The name behind the network.

2004 Annual Report

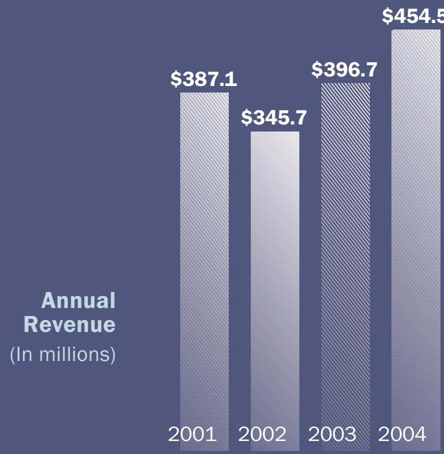
ADTRAN®

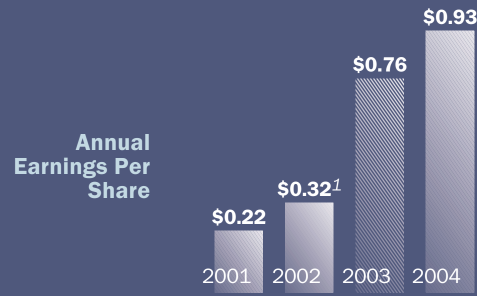
Networking is now an integral part of our culture, and ADTRAN® is deeply entrenched in the business. Our solutions are extensively deployed in the first/last mile of the access network, where millions of people transact each day. Every major service provider in the U.S., and many international ones, as well as thousands of enterprise and government organizations worldwide use ADTRAN solutions to enable voice, data, video, or Internet communications. As a result, it is highly probable that some part of your daily communications pass through an ADTRAN-enabled network.

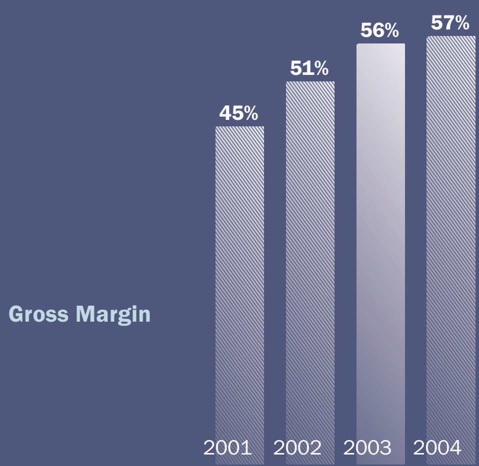
NASDAQ: ADTN

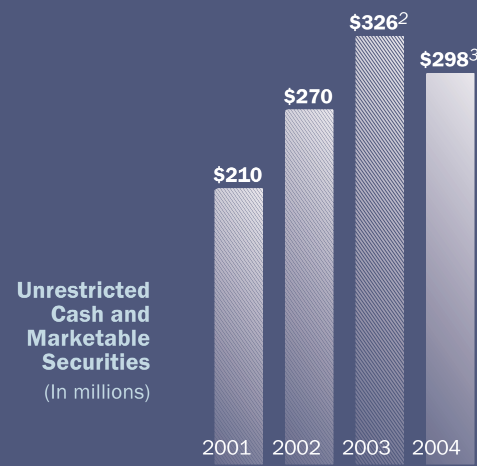
Glossary of terms

ADSL	Asymmetric Digital Subscriber Line
AOS	ADTRAN Operating System
ATM	Asynchronous Transfer Mode
CO	Central Office
CSU	Channel Service Unit
DDS	Digital Data System
DS3	Digital Signal Level 3
DSL	Digital Subscriber Line
DSLAM	Digital Subscriber Line Access Multiplexer
DSU	Data Service Unit
E1	International equivalent of T1
EMS	Element Management System
FCC	Federal Communications Commission
FTTN	Fiber to the Node/Neighborhood
Gbps	Gigabits per second
HDSL	High-bit-rate Digital Subscriber Line
HDTV	High-Definition Television
IAD	Integrated Access Device
ILEC	Incumbent Local Exchange Carrier
IP	Internet Protocol
IPTV	Internet Protocol Television
ISDN	Integrated Services Digital Network
IT	Information Technology
LAN	Local Area Network
M13	Multiplex 1-to-3
Mbps	Megabits per second
OC-3	Optical Carrier Level 3
OC-12	Optical Carrier Level 12
OC-48	Optical Carrier Level 48
OSP	Outside Plant
PBX	Private Branch eXchange
PoE	Power over Ethernet
QoS	Quality of Service
SHDSL	Symmetric High-bit-rate Digital Subscriber Loop
SMB	Small-to-Medium Business
SONET	Synchronous Optical NETwork
STS-1	Synchronous Transport Signal Level 1
T1	Trunk Level 1
T3	North American standard for DS3
TDM	Time Division Multiplex
VPN	Virtual Private Network
VoIP	Voice over Internet Protocol
WAN	Wide Area Network









Consolidated Statements of Income Data

(In thousands, except per share amounts)

Years Ended December 31	2004	2003	2002	2001
Total sales	$454,517	$396,676	$345,725	$387,081
Income before provision for income taxes	$110,016	$88,830	$32,177	$23,737
Net income	$75,141	$61,515	$24,776	$17,329
Earnings per common share	$0.93	$0.76	$0.32	$0.22

Consolidated Balance Sheets Data

(In thousands)

Years Ended December 31	2004	2003	2002	2001
Working capital[4]	$266,371	$220,069	$203,511	$217,387
Total assets	$559,942	$592,309	$521,213	$522,537
Stockholders' equity	$466,637	$493,821	$435,212	$437,628

[1] Includes investment impairment charges of $7.4 million net of tax

[2] Net of $89 million in special and quarterly dividends paid in 2003

[3] Net of $81 million in stock repurchases and $25 million in dividend payments during 2004

[4] Working capital consists of current assets less current liabilities

Letter to Shareholders

We are pleased to report that improved earnings, revenue, and margins once again positioned ADTRAN® among the best performing telecommunications equipment suppliers. Looking back, we achieved considerable success in 2004, despite market dynamics that somewhat moderated our expectations for the year as it drew to a close.

Perhaps of more strategic importance to our shareholders, we believe our 2004 product development and marketing programs have positioned us to take full advantage of the impending wave of investment anticipated from our largest customers — U.S. service providers. Through public statements, these important customers have now confirmed their commitment to introduce next-generation services built on next-generation network architectures. These announcements have been encouraged by recent FCC rulings that have allayed many of their investment concerns. Next-generation access equipment, like ours, has also made it practical for them to deliver on-demand broadband services tailored to subscriber needs, while sharply reducing operating costs. We believe our position as the second largest supplier of broadband access equipment in the U.S. will serve as a major advantage as service provider spending accelerates.

ADTRAN At-A-Glance

ADTRAN is a network access company. We develop products and services that connect business and residential subscribers to high-speed communications networks supporting today's voice, data, video and Internet applications.

Our **Carrier Networks** Division supplies service providers with the equipment they need to deliver broadband services to business and residential subscribers. Service providers use our "access equipment" to connect central offices or remote terminals directly to the subscriber's terminating equipment.

- Broadband Access Platforms
- CO/Remote/OSP DSLAMs
- ATM/TDM Aggregation
- Fiber Access Platforms
- Fiber Add/Drop Multiplexers
- M13/STS-1 Multiplexers
- HDSL2/4 Technologies
- SHDSL and ADSL Technologies
- Integrated Access Devices
- Narrowband Access Platforms

Our **Enterprise Networks** Division supplies businesses, schools, government agencies, and other organizations with the internetworking equipment they need to create sophisticated local and wide area networks. These networks connect remote offices and mobile workers—enabling Internet access, telecommuting, and videoconferencing within an organization.

- Fast Ethernet/PoE Switches
- Gigabit Ethernet Switches
- Integrated Switch-Routers
- T1/Multi-T1/Dual DS3 Access Routers
- VPN/Firewall Devices
- Integrated Access Devices
- Fixed Wireless Radios
- Fiber Optic Connectivity
- T3/T1/E1 DSU/CSUs
- T3/T1/E1 Multiplexers

Sound financial results and growth

Year over year, ADTRAN's revenue increased 14.6 percent to $454.5 million, up from $396.7 million in 2003. We attribute the increase to growing acceptance of our DSL access multiplexers (DSLAMs), optical multiplexers, NetVanta® routers and switches, and to increasing market share gains in both traditional and packet-based DSL technologies. We were especially pleased with the acceptance of our new Total Access® Outside Plant (OSP) DSLAMs, introduced in late 2003. Two of the largest service providers in the U.S. have now adopted our OSP technology, with others expected to follow in 2005.

Earnings improved significantly in 2004, rising to $75.1 million for the year compared to $61.5 million for 2003, an increase of 22.1 percent. Fully diluted earnings per share grew from $0.76 in 2003 to $0.93 in 2004. Gross margins improved throughout the year, reaching a record 57.4 percent, up from 56.0 percent in 2003, and up from 50.6 percent in 2002. We were particularly pleased with the success of our continued attention to product cost reduction and to supply chain modernization efforts.

Net cash provided by operating activities was a healthy $85.8 million for the year. After dividend payouts of $25.1 million and stock repurchases of $81.0 million, unrestricted cash and marketable securities ended the year at a strong $298.0 million. With these resources, we remain solidly positioned to fund an aggressive product development agenda, as well as to fund future working capital needs that may arise with sustained growth.

Adhering to strict policies of corporate governance

We are continuing with a disciplined program of compliance with the standards mandated by the Sarbanes-Oxley Act, including the Section 404 requirement that we document and test key internal controls over financial reporting, and also including our strict Code of Business Conduct and Ethics adopted in 2003. In our view, both measures are a reaffirmation of the high standards of ethical conduct we have enforced since our founding 19 years ago.

Our operating divisions

Both of our operating divisions are focused upon delivering superbly engineered access equipment for network service providers and their enterprise customers. In 2004, both divisions invested aggressively in new product programs, responding to market drivers that are dramatically reshaping the network core, as well as its access nodes. Now in its very early stages, this transformation has presented us with some of the largest and most exciting opportunities in our history. We believe we have properly anticipated these opportunities and are well prepared to take advantage of them as a catalyst for growth in the future.

> ADTRAN continued its long history of profitability in 2004, with a 22 percent increase in earnings to $0.93 per share.

Carrier Networks Division

In our Carrier Networks Division (CN), our Total Access OSP DSLAMs have become an unchallenged market leader. They are essential to a network build-out that brings access nodes closer to subscribers, facilitating delivery of multiple channels of video (high-definition and standard TV), as well as voice and data. They are specifically designed to smooth the network's transition to Ethernet as its native transmission and switching technology. Already, this product line employs next-generation ADSL2+ technology that is capable of delivering service at rates up to 24 Mbps, more than enough for voice, data, and multiple channels of video.

With our success in the broadband access equipment market, we believe we are well positioned to support the network's transition to Ethernet, with minimal disruption of the existing network infrastructure. This includes appropriate accommodations in our highly regarded Total Access® Element

ADTRAN's next-generation access equipment makes it practical for service providers to deliver on-demand broadband services tailored to subscriber needs, while lowering operating costs.

Management System (EMS), now employed by six of the top seven service providers in the U.S. for real-time management of their access networks.

The CN Division has also become an important supplier of fiber optic products that facilitate the build-out of new network architectures in an incremental fashion. In 2004, we enhanced our fiber products to include OC-12 capability, Ethernet delivery, and ring support. As with our DSLAMs and other access equipment, our fiber products are engineered to fit seamlessly into today's network infrastructure and to facilitate its transition to Ethernet. In the future, we fully intend to be positioned among the leaders as fiber pushes relentlessly outward from the core to the subscriber's premises.

In 2004, we aggressively addressed the two most significant trends in networking today—the need for greater bandwidth and IP migration—with numerous, strategic product introductions.

Enterprise Networks Division

Throughout the year, the Enterprise Networks Division (EN) took advantage of its dominant share in traditional WAN connectivity market segments to fund its aggressive development of a broad, new family of internetworking products. With a multi-tier reseller channel numbering in the thousands, the EN Division is well prepared to expand sales of its internetworking product family to a loyal base of small-to-medium businesses (SMBs). Interestingly, our initial set of internetworking products has been found attractive by network service providers as well. For example, one overseas service provider is rolling out nationwide IP service from more than a thousand ADTRAN®-equipped exchanges, using internetworking gear from the EN Division.

EN Division products of note delivered in 2004 include our first Voice over IP (VoIP) access device. In the coming year, we intend to expand our presence in this market dramatically, including single, integrated units that are fully featured to render multi-box solutions a relic of the past.

All of the EN Division's internetworking products are now built upon a single, modern software code base: the ADTRAN Operating System (AOS). Now field-proven and robust, AOS is an increasingly valuable competitive advantage that can be deployed very favorably against incumbent suppliers. It enables much lower-cost solutions and adapts quickly to the new product configurations our customers seek. Our NetVanta® 1224R is a good example of that advantage. Designed to be a "network-in-a-box" for small and branch office applications, it is the industry's first integrated Ethernet switch, router, firewall, and CSU/DSU product that also offers optional VPN and dial backup capabilities.

Sales of the EN Division's internetworking products quickened during the year, including wins at accounts equipping hundreds of network nodes. With a mature AOS software code base to build upon, and an accomplished engineering team, the EN Division looks forward to the grand challenge of displacing an entrenched competitor.

The people of ADTRAN

No annual report would be complete without acknowledging the many contributions of the people that have made ADTRAN a name respected by customers, suppliers, competitors, and the community that we share. We salute their dedication to ADTRAN's mission and their unwavering commitment to excellence.

Sincerely,

Mark C. Smith
Chairman and CEO

Howard A. Thrailkill
President and COO

Meeting the need for speed in today's networks

One of the most universal trends in networking today is a growing demand for bandwidth. Increased dependency on the Internet as an informational and business tool, combined with the availability of new, content-rich applications, is forcing service providers to find ways to increase the capacity of their networks as demand from business and residential consumers grows. In 2004, our efforts were focused on helping customers expand their networks to handle ever-increasing loads of data, video, and voice traffic.

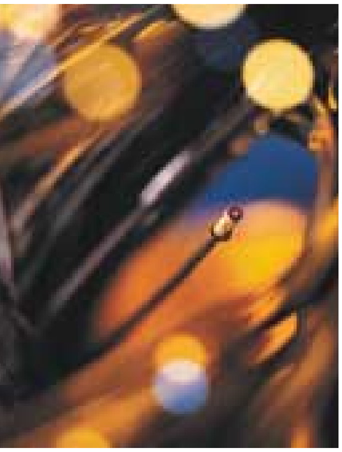
Pushing broadband deeper in the network

As a counter to cable and other competitive methods of broadband access, wireline service providers are launching aggressive campaigns to increase the capacity of their networks over the last mile. Most service providers are opting for a "deep fiber" strategy, where fiber is pushed far into the network, then high-speed DSL technologies are deployed over existing copper loops to the customer premises. In some networks, fiber is delivered directly to the home.

We believe ADTRAN is strongly positioned to benefit from this shift in deployment strategies. Our Total Access platforms are designed to support fiber strategies by allowing both copper and fiber connectivity. Furthermore, our systems are scalable to support service delivery in both rural and urban areas.

DSL standards push copper to new limits

In 2004, we introduced the second generation of our Total Access mini-and OSP DSLAMs. These devices are now equipped to support the new ADSL2+ standard, and effectively double the density of their predecessors. ADSL2+ is a DSL transport technology that achieves rates



In some larger metropolitan areas, network utilization rates are approaching 70 percent, typically the threshold at which service providers invest in their networks.

TIA 2004 Telecommunications Market Review and Forecast

of up to 24 Mbps, offering a broad range of new applications. Our DSLAMs can be optical- or fiber-fed, and allow for easy migration to Ethernet. These solutions are suited for extending broadband from the node to the customer premises in deep fiber deployment scenarios.

Benefiting from growth in the wireless industry

The high-speed wireless communications business continues to increase demand for ADTRAN® networking products. The growing usage of cell phones, pagers, and other personal communications services is resulting in increased demand for copper and fiber transport to and from cell sites.

ADTRAN's Total Access® System positions a network for cost-effective delivery of today's high-speed Internet services, while offering a clear cut path to the premium service offerings of the future.

To accommodate larger numbers of subscribers and higher speed voice/data services, wireless providers are migrating their networks to a standard known as third generation (3G). The typical high-speed 3G cell site can require up to four times the bandwidth of traditional sites. In 2004, as a result of increased demand for bandwidth in wireless markets, we saw increased demand in our traditional products, as well as newly developed optical products.

In 2004, several first-tier wireless service providers deployed our TRACER® license-free, fixed radios in their networks. These radios enable carriers to quickly and cost-effectively deploy temporary or permanent line-of-sight microwave connections at distances up to 30 miles. We expanded this product line significantly in 2004 and early 2005, increasing bandwidth and introducing a new line of user-configurable modular radios to support IP-based applications.

Making optical access more affordable

Fiber continues to permeate the network as wireless and wireline service providers expand network capacity in the last mile. Demand for our OPTI-6100™ fiber access multiplexer, introduced in 2003, increased this year as service providers continued to recognize its price/performance benefits in backhaul and transport applications.

OPTI-6100 is a compact, next-generation optical access platform. It offers service providers an extremely cost-effective solution to address current and emerging fiber applications. OPTI-6100 addresses the real needs of service providers seeking to expand service capacity and maximize backhaul efficiency. This solution is particularly effective for wireless and wireline providers wishing to offer their customers next-generation services with minimum capital outlay and maximum density.

New capabilities added to the OPTI-6100 in 2004 simplified interoperability with high-speed optical metro/regional rings, allowing service providers to easily and inexpensively connect more subscribers to their infrastructure. We also increased the network bandwidth of the OPTI-6100 to OC-12 (622 Mbps). We plan to continue our aggressive investment in optical access technologies in coming years.

Enabling more profitable high-speed Internet services

While the transition to premium services is taking place, reliable, high-speed DSL Internet service remains a cornerstone of data revenue for most service providers. Our Total Access DSLAMs support these service deployments to business and residential con-

Engineering high-speed, business-class service offerings

Widespread Internet usage and other bandwidth-intensive applications are driving business demand for higher-speed, lower-cost network services. Incumbent and competitive providers alike are competing aggressively for this market by offering new, high-speed business services.

Market conditions spur competition
With competition increasing in primary market segments, many service providers are launching new service initiatives based on the ADTRAN Total Access platform These initiatives are typically designed to retain existing customers, attract new ones, and combat competitive threats. Our Total Access platform is flexible enough to provide quick response under competitive market conditions; in many cases improving competitive posture almost immediately.

Jointly engineered solutions produce cost-savings
In some cases, we are actively engaged in the engineering of the new high-speed service offerings, working in close partnership to develop the best possible solution based on the provider's existing network infrastructure.

In most cases, our off-the-shelf Total Access DSLAMs provide a viable, low-cost solution for deploying today's most popular high-speed services. When necessary, the Total Access platform can be customized to accommodate unique network characteristics. Because of the flexible architecture of the Total Access platform, we are often able to deliver a custom engineered solution in a matter of weeks rather than months. Our goal, in every case, is to engineer an innovative approach that provides reliable, end-to-end connection between the exchange and customer premises, while lowering operating costs.

sumers in a more cost-efficient manner than is possible with other solutions. In order to maintain profitability on lower-cost DSL service offerings, providers need a solution that accommodates different types of technologies, lowers upfront costs, and accommodates incremental growth. Total Access DSLAMs meet this criteria.

Total Access DSLAMs are now being used by most of the largest service providers in the U.S. With models for central office, remote terminal, and outside plant installation, Total Access DSLAMs are being adopted for use in a wide range of deployment scenarios across incumbent, competitive, and independent service provider networks. During 2004, we believe our company moved into the number two market position in broadband deployment in the U.S.

Extending service footprints

Our second-generation Total Access mini- and OSP DSLAMs are critical to service providers trying to reach a greater percentage of potential broadband subscribers. Designed for installation in compact and non-traditional outside plant locations, these platforms enable DSL delivery to subscribers previously viewed as unreachable or uneconomical to service, at a cost that protects service provider profitability.

During 2004, ADTRAN remained the leading supplier of environmentally sealed, line-powered OSP DSLAMs to satisfy extended reach DSL connectivity needs in an economically feasible package. At year-end, this product line had been widely adopted by service providers across the U.S.

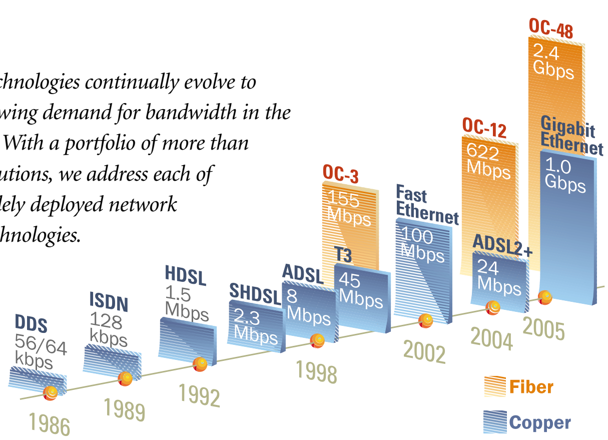
Delivering world-class business services

In countries outside of North America, our Total Access DSLAM with SHDSL is being adopted as an economical way to meet strong demand for E1 (2.048 Mbps) business services over a single copper pair. SHDSL has a capacity of up to 2.3 Mbps per pair; making it a worldwide solution for more effective delivery of E1 services. In 2004, we added enhanced SHDSL support to our portfolio, allowing us to position our product sets for this universally accepted service.

Leading the market in broadband-to-business equipment

T1/HDSL is the primary transmission technology behind dedicated voice and data services to businesses. Our solutions in this technology category continued to contribute significantly to revenue in 2004. We maintained our strong leadership position in this market, with products currently in use by

Access technologies continually evolve to meet growing demand for bandwidth in the network. With a portfolio of more than 1,300 solutions, we address each of these widely deployed network access technologies.



Preparing networks for VoIP, IPTV, and other premium services

Faced with increasing competition from cable and other broadband media, wireline service providers are aggressively upgrading their networks to accommodate the delivery of high-speed, IP-based broadband services to business and residential subscribers. This initiative is expected to require capital investment in excess of $9 billion over the next three years.

New applications demand data-centric networks
Widespread use of the Internet and adoption of high-definition television (HDTV) and other data services continues to increase demand for high-speed, low-cost broadband services. Since data traffic already outweighs voice in terms of bits, and data applications are growing faster than voice, service providers are shifting to IP-centric architectures to optimize their networks for data transport. Today's typical wireline provider offers DSL service at approximately 1.5 Mbps. New architectures will enable the delivery of data services at rates ranging from 10 to 30 Mbps.

New DSLAM capability enables IP deployments
ADTRAN offers a cost-effective solution for delivering high-speed data services over IP architectures. In 2004, we enhanced our Total Access® DSLAM product line to accommodate IP service delivery. Highly suitable for fiber-to-the-node (FTTN) deployment strategies, these devices serve as the connection point between the fiber feed from the central office and the high-speed copper line to the customer premises. Offering numerous interfaces and service delivery methods, Total Access DSLAMs position a network for cost-effective delivery of today's high-speed Internet services, while offering a clear-cut path to VoIP, IPTV, and other premium service offerings.

every major ILEC and numerous independent and competitive providers. More cost-efficient versions of our HDSL2 and HDSL4 technologies, introduced in 2003, fueled growth in these profitable, high-volume product lines during 2004.

Our NetVanta® internetworking product set addresses the needs of today's cost-conscious IT professional by lowering initial equipment costs, and over the longer term, lowering total cost of ownership.

Building value into the SMB network

In 2004, we continued to address the value-oriented enterprise customer with our NetVanta internetworking solutions. Our mission in this market is to provide the complete internetworking product set required to implement more cost-efficient, high-speed remote office and SMB networks. In line with that strategy, in 2004 we introduced numerous new products, including a line of managed Ethernet switches, a network-in-a-box access platform, higher bandwidth routers, and a new generation of Internet security appliances.

We lead the internetworking market in terms of value offered in this product series. In addition to very attractive pricing (typically half the price of competing brand name solutions), NetVanta solutions compete effectively on issues such as warranty, technical support, maintenance upgrades, and add-on options.

Satisfying the demand for higher enterprise bandwidth

Until 2004, our NetVanta IP access router line included models to support up to two T1s (up to 3 Mbps) of bandwidth in enterprise and carrier applications. We expanded this product line in 2004 to include higher capacity models to support dual DS3 (up to 90 Mbps aggregate) and multi-T1 (up to 16 Mbps) applications.

Also in 2004, we addressed the need for a business-class DSL device to support higher speed Internet access from small branch or home offices. By adding ADSL/ADSL2/ADSL2+ (up to 24 Mbps) capability into our NetVanta router line, we introduced a solution that offers business-class functionality, at a cost that compares favorably with low-end, low-function ADSL modems. We anticipate market acceptance by IT managers seeking to enforce corporate IT policies at small branch and home offices, and by service providers using ADSL routers in bundled DSL services.

Powering the revolution in IP access

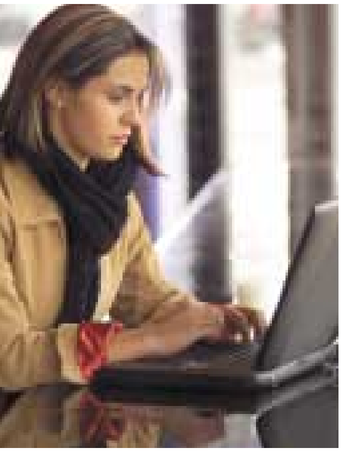
As networks migrate toward integrated communications and entertainment services, one transport technology is emerging as the clear winner—Internet Protocol or IP. Motivated by constant pressure to lower the cost of telecommunications offerings, service providers and businesses alike are transitioning their networks to packet-based IP technologies. This transition gained significant momentum in 2004.

Anticipating the shift to data-centric networks

For years, voice was the dominant type of traffic in the network, and networks were engineered to carry voice first, then integrate data (such as fax machines and dial-up Internet) into that architecture as necessary. Over the past few years, networks have shifted from a voice-centric mix to a data-centric mix. Today, data is the dominant type of traffic, and networks are changing to carry data first, then integrate voice into the data architecture. The result is Voice over IP (VoIP).

Transporting voice over data-centric networks requires changes in the network architecture. Main components of the VoIP model from the desktop to the central office include: IP phones, IP servers, voice-enabled routers and switches, and IP-enabled DSLAMs—equipment capable of maintaining the quality of voice as it passes through devices originally designed for data. The VoIP network must guarantee different qualities of service (QoS) for different applications in order to maintain the integrity of voice, data, video, and other mission-critical applications.

This trend is producing high demand for a wide range of IP-capable, QoS-enabled products across enterprise and service provider networks.



Growth in Ethernet networking is causing fundamental changes in the access network — a blending between the last mile and the first. ADTRAN is one of the few companies in North America best positioned to capture this business.

In 2004, we introduced a number of products to support the deployment of IP-based services, including carrier-class DSLAMs, optical multiplexers, fixed-wireless radios, IADs, and enterprise-class switches and routers.

Accommodating Ethernet in the first mile

The most popular method of delivering IP service is Ethernet, a standard already used extensively in local area networks at the customer premises. Because of its broad acceptance, lower deployment costs, and higher bandwidth capacity, Ethernet is now migrating into the first mile of the service providers' network as an alternative to traditional transport technologies.

Ethernet-enabled DSLAMs are a critical component of the IP network model. In 2004, we enhanced our Total Access® DSLAM portfolio by adding Gigabit Ethernet functionality. These products are now equipped to support next-generation IP applications, and to provide an evolutionary path to higher bandwidth switching and multicast video applications. Service providers with an installed base of Total Access DSLAMs can easily upgrade to IP functionality. We also added Ethernet over SONET functionality to our OPTI-6100™ optical multiplexer.

Using VoIP to enhance competitive position

In order to retain and expand their customer base, providers constantly seek to add new, more attractive service offerings. VoIP represents such an opportunity for most service providers. In 2004, we added VoIP capability to our Total Access IAD product line. The addition of this functionality creates a single, cost-effective platform for extending hosted PBX and other VoIP services to new customers, without replacing existing phones (a major cost savings for the customer).

Total Access IADs are widely deployed by competitive and Internet service providers. We currently hold majority market share positions in both TDM and packet-based versions of this technology. With this new capability, our large installed customer base can readily upgrade their networks to enable VoIP deployment to thousands of existing subscribers, immediately improving their competitive posture.

Reducing connectivity costs using VoIP

Today, many businesses are migrating their networks to VoIP in an effort to reduce the cost of connectivity. VoIP presents a compelling business case for most organizations, offering benefits such as significantly reduced circuit costs, integrated communications, greater empowerment of users, and reduced IT support.

Our NetVanta® internetworking series targets a significant market opportunity, where even small market share gains would represent meaningful revenue increases to our company.

We offer a full suite of internetworking solutions marketed under the NetVanta umbrella to enable VoIP in the enterprise segment of the network. Our switches, routers, and integrated switch-routers are fully VoIP-ready devices. Many of our development efforts in the Enterprise Networks Division over the course of 2004 focused on strengthening VoIP functionality. Improvements to the operating system governing these products in 2004, as well as the introduction of Power over Ethernet switches in early 2005, strongly position this line for widespread deployment in VoIP networks.

Securing market position in internetworking

Our NetVanta internetworking product portfolio is now firmly established in the enterprise local and wide area networking market as a viable alternative to competing brand name products. As first evidence of our success, in the second quarter of 2004, our routers moved into the

Converging standards enhance global positioning

In the past, most of the standards governing telephony and data services in the U.S. were separate from the standards governing these same activities worldwide. T1/HDSL, the predominant data services technology in the U.S., is unique to the U.S. and certain other areas of the world. This standard and others were applied regionally; thus, technologies varied from country to country. With the advent of the Internet, and the subsequent need to develop standards to support packetized data transport, more "globalized" standards have evolved.

Rapid adoption of global standards
Today, ADSL, SHDSL, Ethernet, and other global standards are being rapidly adopted as service providers migrate revenue-generating telephony services to the new end-to-end IP services now in high demand. These standards ensure that thousands of different networks will work together seamlessly and transparently. In spite of its technical complexity, this new infrastructure will be customer friendly and as easy to use as the "plain old telephone service" that has been in place for decades.

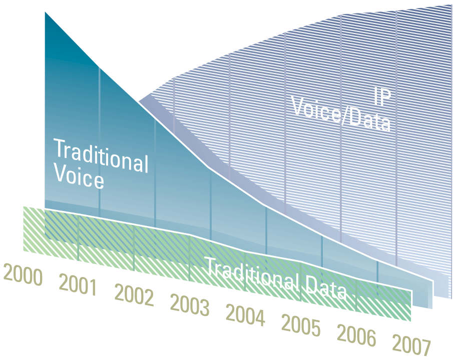
Global application of new products
The globalization of standards simplifies our efforts to conduct business outside of North America. In the past, products initially developed for U.S. deployment required modification in order to comply with varying standards around the world. With the emergence of global standards in both service provider and enterprise networks, our full portfolio of solutions becomes readily available to a significantly greater number of markets worldwide.

number two market position for less-than-1-Gbps access routers based on number of units sold worldwide.* In addition, revenue in this product portfolio nearly doubled year over year.

With new product introductions during 2004, our NetVanta lineup now includes Ethernet switches, integrated switch-routers, low-, medium-, and high-speed access routers, and VPN/Internet security appliances. Each product line offers ways to lower equipment acquisition costs, lower recurring monthly service costs, or both. Given today's price-sensitive atmosphere, we believe the strong value case surrounding these products—low purchase price, low cost of ownership, rich feature set, and high-touch technical support from an established and reputable supplier—represent a strong business opportunity for the future.

Improving time-to-market for internetworking lines

In 2004, we solidified the integration of the ADTRAN® Operating System (AOS) into our NetVanta internetworking product lines. A common operating system simplifies product development efforts and shortens time to market for new products and features. It also offers the highest possible level of LAN-to-WAN integration for the enterprise IT manager. AOS now boasts an impressive list of features and functionality, and is scheduled for regular enhancement three times each year. We believe our investment in AOS over the past two years strongly positions our company for the timely release of new products to aggressively address the SMB internetworking market.



Integrated services over IP will eventually result in converged Internet access, mail services, voice, and video—all simultaneously transported over Ethernet. By 2007, IP traffic will represent 83 percent of all network traffic in the U.S.

Source: RHK Telecom Economics

Entering the Ethernet switch market with an aggressively priced portfolio

In April 2004, with the launch of the NetVanta 1000 Series, we officially entered the Layer 2 Ethernet switch market focused on managed SMB applications. The market for this class of Ethernet switch is estimated to be approximately $5.1 billion† in 2005. We entered this market with the intention of offering a value-oriented alternative to the large incumbent supplier dominating this space.

The first products introduced in this portfolio included business-class, managed Layer 2 Ethernet switches. Shortly thereafter, we launched the NetVanta integrated switch-router, a unique interpretation of this technology that combines everything needed for branch office connectivity in a single chassis. Early in 2005, with the introduction of our Power over Ethernet (PoE) versions of these products, we improved our price advantage on this lineup to more than 50 percent.

The introduction of the NetVanta 1000 Series is another step in our commitment to supply a full line of products to address WAN-to-the-desktop connectivity in the SMB network.

*Source: Dell 'Oro Group, 2004
†IDC, *Worldwide LAN Switch 2004-2008 Forecast Update*, July 2004

Financial Results

13 **Market for the Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities**

14 **Selected Financial Data**

15 **Management's Discussion and Analysis of Financial Condition and Results of Operations**

Overview

Critical Accounting Policies

Results of Operations

2004 Compared to 2003

2003 Compared to 2002

Liquidity and Capital Resources

Effect of Recent Accounting Pronouncements

28 **Management's Report on Internal Control Over Financial Reporting**

29 **Report of Independent Registered Public Accounting Firm**

31 **Financial Statements**

35 **Notes to Consolidated Financial Statements**

Note 1 – Nature of Business and Summary of Significant Accounting Policies

Note 2 – Investments

Note 3 – Inventory

Note 4 – Property, Plant and Equipment

Note 5 – Alabama State Industrial Development Authority Financing and Economic Incentives

Note 6 – Income Taxes

Note 7 – Stock Option Plans

Note 8 – Employee Benefit Plan

Note 9 – Segment Information and Major Customers

Note 10 – Commitments and Contingencies

Note 11 – Earnings Per Share

Note 12 – Summarized Quarterly Financial Data (Unaudited)

Note 13 – Related Party Transactions

Note 14 – Subsequent Events

Forward-Looking Statements

This annual report contains forward-looking statements which reflect management's best judgment based on factors currently known. However, these statements involve risks and uncertainties, including the successful development and market acceptance of new products, the degree of competition in the market for such products, the product and channel mix, component costs, manufacturing efficiencies, and other risks discussed in this annual report under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" and detailed in our annual report on Form 10-K for the year ended December 31, 2004, and in our other filings with the Securities and Exchange Commission. These risks and uncertainties could cause actual results to differ materially from those in the forward-looking statements included in this annual report.

While we are not incorporating anything on our website by reference into this annual report, more information about ADTRAN and copies of our filings with the Securities and Exchange Commission can be found at *www.adtran.com*

Market for the Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

ADTRAN's common stock has been traded on the Nasdaq National Market under the symbol ADTN since our initial public offering of common stock in August 1994. Prior to the initial public offering, there was no established trading market for our common stock. As of January 31, 2005, ADTRAN® had 343 stockholders of record and approximately 14,300 beneficial owners of shares held in street name. The following table shows the high and low closing prices per share for the common stock as reported by Nasdaq for the periods indicated.

Common Stock Prices

2004

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	$37.18	$33.37	$32.96	$24.17
Low	$28.65	$24.52	$22.37	$18.23

2003

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	$20.18	$27.63	$34.63	$37.48
Low	$14.78	$18.04	$22.65	$30.43

The following table shows our declared and paid dividends by quarter. The board of directors presently anticipates that it will declare a regular quarterly dividend as long as the present tax treatment of dividends exists and adequate levels of liquidity are maintained.

Dividends per Common Share

2004

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
$0.080	$0.080	$0.080	$0.080

2003

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
—	—	$1.075 (1)	$0.075

(1) On July 14, 2003, the board of directors declared a special cash dividend of $1.00 per common share and a quarterly cash dividend of $0.075 per common share. Prior to July 14, 2003, ADTRAN had not declared any cash dividends on its common stock.

Stock Repurchases

The following table sets forth ADTRAN's repurchases of its common stock for the months indicated. All shares were purchased in open market transactions.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2004 - October 31, 2004	—	—	—	1,497,900
November 1, 2004 - November 30, 2004	497,200	$21.61	497,200	1,000,700
December 1, 2004 - December 31, 2004	—	—	—	1,000,700
Total	**497,200**	**$21.61**	**497,200**	**1,000,700**

(1) On April 29, 2004, ADTRAN® announced that its board of directors approved the repurchase of up to 4,000,000 shares of its common stock. All repurchases for the periods indicated were made pursuant to this repurchase program, and during February 2005, with the purchase of 1,000,700 shares, this repurchase plan was completed.

On February 11, 2005, ADTRAN announced that its board of directors approved the repurchase of up to 5,000,000 shares of its common stock. This plan will be implemented through open market purchases from time to time as conditions warrant.

Selected Financial Data

The following selected consolidated financial data for, and as of the end of, each of the years in the five-year period ended December 31, 2004, are derived from the consolidated financial statements of ADTRAN, which have been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm. The selected consolidated financial data are qualified in their entirety by the more detailed information in the consolidated financial statements, including the notes thereto. The consolidated financial statements of ADTRAN as of December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004, and the report of PricewaterhouseCoopers LLP thereon, are included elsewhere in this report.

Income Statement Data

(In thousands, except per share amounts)

Year Ended December 31,	2004	2003	2002	2001	2000
Sales					
Carrier Networks Division	$323,333	$267,563	$218,912	$238,367	$315,228
Enterprise Networks Division	131,184	129,113	126,813	148,714	147,721
Total sales	**454,517**	**396,676**	**345,725**	**387,081**	**462,949**
Cost of sales	193,445	174,681	170,789	213,760	233,430
Gross profit	**261,072**	**221,995**	**174,936**	**173,321**	**229,519**
Selling, general and administrative expenses	91,927	83,234	81,217	95,954	87,116
Research and development expenses	67,384	58,144	56,295	58,935	50,628
Operating income	**101,761**	**80,617**	**37,424**	**18,432**	**91,775**
Interest income	7,671	8,912	9,113	8,077	9,025
Interest expense	(2,542)	(2,534)	(2,572)	(2,069)	(1,802)
Other income (expense)	1,353	1,609	234	(29)	(4)
Net realized investment gains (losses)	1,773	226	(12,022)	(674)	84,040
Income before provision for income taxes	**110,016**	**88,830**	**32,177**	**23,737**	**183,034**
Provision for income taxes	34,875	27,315	7,401	6,408	62,232
Net income	**$75,141**	**$61,515**	**$24,776**	**$17,329**	**$120,802**
Earnings per common share - basic	$0.96	$0.80	$0.33	$0.22	$1.56
Earnings per common share assuming dilution (1)	$0.93	$0.76	$0.32	$0.22	$1.52
Weighted average shares outstanding - basic	78,235	76,942	76,090	77,135	77,294
Weighted average shares outstanding assuming dilution (1)	80,985	80,739	76,443	77,353	79,408

Balance Sheet Data

(In thousands)

At December 31,	2004	2003	2002	2001	2000
Working capital (2)	$266,371	$220,069	$203,511	$217,387	$262,778
Total assets	$559,942	$592,309	$521,213	$522,537	$546,336
Total debt	$50,000	$50,000	$50,000	$50,000	$50,000
Stockholders' equity	$466,637	$493,821	$435,212	$437,628	$434,425

(1) Assumes exercise of dilutive stock options calculated under the treasury method. See Notes 1 and 11 of Notes to Consolidated Financial Statements.

(2) ADTRAN's working capital consists of current assets less current liabilities.

On October 13, 2003, the board of directors declared, effective December 15, 2003, a two-for-one stock split to be effected in the form of a stock dividend of one share of common stock for each outstanding share of common stock for stockholders of record on December 1, 2003. Share and per share amounts, including stock options, in the accompanying Consolidated Statements of Income and Notes to Consolidated Financial Statements have been retroactively adjusted to reflect this stock split.

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

Overview

ADTRAN®, Inc. designs, develops, manufactures, markets, and services a broad range of high-speed network access products utilized by providers of telecommunications services and enterprise end users. We currently sell our products to a large number of service providers, including the four largest telecommunications providers, and to private and public enterprises worldwide.

Sales increased this year compared to last year due to our strategy of increasing unit volume and market share through the introduction of new products and succeeding generations of products having lower selling prices and increased functionality as compared to both the prior generation of a product and to the products of competitors. An important part of our strategy is to reduce the cost of each succeeding product generation and then to lower the product's selling price based on the cost savings achieved. As a part of this strategy, we seek in most instances to be a high-quality, low-cost provider of products in our markets. Our success to date is attributable in large measure to our ability to design our products initially with a view to their subsequent redesign, allowing both increased functionality and reduced manufacturing costs in each succeeding product generation. This strategy enables us to sell succeeding generations of products to existing customers, while increasing our market share by selling these enhanced products to new customers.

The year-over-year increase in our Systems revenue is primarily attributable to increasing sales of DSLAMs, optical access products, M13 multiplexers, and NetVanta® products. Our DSLAMs consolidate broadband traffic and provide the technology that allows phone companies to compete with cable companies in the high-speed Internet service market.

The year-over-year increase in High-bit-rate Digital Subscriber Line (HDSL)/T1 revenue is primarily attributable to increasing Carrier Networks sales of HDSL-based Total Access® 3000 broadband platform products, partially offset by declining Enterprise Networks sales of Channel Service Unit/Data Service Unit (CSU/DSU) products. The increase in HDSL revenue is the result of migration from non-intelligent legacy hardware to intelligent remote monitoring access hardware, and the result of market share gains. The industry has integrated the functionality of CSU/DSUs into access routers, thereby reducing the requirement for a standalone CSU/DSU.

The year-over-year decrease in Digital Business Transport (DBT)/Total Reach® sales is the result of newer and higher-speed technologies replacing the lower-speed technology of ISDN and DDS products. We have maintained our overall market share in DBT/Total Reach and continue to take advantage of market opportunities for these products where speed is not the main consideration. However, DBT/Total Reach is a declining market, which is being cannibalized by higher-speed DSL technology.

Our 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. We normally operate with very little order backlog. The majority of our sales in each quarter result from orders booked in that quarter and firm purchase orders released in that quarter by customers under agreements containing non-binding purchase commitments. Furthermore, many of our customers require prompt delivery of products. This results in a limited backlog of orders for these products and requires us to maintain sufficient inventory levels to satisfy anticipated customer demand. If near-term demand for our products declines, or if potential sales in any quarter do not occur as anticipated, our financial results could be adversely affected. Operating expenses are relatively fixed in the short term; therefore, a shortfall in quarterly revenues could significantly impact our financial results in a given quarter. Further, maintaining sufficient inventory levels to assure prompt delivery of our 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 our business and operating results.

Our operating results may also fluctuate as a result of a number of other factors, including increased competition, customer order patterns, changes in product mix, timing differences between price decreases and product cost reductions, product warranty returns, and announcements of new products by us or our competitors. Accordingly, our historical financial performance is not necessarily a meaningful indicator of future results, and, in general, management expects that our financial results may vary from period to period. See Note 12 of Notes to Consolidated Financial Statements.

Critical Accounting Policies

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. These policies have been consistently applied across our two reportable segments: (1) Carrier Networks Division and (2) Enterprise Networks Division.

- We review customer contracts to determine if all of the requirements for revenue recognition have been met prior to recording revenues from sales transactions. We generally record sales revenue upon shipment of our products, net of any discounts, since: (i) we generally do not have significant post-delivery obligations, (ii) the product price is fixed and determinable, (iii) collection of the resulting receivable is probable, and (iv) product returns are reasonably estimable. We generally ship products upon receipt of a purchase order from a customer. We evaluate shipping terms and we record revenue on products shipped in accordance with the applicable terms of each respective contract, generally FOB shipping point. In the case of consigned inventory, revenue is recognized when the customer assumes the risks and rewards of ownership of the product. We record revenue associated with installation services when the installation and all contractual obligations are complete. When contracts include both installation and product sales, the installation is considered as a separate deliverable item. Either the purchaser, ADTRAN®, or a third party can perform installation of our products.

  Sales returns are accrued based on historical sales return experience, which we believe provides a reasonable estimate of future returns. The majority of Enterprise Networks products are sold in the U.S. through a non-exclusive distribution network of major technology distributors and system integrators. These large distribution organizations then sell to an extensive network of value-added resellers and system integrators. Value-added resellers and system integrators may be affiliated with us as a channel partner, or they may purchase from the distributor in an unaffiliated fashion. Our distributors may return products to us that are damaged or defective upon receipt for replacement. Additionally, our distributors may return unused and unopened product for stock-balancing purposes when such returns are accompanied by offsetting orders for products of equal or greater value.

  We participate in cooperative advertising and market development programs with certain customers. We use these programs to reimburse customers for certain forms of advertising, and in general, to allow our customers credits up to a specified percentage of their net purchases. Our costs associated with these programs are estimated and accrued at the time of sale and are included in marketing expenses in our Consolidated Statements of Income. We also participate in rebate programs to provide sales incentives for certain products. Our costs associated with these programs are estimated and accrued at the time of sale, and are recorded as a reduction of sales in our Consolidated Statements of Income.

Prior to accepting a new customer, we perform a detailed credit review of the customer. Credit limits are established for each new customer based on the results of this credit review. Payment terms are established for each new customer, and collection experience is reviewed periodically in order to determine if the customer's payment terms and credit limits need to be revised. We maintain allowances for doubtful accounts for losses resulting from the inability of our customers to make required payments. If the financial conditions of our customers were to deteriorate, resulting in an impairment of their ability to make payments, we may be required to make additional allowances. If circumstances change with regard to individual receivable balances that had previously been determined to be uncollectible (and for which a specific reserve had been established), a reduction in our allowance for doubtful accounts may be required. Our allowance for doubtful accounts was $0.4 million and $1.7 million at December 31, 2004 and 2003, respectively. We recorded $0.7 million and $2.0 million of bad debt expense during the years ended December 31, 2004 and 2002, respectively. During the year ended December 31, 2003, improving financial conditions among our customers allowed us to reduce our allowance for doubtful accounts by $0.7 million, resulting in a credit of $0.7 million to bad debt expense.

- We carry our inventory at the lower of cost or market, with cost being determined using the first-in, first-out method. We use standard costs for material, labor, and manufacturing overhead to value our inventory. Our standard costs are updated on a monthly basis and any variances are expensed in the current period. Therefore, our inventory costs approximate actual costs at the end of each reporting period. We write-down our inventory for estimated obsolescence or unmarketable inventory by an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by management, we may be required to make additional inventory write-downs. Our reserve for excess and obsolete inventory was $4.8 million and $3.1 million at December 31, 2004 and 2003, respectively. Inventory write-downs charged to the reserve were $4.7 million, $1.6 million and $5.7 million for the years ended December 31, 2004, 2003 and 2002, respectively.

- The objective of our short-term investment policy is to preserve principal and maintain adequate liquidity with appropriate diversification, while emphasizing market returns on our monetary assets. The objective of our long-term investment policy is to emphasize total return; that is, the aggregate return from capital appreciation, dividend income, and interest income. These objectives are achieved through investments with appropriate diversification in fixed and variable rate income, public equity, and private equity portfolios. During 2002, we changed our fixed-income investment policy, shortening the maximum maturity from 15 years to five and one-half years, with consistent dollar maturities, year-to-year. We have experienced significant volatility in the market prices of our publicly traded equity investments. These investments are recorded on the Consolidated Balance Sheets at fair value with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss), net of tax. The ultimate realized value on these equity investments is subject to market price volatility until they are sold.

  We review our investment portfolio for potential "other-than-temporary" declines in value on an individual investment basis. We assess, on a quarterly basis, significant declines in value which may be considered other-than-temporary and, if necessary, recognize and record the appropriate charge to write-down the carrying value of such investments. In making this assessment, we take into consideration a wide range of objective and subjective information, including but not limited to the following: the magnitude and duration of historical decline in market prices, credit rating activity, assessments of liquidity, public filings, and statements made by the issuer. We generally begin our identification of potential other-than-temporary impairments by reviewing any security with a market value that has declined from its original or adjusted cost basis by 25% for more than six months. We then evaluate the individual security based on the previously identified factors to determine the amount of the write-down, if any. Actual losses, if any, could ultimately differ from these estimates. Future adverse changes in market conditions or poor operating results of underlying investments could result in additional losses that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future. For 2004, 2003 and 2002, we recorded other-than-temporary write-downs of our marketable equity investments of $0, $0 and $9.6 million, respectively. These write-downs are included in net realized investment gains (losses) in the accompanying Consolidated Statements of Income.

We also invest in privately held entities and record our investments in these entities at cost. We review our investments in these entities periodically in order to determine if circumstances (both financial and non-financial) exist that indicate that we will not recover our initial investment. Impairment charges are recorded on investments having a cost basis that is greater than the value that we would reasonably expect to receive in an arm's length sale of the investment. For 2004, 2003 and 2002, we recorded write-downs of our cost basis investments of $0.1 million, $0 and $2.0 million, respectively. These write-downs are included in net realized investment gains (losses) in the accompanying Consolidated Statements of Income.

- We estimate our income tax provision or benefit in each of the jurisdictions in which we operate, including estimating exposures related to examinations by taxing authorities. We also make judgments regarding the realization of deferred tax assets. The carrying value of our net deferred tax assets is based on our belief that it is more likely than not that we will generate sufficient future taxable income in certain jurisdictions to realize these deferred tax assets. A valuation allowance has been established for deferred tax assets which we do not believe meet the more-likely-than-not criteria established by Statement of Financial Accounting Standard ("SFAS") No. 109, *Accounting for Income Taxes*. Our estimates regarding future taxable income and income tax provision or benefit may vary due to changes in market conditions, changes in tax laws, or other factors. If our assumptions, and consequently our estimates, change in the future, the valuation allowances we have established may be increased or decreased, impacting future income tax expense. For 2004, 2003 and 2002, we recorded a valuation allowance of $0.6 million, $0.4 million and $0, respectively. This valuation allowance is included in non-current deferred tax liabilities in the accompanying Consolidated Balance Sheets.
- We estimate our cost to repair or replace defective products at the time revenue is recognized and include this cost in cost of goods sold in our Consolidated Statements of Income. Our products generally include warranties of one to 10 years for product defects. The liability for warranty returns totaled $1.6 million and $1.5 million at December 31, 2004 and 2003, respectively. These liabilities are included in accrued expenses in the accompanying Consolidated Balance Sheets. Our estimates regarding future warranty obligations may change due to product failure rates, shipment volumes, and other rework costs incurred in correcting a product failure. If our estimates change in the future, the liability for warranty returns we have established may be increased or decreased, impacting future cost of goods sold expense.

Results of Operations

The following table presents selected financial information derived from our Consolidated Statements of Income expressed as a percentage of sales for the years indicated.

(Stated as % of sales)

Year Ended December 31,	2004	2003	2002
Sales			
Carrier Networks Division	71.1%	67.4%	63.3%
Enterprise Networks Division	28.9	32.6	36.7
Total sales	**100.0**	**100.0**	**100.0**
Cost of sales	42.6	44.0	49.4
Gross profit	**57.4**	**56.0**	**50.6**
Selling, general and administrative expenses	20.2	21.0	23.5
Research and development expenses	14.8	14.7	16.2
Operating income	**22.4**	**20.3**	**10.9**
Interest income	1.7	2.3	2.6
Interest expenses	(0.6)	(0.6)	(0.7)
Other income	0.3	0.4	0.0
Net realized investment gains (losses)	0.4	0.1	(3.5)
Income before provision for income taxes	**24.2**	**22.4**	**9.3**
Provision for income taxes	7.7	6.9	2.1
Net income	**16.5%**	**15.5%**	**7.2%**

2004 Compared to 2003

Sales

ADTRAN's sales increased 14.6% from $396.7 million in 2003 to $454.5 million in 2004. The increase is primarily the result of increasing unit volume and market share gains in the Carrier Networks Division. In particular, the increase in overall sales is attributable to an increase in sales of our Systems and HDSL-based Total Access® 3000 broadband platform products, partially offset by decreased sales of our DBT/Total Reach® products. The increase in Systems revenue isprimarily attributable to sales of DSLAMs, optical access products, M13 multiplexers, and NetVanta® products.

Carrier Networks sales increased 20.8% from $267.6 million in 2003 to $323.3 million in 2004. Carrier Networks sales, as a percentage of total sales, increased from 67.4% in 2003 to 71.1% in 2004. The increase in Carrier Networks sales is primarily attributable to an increase in sales of DSLAMs, optical access products, and HDSL-based Total Access 3000 broadband platforms.

Enterprise Networks sales increased 1.6% from $129.1 million in 2003 to $131.2 million in 2004. The increase in Enterprise Networks sales is primarily related to an increase in sales of NetVanta products, partially offset by a decrease in CSU/DSU sales, which is a hardware unit that terminates carrier services at the enterprise location. NetVanta internetworking products consist of access routers, VPN products, and Ethernet switches. The industry has integrated the functionality of CSU/DSUs into access routers, thereby reducing the requirement for a standalone CSU/DSU. Enterprise Networks sales, as a percentage of total sales, decreased from 32.6% in 2003 to 28.9% in 2004.

Foreign sales increased 56.0% from $19.6 million in 2003 to $30.6 million in 2004. The increase in foreign sales is primarily attributable to increased revenue in Australia and Europe.

Cost of Sales

Cost of sales, as a percentage of sales, decreased from 44.0% in 2003 to 42.6% in 2004. The decrease is primarily related to manufacturing efficiencies, the timing differences between the recognition of cost reductions and the lowering of product selling prices, and the sales of higher margin new products. In addition, the decrease resulted from improvements in supply chain management, due to the implementation of an advanced planning system and a web-based procurement process, which has reduced cycle times and increased our manufacturing flexibility. We anticipate that continued deployment of supply chain applications, augmented with process improvement strategies will result in further cost reductions, which we believe will provide a continued competitive advantage. Carrier Networks cost of sales, as a percent of division sales, decreased from 45.8% in 2003 to 43.8% in 2004. Enterprise Networks cost of sales, as a percent of division sales, decreased from 40.4% in 2003 to 39.5% in 2004.

An important part of our 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 our gross profit margin due to timing differences between the recognition of cost reductions and the lowering of product selling prices. In view of the rapid pace of new product introductions by our 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 10.5% from $83.2 million in 2003 to $91.9 million in 2004. This increase is primarily related to the increase in sales and the related increase in sales and marketing expenses. We also incurred increased insurance costs of approximately $1.1 million and increases in professional services costs related to Sarbanes-Oxley compliance. In addition, $0.7 million of bad debt expense was recorded in 2004, compared to $0 of bad debt expense recorded in 2003. During the year ended December 31, 2003, improving financial conditions among our customers allowed us to reduce our allowance for doubtful accounts by $0.7 million, resulting in a credit of $0.7 million to bad debt expense. Selling, general and administrative expenses as a percentage of sales decreased from 21.0% in 2003 to 20.2% in 2004. Selling, general and administrative expenses include personnel costs for administration, finance, information systems, human resources, sales and marketing and general management, as well as rent, utilities, legal and accounting expenses, bad debt expense, advertising, promotional material, gains or losses on the disposal of property, plant and equipment occurring in the normal course of business, trade show expenses, and related travel costs. The decrease in selling, general and administrative expenses as a percentage of sales is due to our continued control of discretionary spending. Selling, general and administrative expenses as a percent of sales will generally fluctuate whenever there is significant fluctuation in revenues during the periods being compared.

Research and Development Expenses

Research and development expenses increased 16.0% from $58.1 million in 2003 to $67.4 million in 2004. The increase in research and development expenses is primarily related to an increase in product approval costs for DSLAMs and optical access products. As a percentage of sales, research and development expenses increased from 14.7% in 2003 to 14.8% in 2004. Research and development expenses as a percent of sales have remained relatively stable due to our continued control of discretionary spending in areas such as travel, contract labor and training. Research and development expenses as a percentage of sales will fluctuate whenever there is a significant fluctuation in revenues during the periods being compared.

We continually evaluate new product opportunities and engage in intensive research and product development efforts. We frequently invest heavily in up-front new product development efforts prior to the actual commencement of sales of a major new product. To date, we have expensed all product research and development costs as incurred. As a result, we may incur significant research and development expenses prior to the receipt of revenues from a major new product group. We are presently incurring research and development expenses in connection with new products and expansion into international markets. In today's challenging industry environment, we have maintained our level of investment in research and development during a period when many competitors have significantly reduced their investments in this area. This investment has provided for continued new product development, enhancement of current products, and product cost reductions.

Interest and Dividend Income

Interest and dividend income decreased 13.5% from $8.9 million in 2003 to $7.7 million in 2004. This decrease is primarily related to lower interest rates and shorter maturities on our fixed income investments.

Interest Expense

Interest expense on our taxable revenue bond remained constant at $2.5 million in 2004 and 2003. See Note 5 of Notes to Consolidated Financial Statements for additional information on our revenue bond.

Net Realized Investment Gains (Losses)

Net realized investment gains increased from $0.2 million in 2003 to $1.8 million in 2004. This increase is primarily related to the sale of a cost basis investment that had previously been written down and additional transactional-based net gains realized in 2004.

Other Income (Expense)

Other income decreased from $1.6 million in 2003 to $1.4 million in 2004. This decrease is primarily related to a reduction in realized foreign currency gains in 2004.

Income Taxes

Our effective tax rate increased from 30.7% in 2003 to 31.7% in 2004. This increase is primarily related to a higher mix of taxable income and the settlement of prior year tax contingencies. This increase was partially offset by additional research and development tax credits from prior years, resulting in higher research and development tax credits as a percent of taxable income.

Net Income

As a result of the above factors, net income increased from $61.5 million in 2003 to $75.1 million in 2004. As a percentage of sales, net income increased from 15.5% in 2003 to 16.5% in 2004.

2003 Compared to 2002

Sales

ADTRAN's sales increased 14.7% from $345.7 million in 2002 to $396.7 million in 2003. The increase is primarily the result of increasing unit volume and market share gains in the Carrier Networks Division. In particular, the increase in overall sales is attributable to an increase in sales of our Systems products, partially offset by decreased sales of our DBT/Total Reach® and HDSL/T1 products. The increase in Systems revenue is attributable to sales of DSLAMs, optical access products and NetVanta® products. NetVanta internetworking products consist of access routers, VPN products, and Ethernet switches. The decrease in HDSL/T1 revenue is primarily attributable to a decrease in Enterprise Networks Division sales of T1 CSU/DSU products, partially offset by an increase in Carrier Networks Division sales of HDSL products.

Carrier Networks sales increased 22.2% from $218.9 million in 2002 to $267.6 million in 2003. Carrier Networks sales, as a percentage of total sales, increased from 63.3% in 2002 to 67.4% in 2003. The increase in Carrier Networks sales is primarily attributable to an increase in sales of DSLAMs, optical access products, and HDSL-based Total Access® 3000 broadband platforms.

Enterprise Networks sales increased 1.8% from $126.8 million in 2002 to $129.1 million in 2003. The increase in Enterprise Networks sales is primarily related to an increase in sales of Total Access® integrated access devices and NetVanta products, partially offset by a decrease in CSU/DSU sales. The industry has integrated the functionality of CSU/DSUs into access routers, thereby reducing the requirement for a standalone CSU/DSU. Enterprise Networks sales, as a percentage of total sales, decreased from 36.7% in 2002 to 32.6% in 2003.

Foreign sales decreased 3.4% from $20.3 million in 2002 to $19.6 million in 2003. The decrease in foreign sales is attributable to market challenges in the European and Asia/Pacific regions. We are still in the process of developing business relationships and expanding our sales base in these regions.

Cost of Sales

Cost of sales, as a percentage of sales, decreased from 49.4% in 2002 to 44.0% in 2003. The decrease is primarily related to manufacturing efficiencies, the timing differences between the recognition of cost reductions and the lowering of product selling prices, and the sales of higher margin new products. In addition, the decrease resulted from improvements in supply chain management, due to the implementation of an advanced planning system and a web-based procurement process, which has reduced cycle times and increased our manufacturing flexibility. We anticipate that continued deployment of supply chain applications, augmented with process improvement strategies will result in further cost reductions, which we believe will provide a continued competitive advantage. Carrier Networks cost of sales, as a percent of division sales, decreased from 51.9% in 2002 to 45.8% in 2003. Enterprise Networks cost of sales, as a percent of division sales, decreased from 45.1% in 2002 to 40.4% in 2003.

An important part of our 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 our gross profit margin due to timing differences between the recognition of cost reductions and the lowering of product selling prices. In view of the rapid pace of new product introductions by our 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 2.5% from $81.2 million in 2002 to $83.2 million in 2003. This increase is primarily related to an increase in sales and the rescission in September 2002 of salary reductions implemented in the second half of 2001 as a cost control mechanism, instead of extensive staff reductions generally imposed throughout the telecommunications industry. The increase in selling, general and administrative expenses is partially offset by $2.0 million of bad debt expense that was recorded in 2002, compared to $0 of bad debt expense that was recorded in 2003. In addition, improving financial conditions among our customers allowed us to reduce our allowance for doubtful accounts by $0.7 million in the latter half of 2003. Selling, general and administrative expenses as a percentage of sales decreased from 23.5% in 2002 to 21.0% in 2003. Selling, general and administrative expenses include personnel costs for administration, finance, information systems, human resources, sales and marketing and general management, as well as rent, utilities, legal and accounting expenses, bad debt expense, advertising, promotional material, gains or losses on the disposal of property, plant and equipment occurring in the normal course of business, trade show expenses, and related travel costs. The decrease in selling, general and administrative expenses as a percentage of sales is due to our continued control of discretionary spending. Selling, general and administrative expenses as a percent of sales will generally fluctuate whenever there is significant fluctuation in revenues during the periods being compared.

Research and Development Expenses

Research and development expenses increased 3.2% from $56.3 million in 2002 to $58.1 million in 2003. The increase in research and development expenses is primarily related to the rescission of salary reductions in September 2002 and an increase in product approval costs. As a percentage of sales, research and development expenses decreased from 16.2% in 2002 to 14.7% in 2003. The decrease in research and development expenses as a percent of sales is due to our continued control of discretionary spending in areas such as travel, contract labor and training. Research and development expenses as a percentage of sales will fluctuate whenever there is a significant fluctuation in revenues during the periods being compared.

We continually evaluate new product opportunities and engage in intensive research and product development efforts. We frequently invest heavily in up-front new product development efforts prior to the actual commencement of sales of a major new product. To date, we have expensed all product research and development costs as incurred. As a result, we may incur significant research and development expenses prior to the receipt of revenues from a major new product group. We are presently incurring research and development expenses in connection with new products and expansion into international markets. In today's challenging industry environment, we have maintained our level of investment in research and development during a period when many competitors have significantly reduced their investments in this area. This investment has provided for continued new product development, enhancement of current products, and product cost reductions.

Interest and Dividend Income

Interest and dividend income decreased 2.2% from $9.1 million in 2002 to $8.9 million in 2003. This decrease is primarily related to lower interest rates and shorter maturities on our fixed income investments, partially offset by an increase in interest producing assets.

Interest Expense

Interest expense on our taxable revenue bond decreased slightly from $2.6 million in 2002 to $2.5 million in 2003. See Note 5 of Notes to Consolidated Financial Statements for additional information on our revenue bond.

Net Realized Investment Gains (Losses)

Net realized investment gain (loss) changed from a net loss of $12.0 million in 2002 to a net gain of $0.2 million in 2003. This change is primarily related to an impairment charge for other-than-temporary declines in the market value of investments that was recognized in the second and third quarters of 2002, compared to transactional-based gains and losses realized in 2003. We assess, on a quarterly basis, significant declines in investment value which may be considered other-than-temporary and, if necessary, recognize and record the appropriate charge to write-down the carrying value of such investments. Accordingly, during 2002, we recorded $9.6 million of other-than-temporary investment impairment charges related to 19 marketable equity securities investments. The remaining $2.4 million of net realized investment loss was related to write-downs of private securities and realized transactional gains and losses in 2002.

Other Income (Expense)

Other income increased from $0.2 million in 2002 to $1.6 million in 2003. This increase is primarily related to net recoveries from former customers, realized foreign currency gains, and scrap material sales.

Income Taxes

Our effective tax rate increased from 23.0% in 2002 to 30.7% in 2003. This increase is primarily related to a higher mix of taxable income and lower research and development tax credits as a percent of taxable income, partially offset by the settlement of tax contingencies during 2003. During the year ended December 31, 2003, we resolved certain tax contingencies resulting in the reduction of our effective tax rate from 31.5% to 30.7%.

Net Income

As a result of the above factors, net income increased from $24.8 million in 2002 to $61.5 million in 2003. As a percentage of sales, net income increased from 7.2% in 2002 to 15.5% in 2003.

Liquidity and Capital Resources

Fifty million dollars of the expansion of Phase III of our corporate headquarters was approved for participation in an incentive program offered by the Alabama State Industrial Development Authority (the "Authority"). The incentive program enables participating companies 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. We cannot be certain that the state of Alabama will continue to make these corporate income tax credits available in the future, and therefore, we may not realize the full benefit of these incentives. Through December 31, 2004, the Authority had issued $50.0 million of its taxable revenue bonds pursuant to the incentive program and loaned the proceeds from the sale of the bonds to ADTRAN®. We are required to make payments to the Authority in the amounts necessary to pay the principal of and interest on the Authority's Taxable Revenue Bond, Series 1995, as amended, currently outstanding in the aggregate principal amount of $50.0 million. The bond matures on January 1, 2020, and bears interest at the rate of 5% per annum. Included in long-term investments are $50.0 million of restricted funds, which is a collateral deposit against the principal amount of this bond. In conjunction with this program, we are eligible to receive certain economic incentives from the state of Alabama that reduce the amount of payroll withholdings that we are required to remit to the state for those employment positions that qualify under the program. Our economic incentives realized for the years ended December 31, 2004, 2003 and 2002 were $1.3 million, $1.5 million and $1.2 million, respectively.

The following table shows our declared and paid dividends by quarter. The board of directors presently anticipates that it will declare a regular quarterly dividend so long as the present tax treatment of dividends exists and adequate levels of liquidity are maintained.

Dividends per Common Share

2004

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
$0.080	$0.080	$0.080	$0.080

2003

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
—	—	$1.075 (1)	$0.075

(1) On July 14, 2003, the board of directors declared a special cash dividend of $1.00 per common share and a quarterly cash dividend of $0.075 per common share. Prior to July 14, 2003, ADTRAN had not declared any cash dividends on its common stock.

On January 24, 2005, the board declared a quarterly cash dividend of $0.08 per common share to be paid to stockholders of record at the close of business on February 4, 2005. The quarterly dividend payment was $6.1 million and was paid on February 16, 2005.

On October 13, 2003, we announced that our board of directors declared, effective December 15, 2003, a two-for-one stock split to be effected in the form of a stock dividend of one share of common stock for each outstanding share of common stock for stockholders of record on December 1, 2003. Share and per share amounts, including stock options, in the accompanying Consolidated Statements of Income and Notes to Consolidated Financial Statements have been retroactively adjusted to reflect our stock split.

In connection with the preparation of this report, we concluded that it was appropriate to classify our auction rate municipal bonds and variable rate municipal demand notes as current investments. Previously, such investments had been classified as cash and cash equivalents. Accordingly, we have revised the classification to report these securities as short-term investments in our Consolidated Balance Sheets as of December 31, 2004 and 2003. We have also made corresponding adjustments to our Consolidated Statements of Cash Flows for the periods ended December 31, 2004, 2003 and 2002 to reflect the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported Consolidated Statements of Cash Flows, or our previously reported Consolidated Statements of Income for any period.

At December 31, 2004 and 2003, we held $93.4 million and $38.0 million, respectively, of auction rate municipal bonds and variable rate municipal demand notes classified as available-for-sale short-term investments. Our investments in these securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every seven to 35 days, and, despite the long-term nature of their stated contractual maturities, we have the ability to quickly liquidate these securities. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from our current investments. All income generated from these current investments was recorded as interest income.

Our working capital, which consists of current assets less current liabilities, increased 21.0% from $220.1 million as of December 31, 2003 to $266.4 million as of December 31, 2004. The quick ratio, defined as cash, cash equivalents, short-term investments, and net accounts receivable, divided by current liabilities, increased from 4.87 as of December 31, 2003 to 6.83 as of December 31, 2004. The current ratio, defined as current assets divided by current liabilities, increased from 6.46 as of December 31, 2003 to 8.40 as of December 31, 2004. The increase in liquidity ratios is primarily a result of our ability to generate cash from operations and a net movement of monetary assets from long-term investments to short-term investments and cash and cash equivalents, partially offset by purchases of company common stock and dividend payments.

At December 31, 2004, we had an income tax receivable of $2.4 million primarily related to amended tax filings for additional federal research and development tax credits. At December 31, 2003, we had an income tax receivable of $11.6 million. This receivable was generated in the fourth quarter of 2003 from the tax benefit associated with the exercise of non-qualified stock options. We receive an income tax deduction for the difference between the exercise price and the market price of a non-qualified stock option upon exercise by the employee. We recorded $3.0 million and $23.6 million for the years ended December 31, 2004 and 2003, respectively, as an income tax deduction for the difference between the exercise price and the market price of non-qualified stock option exercises.

At December 31, 2004, cash on hand was $57.6 million and short-term investments were $124.8 million, which placed our short-term liquidity at $182.4 million. At December 31, 2003, our cash on hand of $94.1 million and short-term investments of $49.9 million placed our short-term liquidity at $144.0 million. The increase from 2003 to 2004 is primarily attributable to our ability to generate cash from operations and a net movement of monetary assets from long-term investments to cash and cash equivalents, partially offset by purchases of company common stock and dividend payments.

At December 31, 2004, our long-term investments decreased by 28.3% to $167.6 million from $233.7 million at December 31, 2003. This decrease is primarily attributable to a net movement of monetary assets from long-term investments to short-term investments and cash and cash equivalents, and a decrease in market value of our long-term investments. The decrease in deferred tax liabilities is primarily attributable to the decrease in market value of our long-term investments. Long-term investments at December 31, 2004 and December 31, 2003 include a restricted balance of $50.0 million related to our revenue bonds, as discussed above. We intend to finance our operations in the future with cash flow from operations. We believe this source of funds to be adequate to meet our operating and capital needs for the foreseeable future.

Accounts receivable increased 21.7% from December 31, 2003 to December 31, 2004. Quarterly days sales outstanding increased 14 days from 42 days as of December 31, 2003 to 56 days as of December 31, 2004. This increase in accounts receivable and quarterly days sales outstanding is the result of an increase in sales in the last half of the fourth quarter of 2004 compared to the fourth quarter of 2003 and does not reflect an increase in the average collection time of accounts receivable. Other receivables decreased 38.0% from December 31, 2003 to December 31, 2004, primarily resulting from timing and fluctuations of payments from subcontractors. Quarterly inventory turnover decreased from 4.86 turns as of December 31, 2003 to 4.70 turns as of December 31, 2004. The decrease in inventory turnover is attributable to a slow down in bookings in the latter half of 2004, partially offset by our continued efforts to streamline our production process, work closely and efficiently with our subcontractors, and increase manufacturing velocity. In addition, improvements in supply chain management, due to the implementation of an advanced planning system and a web-based procurement process, have reduced cycle times and increased our manufacturing flexibility. The deployment of these supply chain applications and initiatives has resulted in improved inventory control.

Accounts payable decreased 7.9% from December 31, 2003 to December 31, 2004. Accrued expenses decreased 11.2% from December 31, 2003 to December 31, 2004. These decreases are primarily related to variations of the timing of our payments. Capital expenditures totaled approximately $7.2 million, $6.8 million and $2.6 million for the years ended December 31, 2004, 2003 and 2002, respectively. These expenditures were primarily used to purchase computer hardware and software, and manufacturing and test equipment.

In July 2001, ADTRAN® announced that its board of directors approved the repurchase of 2,000,000 shares of its common stock. With the repurchase of 323,400 shares in April 2004 for $8.0 million, ADTRAN completed this share repurchase plan. On April 29, 2004, ADTRAN announced that its board of directors approved the repurchase of up to 4,000,000 shares of its common stock. As of December 31, 2004, we had repurchased 2,999,300 shares of our common stock at a total cost of $73.0 million and had the authority to purchase an additional 1,000,700 shares. During February 2005, the purchase of 1,000,700 shares completed this repurchase plan for a total cost of $91.0 million. On February 11, 2005, ADTRAN announced that its board of directors approved the repurchase of up to 5,000,000 shares of its common stock. This plan will be implemented through open market purchases from time to time as conditions warrant.

We issued 84,794 shares of treasury stock and 357,601 newly issued shares of common stock for $5.6 million during the year ended December 31, 2004, to accommodate employee stock option exercises. During 2003, we issued 4,125,242 shares of treasury stock and 404,029 newly issued shares of common stock for $55.1 million to accommodate employee stock option exercises. During 2002, we issued 375,500 shares of treasury stock to accommodate employee stock option exercises.

We have used, and expect to continue to use, the cash generated from operations for working capital, dividend payments, and other general corporate purposes, including (i) product development activities to enhance our existing products and develop new products and (ii) expansion of sales and marketing activities.

We have various contractual obligations and commercial commitments. The following table sets forth, in millions, the annual payments we are required to make under contractual cash obligations and other commercial commitments at December 31, 2004.

Contractual Obligations

(In millions)

	Total	2005	2006	2007	2008	After 2008
Long-term debt	$50.0	—	—	—	—	$50.0
Interest on long-term debt	$37.5	$2.5	$2.5	$2.5	$2.5	$27.5
Investment commitments	$5.1	$1.3	—	$3.8	—	—
Operating lease obligations	$1.8	$0.7	$0.5	$0.4	$0.2	—
Purchase obligations	$27.1	$27.1	—	—	—	—
Totals	**$121.5**	**$31.6**	**$3.0**	**$6.7**	**$2.7**	**$77.5**

We are required to make payments necessary to pay the interest on the Taxable Revenue Bond, Series 1995, as amended, currently outstanding in the aggregate principal amount of $50.0 million. The bond matures on January 1, 2020, and currently bears interest at the rate of 5% per annum. Included in long-term investments are $50.0 million of restricted funds, which is a collateral deposit against the principal amount of this bond.

We do not have off-balance sheet financing arrangements and have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of or requirements for capital resources. See Notes 5 and 10 of Notes to Consolidated Financial Statements for additional information on our revenue bond and operating lease obligations, respectively. We have committed to invest an aggregate of $7.2 million in two private equity funds, of which $2.1 million has been invested to date. At December 31, 2004, we had outstanding purchase agreements with vendors of approximately $27.1 million to purchase materials and services.

Effect of Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board ("FASB") reached consensus on the guidance provided by Emerging Issues Task Force ("EITF") Issue 03-1 ("EITF 03-1"), *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The guidance is applicable to debt and equity securities that are within the scope of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities and Certain Other Investments*. EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. The disclosure provisions of EITF 03-1 for investments accounted for under SFAS No. 115 and SFAS No. 124 were effective for annual reporting periods ending after December 15, 2003. In September 2004, the EITF delayed the effective date for the measurement and recognition guidance included in paragraphs 10 through 20 of EITF 03-1. The disclosures required of EITF 03-1, paragraphs 21 and 22, have not been deferred. We continue to evaluate all existing and future investments in order to determine the applicability of EITF 03-1.

On October 4, 2004, the Working Families Tax Relief Act of 2004 was signed into law. This legislation extended the research and development (R&D) tax credit for 18 months, from July 1, 2004 to December 31, 2005, allowing U.S. companies conducting qualifying research and development activities to receive a tax credit of up to 10% of R&D spending. The additional tax credit was approximately $620 thousand for this fiscal year and was reflected in the fourth quarter tax provision.

On October 22, 2004, the American Jobs Creation Act of 2004 was signed into law. This legislation repeals export tax benefits, which have historically reduced our effective tax rate. This legislation transitions the repeal by allowing 100% of 2004, 80% of 2005, and 60% of 2006 export benefits. The legislation also transitions in a new tax deduction for U.S. manufacturing, which will benefit ADTRAN®. The legislation did not have a material effect on our 2004 tax expense. ADTRAN expects the net effect of the phase out of the extra-territorial income (ETI) and phase in of this new deduction to result in a decrease between 0.50% to 0.75% in the effective tax rate for 2005.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4*. SFAS No. 151 amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005, and is required to be adopted by ADTRAN effective January 1, 2006. We do not expect SFAS No. 151 to have a material impact on our consolidated results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 123(R), *Accounting for Stock-Based Compensation*. SFAS No. 123R revises the guidance in SFAS No. 123 and supercedes Accounting Principles Board Opinion 25 ("APB 25"), and its related implementation guidance. SFAS No. 123R focuses primarily on the accounting for share-based payments to employees in exchange for services, and it requires a public entity to measure and recognize compensation cost for these payments. SFAS No. 123R is effective for reporting periods beginning after June 15, 2005 (third quarter 2005 for ADTRAN). SFAS No. 123R requires ADTRAN to recognize the cost of employee services received in exchange for its equity instruments. Currently, in accordance with APB 25, we record the intrinsic value of stock-based compensation as expense. Accordingly, no compensation expense is currently recognized for fixed stock option plans as the exercise price equals the stock price on the date of grant. Under SFAS No. 123R, ADTRAN will be required to measure compensation expense over the options' vesting period based on the stock options' fair value at the date the options are granted. SFAS No. 123R allows for the use of the Black-Scholes or a lattice option-pricing model to value such options.

ADTRAN has determined that it will use the Black-Scholes option-pricing model to calculate the fair value of its options. As allowed by SFAS No. 123R, ADTRAN can elect either Modified Prospective Application, which applies the statement to new awards and modified awards after the effective date, and to any unvested awards as service is rendered on or after the effective date, or Modified Retrospective Application, which can apply the statement to either all prior years for which SFAS No. 123 was effective or only to prior interim periods in the year of adoption. ADTRAN is currently evaluating which method of application will be used. Note 1 of the Consolidated Financial Statements illustrates the effects on net income and earnings per share if ADTRAN had adopted SFAS No. 123 using the Black-Scholes option-pricing model. Based on information currently available, we expect to recognize approximately $3.8 million of compensation cost during the last six months of 2005 related to our stock option awards. For a discussion of our stock-based compensation plans and agreements, see Note 7.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29*. SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for periods beginning after June 15, 2005, and is required to be adopted by ADTRAN effective July 1, 2005. We do not expect SFAS No. 153 to have a material impact on our consolidated results of operations or financial condition.

Management's Report on Internal Control Over Financial Reporting

Management of ADTRAN®, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. ADTRAN's internal control over financial reporting is 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. ADTRAN's internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of ADTRAN;
- 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 ADTRAN are being made only in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of ADTRAN's assets that could have a material effect on the financial statements.

Internal control over financial reporting includes the controls themselves, monitoring (internal auditing practices) and actions taken to correct deficiencies as identified.

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.

Management assessed the effectiveness of ADTRAN's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*.

Based on our assessment and those criteria, management has concluded that ADTRAN maintained effective internal control over financial reporting as of December 31, 2004.

Our management's assessment of the effectiveness of the Company's internal control over financial reporting as of March 11, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Date: March 11, 2005

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of ADTRAN, Inc.

We have completed an integrated audit of ADTRAN, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholder's equity and cash flows present fairly, in all material respects, the financial position of ADTRAN, Inc. and its subsidiaries at December 31, 2004 and 2003 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements 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 our opinion.

Internal Control Over Financial Reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control over Financial Reporting appearing on page 28 of the 2004 Annual Report to Shareholders that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides 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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) 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.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Birmingham, Alabama
March 11, 2005

Financial Statements

ADTRAN, Inc.

Consolidated Balance Sheets

December 31, 2004 and 2003

(In thousands, except per share amounts)

Assets	2004	2003
Current assets		
Cash and cash equivalents	$57,602	$94,048
Short-term investments	124,831	49,889
Accounts receivable, less allowance for doubtful accounts of $361 and $1,746 at December 31, 2004 and 2003, respectively	63,729	52,384
Other receivables	4,335	6,988
Income tax receivable	2,442	11,586
Inventory, net	42,316	39,975
Prepaid expenses	2,643	2,127
Deferred tax assets	4,488	3,381
Total current assets	**302,386**	**260,378**
Property, plant and equipment, net	89,361	97,667
Other assets	586	530
Long-term investments	167,609	233,734
Total assets	**$559,942**	**$592,309**

Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$22,856	$24,821
Unearned revenue	2,468	3,209
Accrued expenses	2,344	2,621
Accrued payroll	8,347	9,658
Total current liabilities	**36,015**	**40,309**
Deferred tax liabilities	4,825	7,291
Other non-current liabilities	2,465	888
Bonds payable	50,000	50,000
Total liabilities	**93,305**	**98,488**
Commitments and contingencies (see Note 10)		
Stockholders' equity		
Common stock, par value $0.01 per share; 200,000 shares authorized; 79,652 and 79,294 shares issued and outstanding in 2004 and 2003, respectively	797	793
Additional paid-in capital	142,243	135,814
Accumulated other comprehensive income	5,235	10,012
Retained earnings	397,228	347,202
Less treasury stock at cost: 3,238 shares at December 31, 2004	(78,866)	—
Total stockholders' equity	**466,637**	**493,821**
Total liabilities and stockholders' equity	**$559,942**	**$592,309**

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

ADTRAN, Inc.

Consolidated Statements of Income

Years ended December 31, 2004, 2003 and 2002

(In thousands, except per share amounts)	2004	2003	2002
Sales	$454,517	$396,676	$345,725
Cost of sales	193,445	174,681	170,789
Gross profit	**261,072**	**221,995**	**174,936**
Selling, general and administrative expenses	91,927	83,234	81,217
Research and development expenses	67,384	58,144	56,295
Operating income	**101,761**	**80,617**	**37,424**
Interest and dividend income	7,671	8,912	9,113
Interest expense	(2,542)	(2,534)	(2,572)
Other income	1,353	1,609	234
Net realized investment gains (losses)	1,773	226	(12,022)
Income before provision for income taxes	**110,016**	**88,830**	**32,177**
Provision for income taxes	34,875	27,315	7,401
Net income	**$75,141**	**$61,515**	**$24,776**
Weighted average shares outstanding	78,235	76,942	76,090
Weighted average shares outstanding assuming dilution (1)	80,985	80,739	76,443
Earnings per common share – basic	$0.96	$0.80	$0.33
Earnings per common share – assuming dilution (1)	$0.93	$0.76	$0.32

(1) Assumes exercise of dilutive stock options calculated under the treasury stock method. See Notes 1 and 11 of Notes to Consolidated Financial Statements for additional information.

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

ADTRAN, Inc.

Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2004, 2003 and 2002

(In thousands)	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance, December 31, 2001	**39,445**	**$394**	**$96,384**	**$350,234**	**($18,759)**	**$9,375**	**$437,628**
Net income				24,776			24,776
Change in unrealized gain on marketable securities (net of deferred tax of $4,002)						(7,088)	(7,088)
Reclassification adjustment for amounts included in net income (net of income tax of $457)						810	810
Stock options exercised: various prices per share			1		3,695		3,696
Purchase of treasury stock: 1,340 shares					(25,207)		(25,207)
Income tax benefit from exercise of non-qualified stock options			597				597
Balance, December 31, 2002	**39,445**	**$394**	**$96,982**	**$375,010**	**($40,271)**	**$3,097**	**$435,212**
Net Income				61,515			61,515
Dividend payments				(88,926)			(88,926)
Change in unrealized gain on marketable securities (net of deferred tax of $4,484)						7,618	7,618
Reclassification adjustment for amounts included in net income (net of income tax of $576)						(997)	(997)
Unrealized foreign exchange translation (net of deferred tax of $141)						294	294
Stock options exercised: various prices per share	214	2	14,814		40,271		55,087
100% stock dividend	39,635	397		(397)			0
Income tax benefit from exercise of non-qualified stock options			23,637				23,637
Issue of options below fair market value			381				381
Balance, December 31, 2003	**79,294**	**$793**	**$135,814**	**$347,202**	**$0**	**$10,012**	**$493,821**
Net Income				75,141			75,141
Dividend payments				(25,115)			(25,115)
Change in unrealized gain on marketable securities (net of deferred tax of $1,516)						(2,632)	(2,632)
Reclassification adjustment for amounts included in net income (net of income tax of $1,273)						(2,208)	(2,208)
Unrealized foreign exchange translation (net of deferred tax of $45)						63	63
Stock options exercised: various prices per share	358	4	3,465		2,088		5,557
Purchase of treasury stock: 3,323 shares					(80,954)		(80,954)
Income tax benefit from exercise of non-qualified stock options			2,964				2,964
Balance, December 31, 2004	**79,652**	**$797**	**$142,243**	**$397,228**	**($78,866)**	**$5,235**	**$466,637**

ADTRAN issued 281 shares, 4,125 shares and 375 shares of treasury stock to accommodate employee stock option exercises during 2004, 2003 and 2002, respectively, and issued 358, 214 and 0 shares of common stock to accommodate employee stock option exercises during 2004, 2003 and 2002, respectively.

Comprehensive income in 2004 of $70,364 consists of net income of $75,141, unrealized losses on marketable securities of $2,632 (net of deferred tax), reclassification adjustment of $2,208 (net of income tax), and foreign currency translation adjustments of $63 (net of deferred tax).

Comprehensive income in 2003 of $68,430 consists of net income of $61,515, unrealized gains on marketable securities of $7,618 (net of deferred tax), reclassification adjustment of ($997) (net of income tax), and foreign currency translation adjustments of $294 (net of deferred tax).

Comprehensive income in 2002 of $18,498 consists of net income of $24,776, unrealized losses on marketable securities of $7,088 (net of deferred tax), and reclassification adjustment of $810 (net of income tax).

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

ADTRAN, Inc.
Consolidated Statements of Cash Flows
Years ended December 31, 2004, 2003 and 2002

(In thousands)	2004	2003	2002
Cash flows from operating activities			
Net income	$75,141	$61,515	$24,776
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	15,373	15,247	16,406
Loss on sale of property, plant and equipment	65	3	101
Loss (gain) on sale of short-term investments	—	—	(31)
Loss (gain) on sale of long-term investments	(1,773)	(226)	426
Write-down of other equity and debt securities	—	—	11,627
Non-cash compensation expense	—	381	—
Deferred income taxes	(769)	2,812	1,210
Income tax benefit from exercise of non-qualified stock options	2,964	23,638	597
Change in operating assets and liabilities:			
Accounts receivable, net	(11,345)	(13,502)	21,716
Other receivables	2,653	(2,528)	5,150
Income tax receivable	9,144	(11,586)	—
Inventory, net	(2,341)	(49)	16,923
Prepaid expenses and other assets	(572)	498	857
Accounts payable	(1,965)	10,241	2,237
Accrued expenses and unearned revenue	(752)	3,683	728
Income taxes payable	—	(4,773)	2,455
Net cash provided by operating activities	**85,823**	**85,354**	**105,178**
Cash flows from investing activities			
Expenditures for property, plant and equipment	(7,165)	(6,782)	(2,647)
Proceeds from the disposition of property, plant and equipment	32	38	100
Proceeds from sale of available-for-sale investments	126,610	99,421	145,510
Purchases of available-for-sale investments	(146,018)	(176,312)	(189,386)
Proceeds from maturities of held-to-maturity investments	4,720	18,738	42,377
Purchases of held-to-maturity investments	—	(10,856)	(42,909)
Net cash used in investing activities	**(21,821)**	**(75,753)**	**(46,955)**
Cash flows from financing activities			
Proceeds from issuance of common stock	5,557	55,087	3,696
Purchase of treasury stock	(80,954)	—	(25,206)
Dividend payments	(25,115)	(88,927)	—
Net cash used in financing activities	**(100,512)**	**(33,840)**	**(21,510)**
Net (decrease) increase in cash and cash equivalents	(36,510)	(24,239)	36,713
Effect of exchange rate changes	64	294	—
Cash and cash equivalents, beginning of year	**94,048**	**117,993**	**81,280**
Cash and cash equivalents, end of year	**$57,602**	**$94,048**	**$117,993**
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	$2,542	$2,576	$2,529
Cash paid during the year for income taxes	$25,113	$14,061	$8,498

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

Notes to Consolidated Financial Statements

1 Nature of Business and Summary of Significant Accounting Policies

ADTRAN®, Inc. designs, develops, manufactures, markets, and services a broad range of high-speed network access products utilized by providers of telecommunications services (serviced by our Carrier Networks Division) and corporate end users (serviced by our Enterprise Networks Division) to implement advanced digital services over public and private networks. Our products are used primarily in the "last mile" of the network, or the local loop. The last mile is that segment of a telecommunications network that connects end-user subscribers to a service provider's closest facility. Our products typically connect two ends of a telecommunications circuit, and serve to transmit data, voice, and video over that circuit.

Principles of Consolidation

Our consolidated financial statements include ADTRAN and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

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

Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. Investments represent re-marketed preferred stocks, municipal bonds, and marketable equity securities. Re-marketed preferred stocks and variable rate municipal bonds are designed to be marketed as money market instruments. These instruments' dividend 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).

Long-term investments represent restricted money market funds, municipal bonds, marketable equity securities, and other equity and debt investments. The fair value of the restricted money market funds approximates fair value due to a variable interest rate. Marketable equity securities are reported at market value as determined by the most recently traded price of the securities at the balance sheet date, although the securities may not be readily marketable due to the size of the available market. Unrealized gains and losses, net of tax, are reported as a separate component of stockholders' equity. Realized gains and losses on sales of securities are computed under the specific identification method and are included in current income. We periodically review our investment portfolio for investments considered to have sustained an other-than-temporary decline in value. Impairment charges for other-than-temporary declines in value are recorded as realized losses in the accompanying Consolidated Statements of Income. Our investments at December 31, 2004 and 2003 are classified as available-for-sale or held-to-maturity (see Note 2).

Other Receivables

Other receivables are comprised primarily of accrued interest, amounts due from subcontract manufacturers for product component transfer, and rebates due from vendors.

Inventory

Inventory is carried at the lower of cost or market, with cost being determined using the first-in, first-out method. Standard costs for material, labor, and manufacturing overhead are used to value inventory. All standard costs are rolled forward on a monthly basis. Therefore, inventory costs approximate actual costs at the end of each reporting period. We establish reserves for estimated excess, obsolete, or unmarketable inventory by an amount equal to the difference between the cost of the inventory and the estimated market value of the inventory based upon assumptions about future demand and market conditions. When excess and obsolete inventories are disposed of by our company, the related write-downs are charged against the inventory reserve.

Property, Plant and Equipment

Property, plant and equipment, which are stated at cost, are depreciated using methods which approximate straight-line depreciation over the estimated useful lives of the assets. We depreciate building and land improvements from five to 39 years, office machinery and equipment from three to seven years, and engineering machinery and equipment from three to seven years. Expenditures for repairs and maintenance are charged to expense as incurred. Betterments that 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 selling, general and administrative expenses in the accompanying Consolidated Statements of Income.

Liability for Warranty Returns

Our products generally include warranties of one to 10 years for product defects. We accrue for warranty returns at the cost to repair or replace the defective products at the time revenue is recognized. We engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers. Our warranty obligation is affected by product failure rates, material usage, and other rework costs incurred in correcting a product failure. The liability for warranty returns totaled $1.6 million and $1.5 million at December 31, 2004 and 2003, respectively. These liabilities are included in accrued expenses in the accompanying Consolidated Balance Sheets.

		Additions			
(In thousands)	Balance at Beginning of Period	Charged (Credited) to Costs and Expenses	Charged (Credited) to Other Accounts	Deductions	Balance at End of Period
Year ended December 31, 2004					
Warranty liability	$1,541	$2,054	—	$2,035	$1,560
Year ended December 31, 2003					
Warranty liability	$1,384	$3,034	—	$2,877	$1,541

Impairment of Long-Lived Assets

We review long-lived assets for impairment under the guidance prescribed by Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standard (“SFAS”) No. 144 (SFAS No. 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*. We evaluate long-lived assets used in operations for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and the undiscounted cash flows estimated to be generated by those assets are less than the assets’ carrying values. An impairment loss would be recognized in the amount by which the recorded value of the asset exceeds the fair value of the asset, measured by the quoted market price of an asset or an estimate based on the best information available in the circumstances. There were no such losses recognized during 2004, 2003 and 2002.

Research and Development Costs

Research and development costs are expensed as incurred and include compensation for engineers, support personnel, outside contracted services, and material costs associated with new product development, the enhancement of current products, and product cost reductions. We continually evaluate new product opportunities and engage in intensive research and product development efforts. Research and development costs totaled $67.4 million, $58.1 million and $56.3 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was $2.9 million, $2.2 million and $2.8 million for the years ended December 31, 2004, 2003 and 2002, respectively.

Comprehensive Income

Comprehensive income consists of all changes in equity (net assets) during a period from non-owner sources. Items included in comprehensive income include net income, changes in unrealized gains and losses on marketable securities, and foreign currency translation adjustments. Comprehensive income is presented in the Consolidated Statements of Changes in Stockholders' Equity.

Income Taxes

The provision for income taxes has been determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year plus the change in deferred taxes during the year. Deferred taxes result from the difference between financial and tax bases of the Company's assets and liabilities and are adjusted for changes in tax rates and tax laws when such changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. We also receive an income tax deduction for the difference between the exercise price and the market price of non-qualified stock options upon exercise by the employee.

Foreign Currency

We record transactions denominated in foreign currencies on a monthly basis using the prior month-end exchange rate. Assets and liabilities denominated in foreign currencies are translated at the balance sheet dates using the closing rates of exchange between those foreign currencies and the U.S. dollar with any transaction gains or losses reported in income. Adjustments from translating financial statements of international subsidiaries are recorded in other accumulated comprehensive income or loss.

Revenue Recognition

Revenue is generally recognized upon shipment of the product to the customer in accordance with the terms of the sales agreement, generally FOB shipping point. In the case of consigned inventory, revenue is recognized when the customer assumes the risks and rewards of ownership of the product. We record revenue associated with installation services when the installation and all contractual obligations are complete. When contracts include both installation and product sales, the installation is considered as a separate deliverable item. Either the purchaser, ADTRAN, or a third party can perform the installation of our products. Shipping fees are recorded as revenue and the related cost is included in cost of sales. Revenue is recorded net of discounts. Also, revenue is recorded when the product price is fixed and determinable, collection of the resulting receivable is probable, and product returns are reasonably estimable.

The majority of Enterprise Networks products are sold in the United States through a non-exclusive distribution network of major technology distributors and system integrators. These large distribution organizations then sell to an extensive network of value-added resellers or system integrators. Value-added resellers and system integrators may be affiliated with us as a channel partner, or they may purchase from the distributor in an unaffiliated fashion. Our distributors may return products to us that are damaged or defective upon receipt. Additionally, our distributors may return unused and unopened product for stock-balancing purposes when such returns are accompanied by offsetting orders for products of equal or greater value.

We participate in cooperative advertising and market development programs with certain customers. We use these programs to reimburse customers for certain forms of advertising, and in general, to allow our customers credits up to a specified percentage of their net purchases. Our costs associated with these programs are estimated and accrued at the time of sale and are included in marketing expenses in our Consolidated Statements of Income. We also participate in rebate programs to provide sales incentives for certain products. Our costs associated with these programs are estimated and accrued at the time of sale, and are recorded as a reduction of sales in our Consolidated Statements of Income.

Unearned Revenue

Unearned revenue primarily represents customer billings on our maintenance service programs where we still have contractual obligations. We currently offer one-year, three-year, and five-year maintenance contracts, primarily on Enterprise Networks Division products sold through distribution channels. Revenue attributable to these maintenance contracts is recognized ratably on a straight-line basis over the related contract term.

Other Income (Expense)

Other income (expense) includes miscellaneous income or expense, gains or losses on foreign currency transactions, raw material scrap sales, and net recoveries from former customers.

Stock-Based Compensation

We record compensation expense for all stock-based compensation plans using the intrinsic value method in which compensation expense, if any, is measured as the excess of the market price of the stock over the exercise price of the award on the measurement date. We recorded $0.2 million, net of tax, of compensation expense in 2003 for stock options granted at less than market value.

We apply APB Opinion No. 25 ("APB 25") and related interpretations in accounting for our stock option plans. Had compensation cost for our 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, *Accounting for Stock-Based Compensation*, net income and earnings per share would have been reduced to the pro forma amounts indicated below:

Pro Forma Net Income & Earnings Per Share

(In thousands, except per share amounts)	2004	2003	2002
Net income - as reported	$75,141	$61,515	$24,776
Add: stock-based compensation expense, included in reported net income, net of tax	—	216	—
Less: stock-based compensation expense, net of tax	(18,112)	(22,755)	(21,998)
Net income - pro forma	$57,029	$38,976	$2,778

Earnings per share

Basic - as reported	$0.96	$0.80	$0.33
Basic - pro forma	$0.73	$0.50	$0.04
Diluted - as reported	$0.93	$0.76	$0.32
Diluted - pro forma	$0.70	$0.48	$0.04

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:

Weighted Average Assumption

	2004	2003	2002
Expected dividend yield	1.44%	0.93%	0%
Expected life (years)	5.00	5.00	4.21
Expected volatility	60.0%	55.9%	49.6%
Risk-free interest rate	3.34%	3.20%	3.30%

In December 2004, the FASB issued SFAS No. 123(R), *Accounting for Stock-Based Compensation*. SFAS No. 123R revises the guidance in SFAS No. 123 and supercedes APB 25, and its related implementation guidance. SFAS No. 123R focuses primarily on the accounting for share-based payments to employees in exchange for services, and it requires a public entity to measure and recognize compensation cost for these payments. SFAS No. 123R is effective for reporting periods beginning after June 15, 2005 (third quarter 2005 for ADTRAN®). Upon adoption, SFAS No. 123R will require ADTRAN to recognize the cost of employee services received in exchange for its equity instruments. Currently, in accordance with APB 25, we record the intrinsic value of stock-based compensation as expense. Accordingly, no compensation expense is currently recognized for fixed stock option plans as the exercise price equals the stock price on the date of grant. Under SFAS No. 123R, ADTRAN will be required to measure compensation expense over the options' vesting period based on the stock options' fair value at the date the options are granted. SFAS No. 123R allows for the use of the Black-Scholes or a lattice option-pricing model to value such options.

ADTRAN has determined that it will use the Black-Scholes option-pricing model to calculate the fair value of its options. As allowed by SFAS No. 123R, ADTRAN can elect either the Modified Prospective Application, which applies the statement to new awards and modified awards after the effective date, and to any unvested awards as service is rendered on or after the effective date, or the Modified Retrospective Application, which can apply the Statement to either all prior years for which SFAS No. 123 was effective or only to prior interim periods in the year of adoption. ADTRAN is currently evaluating which method of application will be used. The previous table illustrates the effects on net income and earnings per share if ADTRAN had adopted SFAS No. 123 using the Black-Scholes option-pricing model. Based on information currently available, we expect to recognize approximately $3.8 million of compensation cost during the last six months of 2005 related to our stock option awards. For a discussion of our stock-based compensation plans and agreements, see Note 7.

Earnings Per Share

Earnings per common share, and earnings per common share assuming dilution, are based on the weighted average number of common shares and, when dilutive, common equivalent shares outstanding during the year (see Note 11).

Dividends

The board of directors presently anticipates that it will declare a regular quarterly dividend so long as the current tax treatment of dividends exists and adequate levels of liquidity are maintained. During the year ended December 31, 2004, ADTRAN paid $25.1 million in dividend payments. On January 24, 2005, the board of directors declared a quarterly cash dividend of $0.08 per common share to be paid to holders of record at the close of business on February 4, 2005. The ex-dividend date was February 2, 2005, and the payment date was February 16, 2005. The quarterly dividend payment was $6.1 million.

Stock Split

On October 13, 2003, the board of directors declared, effective December 15, 2003, a two-for-one stock split to be effected in the form of a stock dividend of one share of common stock for each outstanding share of common stock for stockholders of record on December 1, 2003. Share and per share amounts, including stock options, in the accompanying Consolidated Statements of Income and Notes to Consolidated Financial Statements have been retroactively adjusted to reflect the stock split.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. ADTRAN's more significant estimates include the allowance for doubtful accounts, obsolete and excess inventory reserves, warranty reserve, and estimated income tax contingencies. Actual results could differ from those estimates.

Reclassifications

Certain reclassifications have been made to the 2003 and 2002 Consolidated Financial Statements in order to conform to the 2004 presentation. These reclassifications had no effect on previously reported net income, cash flows from operations, or total stockholders' equity.

Revision in the Classification of Certain Securities

In connection with the preparation of this report, we concluded that it was appropriate to classify our auction rate municipal bonds and variable rate municipal demand notes as current investments. Previously, such investments had been classified as cash and cash equivalents. Accordingly, we have revised the classification to report these securities as short-term investments in our Consolidated Balance Sheets as of December 31, 2004 and 2003. We have also made corresponding adjustments to our Consolidated Statements of Cash Flows for the periods ended December 31, 2004, 2003 and 2002 to reflect the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported Consolidated Statements of Cash Flows, or our previously reported Consolidated Statements of Income for any period. However, for the fiscal years ended December 31, 2003 and 2002 net cash used in investing activities related to these current investments of $38.0 million and $7.1 million, respectively, was included in cash and cash equivalents in our Consolidated Statements of Cash Flows.

At December 31, 2004 and 2003, we held $93.4 million and $38.0 million, respectively, of auction rate municipal bonds and variable rate municipal demand notes classified as available-for-sale short-term investments. Our investments in these securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every seven to 35 days, and, despite the long-term nature of their stated contractual maturities, we have the ability to quickly liquidate these securities. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these current investments. All income generated from these current investments was recorded as interest income.

Recently Issued Accounting Standards

In March 2004, the FASB reached consensus on the guidance provided by Emerging Issues Task Force ("EITF") Issue 03-1 ("EITF 03-1"), *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments.* The guidance is applicable to debt and equity securities that are within the scope of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities and Certain Other Investments.* EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. The disclosure provisions of EITF 03-1 for investments accounted for under SFAS No. 115 and SFAS No. 124 were effective for annual reporting periods ending after December 15, 2003. In September 2004, the EITF delayed the effective date for the measurement and recognition guidance included in paragraphs 10 through 20 of EITF 03-1. The disclosures required of EITF 03-1, paragraphs 21 and 22, have not been deferred. We continue to evaluate all existing and future investments in order to determine the applicability of EITF 03-1.

On October 4, 2004, the Working Families Tax Relief Act of 2004 was signed into law. This legislation extended the research and development (R&D) tax credit for 18 months, from July 1, 2004 to December 31, 2005, allowing U.S. companies conducting qualifying research and development activities to receive a tax credit of up to 10% of R&D spending. The additional tax credit was approximately $620 thousand for this fiscal year and was reflected in the fourth quarter tax provision.

On October 22, 2004, the American Jobs Creation Act of 2004 was signed into law. This legislation repeals export tax benefits, which have historically reduced our effective tax rate. This legislation transitions the repeal by allowing 100% of 2004, 80% of 2005, and 60% of 2006 export benefits. The legislation also transitions in a new tax deduction for U.S. manufacturing, which will benefit ADTRAN®. The legislation did not have a material effect on our 2004 tax expense. ADTRAN expects the net effect of the phase out of the extra-territorial income (ETI) and phase in of this new deduction to result in a decrease between 0.50% to 0.75% in the effective tax rate for 2005.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – An Amendment of ARB No. 43, Chapter 4.* SFAS No. 151 amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. Additionally, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005, and is required to be adopted by ADTRAN effective January 1, 2006. We do not expect SFAS No. 151 to have a material impact on our consolidated results of operations or financial condition.

In December 2004, the FASB issued SFAS No. 123R, *Accounting for Stock-Based Compensation*. SFAS No. 123R revises the guidance in SFAS No. 123 and supercedes APB 25, and its related implementation guidance. SFAS No. 123R focuses primarily on the accounting for share-based payments to employees in exchange for services, and it requires a public entity to measure and recognize compensation cost for these payments. SFAS No. 123R is effective for reporting periods beginning after June 15, 2005 (third quarter 2005 for ADTRAN). SFAS No. 123R requires ADTRAN to recognize the cost of employee services received in exchange for its equity instruments. Currently, in accordance with APB 25, we record the intrinsic value of stock-based compensation as expense. Accordingly, no compensation expense is currently recognized for fixed stock option plans as the exercise price equals the stock price on the date of grant. Under SFAS No. 123R, ADTRAN will be required to measure compensation expense over the options' vesting period based on the stock options' fair value at the date the options are granted. SFAS No. 123R allows for the use of the Black-Scholes or a lattice option-pricing model to value such options.

ADTRAN has determined that it will use the Black-Scholes option-pricing model to calculate the fair value of its options. As allowed by SFAS No. 123R, ADTRAN can elect either the Modified Prospective Application, which applies the statement to new awards and modified awards after the effective date, and to any unvested awards as service is rendered on or after the effective date, or the Modified Retrospective Application, which can apply the statement to either all prior years for which SFAS No. 123 was effective or only to prior interim periods in the year of adoption. ADTRAN is currently evaluating which method of application will be used. Based on information currently available, we expect to recognize approximately $3.8 million of compensation cost during the last six months of 2005 related to our stock option awards. For a discussion of our stock-based compensation plans and agreements, see Note 7.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29*. SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for periods beginning after June 15, 2005, and is required to be adopted by ADTRAN effective July 1, 2005. We do not expect SFAS No. 153 to have a material impact on our consolidated results of operations or financial condition.

2 Investments

We classify our investments as either available-for-sale or held-to-maturity. At December 31, 2004 and 2003, we held the following securities, recorded at either fair value or amortized cost, which approximates fair value.

December 31, 2004

(In thousands) Available-for-sale securities	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Restricted money market funds	$50,000			$50,000
Municipal bonds and fixed income mutual funds	126,697	$283	($508)	126,472
Marketable equity securities	12,568	8,148	(232)	20,484
Auction rate securities	93,382			93,382
Other equity securities	2,102			2,102
Total available-for-sale securities	**$284,749**	**$8,431**	**($740)**	**$292,440**

December 31, 2003

(In thousands) Available-for-sale securities	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Restricted money market funds	$50,000			$50,000
Municipal bonds and fixed income mutual funds	159,055	$2,002	($356)	160,701
Marketable equity securities	15,939	13,741	(177)	29,503
Auction rate securities	38,024			38,024
Other equity securities	1,976			1,976
Total available-for-sale securities	**$264,994**	**$15,743**	**($533)**	**$280,204**
Held-to-maturity securities				
Municipal bonds and other government fixed income securities	$3,069			$3,069
Other debt securities	350			350
Total held-to-maturity securities	**$3,419**			**$3,419**

In connection with the preparation of this report, we concluded that it was appropriate to classify our auction rate municipal bonds and variable rate municipal demand notes as current investments. Previously, such investments had been classified as cash and cash equivalents. Accordingly, we have revised the classification to report these securities as short-term investments in our Consolidated Balance Sheets as of December 31, 2004 and 2003. We have also made corresponding adjustments to our Consolidated Statements of Cash Flows for the periods ended December 31, 2004, 2003 and 2002 to reflect the gross purchases and sales of these securities as investing activities rather than as a component of cash and cash equivalents. This change in classification does not affect previously reported cash flows from operations or from financing activities in our previously reported Consolidated Statements of Cash Flows, or our previously reported Consolidated Statements of Income for any period.

At December 31, 2004 and 2003, we held $93.4 million and $38.0 million, respectively, of auction rate municipal bonds and variable rate municipal demand notes classified as available-for-sale short-term investments. Our investments in these securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every seven to 35 days, and despite the long-term nature of their stated contractual maturities, we have the ability to quickly liquidate these securities. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these current investments. All income generated from these current investments was recorded as interest income.

We review our investment portfolio for potential "other-than-temporary" declines in value on an individual investment basis. We assess, on a quarterly basis, significant declines in value which may be considered other-than-temporary and, if necessary, recognize and record the appropriate charge to write-down the carrying value of such investments. In making this assessment, we take into consideration a wide range of objective and subjective information, including but not limited to the following: the magnitude and duration of historical decline in market prices, credit rating activity, assessments of liquidity, public filings, and statements made by the issuer. We generally begin our identification of potential other-than-temporary impairments by reviewing any security with a market value that has declined from its original or adjusted cost basis by 25% for more than six months. We then evaluate the individual security based on the previously identified factors to determine the amount of the write-down, if any.

Gross realized gains on the sale of securities were approximately $3.8 million, $2.2 million and $1.4 million for the years ended December 31, 2004, 2003 and 2002, respectively. Gross realized losses on the sale of securities were approximately $2.0 million, $2.0 million and $1.7 million for the years ended December 31, 2004, 2003 and 2002, respectively. As of December 31, 2004 and 2003, we had net unrealized gains of $7.7 million and $15.2 million, respectively. As of December 31, 2004, we had $0.2 million of unrealized losses with a duration greater than 12 months. As of December 31, 2003, we had no unrealized losses with a duration greater than 12 months. The fair values of investments with unrealized losses were $22.5 million and $86.5 million at December 31, 2004 and 2003, respectively.

We also invest in privately held companies and record our investments in these entities at cost. As of December 31, 2004 and 2003, we had $2.1 million and $2.3 million, respectively, of investments carried at cost. These investments are included in long-term investments in the accompanying Consolidated Balance Sheets. We review our investments in these entities periodically in order to determine if circumstances (both financial and non-financial) exist that indicate that we will not recover our initial investment. Impairment charges are recorded on investments having a cost basis that is greater than the value that we would reasonably expect to receive in an arm's length sale of the investment. During 2004, 2003 and 2002, we recognized gross losses of $0.1 million, $0 and $2.0 million, respectively, on cost basis investments.

During the year ended December 31, 2004, we received $1.0 million for an investment that was classified as held-to-maturity and had previously been written down to $0.3 million. This transaction resulted in a net realized gain of $0.7 million and was the result of the sale of our ownership in a private company in which we had invested.

We have committed to invest an aggregate of $7.2 million in two private equity funds, of which $2.1 million has been invested to date. The duration of each of these commitments is five years, with $2.4 million expiring in 2005 and $4.8 million expiring in 2007. This investment is included in our total available-for-sale investments and is classified in long-term investments in the accompanying Consolidated Balance Sheets.

3 Inventory

At December 31, 2004 and 2003, inventory was comprised of the following:

(In thousands)	2004	2003
Raw materials	$24,051	$19,526
Work in process	4,526	3,937
Finished goods	18,558	19,614
Inventory reserve	(4,819)	(3,102)
Total	**$42,316**	**$39,975**

4 Property, Plant and Equipment

At December 31, 2004 and 2003, property, plant and equipment was comprised of the following:

(In thousands)	2004	2003
Land	$4,263	$4,263
Land improvements	11,559	11,559
Building	68,554	68,480
Furniture and fixtures	14,814	14,130
Computer hardware and software	46,292	44,845
Engineering and other equipment	58,756	54,730
Total property, plant and equipment	**204,238**	**198,007**
Less accumulated depreciation	(114,877)	(100,340)
Total property, plant and equipment (net)	**$89,361**	**$97,667**

Depreciation expense was $15.4 million, $15.2 million and $16.4 million in 2004, 2003 and 2002, respectively.

5 Alabama State Industrial Development Authority Financing and Economic Incentives

In conjunction with an expansion of our Huntsville, Alabama, facility, we were approved for participation in an incentive program offered by the state of Alabama State Industrial Development Authority (the "Authority"). Pursuant to the program, on January 13, 1995, the Authority issued $20.0 million of its taxable revenue bonds and loaned the proceeds from the sale of the bonds to ADTRAN®. The bonds were originally purchased by AmSouth Bank of Alabama, Birmingham, Alabama (the "Bank"). Wachovia Bank, N.A., Nashville, Tennessee (formerly First Union National Bank of Tennessee) (the "Bondholder"), purchased the original bonds from the Bank and made further advances to the Authority, bringing the total amount outstanding to $50.0 million. An Amended and Restated Taxable Revenue Bond ("Amended and Restated Bond") was issued and the original financing agreement was amended. The Amended and Restated Bond bears interest, payable monthly. In 2004, the interest rate was 5%. The Amended and Restated Bond matures on January 1, 2020. The estimated market value of the bond at December 31, 2004 was approximately $48.7 million. We are 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 is $50.0 million, which is invested in restricted money market funds. These funds serve as collateral deposit against the principal of this bond. In conjunction with this program, we are eligible to receive certain economic incentives from the state of Alabama that reduce the amount of payroll withholdings that we are required to remit to the state for those employment positions that qualify under the program. Our economic incentives realized for the years ended December 31, 2004, 2003 and 2002 were $1.3 million, $1.5 million and $1.2 million, respectively.

6 Income Taxes

A summary of the components of the provision for income taxes as of December 31, 2004, 2003 and 2002 is as follows:

(In thousands)	2004	2003	2002
Current			
Federal	$30,750	$23,247	$5,695
State	4,894	1,256	496
Total Current	**35,644**	**24,503**	**6,191**
Deferred tax provision (benefit)	(769)	2,812	1,210
Total provision for income taxes	**$34,875**	**$27,315**	**$7,401**

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

(In thousands)	2004	2003	2002
Tax provision computed at the federal statutory rate (35% in 2004, 2003 and 2002)	$38,506	$31,091	$11,262
State income tax provision, net of federal benefit	4,440	2,028	1,380
Federal research credits	(4,982)	(2,270)	(2,200)
Tax-exempt income	(1,295)	(1,546)	(1,724)
State tax incentives	(1,260)	(1,539)	(1,156)
Extra-territorial income	(663)	(82)	(473)
Other	129	(367)	312
Total provision for income taxes	**$34,875**	**$27,315**	**$7,401**
Effective tax rate	**31.7%**	**30.7%**	**23.0%**

Temporary differences which created deferred tax assets and liabilities at December 31, 2004 and 2003 are as follows:

(In thousands)	2004		2003	
	Current	Non-Current	Current	Non-Current
Accumulated depreciation		($3,178)		($5,185)
Investments		(1,647)		(2,106)
Accounts receivable	$132		$639	
Inventory	3,120		1,687	
Accrued expenses	1,236		1,055	
State research credits		556		441
Valuation allowance		(556)		(441)
Deferred tax asset (liability)	**$4,488**	**($4,825)**	**$3,381**	**($7,291)**

In accordance with SFAS No. 109, *Accounting for Income Taxes*, we believe it is more likely than not that we will not realize a portion of the benefits of certain deferred tax assets arising from state research credits, and accordingly, have provided a valuation allowance for them.

During 2004, we settled prior year state tax contingencies, resulting in an additional $1.0 million of state tax expense. Also in 2004, we realized additional research and development credits from prior years. During 2004, 2003 and 2002, we recorded an income tax deduction of $3.0 million, $23.6 million and $0.6 million, respectively, as an adjustment to equity in accordance with APB 25. The income tax deduction is calculated on the difference between the exercise price and the market price of non-qualified stock option exercises. Approximately 43% of the income tax deduction relates to disqualifying dispositions of incentive stock options and 57% relates to non-qualified stock options.

On October 4, 2004, the Working Families Tax Relief Act of 2004 was signed into law. This legislation extended the research and development (R&D) tax credit for 18 months, from July 1, 2004 to December 31, 2005, allowing U.S. companies conducting qualifying research and development activities to receive a tax credit of up to 10% of R&D spending. The additional tax credit was approximately $620 thousand for this fiscal year and was reflected in the fourth quarter tax provision.

On October 22, 2004, the American Jobs Creation Act of 2004 was signed into law. This legislation repeals export tax benefits, which have historically reduced our effective tax rate. This legislation transitions the repeal by allowing 100% of 2004, 80% of 2005, and 60% of 2006 export benefits. The legislation also transitions in a new tax deduction for U.S. manufacturing, which will benefit ADTRAN. The legislation did not have a material effect on our 2004 tax expense. ADTRAN expects the net effect of the phase out of the Extra-Territorial Income (ETI) and phase in of this new deduction to result in a decrease between 0.50% to 0.75% in the effective tax rate for 2005.

7 Stock Option Plans

Our board of directors adopted the 1996 Employees Incentive Stock Option Plan (the "1996 Plan") effective February 14, 1996, as amended, under which 16,976,200 shares of common stock were reserved for issuance to certain employees and officers through incentive stock options and non-qualified stock options. We currently have options outstanding under the 1986 Employee Incentive Stock Option Plan (the "1986 Plan"), which expired on February 14, 1996. Options granted under the 1996 Plan or the 1986 Plan become exercisable after one year of continued employment, normally pursuant to a four- or 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, 2004, range from 2005 to 2014.

The board of directors adopted the 1995 Directors Stock Option Plan ("Directors Plan") effective October 31, 1995, as amended, under which 400,000 shares of common stock have been reserved. The Directors Plan is a formula plan to provide options to our non-employee directors. At December 31, 2004, 424,500 options had been granted under the Directors Plan, 72,000 options had been cancelled or forfeited, and 47,500 options remained available for grant. Expiration dates of options outstanding under the Directors Plan at December 31, 2004, range from 2006 to 2014.

On January 28, 2002, our board of directors approved a voluntary stock option exchange program for ADTRAN® employees, executive officers, and directors. In conjunction with the exchange offer, we filed a Tender Offer Statement on Schedule TO with the Securities and Exchange Commission. Under the option exchange program, employees, executive officers, and directors who held options to purchase our common stock and who had not received options after July 23, 2001, were given the opportunity to exchange unexercised stock options granted prior to September 30, 2000, with exercise prices of at least $20 per share. For every four shares of an eligible option, three shares were made available under the new option grant. The newly issued options vest according to the vesting schedule of the tendered options. A total of 2,868,800 options were tendered and cancelled. As of December 31, 2002, a total of 1,983,366 new options were granted to qualified participants in the exchange program. The new option grant was made on August 30, 2002, at an exercise price of $8.695 per share.

Pertinent information regarding our stock option plans is as follows:

(In thousands, except per share amounts)	Number of Options	Range of Exercise Prices	Weighted Average Exercise Price	Vesting Provisions
Options outstanding, December 31, 2001	**10,366**	**$0.84 - $34.91**	**$13.66**	**Various**
Options granted	4,312	$8.69 - $16.45	$9.82	Various
Options cancelled/forfeited	(3,297)	$8.70 - $34.91	$31.75	Various
Options exercised	(397)	$1.25 - $15.18	$9.97	Various
Options outstanding, December 31, 2002	**10,984**	**$1.67 - $34.91**	**$12.43**	**Various**
Options granted	747	$18.04 - $36.64	$31.44	Various
Options cancelled/forfeited	(118)	$1.67 - $34.91	$14.28	Various
Options exercised	(4,550)	$1.67 - $34.91	$12.23	Various
Options outstanding, December 31, 2003	**7,063**	**$8.69 - $36.64**	**$14.53**	**Various**
Options granted	732	$19.20 - $37.18	$22.13	Various
Options cancelled/forfeited	(46)	$8.70 - $36.64	$17.06	Various
Options exercised	(450)	$8.69 - $34.91	$12.83	Various
Options outstanding, December 31, 2004	**7,299**	**$8.69 - $37.18**	**$15.39**	**Various**

The following table summarizes information about stock options outstanding at December 31, 2004:

Options Outstanding at December 31, 2004

(In thousands, except per share amounts)

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$8.69 - $9.90	683	5.50	$8.74	674	$8.73
$10.29 - $13.75	3,958	6.71	$11.52	2,301	$11.64
$14.03 - $17.94	201	6.62	$15.00	137	$15.38
$18.03 - $24.78	1,720	6.80	$19.78	970	$18.12
$28.18 - $37.18	737	8.74	$32.20	232	$32.32
Total	**7,299**			**4,314**	

Of the options above, 7,294,764 were issued at exercise prices that approximate fair market value at the date of grant and 4,000 were issued below fair market value at the date of grant. During the year ended December 31, 2003, we recorded compensation expense of $0.2 million, net of income tax, related to 31,000 options issued below fair market value at the date of grant. At December 31, 2004, 4,138,534 options were available for grant under the plans.

8 Employee Benefit Plan

Effective January 1, 1990, we adopted a savings plan (the "Savings Plan") for the benefit of eligible employees. The Savings Plan allows employees to contribute part of their compensation to the plan on a tax-deferred basis, and requires us to contribute an amount equal to 3% of compensation each year for eligible employees who have completed a year of service. The Savings Plan is intended to qualify under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended (the "Code"), and is intended to be a "safe harbor" 401(k) plan under code Section 401(k)(12). Prior to January 1, 2001, we contributed matching contributions in an amount equal to 50% of each eligible employee's elective deferrals under the Savings Plan, up to 5% of the employee's compensation for the plan year. Effective January 1, 2001, the plan requires us to contribute a "safe harbor" amount equal to 3% of compensation each year for eligible employees who have completed a year of service up to the statutory maximum compensation ($205,000 for 2004). Employees who become eligible for the safe harbor contribution during the plan year are eligible for 3% of compensation, including compensation earned during any portion of the plan year during which the employee was eligible to defer, but not yet eligible for the safe harbor contribution. All contributions under the Savings Plan are 100% vested. Charges to operations for employer contributions and plan administration for the Savings Plan amounted to approximately $2.7 million, $2.5 million and $2.1 million in 2004, 2003 and 2002, respectively.

9 Segment Information and Major Customers

ADTRAN operates two reportable segments: (1) Carrier Networks Division and (2) Enterprise Networks Division. 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. We evaluate the performance of our segments based on gross profit; therefore, selling, general and administrative costs, as well as research and development, other income, interest income/expense, net realized investment gains (losses), and provision for taxes are reported on an entity-wide basis only. There are no inter-segment revenues.

Sales by Market Segment

The following table presents information about the reported sales and gross profit of our reportable segments for each of the years ended December 31, 2004, 2003 and 2002 reconciled to net income. Asset information by reportable segment is not reported, since we do not produce such information internally.

(In thousands)	2004		2003		2002	
	Sales	Gross Profit	Sales	Gross Profit	Sales	Gross Profit
Carrier Networks	$323,333	$181,740	$267,563	$145,007	$218,912	$105,277
Enterprise Networks	131,184	79,332	129,113	76,988	126,813	69,659
	$454,517	**$261,072**	**$396,676**	**$221,995**	**$345,725**	**$174,936**
Selling, general and administrative expenses		91,927		83,234		81,217
R&D expenses		67,384		58,144		56,295
Operating income		101,761		80,617		37,424
Other income (expenses), net		8,255		8,213		(5,247)
Income before provision for income taxes		**110,016**		**88,830**		**32,177**
Provision for income taxes		34,875		27,315		7,401
Net income		**$75,141**		**$61,515**		**$24,776**

Sales by Product

The Digital Business Transport (DBT)/Total Reach® category is comprised of revenue from ISDN and DDS transport and connectivity products sold to carrier and enterprise customers. The High-bit-rate Digital Subscriber Line (HDSL)/T1 category is comprised of revenue from HDSL-related carrier products and T1 CSU/DSU enterprise products. The Systems category includes revenue from Total Access® narrow band products, M13 multiplexers, integrated access devices, DSLAM products, optical access products, and NetVanta® products comprised of access routers, Ethernet switches, and VPN products. The following information presents sales by product for the years ended December 31, 2004, 2003 and 2002:

(In thousands)	2004	2003	2002
Digital Business Transport (DBT)/Total Reach	$22,023	$31,850	$44,932
High-bit-rate Digital Subscriber Line (HDSL)/T1	215,479	193,235	196,892
Systems	217,015	171,591	103,901
Total	**$454,517**	**$396,676**	**$345,725**

Sales by Geographic Region

The following is sales information by geographic area for the years ended December 31, 2004, 2003 and 2002:

(In thousands)	2004	2003	2002
United States	$423,913	$377,060	$325,429
All other	30,604	19,616	20,296
Total	**$454,517**	**$396,676**	**$345,725**

Single customers comprising more than 10% of our revenue in 2004 included SBC Communications, Inc. at 21%, Sprint Corporation at 15%, and Verizon Communications, Inc. at 12%. Single customers comprising more than 10% of our revenue in 2003 included SBC Communications, Inc. at 23%, Sprint Corporation at 14%, and Verizon Communications, Inc. at 15%. Single customers comprising more than 10% of our revenue in 2002 included SBC Communications, Inc. at 21%, Sprint Corporation at 10%, and Verizon Communications, Inc. at 14%. No other customer accounted for 10% or more of our sales in 2004, 2003 or 2002. Sales of network access equipment to Incumbent Local Exchange Carriers (ILECs) and major independent telecommunications companies amounted to approximately 58%, 60% and 57% of total sales during the years ended December 31, 2004, 2003 and 2002, respectively. Our Enterprise Networks Division sells a significant portion of products to value-added resellers through a multi-tier distribution system. Our total sales of this type amounted to 26%, 25% and 25% of our revenue for each of the years ended December 31, 2004, 2003 and 2002, respectively, and were routed through four primary fulfillment distributors.

As of December 31, 2004, long-lived assets totaled $89.4 million, which includes $89.3 million held in the U.S. and $0.1 million held outside the U.S. As of December 31, 2003, long-lived assets totaled $97.7 million, which includes $97.5 million held in the U.S. and $0.2 million held outside the U.S.

10 Commitments and Contingencies

We have certain contingent liabilities from time to time from litigation for employment or other matters arising in the normal course of business. Although the outcome of any litigation can never be certain, it is our opinion that the outcome of such contingencies will not materially affect our business, operations, financial condition or cash flows.

We lease office space and equipment under operating leases which expire at various dates through 2008. As of December 31, 2004, future minimum rental payments under non-cancelable operating leases with original maturities of greater than 12 months are approximately as follows:

(In thousands)	
2005	$668
2006	506
2007	449
2008	152
Total	**$1,775**

Rental expense was approximately $1.5 million, $1.9 million and $2.1 million in 2004, 2003 and 2002, respectively.

We have various other contractual obligations and commercial commitments. The following table sets forth, in millions, the annual payments we are required to make under contractual cash obligations and other commercial commitments at December 31, 2004.

Contractual Obligations

(In millions)	Total	2005	2006	2007	2008	After 2008
Long-term debt	$50.0	—	—	—	—	$50.0
Interest on long-term debt	$37.5	$2.5	$2.5	$2.5	$2.5	$27.5
Investment commitments	$5.1	$1.3	—	$3.8	—	—
Operating lease obligations	$1.8	$0.7	$0.5	$0.4	$0.2	—
Purchase obligations	$27.1	$27.1	—	—	—	—
Total	**$121.5**	**$31.6**	**$3.0**	**$6.7**	**$2.7**	**$77.5**

We are required to make payments necessary to pay the interest on the Taxable Revenue Bond, Series 1995, as amended, currently outstanding in the aggregate principal amount of $50.0 million. The bond matures on January 1, 2020, and currently bears interest at the rate of 5% per annum. Included in long-term investments are $50.0 million of restricted funds, which is a collateral deposit against the principal amount of this bond.

We do not have off-balance sheet financing arrangements and have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of, or requirements for, capital resources. At December 31, 2004 and 2003, we had outstanding purchase agreements with vendors of approximately $27.1 million and $27.9 million to purchase materials and services. Additionally, we have committed to invest an aggregate of $7.2 million in two private equity funds, of which $2.1 million has been invested to date.

11 Earnings Per Share

A summary of the calculation of basic and diluted earnings per share (EPS) for the years ended December 31, 2004, 2003 and 2002 is as follows:

(In thousands, except per share amounts)

For the Year Ended December 31, 2004

Basic EPS	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Net income	$75,141	78,235	$0.96
Effect of dilutive securities			
Stock options		2,750	
Diluted EPS			
Income available to common stockholders (with dilution) for assumed options exercised	$75,141	80,985	$0.93

For the Year Ended December 31, 2003

Basic EPS	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Net income	$61,515	76,942	$0.80
Effect of dilutive securities			
Stock options		3,797	
Diluted EPS			
Income available to common stockholders (with dilution) for assumed options exercised	$61,515	80,739	$0.76

For the Year Ended December 31, 2002

Basic EPS	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Net income	$24,776	76,090	$0.33*
Effect of dilutive securities			
Stock options		353	
Diluted EPS			
Income available to common stockholders (with dilution) for assumed options exercised	$24,776	76,443	$0.32*

* *Includes an impairment charge related to other-than-temporary declines in the fair value of equity securities, resulting in an after-tax loss of $7.4 million ($0.10 per share assuming dilution).*

The following options were outstanding during the respective years shown below, but were not included in the computation of that year's diluted EPS because the options' exercise prices were greater than the average market price of the common shares shown below, therefore making them anti-dilutive under the treasury method.

Anti-Dilutive Options Outstanding

(In thousands, except per share amounts)

2004			2003			2002		
Options Granted	Exercise Price	Expiration	Options Granted	Exercise Price	Expiration	Options Granted	Exercise Price	Expiration
2	$32.88	2006	2	$32.88	2006	44	$15.88 - $20.50	2005
26	$34.91	2010	28	$34.91	2010	28	$15.25 - $20.75	2006
702	$28.18 - $36.64	2013	740	$28.18 - $36.64	2013	847	$12.69 - $21.36	2007
7	$29.50 - $37.18	2014				20	$13.13 - $15.50	2008
						1,749	$17.93 - $19.85	2009
						120	$19.50 - $34.91	2010
						2,621	$12.67 - $14.04	2011
						171	$12.99 - $16.45	2012

12 Summarized Quarterly Financial Data (Unaudited)

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

Unaudited Quarterly Operating Results

(In thousands, except for per share amounts)

Three months ended	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004
Net sales	$114,039	$120,601	$115,251	$104,625
Gross profit	$65,518	$69,761	$66,812	$58,981
Operating income	$28,431	$29,881	$25,758	$17,691
Net income	$20,398	$21,398	$18,751	$14,594
Earnings per common share assuming dilution (1)	$0.25	$0.26	$0.23	$0.18
Earnings per common share	$0.26	$0.27	$0.24	$0.19

Three months ended	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Net sales	$86,223	$90,437	$106,201	$113,815
Gross profit	$47,073	$49,670	$58,917	$66,304
Operating income	$12,650	$15,715	$23,305	$30,315
Net income	$10,539	$12,379	$17,165	$21,432
Earnings per common share assuming dilution (1)	$0.14	$0.15	$0.21	$0.26
Earnings per common share	$0.14	$0.16	$0.22	$0.27

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

13 Related Party Transactions

We employ the law firm of one of our directors emeritus for legal services. All bills for services rendered by this firm are reviewed and approved by our chief financial officer. We believe that the fees for such services are reasonable and comparable to those charged by other firms for services rendered to us. We paid $121 thousand and $120 thousand during the year ended December 31, 2004 and 2003, respectively, for these legal services.

One of our non-employee directors is the Vice Chairman – Planning and Administration, of one of our significant customers who is also a vendor. In the normal course of business, we receive payments from and make payments to this customer. We believe these payments are reasonable. For the year ended December 31, 2004 and 2003, we received payments, directly and indirectly, from this customer in the amount of approximately $25.3 million and $22.8 million, respectively, for products supplied to this customer. In addition, for the year ended December 31, 2004 and 2003, we paid this customer $619 thousand and $567 thousand, respectively, for services provided to us.

14 Subsequent Events

During February 2005, with the purchase of 1,000,700 shares at an average price of $17.96, we completed our April 29, 2004 repurchase plan. On February 11, 2005, ADTRAN® announced that its board of directors approved the repurchase of up to 5,000,000 shares of its common stock. This plan will be implemented through open market purchases from time to time as conditions warrant. During February 2005, we purchased an additional 153,351 shares at an average price of $18.03 under the new share repurchase plan.

On January 24, 2005, the board declared a quarterly cash dividend of $0.08 per common share to be paid to stockholders of record at the close of business on February 4, 2005. The quarterly dividend payment was $6.1 million and was paid on February 16, 2005.

Directors and Executive Officers

Mark C. Smith
Chairman of the Board and Chief Executive Officer of the Company

Howard A. Thrailkill
President, Chief Operating Officer, and Director of the Company

Richard A. Anderson
Director of the Company, Vice Chairman – Planning and Administration of BellSouth Corporation

W. Frank Blount
Director of the Company, Chairman and Chief Executive Officer of JI Ventures, Inc. (venture capital), Chairman and Chief Executive Officer of TTS Management Corporation (acquisition management company), retired Chief Executive Officer of Telstra Corporation Ltd.

H. Fenwick Huss
Director of the Company, Dean of the J. Mack Robinson College of Business at Georgia State University

William L. Marks
Director of the Company, Chairman of the Board and Chief Executive Officer of Whitney Holding Corp. (holding company for Whitney National Bank of New Orleans)

Roy J. Nichols
Director of the Company, Chairman of the Board of Torch Concepts (a software development company), former Vice Chairman of the Board and Chief Technical Officer of Nichols Research Corporation

James L. North
Director Emeritus, Counsel to the Company since it commenced operations in 1986, attorney with James L. North & Associates, Birmingham, Alabama

James E. Matthews
Senior Vice President – Finance, Chief Financial Officer, and Treasurer

Thomas R. Stanton
Senior Vice President and General Manager – Carrier Networks

Peter C. Voetsch
Senior Vice President – Operations

Danny J. Windham
Senior Vice President and General Manager – Enterprise Networks

Robert A. Fredrickson
Vice President – Carrier Networks Sales

Steven L. Harvey
Vice President – Enterprise Networks and Service Provider Sales

P. Steven Locke
Vice President – Carrier Networks Marketing and Service Provider Sales

Everette R. Ramage
Vice President – Enterprise Networks Engineering

Kevin W. Schneider
Chief Technology Officer

Transfer Agent
Wachovia Bank N.A.
Charlotte, North Carolina

Independent Registered Public Accounting Firm
PricewaterhouseCoopers LLP
Birmingham, Alabama

General Counsel
James L. North, Attorney at Law
Birmingham, Alabama

Special Counsel
McKenna Long & Aldridge LLP
Atlanta, Georgia

Form 10-K
ADTRAN's 2004 Annual Report on Form 10-K (without exhibits) as filed with the Securities and Exchange Commission is available to stockholders without charge upon written request to:

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Huntsville, Alabama 35814-4000
256 963-8611 or 256 963-8220
investorrelations@adtran.com (e-mail)

Annual Meeting
The 2005 Annual Meeting of Stockholders will be held at ADTRAN corporate headquarters, 901 Explorer Boulevard, Huntsville, Alabama, on Wednesday, May 18, 2005, at 10:30 a.m. Central time.

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www.adtran.com

The Network Access Company

ADTRAN is an ISO 9001, ISO 14001, and a TL 9000 certified supplier.

ADTRAN, Inc. is an Equal Opportunity Employer committed to utilizing Minority Business Enterprises (MBE), Woman-Owned Business Enterprises (WBE) and Disabled Veteran Business Enterprises (DVBE) whenever possible and practical for procurements supporting ADTRAN and our customers.