

New Networks.
New Products.
Record Performance.

2005 Annual Report

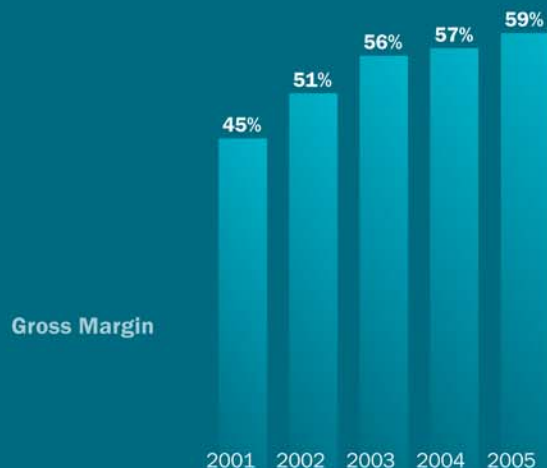


Glossary of terms

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

NASDAQ: ADTN

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 detailed in our annual report on Form 10-K for the year ended December 31, 2005. These risks and uncertainties could cause actual results to differ materially from those in the forward-looking statements included in this annual report.



Consolidated Statements of Income Data

(In thousands, except per share amounts)

Years Ended December 31	2005	2004	2003	2002	2001
Total sales	\$513,215	\$454,517	\$396,676	\$345,725	\$387,081
Income before provision for income taxes	\$153,374	\$110,016	\$88,830	\$32,177	\$23,737
Net income	\$101,150	\$75,141	\$61,515	\$24,776	\$17,329
Earnings per common share (Diluted)	\$1.30	\$0.93	\$0.76	\$0.32	\$0.22

Consolidated Balance Sheets Data

(In thousands)

Years Ended December 31	2005	2004	2003	2002	2001
Working capital ⁵	\$344,305	\$266,371	\$220,069	\$203,511	\$217,387
Total assets	\$652,618	\$559,942	\$592,309	\$521,213	\$522,537
Stockholders' equity	\$542,171	\$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 Net of \$24 million in stock repurchases and \$26 million in dividend payments during 2005

⁵ Working capital consists of current assets less current liabilities



Letter to Shareholders

ADTRAN® reached significant milestones in 2005, as we delivered a record year for both revenues and operating income. We attribute this level of performance to our solid execution, a growing economy, and an improving spending environment on the part of service providers and corporate customers.

Our continued success is a result of the unwavering commitment from our employees to exceed customer expectations, increase shareholder value, drive product innovations and strive for excellence. These values have been instilled in our culture for nearly two decades. As we enter a new era for ADTRAN and the networking industry, our vision for the company is to continue to enforce the highest possible degree of business ethics, further cultivate our engineering heritage and foster an environment that thrives with an entrepreneurial spirit.

Ready for next generation demands

Today, ADTRAN supplies networking and access equipment that enables the delivery of voice, data, video, and Internet services to meet the growing demands of both business and residential class customers. As people demand more services from their telecommunication providers, ADTRAN is providing the network infrastructure and equipment to help meet these customer needs. We believe that our commitment and focus to this market, along with industry-leading execution and operating performance, have allowed us to become one of the world's best performing network equipment suppliers.

Our achievements in 2005 also are a result of focused product development and marketing activities in three primary growth areas: Broadband Access, Optical Access and Business Networking. These emerging product areas broaden ADTRAN's existing portfolio and help position us to address the new network architectures associated with the delivery of next-generation services.

In addition to new product developments, we continued to evolve our international sales and marketing infrastructure in 2005. These steps will further enable us to focus our efforts on an underdeveloped customer base where ADTRAN has a significant opportunity to gain market share. Additionally, we created a dedicated sales force to meet the unique needs of wireless service providers in the U.S., positioning us to better serve this growing segment of the market as well.

Solid financial results

Year over year, ADTRAN's revenue increased 12.9 percent to \$513.2 million, up from \$454.5 million in 2004. We attribute the increase to the growing acceptance of our Total Access® DSLAM products, OPTI® multiplexers, NetVanta® routers and switches, and overall gains in our traditional product areas. We continue to be especially pleased with the adoption of our new Total Access® Outside Plant (OSP) DSLAMs, which have now been accepted by each of the eight largest wireline service providers in the U.S. Additionally, 2005 provided significant revenue growth in Optical Access products, which have been deployed in both wireline and wireless applications. Another strong performer was our Business Networking family of IP networking products, specifically designed for small- and medium-sized businesses.

Earnings improved significantly in 2005, rising to \$101.2 million for the year compared to \$75.1 million for 2004, an increase of 34.6 percent. Fully diluted earnings per share grew from \$0.93 in 2004

to \$1.30 in 2005. Gross margins improved throughout the year, reaching a record 59.1 percent, up from 57.1 percent in 2004, and up from 55.6 percent in 2003. Our continued attention to product cost reduction and supply chain modernization were two of the most meaningful efforts in improving our cost structure for the year.

Net cash provided by operating activities was an impressive \$128.9 million for the year. After dividend payouts of \$25.8 million and stock repurchases of \$24.1 million, unrestricted cash and marketable securities ended the year at a strong \$382.7 million. With these resources, we remain well positioned to continue funding an aggressive product development agenda, as well as to fund future working capital needs that may arise with sustained growth.

Highest standard of ethics, adhering to corporate governance principles

We continually adhere to the strictest principles of corporate governance, complying with the standards mandated by the Sarbanes-Oxley Act, including Section 404 requirements, which require that we document and routinely test key internal controls over financial reporting. We have established and published a comprehensive set of Corporate Governance Principles. These actions reaffirm the high standards of ethical conduct we have enforced since our founding 20 years ago.

New networks, new products, record performance

In 2005, our company continued to invest aggressively in new product development and sales and marketing activities. Our investment strategy significantly contributed to a record year in revenue and operating profits and we believe this strategy will perpetuate our growth well into the future. Our 2005 results suggest that we have accurately anticipated emerging market trends. We believe this will provide a positive environment for growth into 2006 and beyond.

ADTRAN supplies leading service providers around the world with the equipment they need to deliver broadband services to businesses and residential subscribers.

Our access equipment is used to connect central offices and remote terminals directly to the subscriber's terminating equipment.

Businesses, schools, government agencies, and other organizations use ADTRAN switches, routers and internetworking equipment to create sophisticated local and wide area networks. SMB customers use ADTRAN technologies to create networks that connect remote offices and mobile workers—enabling Internet access, telecommuting, and videoconferencing.

- Broadband Access Platforms
- Central Office DSLAMs
- Outside Plant DSLAMs
- IP/ATM/TDM Aggregation
- Ethernet Delivery Systems
- Fiber Optic Multiplexing Systems
- Bandwidth Management and Grooming
- HDSL Technologies
- SHDSL, ADSL, and VDSL Technologies
- Integrated Access Devices
- Multi-Service Access Gateways
- IP Business Gateways
- Fixed Wireless Radios
- Fast Ethernet Switches
- Power over Ethernet Switches
- Gigabit Ethernet Switches
- Integrated Switch-Routers
- Access Routers
- VPN/Firewall Devices
- DSU/CSUs
- Multiplexers

Our Total Access OSP DSLAMs have been deployed by every major wireline service provider in the U.S. and are part of the strategy to introduce IPTV using DSL technology. These products are instrumental in enabling service providers to reengineer their network architectures to place equipment closer to subscribers, thereby enhancing the services that can be delivered. These services include new offerings such as video (high-definition and standard TV) and enhanced VoIP services, in addition to traditional voice and data services.

These products are specifically designed to facilitate the network's transition to IP- and Ethernet-based architectures. Already, this product line employs next-generation technology that is capable of delivering converged services comprised of voice, data, and multiple channels of video. In 2006, we will continue investment in this product category to incorporate emerging technologies like VDSL2 to further enhance the bandwidth available for voice, data and video applications.

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

We also have seen significant growth in our Optical Access product family, which capitalizes on the growing trend of using fiber optic circuits to interconnect network elements and deliver service to large enterprise facilities. Today, our fiber products include enhanced Ethernet capabilities and are designed with the flexibility to deliver the higher bandwidth required by our customer base. As bandwidth needs increase as a result of next-generation wireless and wireline service offerings, we expect continued success with our fiber optic products.

Our Business Networking products continue to lead the market for Wide Area Networking, while aggressively expanding our push into the market for Local Area Networking products. In 2005, we introduced our first Gigabit and Power-over-Ethernet switches along with a new family of

IP-based Integrated Access Devices (IP gateways), all designed to complement our growing line of access routers and security appliances.

Our Business Networking products are sold and supported through a well-established multi-tier distribution channel, which focuses on meeting the needs of small- to medium-sized businesses (SMBs). During 2005, a variety of major incumbent and competitive service providers began reselling ADTRAN products in conjunction with their business related service offerings. In 2006, we plan to continue our investment in these areas and will be introducing additional products to broaden our offering as enterprise end-users continue their migration toward a converged IP network.

The people of ADTRAN

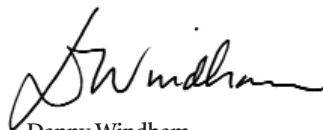
Another milestone in 2005 included the retirement of our founder and CEO, Mark Smith, and President and Chief Operating Officer, Howard Thrailkill. As we have assumed the lead of this well-regarded company in their departure, one thing that will remain constant is our commitment to work diligently to continue the traditions of excellence that are the hallmark of ADTRAN.

As we reflect on the accomplishments of 2005, we recognize that our success was due to the dedicated efforts of our employees worldwide. We sincerely appreciate their contributions that have continued to make ADTRAN a company trusted by our customers, suppliers and shareholders alike.

Sincerely,



Tom Stanton
Chief Executive Officer



Danny Windham
President and Chief Operating Officer



The right place at the right time

One thing is certain — the demand for higher-speed, lower-cost network services is increasing. Today, service providers are in a race to provide better and faster networks in response to consumer demands for greater bandwidth. Businesses are transitioning to Internet Protocol (IP) networks so that they can handle the ever-increasing traffic demands of their voice and data networks. Companies are using the power of IP to connect their employees and remote offices in smarter, more efficient ways than ever before.

As a result, service providers are transitioning their networks to next-generation IP architectures and ADTRAN's network access equipment helps build this infrastructure for network connectivity. Our new products enable convergence for wireless, wireline and business networks.

As consumers continue to demand more bandwidth and advanced services from their networks, we believe ADTRAN is in the right place, at the right time.



Increasing demand for greater bandwidth makes ADTRAN solutions more attractive than ever

In 2005, we shipped approximately one million residential DSL ports to help service providers meet the increasing demand for bandwidth and high-speed Internet access.

Competition drives new network investments

Regulatory influences and advanced service offerings have driven service provider networks in a new direction. It is essential for them to find innovative ways to reduce their operating costs while delivering new services at competitive rates. ADTRAN helps make that possible.

In response to the competitive pressures from cable and wireless service providers, wireline service providers are looking to deliver services that combine voice, data and Internet into a single offering. In 2005, service providers continued to rely on ADTRAN to increase the capacity of their networks and upgrade their infrastructure so that they could deliver attractively priced bundles aimed at retaining current customers and increasing average revenue per user (ARPU).

This demand, combined with a favorable regulatory environment, resulted in accelerated spending by our largest customer base, wireline service providers. For instance, recent regulatory changes in the U.S. have eased requirements for incumbent service providers to “share” parts of the network with competitors under FCC-mandated rates, minimizing the reluctance these providers had shown toward broadband capital investment.

Transitioning the network into the future

The trend toward convergence and a unified network architecture is shaping the industry—the result is a new network for new demands. Today’s networks are in the midst of migrating from voice-centric to data-centric architectures. Networks that were originally designed to deliver voice services were adapted to deliver data services, but the increasing demand for data has outgrown the capacity of traditional architectural models.

Networks are evolving to accommodate the shift from circuit-switched voice to Ethernet and IP-centric networks.

Ethernet/IP networks offer many advantages to service providers and their business and residential customers. A single, unified architecture is more easily maintained than separate voice and data networks. In addition, packet-based IP technologies improve the efficiency of the transport systems used to deliver services, which translate to lower recurring costs.



Cost effective solutions for total connectivity

Life in the fast lane

For business class services, Ethernet delivery is the key element in connecting businesses to other businesses or service providers for voice and data services, and in many cases, it is becoming the native transmission technology. In addition to its value as a unifying, simplifying architecture, Ethernet scales easily to Gigabit speeds (billions of bits per second), which is essential for the delivery of high-speed services. Many of ADTRAN's system level platforms feature Gigabit Ethernet access.

As an example, we added a Gigabit Ethernet switch product line to our portfolio. These devices are ideal for business networks that need higher-speed bandwidth on the Local Area Network (LAN) to support video and other bandwidth intensive applications. This entry, as well as others, further position ADTRAN to support the trend toward Gigabit-to-the-desktop applications as PC manufacturers add higher-speed network interface options to systems being sold to business users.

Global standards provide seamless access

Today, ADSL2+, SHDSL, VDSL2, 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 help ensure that thou-

sands of different networks will work together transparently. Despite its technical complexity, this new infrastructure will enable seamless network access to customers anywhere, anytime.

The mobile generation expects more

The popularity of cell phones, PDAs and other mobile communication devices is resulting in increased demand for copper and fiber transport to and from cell sites. Customers expect access to voice and data services of their choice, regardless of where they are located. Like wireline service providers, wireless carriers must respond by providing on-demand, higher bandwidth services.

As growth in the wireless market continues, techniques for reducing network costs and enhancing data delivery are significant objectives for wireless service providers. We expanded our TRACER® license-free radios that allow wireless carriers to increase bandwidth capacity without intensive upgrades to their existing antenna and tower infrastructure. These products also minimize the recurring costs associated with leasing additional tower space, normally required for capacity expansion. In the last half of 2005, ADTRAN moved into the leading market position for license-free microwave 5GHz solutions that provide connectivity for the wireless market in the U.S.

As a value leader for networking solutions, we have invested in best practices to increase functionality and lower the total cost of ownership (TCO) for both business customers and service providers alike.

The need for expanded communications services has led to an unprecedented interest in field-proven, value-based networking. ADTRAN is addressing the SMB market by offering the full internetworking product set required to implement a complete, cost-efficient, high-speed network.

The level of hardware integration found within all of ADTRAN's NetVanta products significantly lowers TCO, the measure most IT managers use when evaluating LAN equipment purchases. Where other vendors' solutions sometimes involve hidden charges, such as maintenance agreements and firmware updates, ADTRAN offers free technical support and free firmware updates, further improving the value of an investment in our network solutions.



Worldwide standards open new markets

Standards help ensure that thousands of disparate networks will be able to seamlessly work together. Prior to the emergence of global standards, products that were initially launched in the U.S. required numerous modifications before they could comply with varying country standards.

The growth of the Internet has led to global standards to support packetized data transport across networks, making it easier for ADTRAN to enter new markets outside of North America.



Our Systems segment, which includes Total Access, OPTI and NetVanta products, grew to 54 percent of total revenue in 2005. We believe ADTRAN is aligned for continued growth in these strategic product areas.



Solutions positioned to take advantage of today's growth markets

We achieved record performance in 2005 in our core businesses, with sales in our HDSL/T1 category growing to \$225 million in 2005. We also grew our Systems sales to \$276 million, ending the year with Systems growth approximately 27 percent above 2004 levels.

While many of our product categories are designed to aid in the delivery of next-generation services and assist with the migration to IP, none are more important to our continued growth than those of our three primary growth areas in Systems: Broadband Access, Optical Access, and Business Networking. We believe that we are well positioned for continued growth in these strategic areas in 2006.

Broadband Access

Broadband Access solutions, such as our Total Access DSLAM products, are used to connect central offices, remote terminals or neighborhood nodes directly to a subscriber's equipment, so broadband services can affordably be delivered to business and residential subscribers.

Optical Access

Optical Access solutions, which include the OPTI-6100, are designed to carry very high bandwidth traffic over fiber optic lines, which are often required by large end-users who are consolidating traffic from multiple points in the network.

Business Networking

Business Networking solutions, which are comprised of our NetVanta series, are used to create sophisticated local and wide area networks. These products are designed for businesses that need to build networks for the delivery of voice, data and video between multiple desktops, businesses or locations.



Best practices increase productivity

Our continued attention to reducing product costs and automating our supply chain resulted in benefits for our customers and shareholders.

Advanced automation and e-procurement tools have improved our efficiency and reduced cycle time. And in 2005, our achievements in supply chain management were recognized with the prestigious Ken Sharma Award for Excellence. Winners were chosen from around the

world and honored for groundbreaking best practices.

In addition to our supply chain modernization, we continue to lower our material costs by developing custom chipsets, rather than relying on off-the-shelf solutions. This design capability allows flexibility in our design approach. Therefore, many of our products can easily be customized to accommodate customer requests for new network functionality.



Broadband Access

Making high-speed Internet affordable for businesses and residential subscribers

All of the largest wireline service providers in the U.S. use our Total Access DSLAMs to support DSL deployments to business and residential consumers. Reliable, high-speed DSL Internet service remains a cornerstone of data revenue for most service providers. 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 scales for incremental growth. Our Total Access DSLAM products are designed to meet these needs.

Innovative DSL technologies reach new subscribers

As major wireline service providers prepare to deliver enhanced residential broadband services, Fiber To The Node (FTTN) is a logical architecture for delivering these new offerings. Traditional DSL systems have been designed for higher port densities and cabinets, making them expensive to place closer to the subscriber, a requirement to achieve the data rates necessary for these new service offerings. The ADTRAN OSP DSLAMs are designed specifically to support this emerging network architecture.

Optical Access

Fiber enables higher-speed service delivery

As more traffic is pushed across the network, there is demand for additional infrastructure to support these higher speeds. In applications where bandwidth requirements exceed the capabilities of copper, fiber enables significantly faster connections. ADTRAN's innovative OPTI family of optical multiplexers provides an economical solution to carry large traffic loads over fiber optic connections.

Demand for optical access equipment increased as wireless and wireline service providers expanded their

network capacity and introduced more data-centric services. In 2005, we enhanced the OPTI Series of fiber products with expanded ring support and new tools for network monitoring and service assurance. We also introduced Gigabit Ethernet to this platform, providing a broader array of Ethernet services.

Business Networking

All-in-one-networking solutions address SMB market

In 2005, we expanded our NetVanta product suite to include Gigabit Ethernet switches and Power over Ethernet support. This series now includes Ethernet switches, integrated switch-routers, low-, medium-, and high-speed access routers, and VPN/Internet security appliances. All NetVanta products, including switches, routers, and integrated switch-routers, are fully VoIP-ready devices. For companies that value devices built to target their IT challenges, we believe that NetVanta is the right solution.

Because of our innovative product development, advanced engineering practices and our highly integrated silicon development, NetVanta products are typically available at up to half the price of competing brand name solutions. In addition to being a value leader, NetVanta was the industry's first integrated switch-router platform and is part of today's cost-conscious network architectures.

Our NetVanta products are specifically designed for the SMB and enterprise market. In fact, NetVanta routers currently hold the second market position for less-than-1-Gbps access routers based on number of units sold worldwide. Our new all-in-one-networking solutions integrate a Power over Ethernet switch, router, firewall, VPN, and DSU/CSU, all in a single solution. Each of these products lower network costs, without compromising quality, performance or security.

NetVanta was the industry's first integrated switch-router platform.



We are helping businesses of all sizes meet the needs of an Internet generation, hungry for bandwidth and converged network services.



Preparing for the shift to VoIP

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, and then integrate voice into the data traffic. The result is Voice over IP (VoIP).

VoIP is compelling for numerous reasons: it uses the converged architecture of Ethernet/IP networks and makes use of IP-based voice switches, which can be less expensive to purchase and maintain than traditional circuit switches.

*“The forecasted rapid growth in adoption rates of next-generation services like VoIP among SMB customers is fueling the need for the evolution of the IAD into an intelligent, multiservice platform.”**

ADTRAN VoIP technology, first developed for business enterprise products, now extends into the Total Access system line, offering service providers an effective migration strategy for their networks to support customer demands. We have leveraged our industry expertise in traditional telephony solutions to engineer powerful, flexible new platforms for reliable IP voice services.

**In-Stat, 2005*

Positioned to take advantage of tomorrow's growth markets

Enhanced Broadband—the first step to the new network

Competition from cable and wireless service providers is challenging wireline providers to increase broadband access speeds far beyond today's Internet access rates. Service providers recognize the importance of Enhanced Broadband as a fundamental step in network evolution for services such as IPTV, gaming, media streaming, or other future applications.

IPTV—converging Ethernet and TV for on-demand services

The interest surrounding IPTV is becoming a fundamental driver in the migration toward Ethernet/IP networks. With IPTV, television content is transported using Ethernet, and channels are switched on and off upon request, rather than broadcasted as in traditional cable systems. Switching offers many advantages, including transport efficiency and support for on-demand services. Service providers began supporting IPTV trials last year in anticipation of the growing demand for this converged service.





New products for new networks

As Ethernet networking continues to fundamentally change the networking landscape, ADTRAN is ready.

We are working on the emerging technologies that are delivering services to new subscribers and providing the connectivity for distributed offices.

Our Total Access line is being expanded to bridge the gap between existing and next-generation networks, supporting both legacy and emerging service interfaces over copper and fiber. This line will be able to support existing infrastructure, as well as help customers prepare for bandwidth intensive applications such as IPTV.

With the shift to IP networks, ADTRAN is expanding its NetVanta line in 2006 to provide a converged IP platform that provides a complete VoIP and data networking solution that integrates multiple product functions into a single device.

IPTV is one of many reasons to provide faster broadband access. Our Total Access 1100F is a new solution that enables IPTV and deep fiber connectivity for ADTRAN's widely accepted Total Access OSP and Mini-DSLAMs. This solution is capable of providing the higher speeds that services such as IPTV will require, transforming the DSLAMs from Internet delivery platforms into IPTV and premium service platforms.

Ongoing growth in wireless

Mobility and bandwidth are the foundation of the next generation wireless network; and service providers are bundling an array of services to attract and retain subscribers.

We believe that increasing demand for IP connectivity and higher bandwidth results in favorable market conditions for ADTRAN.

We believe ADTRAN's wireless solutions are well positioned for this environment, with the bandwidth, manageability, and scalability required for converged networks. Anticipating the ongoing growth in this arena, we've recently created new product families and a dedicated sales force to expand our efforts in this wireless carrier market segment.

Ready for the next generation of networks

Favorable market conditions

The increasing demand for higher bandwidth, IP connectivity and next-generation services, coupled with the anticipated continuing investment of wireless and wireline service providers, should result in favorable market conditions for ADTRAN.

The race is on

ADTRAN is once again at the forefront of the various technologies, techniques, and challenges associated with the migration from the traditional to the new network of the future. Our systems are designed with the flexibility to support a myriad of applications, regardless of the chosen architecture.

Our continued innovations in network access and connectivity will help businesses of all sizes prepare for advanced technologies, such as VoIP and IP telephony. With continued global spending for infrastructure and a broad portfolio of network solutions, ADTRAN stands ready to advance the network with new products for new networks.

ADTRAN leads industry initiatives

With an eye to the future, ADTRAN is focusing on next generation network initiatives by leading standards development efforts. This year, ADTRAN became a co-chair for the Alliance for Telecommunications Industry Solutions (ATIS) IPTV Exploratory Group. Together with other leading subject matter experts, this group will identify and examine deployment issues and establish recommendations supporting the advancement of IPTV.

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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. As of February 10, 2006, ADTRAN® had 330 stockholders of record and approximately 13,496 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

2005

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	\$18.92	\$27.04	\$31.50	\$32.95
Low	\$15.76	\$17.27	\$24.93	\$27.00

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

The following table shows the dividends paid in each quarter of 2005 and 2004. 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

2005

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	\$0.080	\$0.080	\$0.090	\$0.090

2004

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

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, 2005, 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, 2005 and 2004 and for each of the years in the three-year period ended December 31, 2005, and the report of PricewaterhouseCoopers LLP thereon, are included elsewhere in this report.

Income Statement Data (1)

(In thousands, except per share amounts)

Year Ended December 31,	2005	2004	2003	2002	2001
Sales					
Carrier Networks Division	\$386,051	\$323,333	\$267,563	\$218,912	\$238,367
Enterprise Networks Division	127,164	131,184	129,113	126,813	148,714
Total sales	513,215	454,517	396,676	345,725	387,081
Cost of sales	209,895	195,182	176,108	172,070	215,138
Gross profit	303,320	259,335	220,568	173,655	171,943
Selling, general and administrative expenses	96,411	90,190	81,807	79,936	94,576
Research and development expenses	62,654	67,384	58,144	56,295	58,935
Operating income	144,255	101,761	80,617	37,424	18,432
Interest income	10,001	7,671	8,912	9,113	8,077
Interest expense	(2,535)	(2,542)	(2,534)	(2,572)	(2,069)
Other (expense) income, net	(59)	1,353	1,609	234	(29)
Net realized investment gains (losses)	1,712	1,773	226	(12,022)	(674)
Income before provision for income taxes	153,374	110,016	88,830	32,177	23,737
Provision for income taxes	52,224	34,875	27,315	7,401	6,408
Net income	\$101,150	\$75,141	\$61,515	\$24,776	\$17,329
Weighted average shares outstanding - basic (5)	75,775	78,235	76,942	76,090	77,135
Weighted average shares outstanding - assuming dilution (2) (5)	77,966	80,985	80,739	76,443	77,353
Earnings per common share - basic (5)	\$1.33	\$0.96	\$0.80	\$0.33	\$0.22
Earnings per common share - assuming dilution (2) (5)	\$1.30	\$0.93	\$0.76	\$0.32	\$0.22
Dividends declared and paid per common share (3) (5)	\$0.34	\$0.32	\$1.15	—	—

Balance Sheet Data

(In thousands)

At December 31,	2005	2004	2003	2002	2001
Working capital (4)	\$344,305	\$266,371	\$220,069	\$203,511	\$217,387
Total assets	\$652,618	\$559,942	\$592,309	\$521,213	\$522,537
Total debt	\$50,000	\$50,000	\$50,000	\$50,000	\$50,000
Stockholders' equity	\$542,171	\$466,637	\$493,821	\$435,212	\$437,628

- (1) In the first quarter of 2005, ADTRAN made changes to the classification of prior period purchasing costs related to procurement of materials from selling, general and administrative expenses to cost of sales. These reclassifications are included in the numbers above and had no effect on previously reported net income or stockholders' equity.
- (2) Assumes exercise of dilutive stock options calculated under the treasury method. See Notes 1 and 11 of Notes to Consolidated Financial Statements.
- (3) 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.

- (4) ADTRAN's working capital consists of current assets less current liabilities.
- (5) 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 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 Units/Data Service Units (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 a 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 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. 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. 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 this 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 and Estimates

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 rebates or discounts, since: (i) we generally do not have significant post-delivery obligations, (ii) the product price is fixed or 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 United States through a non-exclusive distribution network of major technology distributors. These organizations then distribute 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. Additionally, our distributors may return unused and unopened product for stock-balancing purposes when these 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 selling, general and administrative 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 condition of our customers deteriorates, 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 have previously been determined to be uncollectible (and for which a specific reserve has been established), a reduction

in our allowance for doubtful accounts may be required. Our allowance for doubtful accounts was \$0.3 million at December 31, 2005 and \$0.4 million at December 31, 2004.

- 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 \$5.3 million and \$4.8 million at December 31, 2005 and 2004, respectively. Inventory write-downs charged to the reserve were \$3.5 million, \$4.7 million and \$1.6 million for the years ended December 31, 2005, 2004 and 2003, 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 principal preservation and 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 securities, public equity, and private equity portfolios. 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.

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. In 2004 we recorded a write-down of our cost basis investments of \$0.1 million. This write-down is included in net realized investment gains (losses) in the accompanying consolidated statement 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 Standards (“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 2005, 2004 and 2003, the valuation allowance was \$0.7 million, \$0.6 million and \$0.4 million, respectively. This valuation allowance is included in non-current deferred tax liabilities in the accompanying balance sheets.

- Our products generally include warranties of one to ten years for product defects. We accrue for warranty returns based on our estimate of 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. ADTRAN®'s products continue to become more complex in both size and functionality as many of our product offerings migrate from line card applications to systems products. These products will require more warranty repairs to be completed at the installed location due to their size and complexity, rather than at a manufacturing site or repair depot. This field service obligation, as well as the increasing complexity of our products, will cause warranty obligations, when they arise, to be more costly. Our estimates regarding future warranty obligations may change due to product failure rates, material usage, and other rework costs incurred in correcting a product failure. In addition, from time to time, specific warranty accruals may be made if unforeseen problems arise. Should our actual experience relative to these factors be worse than our estimates, we will be required to record additional warranty expense. Alternatively, if we provide more reserves than we need, we will reverse a portion of such provisions in future periods. The liability for warranty returns totaled \$4.0 million and \$1.6 million at December 31, 2005 and 2004, respectively. These liabilities are included in accrued expenses in the accompanying consolidated balance sheets.

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.

Year Ended December 31,	2005	2004	2003
Sales			
Carrier Networks Division	75.2%	71.1%	67.4%
Enterprise Networks Division	24.8	28.9	32.6
Total sales	100.0	100.0	100.0
Cost of sales	40.9	42.9	44.4
Gross profit	59.1	57.1	55.6
Selling, general and administrative expenses	18.8	19.9	20.6
Research and development expenses	12.2	14.8	14.7
Operating income	28.1	22.4	20.3
Interest income	1.9	1.7	2.3
Interest expense	(0.5)	(0.6)	(0.6)
Other income	0.1	0.3	0.4
Net realized investment gains	0.3	0.4	0.1
Income before provision for income taxes	29.9	24.2	22.4
Provision for income taxes	10.2	7.7	6.9
Net income	19.7%	16.5%	15.5%

2005 Compared to 2004

Sales

ADTRAN's sales increased 12.9% from \$454.5 million in 2004 to \$513.2 million in 2005. 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 is primarily attributable to sales of DSLAMs, optical access products, M13 multiplexers, and NetVanta[®] products partially offset by a decrease in sales of IAD products.

Carrier Networks sales increased 19.4% from \$323.3 million in 2004 to \$386.1 million in 2005. Carrier Networks sales, as a percentage of total sales, increased from 71.1% in 2004 to 75.2% in 2005. 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 decreased 3.0% from \$131.2 million in 2004 to \$127.2 million in 2005. The decrease in Enterprise Networks sales is primarily related to decreases in IAD and CSU/DSU sales, partially offset by an increase in sales of NetVanta products. NetVanta internetworking products consist of access routers, VPN products, and Ethernet switches. The industry has integrated the functionality of CSU/DSUs, which are hardware units that terminates carrier services at the enterprise location, into access routers, thereby reducing the requirement for a standalone CSU/DSU. Enterprise Networks sales, as a percentage of total sales, decreased from 28.9% in 2004 to 24.8% in 2005.

Foreign sales increased 90.2% from \$30.6 million in 2004 to \$58.2 million in 2005. 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 42.9% in 2004 to 40.9% in 2005. 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 44.2% in 2004 to 41.5% in 2005. Enterprise Networks cost of sales, as a percent of division sales, decreased from 39.9% in 2004 to 39.0% in 2005.

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 6.9% from \$90.2 million in 2004 to \$96.4 million in 2005. We incurred increases in professional services of \$1.5 million related to audit and tax engagements, legal fees and maintenance/support agreements. Increases in sales and marketing expenses were \$1.5 million, and increases in management incentive bonus costs were \$1.6 million. Increased insurance costs were approximately \$0.7 million and increased deferred compensation costs were \$0.5 million. We also recorded \$0.4 million of expense related to the acceleration of vesting of stock options for a retiring officer.

Selling, general and administrative expenses as a percentage of sales decreased from 19.9% in 2004 to 18.8% in 2005. 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 decreased 7.0% from \$67.4 million in 2004 to \$62.7 million in 2005. As a percentage of sales, research and development expenses decreased from 14.8% in 2004 to 12.2% in 2005. The decrease in research and development expenses as a percentage of sales is primarily related to an increase in revenue combined with a decrease in product approval costs. 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 increased 29.9% from \$7.7 million in 2004 to \$10.0 million in 2005. This increase is primarily related to increased fixed income investments, higher interest rates and the continuing realignment of our investment portfolio resulting in additional interest income.

Interest Expense

Interest expense on our taxable revenue bond remained constant at \$2.5 million in 2005 and 2004. See "Liquidity and Capital Resources" below and Note 5 of Notes to Consolidated Financial Statements for additional information on our revenue bond.

Net Realized Investment Gains

Net realized investment gains remained relatively constant at \$1.8 million in 2004 and \$1.7 million in 2005.

Other Income (Expense)

Other income decreased from \$1.4 million in 2004 to other expense of \$0.1 million in 2005. This decrease is primarily related to a \$1.0 million accrual for a litigation contingency. This contingency was resolved in 2006 as accrued.

Income Taxes

Our effective tax rate increased from 31.7% in 2004 to 34.1% in 2005. This increase is primarily due to more research and development tax credits being recognized in 2004 than in 2005. The level of our research and development activity increased during 2005; however, the impact of our research and development credit on the current year's tax rate was diminished by increased earnings before tax over the prior year.

Net Income

As a result of the above factors, net income increased from \$75.1 million in 2004 to \$101.2 million in 2005. As a percentage of sales, net income increased from 16.5% in 2004 to 19.7% in 2005.

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 is primarily 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 44.4% in 2003 to 42.9% 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 46.2% in 2003 to 44.2% in 2004. Enterprise Networks cost of sales, as a percent of division sales, decreased from 40.7% in 2003 to 39.9% 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 10.4% from \$81.8 million in 2003 to \$90.2 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 20.6% in 2003 to 19.9% 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 "Liquidity and Capital Resources" below and Note 5 of Notes to Consolidated Financial Statements for additional information on our revenue bond.

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.

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.

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.

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; therefore, we may not realize the full benefit of these incentives. Through December 31, 2005, 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, 2005, 2004 and 2003 were \$1.4 million, \$1.3 million and \$1.5 million, respectively.

The following table shows dividends paid in each quarter of 2005 and 2004. 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

2005

First Quarter	Second Quarter	Third Quarter	Fourth Quarter
\$0.080	\$0.080	\$0.090	\$0.090

2004

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

At December 31, 2005 and 2004, we held \$91.6 million and \$93.4 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. 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 29.2% from \$266.4 million as of December 31, 2004 to \$344.3 million as of December 31, 2005. The quick ratio, defined as cash, cash equivalents, short-term investments, and net accounts receivable, divided by current liabilities, decreased from 6.83 as of December 31, 2004 to 6.53 as of December 31, 2005. The current ratio, defined as current assets divided by current liabilities, decreased from 8.40 as of December 31, 2004 to 7.74 as of December 31, 2005. These liquidity ratios will fluctuate with increased business growth and as our inventory, accounts receivable and income tax position change. The decreases in these ratios from 2004 to 2005 are primarily due to the increases in accrued expenses and income tax payable at December 31, 2005.

At December 31, 2005, we had an income tax payable of \$4.6 million primarily related to current year taxable income. 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. 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 employees. We recorded \$8.0 million and \$3.0 million for the years ended December 31, 2005 and 2004, 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, 2005, cash on hand was \$112.8 million and short-term investments were \$154.1 million, which placed our short-term liquidity at \$266.9 million. Short-term investments at December 31, 2005 include \$0.9 million related to our deferred compensation plan. At December 31, 2004, our cash on hand of \$57.6 million and short-term investments of \$124.8 million placed our short-term liquidity at \$182.4 million. The increase from 2004 to 2005 is primarily attributable to our ability to generate cash from operations and a net temporary 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, 2005, our long-term investments remained relatively constant at \$170.8 million from \$167.6 million at December 31, 2004. Long-term investments at December 31, 2005 and December 31, 2004 include a restricted balance of \$50.0 million related to our revenue bonds, as discussed above. Long-term investments at December 31, 2005 also include \$1.5 million related to our deferred compensation plan.

Accounts receivable increased 3.9% from December 31, 2004 to December 31, 2005. Quarterly days sales outstanding decreased 13 days from 56 days as of December 31, 2004 to 43 days as of December 31, 2005. Other receivables decreased 25.9% from December 31, 2004 to December 31, 2005, primarily resulting from timing and fluctuations of payments from subcontractors. Quarterly inventory turnover increased from 4.70 turns as of December 31, 2004 to 4.34 turns as of December 31, 2005. Inventory increased 18.8% from December 31, 2004 to December 31, 2005 due to the general increase in business activity.

Accounts payable increased 12.4% from December 31, 2004 to December 31, 2005. These increases are primarily related to variations of the timing of our payments and the general increase in business activity. Accrued expenses increased 105.6%, or \$2.5 million, from December 31, 2004 to December 31, 2005 primarily due to the increase in warranty reserves related to increased failure rates in newly released products. Capital expenditures totaled approximately \$8.9 million, \$7.2 million and \$6.8 million for the years ended December 31, 2005, 2004 and 2003, 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 \$72.9 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 \$90.9 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. As of December 31, 2005, we had repurchased a total of 286,563 shares of common stock under this plan at a total cost of \$6.1 million, and have the authority to purchase an additional 4,713,437 shares.

We issued 1,413,378 shares of treasury stock for \$16.9 million during the year ended December 31, 2005 to accommodate employee stock option exercises. During 2004, we issued 84,794 shares of treasury stock and 357,601 newly issued shares of common stock for \$5.6 million 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.

We intend to finance our operations with cash flow from operations. 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 believe this source of funds to be adequate to meet our operating and capital needs for the foreseeable future.

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, 2005.

Contractual Obligations

<i>(In millions)</i>	Total	2006	2007	2008	2009	After 2009
Long-term debt	\$50.0	—	—	—	—	\$50.0
Interest on long-term debt	35.0	2.5	2.5	2.5	2.5	25.0
Investment commitments	3.4	3.4	—	—	—	—
Operating lease obligations	1.3	0.7	0.5	0.1	—	—
Purchase obligations	34.1	34.1	—	—	—	—
Totals	\$123.8	\$40.7	\$3.0	\$2.6	\$2.5	\$75.0

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 up to an aggregate of \$7.85 million in two private equity funds, of which \$4.5 million has been invested to date. At December 31, 2005, we had outstanding purchase agreements with vendors of approximately \$34.1 million to purchase materials and services.

Effect of Recent Accounting Pronouncements

In November 2005, the Financial Accounting Standards Board (FASB) issued Financial Statement of Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This FSP nullifies certain requirements of Emerging Issues Task Force Bulletin (EITF) 03-1 and supersedes EITF Abstracts, Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005, and is required to be adopted by ADTRAN effective January 1, 2006. We are continuing to evaluate this guidance and the impact it will have on our consolidated results of operations or financial condition. For a discussion of our investments, see Note 2 to the Notes to Consolidated Financial Statements.

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, *Share Based Payment*. SFAS No. 123R revises the guidance in SFAS No. 123 and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 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 fiscal years beginning after June 15, 2005 and was adopted by ADTRAN® effective January 1, 2006. SFAS No. 123R requires ADTRAN to recognize the cost of employee services received in exchange for its equity instruments. Currently, in accordance with APB No. 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' requisite service 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 will elect to use the Modified Prospective Application method, 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. ADTRAN expects the adoption of SFAS No. 123R to reduce 2006 diluted earnings per share by approximately \$0.08 per share. This estimate is based on the number of options currently outstanding and exercisable and could change based on the number of options granted or forfeited in 2006. ADTRAN is continuing to evaluate this guidance and the impact it will have on its consolidated results of operations or financial condition. For a discussion of our stock-based compensation plans and agreements, see Note 7 to the Notes to Consolidated Financial Statements.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Non-monetary Assets – An Amendment of APB Opinion No. 29*. SFAS No. 153 eliminates the exception from fair value measurement for non-monetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, *Accounting for Non-monetary Transactions*, and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a non-monetary 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 was adopted by ADTRAN on July 1, 2005. Adoption of SFAS No. 153 did not have a material impact on our consolidated results of operations or financial condition.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS 154 replaces APB No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impractical and for reporting a change when retrospective application is impractical. SFAS No. 154 also addresses the reporting of an error by restating previously issued financial statements. SFAS No. 154 becomes effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. ADTRAN adopted this pronouncement effective January 1, 2006.

In June 2005, the FASB issued FASB Staff Position No. FAS 143-1, *Accounting for Electronic Waste Obligations* (FSP FAS 143-1). This position provides guidance on accounting for electronic equipment waste obligations associated with Directive 2002/96/EC on Waste Electrical and Electronic Equipment (the "Directive") adopted by the European Union. In particular, the new guidance specifies the appropriate accounting for obligations to dispose of "historical" waste, defined as electronic waste obligations relating to equipment put on the market prior to August 13, 2005. Under the Directive, when historical waste equipment is replaced, the waste management obligation for that equipment may be transferred to the producer of the replacement equipment depending upon the law adopted by the applicable European Union country. In this case, the producer of the new asset should recognize revenue for the total amount received reduced by the fair value of the obligation required for disposal of the replaced asset. The producer of the new asset should derecognize the liability when the obligation is settled. FSP FAS 143-1 is effective for reporting periods ending after June 8, 2005 and was adopted by ADTRAN on July 1, 2005. Adoption of FSP FAS 143-1 did not have a material impact on our consolidated results of operations or financial conditions.

In July 2005, the FASB issued a proposed Interpretation, *Accounting for Uncertain Tax Provisions, an Interpretation of FASB Statement 109*. This proposed Interpretation would clarify the accounting for uncertain tax positions as described in SFAS No. 109, *Accounting for Income Taxes*, and would require a company to recognize, in its financial statements, the best estimate of the impact of a tax position only if that position is probable of being sustained on an audit basis solely on the technical merit of the position. On October 10, 2005, the FASB confirmed that the guidance in this proposed Interpretation has been delayed and will not be finalized before the first quarter of 2006. ADTRAN will continue to monitor this guidance and the impact it might have on its consolidated results of operations or financial condition.

Quantitative and Qualitative Disclosures About Market Risk

ADTRAN has not conducted transactions, established commitments or entered into relationships requiring disclosures beyond those provided elsewhere in this Form 10-K.

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.

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, 2005. 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, 2005.

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

Report of Independent Registered Public Accounting Firm

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

We have completed integrated audits of ADTRAN, Inc.'s December 31, 2005 and December 31, 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its December 31, 2003 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, stockholder's equity and cash flows present fairly, in all material respects, the financial position of ADTRAN, Inc. and its subsidiaries at December 31, 2005 and December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 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 27 of the 2005 Annual Report to the Shareholders, that the Company maintained effective internal control over financial reporting as of December 31, 2005 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, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the 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 2, 2006

Financial Statements

ADTRAN[®], Inc.

Consolidated Balance Sheets

December 31, 2005 and 2004

(In thousands, except per share amounts)

Assets	2005	2004
Current assets		
Cash and cash equivalents	\$ 112,794	\$ 57,602
Short-term investments	154,080	124,831
Accounts receivable, less allowance for doubtful accounts of \$349 and \$361 at December 31, 2005 and 2004, respectively	66,246	63,729
Other receivables	3,214	4,335
Income tax receivable	—	2,442
Inventory, net	50,266	42,316
Prepaid expenses	2,794	2,643
Deferred tax assets	5,960	4,488
Total current assets	395,354	302,386
Property, plant and equipment, net	85,033	89,361
Deferred tax assets	898	—
Other assets	497	586
Long-term investments	170,836	167,609
Total assets	\$652,618	\$559,942
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	\$25,682	\$22,856
Unearned revenue	4,318	2,468
Accrued expenses	4,820	2,344
Accrued payroll	11,678	8,347
Income tax payable	4,551	—
Total current liabilities	51,049	36,015
Deferred tax liabilities	5,330	4,825
Other non-current liabilities	4,068	2,465
Bonds payable	50,000	50,000
Total liabilities	110,447	93,305
Commitments and contingencies (see Note 10)		
Stockholders' equity		
Common stock, par value \$0.01 per share; 200,000 shares authorized; 79,652 issued and outstanding in 2005 and 2004	797	797
Additional paid-in capital	135,582	142,243
Accumulated other comprehensive income	4,172	5,235
Retained earnings	472,558	397,228
Less treasury stock at cost: 3,116 shares at December 31, 2005 and 3,238 shares at December 31, 2004	(70,938)	(78,866)
Total stockholders' equity	542,171	466,637
Total liabilities and stockholders' equity	\$652,618	\$559,942

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

ADTRAN, Inc.**Consolidated Statements of Income**

Years ended December 31, 2005, 2004 and 2003

<i>(In thousands, except per share amounts)</i>	2005	2004	2003
Sales	\$513,215	\$454,517	\$396,676
Cost of sales	209,895	195,182	176,108
Gross profit	303,320	259,335	220,568
Selling, general and administrative expenses	96,411	90,190	81,807
Research and development expenses	62,654	67,384	58,144
Operating income	144,255	101,761	80,617
Interest and dividend income	10,001	7,671	8,912
Interest expense	(2,535)	(2,542)	(2,534)
Other (expense) income	(59)	1,353	1,609
Net realized investment gains	1,712	1,773	226
Income before provision for income taxes	153,374	110,016	88,830
Provision for income taxes	52,224	34,875	27,315
Net income	\$101,150	\$75,141	\$61,515
Weighted average shares outstanding	75,775	78,235	76,942
Weighted average shares outstanding assuming dilution (1)	77,966	80,985	80,739
Earnings per common share – basic	\$1.33	\$0.96	\$0.80
Earnings per common share – assuming dilution (1)	\$1.30	\$0.93	\$0.76

(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 and Comprehensive Income (Loss)

Years ended December 31, 2005, 2004 and 2003

<i>(In thousands)</i>	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
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)
Other comprehensive income, net of tax:							
Change in unrealized gain on marketable securities (net of deferred tax of \$4,484)						7,618	
Reclassification adjustment for amounts included in net income (net of income tax of \$576)						(997)	
Unrealized foreign exchange translation (net of deferred tax of \$141)						294	
Other comprehensive income, subtotal							6,915
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)
Other comprehensive loss, net of tax:							
Change in unrealized gain on marketable securities (net of deferred tax of \$1,516)						(2,632)	
Reclassification adjustment for amounts included in net income (net of income tax of \$1,273)						(2,208)	
Unrealized foreign exchange translation (net of deferred tax of \$45)						63	
Other comprehensive loss, subtotal							(4,777)
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, Inc.**Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (Loss)***Continued*

<i>(In thousands)</i>	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Net Income				101,150			101,150
Dividend payments				(25,820)			(25,820)
Other comprehensive loss, net of tax:							
Change in unrealized gain on marketable securities (net of deferred tax of \$617)						861	
Reclassification adjustment for amounts included in net income (net of income tax of \$752)						(1,302)	
Unrealized foreign exchange translation (net of deferred tax of \$0)						(622)	
Other comprehensive loss, subtotal							(1,063)
Stock options exercised:							
Various prices per share			(15,064)		32,002		16,938
Purchase of treasury stock: 1,287 shares					(24,074)		(24,074)
Income tax benefit from exercise of non-qualified stock options			7,981				7,981
Accelerated vesting of stock options			422				422
Balance, December 31, 2005	79,652	\$797	\$135,582	\$472,558	(\$70,938)	\$4,172	\$542,171

ADTRAN issued 1,413 shares, 281 shares and 4,125 shares of treasury stock, and issued 0 shares, 358 shares and 214 shares of previously un-issued common stock to accommodate employee stock option exercises during 2005, 2004 and 2003, respectively. In 2005 and 2003, ADTRAN received 25 shares and 14 shares, respectively, of shares previously held for at least six months as payment of the exercise price for employee stock options. None of the transactions with respect to these shares were made in the open market. The average price paid per share with respect to these transactions was based on the closing price of the common stock on the NASDAQ National Market on the date of the transaction.

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

ADTRAN® , Inc.**Consolidated Statements of Cash Flows**

Years ended December 31, 2005, 2004 and 2003

<i>(In thousands)</i>	2005	2004	2003
Cash flows from operating activities			
Net income	\$101,150	\$75,141	\$61,515
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	13,199	15,373	15,247
Loss on sale of property, plant and equipment	3	65	3
Gain on sale of long-term investments	(1,712)	(1,773)	(226)
Non-cash compensation expense	422	—	381
Deferred income taxes	(1,644)	(769)	2,812
Income tax benefit from exercise of non-qualified stock options	7,981	2,964	23,638
Change in operating assets and liabilities:			
Accounts receivable, net	(2,517)	(11,345)	(13,502)
Other receivables	1,121	2,653	(2,528)
Income tax receivable	2,442	9,144	(11,586)
Inventory, net	(7,950)	(2,341)	(49)
Prepaid expenses and other assets	(148)	(572)	498
Accounts payable	2,826	(1,965)	10,241
Accrued expenses and other liabilities	9,259	(752)	3,683
Income taxes payable	4,551	—	(4,773)
Net cash provided by operating activities	128,983	85,823	85,354
Cash flows from investing activities			
Expenditures for property, plant and equipment	(8,876)	(7,165)	(6,782)
Proceeds from the disposition of property, plant and equipment	2	32	38
Proceeds from sale of available-for-sale investments	211,288	126,610	99,421
Purchases of available-for-sale investments	(242,627)	(146,018)	(176,312)
Proceeds from maturities of held-to-maturity investments	—	4,720	18,738
Purchases of held-to-maturity investments	—	—	(10,856)
Net cash used in investing activities	(40,213)	(21,821)	(75,753)
Cash flows from financing activities			
Proceeds from issuance of common stock	16,938	5,557	55,087
Purchase of treasury stock	(24,074)	(80,954)	—
Dividend payments	(25,820)	(25,115)	(88,927)
Net cash used in financing activities	(32,956)	(100,512)	(33,840)
Net increase (decrease) in cash and cash equivalents	55,814	(36,510)	(24,239)
Effect of exchange rate changes	(622)	64	294
Cash and cash equivalents, beginning of year	57,602	94,048	117,993
Cash and cash equivalents, end of year	\$112,794	\$57,602	\$94,048
Supplemental disclosure of cash flow information			
Cash paid during the year for interest	\$2,667	\$2,542	\$2,576
Cash paid during the year for income taxes	\$40,311	\$25,113	\$14,061

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 inter-company 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 available for sale (see Note 2) with original maturities of three months or less.

Financial Instruments

The carrying amounts 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.

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, 2005 and 2004 are classified as available-for-sale (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 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 we dispose of excess and obsolete inventories, 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

Our products generally include warranties of one to ten 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. ADTRAN®'s products continue to become more complex in both size and functionality as many many of our product offerings migrate from line card applications to systems products. These products will require more warranty repairs to be completed at the installed location due to their size and complexity, rather than at a manufacturing site or repair depot. This field service obligation, as well as the increasing complexity of our products, will cause warranty obligations, when they arise, to be more expensive. Our warranty obligation is affected by product failure rates, material usage, and other rework costs incurred in correcting a product failure. In addition, from time to time, specific warranty accruals may be made if unforeseen problems arise. Should our actual experience relative to these factors be worse than our estimates, we will be required to record additional warranty expense. Alternatively, if we provide more reserves than we need, we will reverse a portion of such provisions in future periods. The liability for warranty returns totaled \$4.0 million and \$1.6 million at December 31, 2005 and 2004 respectively. These liabilities are included in accrued expenses in the accompanying consolidated balance sheets.

<i>(In thousands)</i>	2005	2004
Year ended December 31,		
Balance at beginning of period	\$1,560	\$1,541
Plus: amounts charged to cost and expenses	4,320	2,054
Less: deductions	(1,908)	(2,035)
Balance at end of period	\$3,972	\$1,560

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, *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 2005, 2004 and 2003.

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 \$62.7 million, \$67.4 million and \$58.1 million for the years ended December 31, 2005, 2004 and 2003, respectively.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was \$2.7 million, \$2.9 million, and \$2.2 million for the years ended December 31, 2005, 2004 and 2003, 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 nonqualified 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. These large organizations then distribute 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 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 (Expense) Income

Other (expense) income includes miscellaneous income or expense, gains or losses on foreign currency transactions, raw material scrap sales, litigation costs, 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 \$0.3 million, net of tax, of compensation expense in 2005 related to the acceleration of vesting of stock options for a retiring officer.

We apply Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and its 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 and Earnings Per Share

<i>(In thousands, except per share amounts)</i>	2005	2004	2003
Net income-as reported	\$101,150	\$75,141	\$61,515
Add: stock-based compensation expense included in reported net income, net of tax	278	—	216
Less: stock-based compensation expense, net of tax	(8,627)	(18,112)	(22,755)
Net income — pro forma	\$92,801	\$57,029	\$38,976
Earnings per share			
Basic-as reported	1.33	\$0.96	\$0.80
Basic-pro forma	1.22	\$0.73	\$0.50
Diluted-as reported	1.30	\$0.93	\$0.76
Diluted-pro forma	1.19	\$0.70	\$0.48

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

	2005	2004	2003
Expected dividend yield	1.18%	1.44%	0.93%
Expected life (years)	5.00	5.00	5.00
Expected volatility	55.48%	60.00%	55.90%
Risk-free interest rate	4.35%	3.34%	3.20%

In December 2004, the FASB issued SFAS No. 123R, *Share Based Payment*. SFAS No. 123R revises the guidance in SFAS No. 123 and supersedes APB No. 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 fiscal years beginning after June 15, 2005 and was adopted by ADTRAN effective January 1, 2006. SFAS No. 123R requires ADTRAN to recognize the cost of employee services received in exchange for its equity instruments. Currently, in accordance with APB No. 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' requisite service 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 will elect to use the Modified Prospective Application method, 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. ADTRAN is continuing to evaluate this guidance and the impact it will have on its consolidated results of operations or financial condition. 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, 2005, ADTRAN® paid \$25.8 million in dividend payments. On January 23, 2006, the board of directors declared a quarterly cash dividend of \$0.09 per common share to be paid to holders of record at the close of business on February 7, 2006. The ex-dividend date was February 3, 2006 and the payment date was February 17, 2006. The quarterly dividend payment was \$6.9 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.

Changes in Classifications

In the first quarter of 2005, ADTRAN made changes to the classifications of purchasing costs related to procurement of materials from selling, general and administrative expenses to cost of sales. These and certain other reclassifications have been made to the 2004 and 2003 consolidated financial statements in order to conform to the 2005 presentation. These reclassifications had no effect on previously reported net income, cash flows from operations, or total stockholders' equity.

Recently Issued Accounting Standards

In November 2005, the Financial Accounting Standards Board (FASB) issued Financial Statement of Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This FSP nullifies certain requirements of Emerging Issues Task Force (EITF) 03-1 and supersedes EITF Abstracts, Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005, and is required to be adopted by ADTRAN effective January 1, 2006. We are continuing to evaluate this guidance and the impact it will have on our consolidated results of operations or financial condition. For a discussion of our investments, see Note 2.

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. 153, *Exchanges of Non-monetary Assets – An Amendment of APB Opinion No. 29*. SFAS No. 153 eliminates the exception from fair value measurement for non-monetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, *Accounting for Non-monetary Transactions*, and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a non-monetary 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 was adopted by ADTRAN on July 1, 2005. Adoption of SFAS No. 153 did not have a material impact on our consolidated results of operations or financial condition.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*. SFAS 154 replaces APB No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impractical and for reporting a change when retrospective application is impractical. SFAS No. 154 also addresses the reporting of an error by restating previously issued financial statements. SFAS No. 154 becomes effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. ADTRAN adopted this pronouncement effective January 1, 2006.

In June 2005, the FASB issued FASB Staff Position No. FAS 143-1, *Accounting for Electronic Waste Obligations* (FSP FAS 143-1). This position provides guidance on accounting for electronic equipment waste obligations associated with Directive 2002/96/EC on Waste Electrical and Electronic Equipment (the “Directive”) adopted by the European Union. In particular, the new guidance specifies the appropriate accounting for obligations to dispose of “historical” waste, defined as electronic waste obligations relating to equipment put on the market prior to August 13, 2005. Under the Directive, when historical waste equipment is replaced, the waste management obligation for that equipment may be transferred to the producer of the replacement equipment depending upon the law adopted by the applicable European Union country. In this case, the producer of the new asset should recognize revenue for the total amount received reduced by the fair value of the obligation required for disposal of the replaced asset. The producer of the new asset should derecognize the liability when the obligation is settled. FSP FAS 143-1 is effective for reporting periods ending after June 8, 2005 and was adopted by ADTRAN on July 1, 2005. Adoption of FSP FAS 143-1 did not have a material impact on our consolidated results of operations or financial conditions.

In July 2005, the FASB issued a proposed Interpretation, *Accounting for Uncertain Tax Provisions, an Interpretation of FASB Statement 109*. This proposed Interpretation would clarify the accounting for uncertain tax positions as described in SFAS No. 109, *Accounting for Income Taxes*, and would require a company to recognize, in its financial statements, the best estimate of the impact of a tax position only if that position is probable of being sustained on an audit basis solely on the technical merit of the position. On October 10, 2005, the FASB confirmed that the guidance in this proposed Interpretation has been delayed and will not be finalized before the first quarter of 2006. ADTRAN will continue to monitor this guidance and the impact it might have on its 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, 2005 and 2004, we held the following securities, recorded at either fair value or amortized cost, which approximates fair value.

December 31, 2005

(In thousands)

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities				
Restricted investments	\$52,248	\$165	—	\$52,413
Municipal bonds and fixed income mutual funds	159,023	26	(1,343)	157,706
Marketable equity securities	12,385	8,373	(179)	20,579
Auction rate securities	91,584	—	—	91,584
Other equity securities	2,634	—	—	2,634
Total available-for-sale securities	\$317,874	\$8,564	\$(1,522)	\$324,916

December 31, 2004

(In thousands)

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities				
Restricted investments	\$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

Restricted investments at December 31, 2005 include \$50.0 million invested in restricted money market funds and \$2.4 million of deferred compensation plan assets. Restricted investments at December 31, 2004 consist of \$50.0 million invested in restricted money market funds.

At December 31, 2005 and 2004, we held \$91.6 million and \$93.4 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. 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 \$1.9 million, \$3.8 million and \$2.2 million for the years ended December 31, 2005, 2004 and 2003, respectively. Gross realized losses on the sale of securities were approximately \$0.4 million, \$2.0 million and \$1.7 million for the years ended December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005 and 2004, we had net unrealized gains of \$7.0 million and \$7.7 million, respectively. As of December 31, 2005 and 2004, we had \$0.9 million and \$0.2 million, respectively of unrealized losses with durations greater than 12 months. The fair values of investments with unrealized losses were \$134.1 million and \$22.5 million at December 31, 2005 and 2004, respectively.

We also invest in privately held companies and record our investments in these entities at cost or impaired cost. As of December 31, 2005 and 2004, we had \$2.6 million and \$2.1 million, respectively, of investments carried at cost or impaired 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 2005, 2004 and 2003, we recognized gross losses of \$0, \$0.1 million and \$0, respectively, on cost basis investments.

During the year ended December 31, 2004, we received \$1.0 million for investments that were classified as held-to-maturity and had previously been written down to \$0.3 million. These transactions resulted in a net realized gain of \$0.7 million and were the result of the sale of our investment in a private company.

We have committed to invest an aggregate of up to \$7.9 million in two private equity funds, of which \$4.5 million has been invested to date. The duration of each of these commitments is ten years, with \$0.8 million expiring in 2010 and \$2.6 million expiring in 2012. 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, 2005 and 2004, inventory was comprised of the following:

<i>(In thousands)</i>	2005	2004
Raw materials	\$26,504	\$24,051
Work in process	4,056	4,526
Finished goods	25,006	18,558
Inventory reserve	(5,300)	(4,819)
Total	\$50,266	\$42,316

4 Property, Plant and Equipment

At December 31, 2005 and 2004, property, plant and equipment was comprised of the following:

<i>(In thousands)</i>	2005	2004
Land	\$4,263	\$4,263
Land improvements	11,757	11,559
Building	68,554	68,554
Furniture and fixtures	15,326	14,814
Computer hardware and software	48,294	46,292
Engineering and other equipment	63,131	58,756
Total property, plant and equipment	211,325	204,238
Less accumulated depreciation	(126,292)	(114,877)
Total property, plant and equipment (net)	\$85,033	\$89,361

Depreciation expense was \$13.2 million, \$15.4 million and \$15.2 million in 2005, 2004 and 2003, 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 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 2005, 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, 2005 was approximately \$49.0 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, 2005, 2004 and 2003 were \$1.4 million, \$1.3 million and \$1.5 million, respectively.

6 Income Taxes

A summary of the components of the provision for income taxes as of December 31, 2005, 2004 and 2003 is as follows:

<i>(In thousands)</i>	2005	2004	2003
Current			
Federal	\$48,520	\$30,750	\$23,247
State	5,348	4,894	1,256
Total Current	53,868	35,644	24,503
Deferred tax provision (benefit)	(1,644)	(769)	2,812
Total provision for income taxes	\$52,224	\$34,875	\$27,315

The effective income tax rate differs from the federal statutory rate due to the following:

	2005	2004	2003
Tax provision computed at the federal statutory rate (35% in 2005, 2004 and 2003)	35.00%	35.00%	35.00%
State income tax provision, net of federal benefit	3.24%	4.04%	2.28%
Federal research credits	(1.46%)	(4.53%)	(2.56%)
Tax-exempt income	(1.46%)	(1.18%)	(1.74%)
State tax incentives	(0.93%)	(1.15%)	(1.73%)
Extra-territorial income	(0.35%)	(0.60%)	(0.09%)
Domestic production activity deduction	(0.50%)	0.00%	0.00%
Other, net	0.51%	0.12%	(0.41%)
Effective tax rate	34.05%	31.70%	30.75%

Deferred income taxes on the balance sheet result from temporary differences between the amount of assets and liabilities recognized for financial reporting and tax purposes. The principal components of our current and non-current deferred taxes are as follows:

<i>(In thousands)</i>	2005	2004
Current deferred tax assets		
Accounts receivable	\$132	\$132
Inventory	3,581	3,120
Accrued expenses	2,247	1,236
Total current deferred tax assets	\$5,960	\$4,488
Non current deferred tax assets		
Accrued expenses	112	—
Deferred compensation	786	—
Total non current deferred tax assets	\$898	—
Total deferred tax assets	\$6,858	\$4,488
Non current deferred tax liabilities		
Accumulated depreciation	\$(3,250)	\$(3,178)
Investments	(2,017)	(1,647)
Deferred compensation	(63)	—
State research credits	734	556
Valuation allowance	(734)	(556)
Total non current deferred tax liabilities	\$(5,330)	\$(4,825)
Total deferred tax assets (liability)	\$1,528	\$(337)

We have state research tax credit carry-forwards of \$0.7 million which will expire between 2016 and 2020. In accordance with SFAS No. 109, *Accounting for Income Taxes*, we believe it is more likely than not that we will not realize the benefits of our deferred tax asset arising from these credits, and accordingly, have provided a valuation allowance. We do not provide for U.S. income tax on undistributed earnings of our foreign operations, whose earnings are intended to be permanently reinvested. For years ended December 31, 2005, 2004 and 2003, foreign profits before income taxes were not material.

During 2004, we settled prior year state tax contingencies, resulting in an additional \$1.0 million of state tax expense. We also realized additional research and development credits from prior years in the year ending December 31, 2004. During 2005, 2004 and 2003, we recorded an income tax deduction of \$8.0 million, \$3.0 million and \$23.6 million, respectively, as an adjustment to equity in accordance with APB 25. This deduction is calculated on the difference between the exercise price and the market price of nonqualified stock option exercises. For the year ended December 31, 2005, approximately 43% of the income tax deduction relates to disqualifying dispositions of incentive stock options and 57% relates to non-qualified stock options.

7 Stock Incentive 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 1996 Plan, which expired on February 14, 2006. Options granted under the 1996 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 at December 31, 2005, range from 2006 to 2015. There were no remaining options outstanding under the 1986 Employees Incentive Stock Option Plan at December 31, 2005. On January 23, 2006, the board of directors adopted the 2006 Employees Incentive Stock Option Plan (the “2006 Plan”), which reserves 13,000,000 shares of common stock for issuance to certain employees and officers through incentive stock options and non-qualified stock options, stock appreciation rights, restricted stock and restricted stock units. The 2006 Plan was adopted subject to stockholder approval at ADTRAN’s annual meeting of stockholders to be held May 9, 2006.

Our stockholders approved the 2005 Directors Stock Option Plan (“2005 Directors Plan”) on May 18, 2005, 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, 2005, 30,000 options had been granted under the 2005 Directors Plan and 370,000 remained available for grant. We currently have options outstanding under the 1995 Directors Stock Option Plan, as amended (“1995 Directors Plan”), which expired October 31, 2005. The 1995 Directors Plan was also a formula plan to provide for the grant of options to our non-employee directors. A total of 400,000 shares of common stock were reserved for issuance under the 1995 Directors Plan. At December 31, 2005, 424,500 options had been granted under the 1995 Directors Plan, 72,000 options had been cancelled or forfeited, 47,500 options expired, and no options remained available for grant. Expiration dates of options outstanding under both plans at December 31, 2005, range from 2006 to 2015.

Pertinent information regarding our stock incentive plans is as follows:

<i>(In thousands, except per share amounts)</i>	Number of Options	Range of Exercise Prices	Weighted Average Exercise Price	Vesting Provisions
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
Options granted	794	\$15.76 - \$30.04	\$29.78	Various
Options cancelled/forfeited	(113)	\$8.69 - \$36.64	\$19.73	Various
Options exercised	(1,439)	\$8.69 - \$28.18	\$12.29	Various
Options outstanding, December 31, 2005	6,541	\$8.69 - 37.18	\$17.74	Various

The following table summarizes information about stock options outstanding at December 31, 2005:

Options Outstanding at December 31, 2005

(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 - \$10.29	467	4.53	\$8.76	462	\$8.75
\$10.50 - \$10.50	1,359	6.79	\$10.50	906	\$10.50
\$10.63 - \$12.75	1,580	4.72	\$12.35	1,580	\$12.35
\$13.22 - \$22.17	1,648	6.02	\$19.45	1,114	\$18.38
\$24.78 - \$37.18	1,487	8.83	\$31.02	385	\$32.29
Total	6,541			4,447	

All of the options above were issued at exercise prices that approximate fair market value at the date of grant. During the year ended December 31, 2005, we recorded compensation expense of \$0.3 million, net of income tax, related to the acceleration of vesting of 28,450 options issued at fair market value on the date of grant. At December 31, 2005, 3,808,419 options were available for grant under the shareholder approved plans.

8 Employee Benefit Plan

401(k) Savings 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 (\$210,000 for 2005). 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 \$2.8 million, \$2.7 million and \$2.5 million in 2005, 2004 and 2003, respectively.

Deferred Compensation Plan

We maintain a shareholder approved deferred compensation plan (“Deferred Compensation Plan”). This plan is available to officers of ADTRAN® who have been duly elected by our board of directors. The plan allows participants to defer all or a portion of their salary and annual bonuses. We can make discretionary matching contributions of the participant’s salary deferral, and those assets are invested in instruments as directed by the participant. The Deferred Compensation Plan does not have dollar limits on tax-deferred contributions. The assets of the Deferred Compensation Plan are held in a rabbi trust (“Trust”) and may be available to satisfy the claims of our creditors in the event of bankruptcy or insolvency. Participants have the ability to direct the Plan Administrator to invest their salary and bonus deferrals into pre-approved mutual funds held by the Trust. The Deferred Compensation Plan does not include common stock of ADTRAN. Participants are required to receive distributions in cash. We account for the Deferred

Compensation Plan in accordance with EITF Abstract 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned are Held in a Rabbi Trust and Invested*.

Assets of the Trust are invested in mutual funds that cover an investment spectrum ranging from equities to money market instruments. These mutual funds are publicly quoted and reported at market value. We account for these investments in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The market value of the assets held by the Trust at December 31, 2005 was \$2.4 million; \$0.9 million classified as short-term investments, and \$1.5 million classified as long-term investments in the accompanying 2005 consolidated balance sheet. The amounts payable to the plan participants at December 31, 2005 was \$2.4 million; \$0.9 million classified as accounts payable, and \$1.5 million classified as other non-current liabilities in the accompanying 2005 consolidated balance sheet.

In accordance with EITF 97-14, increases or decreases in the market value of the plan assets have been included as other income in the accompanying 2005 consolidated statement of income. Increases or decreases in the market value of the deferred compensation liability are included as selling, general and administrative expense in the accompanying 2005 consolidated statement of income. Based on the changes in the total market value of the Trust's assets, we recorded deferred compensation adjustments of \$0.2 million in 2005.

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.

The following table presents information about the reported sales and gross profit of our reportable segments for each of the years ended December 31, 2005, 2004 and 2003 reconciled to net income. Asset information by reportable segment is not reported, since we do not produce such information internally.

Sales by Market Segment

<i>(In thousands)</i>	2005		2004		2003	
	Sales	Gross Profit	Sales	Gross Profit	Sales	Gross Profit
Carrier Networks	\$386,051	\$225,781	\$323,333	\$180,504	\$267,563	\$144,044
Enterprise Networks	127,164	77,539	131,184	78,831	129,113	76,524
	\$513,215	\$303,320	\$454,517	\$259,335	\$396,676	\$220,568
Selling, general and administrative expense		96,411		90,190		81,807
Research and Development expense		62,654		67,384		58,144
Operating income		\$144,255		\$101,761		\$80,617
Other income, net		9,119		8,255		8,213
Income before provision for income taxes		153,374		110,016		88,830
Provision for income taxes		52,224		34,875		27,315
Net income		\$101,150		\$75,141		\$61,515

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 category for the years ended December 31, 2005, 2004 and 2003:

<i>(In thousands)</i>	2005	2004	2003
Digital Business Transport (DBT)/Total Reach	\$11,831	\$22,023	\$31,850
High-bit-rate Digital Subscriber Line (HDSL)/T1	225,381	215,479	193,235
Systems	276,003	217,015	171,591
Total	\$513,215	\$454,517	\$396,676

Sales by Geographic Region

The following is sales information by geographic area for the years ended December 31, 2005, 2004 and 2003:

<i>(In thousands)</i>	2005	2004	2003
United States	\$455,065	\$423,913	\$377,060
All other	58,150	30,604	19,616
Total	\$513,215	\$454,517	\$396,676

Single customers comprising more than 10% of our revenue in 2005 include AT&T® Inc. (formerly SBC Communications, Inc. and AT&T Inc.) at 20%, Sprint® Corporation at 14% and Verizon® Communications, Inc. at 11%. Single customers comprising more than 10% of our revenue in 2004 included AT&T 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 AT&T Inc. at 23%, Sprint Corporation at 14% and Verizon Communications, Inc. at 15.0%. No other customer accounted for 10% or more of our sales in 2005, 2004, or 2003. Sales of network access equipment to Incumbent Local Exchange Carriers (ILECs) and major independent telecommunications companies amounted to approximately 56%, 58% and 60% of total sales during the years ended December 31, 2005, 2004 and 2003, 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%, 26% and 25% of our revenue for each of the years ended December 31, 2005, 2004 and 2003, respectively, and were routed through four primary fulfillment distributors.

As of December 31, 2005, long-lived assets, net, totaled \$85.0 million, which includes \$84.9 million held in the United States and \$0.1 million held outside the United States. As of December 31, 2004, long-lived assets, net, totaled \$89.4 million, which included \$89.3 million held in the United States and \$0.1 million held outside the United States.

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, 2005, future minimum rental payments under non-cancelable operating leases with original maturities of greater than 12 months are approximately as follows:

<i>(In thousands)</i>	
2006	\$716
2007	465
2008	159
Total	\$1,340

Rental expense was approximately \$1.0 million, \$1.5 million and \$1.9 million in 2005, 2004 and 2003, 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, 2005.

Contractual Obligations

<i>(In millions)</i>	Total	2006	2007	2008	2009	After 2009
Long-term debt	\$50.0	—	—	—	—	\$50.0
Interest on long-term debt	35.0	2.5	2.5	2.5	2.5	25.0
Investment commitments	3.4	3.4	—	—	—	—
Operating lease obligations	1.3	0.7	0.5	0.1	—	—
Purchase obligations	34.1	34.1	—	—	—	—
Total	\$123.8	\$40.7	\$3.0	\$2.6	\$2.5	\$75.0

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, 2005 and 2004, we had outstanding purchase agreements with vendors of approximately \$34.1 million and \$27.1 million respectively, to purchase materials and services. Additionally, we have committed to invest up to an aggregate of \$7.9 million in two private equity funds, of which \$4.5 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, 2005, 2004 and 2003 is as follows:

Year ended	2005	2004	2003
Numerator			
Net income	\$101,150	\$75,141	\$61,515
Denominator			
Weighted average number of shares - basic	\$75,775	\$78,235	\$76,942
Effect of dilutive securities - stock options	2,191	2,750	3,797
Weighted average number of shares - diluted	\$77,966	\$80,985	\$80,739
Net income per share - basic	\$1.33	\$0.96	\$0.80
Net income per share - diluted	\$1.30	\$0.93	\$0.76

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)

2005			2004			2003		
Options Granted	Exercise Price	Expiration Date	Options Granted	Exercise Price	Expiration Date	Options Granted	Exercise Price	Expiration Date
2	\$32.88	2006	2	\$32.88	2006	2	\$32.88	2006
27	\$24.78 - \$34.91	2010	26	\$34.91	2010	28	\$34.91	2010
670	\$28.18 - \$36.64	2013	702	\$28.18 - \$36.64	2013	740	\$28.18 - \$36.64	2013
6	\$29.67 - \$37.18	2014	7	\$29.50 - \$37.18	2014			
783	\$25.36 - \$30.04	2015						

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, 2005	June 30, 2005	September 30, 2005	December 31, 2005
Net sales	\$104,577	\$118,873	\$149,170	\$140,595
Gross profit	\$60,228	\$69,546	\$89,314	\$84,232
Operating income	\$20,936	\$28,882	\$49,216	\$45,221
Net income	\$15,220	\$20,719	\$33,015	\$32,196
Earnings per common share assuming dilution (1)	\$0.20	\$0.27	\$0.42	\$0.41
Earnings per common share	\$0.20	\$0.28	\$0.44	\$0.41
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	\$65,088	\$69,322	\$66,382	\$58,543
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

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

13 Related Party Transactions

We employ the law firm of our director 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 during the years ended December 31, 2005 and 2004 for these legal services.

At December 31, 2005, one of our non-employee directors was 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, 2005 and 2004, we received payments, directly and indirectly, from this customer in the amount of approximately \$21.5 million and \$25.3 million, respectively, for products supplied to this customer. In addition, for the year ended December 31, 2005 and 2004, we paid this customer \$0.5 million and \$0.6 million, respectively, for services provided to us.

14 Subsequent Events

On January 23, 2006, the board declared a quarterly cash dividend of \$0.09 per common share to be paid to stockholders of record at the close of business on February 7, 2006. The quarterly dividend payment was \$6.9 million and was paid on February 17, 2006.

On January 23, 2006, at the board of directors meeting on that date, the board accepted the resignation of Richard A. Anderson as a director and appointed Danny J. Windham as a director to fill the vacancy created by Mr. Anderson's resignation, effective January 23, 2006. Mr. Windham currently serves as President, Chief Operating Officer and Secretary of the Company.

Directors and Executive Officers

Mark C. Smith

Chairman of the Board

Thomas R. Stanton

Chief Executive Officer of the Company

Danny J. Windham

President, Chief Operating Officer, Secretary, and Director of the Company

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, 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

Robert A. Fredrickson

Vice President—Carrier Networks Sales

Steven L. Harvey

Vice President—Enterprise Networks and Competitive Service Provider Sales

P. Steven Locke

Vice President—Carrier Networks Marketing and Competitive Service Provider Sales

Everette R. Ramage

Vice President—Enterprise Networks Engineering

Kevin W. Schneider

Vice President—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 2005 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
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Annual Meeting

The 2006 Annual Meeting of Stockholders will be held at ADTRAN® corporate headquarters, 901 Explorer Boulevard, Huntsville, Alabama, on Tuesday, May 9, 2006, at 10:30 a.m. Central time.

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www.adtran.com



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.

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