME TAXES

A summary of the components of the provision (benefit) for income taxes as of December 31 is as follows:

|   | 1998                | 1997                | 1996                |
|---|---------------------|---------------------|---------------------|
| Current:                                |                     |                     |                     |
| Federal                                 | \$17,551,986        | \$21,251,520        | \$21,329,522        |
| State                                   | 1,564,664           | 1,679,903           | 2,247,809           |
| <b>Total Current</b>                    | <b>19,116,650</b>   | <b>22,931,423</b>   | <b>23,577,331</b>   |
| Deferred tax provision (benefit)        | 1,188,956           | (313,867)           | 104,561             |
| <b>Total provision for income taxes</b> | <b>\$20,305,606</b> | <b>\$22,617,556</b> | <b>\$23,681,892</b> |

The provision for income taxes differs from the amounts computed by applying the federal statutory rate due to the following:

|  | 1998                | 1997                | 1996                |
|--|---------------------|---------------------|---------------------|
| Tax provision computed at the federal statutory rate<br>(35% in 1998, 1997 and 1996) | \$21,215,340        | \$21,989,390        | \$22,225,629        |
| State income tax provision, net of federal benefit                                   | 1,017,032           | 1,091,936           | 1,461,076           |
| Federal research credits   | (1,650,877)         | (1,248,925)         | (151,500)           |
| Permanent differences and other  | (275,889)           | 785,155             | 146,687             |
|  | <b>\$20,305,606</b> | <b>\$22,617,556</b> | <b>\$23,681,892</b> |

Temporary differences which create deferred tax assets and liabilities at December 31, 1998 and 1997 are detailed below.

|                                       | 1998               |                      | 1997               |                      |
|---------------------------------------|--------------------|----------------------|--------------------|----------------------|
|                                       | <b>Current</b>     | <b>Non-current</b>   | <b>Current</b>     | <b>Non-current</b>   |
| Property, plant and equipment         |                    | (\$3,295,140)        |                    | (\$2,147,635)        |
| Accounts receivable                   | \$ 422,758         |                      | \$ 381,022         |                      |
| Inventory                             | 844,519            |                      | 1,130,083          |                      |
| Accruals                              | 1,149,408          |                      | 947,031            |                      |
| <b>Deferred tax asset (liability)</b> | <b>\$2,416,685</b> | <b>(\$3,295,140)</b> | <b>\$2,458,136</b> | <b>(\$2,147,635)</b> |

No valuation allowance is deemed necessary by management as the realization of recorded deferred tax assets is considered more likely than not.

## 8 OPERATING LEASES

The Company leases office space and equipment under operating leases. As of December 31, 1998, future minimum rental payments under the non-cancelable operating leases are approximately as follows:

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|      |                    |
|------|--------------------|
| 1999 | \$ 962,000         |
| 2000 | 525,000            |
| 2001 | 228,000            |
| 2002 | 215,000            |
| 2003 | 108,000            |
|      | <b>\$2,038,000</b> |

Rental expense was approximately \$908,000, \$657,000 and \$851,000, in 1998, 1997 and 1996, respectively.

## 9 EMPLOYEE INCENTIVE STOCK OPTION PLAN AND DIRECTOR'S STOCK OPTION PLAN

The Board of Directors of the Company adopted the 1996 Employees Incentive Stock Option Plan (the "1996 Plan") effective February 14, 1996, under which 2,488,100 shares of common stock were reserved for issuance to certain employees and officers through incentive stock options and non-qualified stock options. In addition, the Company currently has options outstanding under its 1986 Employee Incentive Stock Option Plan (the "1986 Plan"), which plan expired on February 14, 1996. Options granted under the 1996 Plan or the 1986 Plan become exercisable after one year of continued employment after the date of grant or pursuant to a five year vesting schedule beginning on the first anniversary of the grant date. Expiration dates of options outstanding under the 1996 Plan and the 1986 Plan at December 31, 1998 range from 1999 to 2008.

The Board of Directors of the Company adopted a Director's Stock Option Plan effective October 31, 1995 under which 70,000 shares of common stock have been reserved. The Plan is a formula plan to provide options to non-employee directors of the Company. At December 31, 1998, 42,000 options had been granted under the plan. Expiration dates of options outstanding under the Director's Stock Option Plan at December 31, 1998 range from 2005 to 2008.

Pertinent information regarding the Plans is as follows:

|  | Number of Options | Range of Exercise Prices | Weighted Average Exercise Price | Vesting Provisions |
|--|-------------------|--------------------------|---------------------------------|--------------------|
| Options outstanding, December 31, 1995 | 2,170,395         | \$ .06 - \$46.25         | \$1.83                          | 100% /year         |
| Options granted                        | 342,000           | \$39.75 - \$65.75        | \$63.99                         | 20% /year          |
| Options granted                        | 7,950             | \$30.50 - \$65.75        | \$44.43                         | 100% /year         |
| Options cancelled                      | (9,050)           | \$3.33 - \$65.75         | \$61.78                         | various            |
| Options exercised                      | (1,307,239)       | \$ .06 - \$31.75         | \$0.60                          | 100% /year         |
|  |                   |                          |                                 |                    |
| Options outstanding, December 31, 1996 | 1,204,056         | \$ .11 - \$65.75         | \$20.38                         | various            |
| Options granted                        | 697,750           | \$22.00 - \$42.38        | \$25.62                         | various            |
| Options granted                        | 3,000             | \$42.72 - \$42.72        | \$42.72                         | various            |
| Options granted                        | 21,700            | \$25.37 - \$45.78        | \$32.26                         | various            |
| Options cancelled                      | (38,300)          | \$22.00 - \$65.75        | \$50.89                         | various            |
| Options exercised                      | (611,750)         | \$ .11 - \$31.75         | \$ .68                          | various            |
|  |                   |                          |                                 |                    |
| Options outstanding, December 31, 1997 | 1,276,456         | \$ .17 - \$65.75         | \$32.24                         | various            |
| Options granted                        | 1,018,225         | \$18.31 - \$26.25        | \$21.46                         | various            |
| Options granted                        | 10,250            | \$30.50 - \$31.00        | \$30.69                         | various            |
| Options cancelled                      | (45,370)          | \$21.31 - \$65.75        | \$35.61                         | various            |
| Options exercised                      | (42,215)          | \$ .17 - \$3.33          | \$1.38                          | various            |
|  |                   |                          |                                 |                    |
| Options outstanding, December 31, 1998 | 2,217,346         | \$ .50 - \$65.75         | \$27.78                         | various            |

The following table summarizes information about stock options outstanding at December 31, 1998:

| Range of Exercise Prices | Number Outstanding 12/31/98 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable 12/31/98 | Weighted Average Exercise Price |
|--------------------------|-----------------------------|---|---------------------------------|-----------------------------|---------------------------------|
| \$ .50 - \$3.33          | 137,541                     | 3.47  | \$2.24                          | 137,541                     | \$2.24                          |
| \$12.53-\$21.31          | 959,625                     | 9.17  | \$21.22                         | 8,000                       | \$12.53                         |
| \$22.00- \$28.50         | 723,580                     | 8.57  | \$25.29                         | 141,724                     | \$25.47                         |
| \$30.38- \$46.25         | 115,100                     | 7.83  | \$36.81                         | 80,290                      | \$36.64                         |
| \$56.25- \$65.75         | 281,500                     | 7.57  | \$65.34                         | 116,800                     | \$65.11                         |
|                          | <b>2,217,346</b>            |   |                                 | <b>484,355</b>              |                                 |

The options above were issued at exercise prices which approximate fair market value at the date of grant. At December 31, 1998, 528,695 options were available for grant under the plans. The Company applies APB Opinion 25 and related Interpretations in accounting for its stock plans. Accordingly, no compensation cost has been recognized related to stock options. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method prescribed in SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

|  | 1998         | 1997         | 1996         |
|--|--------------|--------------|--------------|
| Net income - as reported                           | \$40,309,650 | \$40,209,272 | \$39,819,904 |
| Net income - pro forma                             | \$35,417,764 | \$37,634,225 | \$38,018,766 |
| Earnings per share - as reported assuming dilution | \$1.03       | \$1.02       | \$1.01       |
| Earnings per share - pro forma assuming dilution   | \$.90        | \$.96        | \$.96        |

The pro forma amounts reflected above are not representative of the effects on reported net income in future years because, in general, the options granted typically do not vest for several years and additional awards are made each year. The fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model with the following weighted-average assumptions:

|                         | 1998  | 1997  | 1996  |
|-------------------------|-------|-------|-------|
| Dividend yield          | 0%    | 0%    | 0%    |
| Expected life (years)   | 5     | 5     | 5     |
| Expected volatility     | 59.1% | 49.1% | 48.7% |
| Risk-free interest rate | 4.67% | 6.06% | 7.09% |

## 10 EMPLOYEE BENEFIT PLAN

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In March 1990, the Company adopted an incentive savings plan (the "Savings Plan") for all of its employees. The Savings Plan provides certain employment benefits to all eligible employees and qualifies as a deferred arrangement under Section 401(k) of the Internal Revenue Code of 1986, as amended. The Company matches one-half of a participant's contribution, limited to 5% of a participant's income. An employee's interest in the Company's contributions becomes 100% vested at the date participation in the Savings Plan commenced. Charges to operations for the plan amounted to approximately \$928,000, \$717,000, and \$547,000, in 1998, 1997 and 1996, respectively.

## 11 SEGMENT INFORMATION AND MAJOR CUSTOMERS

The Company operates two reportable segments – (1) Telco and (2) CPE. The accounting policies of the segments are the same as those described in the "Summary of Significant Accounting Policies" (see Note 1) to the extent that such policies affect the reported segment information. The Company evaluates the performance of its segments based on gross profit; therefore, selling, general and administrative costs, as well as research and development, interest income/expense, and provision for taxes, is reported on an entity wide basis only. There are no intersegment revenues.

The table below presents information about the reported sales and gross profit of the Company for each of the years in the three year period ended December 31, 1998. Asset information by reportable segment is not reported, since the Company does not produce such information internally.

|                | 1998             |                  | 1997             |                  | 1996             |                  |
|----------------|------------------|------------------|------------------|------------------|------------------|------------------|
|                | Sales            | Gross Profit     | Sales            | Gross Profit     | Sales            | Gross Profit     |
| (in thousands) |                  |                  |                  |                  |                  |                  |
| Telco          | \$167,500        | \$91,574         | \$171,838        | \$84,568         | \$171,902        | \$82,624         |
| CPE            | 119,059          | 64,975           | 93,497           | 50,513           | 78,219           | 37,544           |
| <b>Total</b>   | <b>\$286,559</b> | <b>\$156,549</b> | <b>\$265,335</b> | <b>\$135,081</b> | <b>\$250,121</b> | <b>\$120,168</b> |

The following is sales information by geographic area for the years ended December 31:

| <b>Sales</b><br>(in thousands) | <b>1998</b>      | <b>1997</b>      | <b>1996</b>      |
|--------------------------------|------------------|------------------|------------------|
| United States                  | \$277,062        | \$242,230        | \$231,703        |
| Foreign                        | 9,497            | 23,105           | 18,418           |
|                                | <b>\$286,559</b> | <b>\$265,335</b> | <b>\$250,121</b> |

Sales of the Company's transmission and test equipment to the Regional Bell Operating Companies (RBOCs) amounted to approximately 29%, 33% and 36% of total sales during the years ended December 31, 1998, 1997 and 1996, respectively. At December 31, 1998, 1997 and 1996 respectively, 21%, 26% and 23% of the accounts receivable balance consisted of amounts due from RBOCs.

## 12 CONTINGENCIES

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The Company has certain contingent liabilities resulting from litigation arising in the normal course of business. Although the outcome of any litigation can never be certain, it is the Company's opinion that the outcome of such contingencies will not materially affect its business, operations, financial condition or cash flows.

## 13 EARNINGS PER SHARE

A summary of the calculation of basic and diluted earnings per share for the years ended December 31, 1998, 1997 and 1996 is as follows:

|  | <b>For the Year Ended 1998</b> |                                 |                             |
|--|--------------------------------|---------------------------------|-----------------------------|
|  | <b>Income<br/>(Numerator)</b>  | <b>Shares<br/>(Denominator)</b> | <b>Per-Share<br/>Amount</b> |
| <b>Basic EPS</b>   |                                |                                 |                             |
| Income available to common stockholders                          | \$40,309,650                   | 38,981,558                      | \$1.03                      |
| <b>Effect of Dilutive Securities</b>                             |                                |                                 |                             |
| Stock Options  | 0                              | 182,205                         |                             |
| <b>Diluted EPS</b>   |                                |                                 |                             |
| Income available to common stockholders<br>+ assumed conversions | \$40,309,650                   | 39,163,763                      | \$1.03                      |

| For the Year Ended 1997  |                       |                         |                     |
|--|-----------------------|-------------------------|---------------------|
|  | Income<br>(Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
| <b>Basic EPS</b>   |                       |                         |                     |
| Income available to common stockholders                          | \$40,209,272          | 39,201,871              | \$1.03              |
| <b>Effect of Dilutive Securities</b>                             |                       |                         |                     |
| Stock Options  | 0                     | 363,626                 |                     |
| <b>Diluted EPS</b>   |                       |                         |                     |
| Income available to common stockholders<br>+ assumed conversions | \$40,209,272          | 39,565,497              | \$1.02              |
| For the Year Ended 1996  |                       |                         |                     |
|  | Income<br>(Numerator) | Shares<br>(Denominator) | Per-Share<br>Amount |
| <b>Basic EPS</b>   |                       |                         |                     |
| Income available to common stockholders                          | \$39,819,904          | 38,603,289              | \$1.03              |
| <b>Effect of Dilutive Securities</b>                             |                       |                         |                     |
| Stock Options  | 0                     | 945,365                 |                     |
| <b>Diluted EPS</b>   |                       |                         |                     |
| Income available to common stockholders<br>+ assumed conversions | \$39,819,904          | 39,548,654              | \$1.01              |

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The following options were outstanding during the respective year, but were not included in the computation of that year's diluted EPS because the options' exercise price was greater than the average market price of the common shares in the respective year.

| 1998               |                   |            | 1997               |                   |            | 1996               |                   |            |
|--------------------|-------------------|------------|--------------------|-------------------|------------|--------------------|-------------------|------------|
| Options<br>Granted | Exercise<br>Price | Expiration | Options<br>Granted | Exercise<br>Price | Expiration | Options<br>Granted | Exercise<br>Price | Expiration |
| 58,450             | \$31.75-\$46.25   | 2005       | 3,500              | \$46.25           | 2005       | 6,000              | \$46.25           | 2005       |
| 284,450            | \$56.25-\$65.75   | 2006       | 294,400            | \$56.25-\$65.75   | 2006       | 8,500              | \$56.25-\$59.50   | 2005       |
| 20,450             | \$39.63-\$46.25   | 2006       | 17,700             | \$37.63-\$42.38   | 2007       | 309,000            | \$63.75-\$65.75   | 2005       |
| 2,500              | \$30.50-\$30.75   | 2006       |                    |                   |            |                    |                   |            |
| 23,700             | \$35.63-\$42.72   | 2007       |                    |                   |            |                    |                   |            |
| 8,200              | \$27.50-\$28.50   | 2007       |                    |                   |            |                    |                   |            |
| 28,500             | \$26.25-\$30.38   | 2008       |                    |                   |            |                    |                   |            |

## 14 SUMMARIZED QUARTERLY FINANCIAL DATA (UNAUDITED)

The following table presents unaudited quarterly operating results for each of the Company's last eight fiscal quarters. This information has been prepared by the Company on a basis consistent with the Company's audited financial statements and includes all adjustments, consisting only of normal recurring adjustments, that the Company considers necessary for a fair presentation of the data.

| <i>(In thousands, except for per share amounts)</i> | Three Months Ended |                 |                      |                     |
|---|--------------------|-----------------|----------------------|---------------------|
|   | March 31<br>1998   | June 30<br>1998 | September 30<br>1998 | December 31<br>1998 |
| Net sales   | \$65,327           | \$71,155        | \$77,044             | \$73,033            |
| Gross profit  | 35,919             | 38,950          | 42,310               | 39,370              |
| Income from operations                              | 14,283             | 14,441          | 16,377               | 12,165              |
| Net income  | 9,893              | 10,145          | 11,441               | 8,831               |
| Earnings per common share assuming dilution         | \$.25              | \$.26           | \$.29                | \$.23               |
| Earnings per common share                           | \$.25              | \$.26           | \$.29                | \$.23               |

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| <i>(In thousands, except for per share amounts)</i> | Three Months Ended |                 |                      |                     |
|---|--------------------|-----------------|----------------------|---------------------|
|   | March 31<br>1997   | June 30<br>1997 | September 30<br>1997 | December 31<br>1997 |
| Net sales   | \$61,231           | \$59,125        | \$70,579             | \$74,400            |
| Gross profit  | 31,791             | 28,632          | 36,092               | 38,566              |
| Income from operations                              | 14,258             | 10,291          | 16,778               | 18,726              |
| Net income  | 9,522              | 6,980           | 11,141               | 12,566              |
| Earnings per common share assuming dilution         | \$.24              | \$.18           | \$.28                | \$.32               |
| Earnings per common share                           | \$.25              | \$.18           | \$.28                | \$.32               |