

ADTRAN INC  
Form 10-Q  
November 03, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the Quarterly Period Ended September 30, 2008

OR

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-24612

**ADTRAN, INC.**

*(Exact name of Registrant as specified in its charter)*

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**Delaware**  
*(State of Incorporation)*

**63-0918200**  
*(I.R.S. Employer*

*Identification No.)*

**901 Explorer Boulevard, Huntsville, Alabama 35806-2807**

*(Address of principal executive offices, including zip code)*

**(256) 963-8000**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer  Smaller Reporting Company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the latest practicable date:

| Class                         | Outstanding at October 27, 2008 |
|-------------------------------|---------------------------------|
| Common Stock, \$.01 Par Value | 62,251,183 shares               |

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**ADTRAN, INC.**  
**Quarterly Report on Form 10-Q**  
**For the Three and Nine Months Ended September 30, 2008**

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**FORWARD LOOKING STATEMENTS**

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for certain forward-looking statements made by or on behalf of ADTRAN. ADTRAN and its representatives may from time to time make written or oral forward-looking statements, including statements contained in this report, our other filings with the Securities and Exchange Commission (SEC) and other communications with our stockholders. Generally, the words, believe, expect, intend, estimate, anticipate, will, may, could and similar expressions identify forward-looking statements. We caution you that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. A list of factors that could materially affect our business, financial condition or operating results is included under Factors That Could Affect Our Future Results in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Item 2 of Part I of this report. They have also been discussed in Item 1A of Part I in our most recent Annual Report on Form 10-K filed on February 28, 2008 with the SEC. Though we have attempted to list comprehensively these important factors, we caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or a combination of factors may have on our business.

You are further cautioned not to place undue reliance on these forward-looking statements because they speak only of our views as of the date that the statements were made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ADTRAN, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except per share amounts)**

|   | <b>September 30,<br/>2008<br/>(Unaudited)</b> | <b>December 31,<br/>2007</b> |
|---|---|------------------------------|
| <b>ASSETS</b>   |   |                              |
| <b>Current Assets</b>   |   |                              |
| Cash and cash equivalents   | \$ 40,765                                     | \$ 13,941                    |
| Short-term investments  | 105,583                                       | 148,416                      |
| Accounts receivable, less allowance for doubtful accounts of \$25 at September 30, 2008 and \$109 at December 31, 2007                | 59,214  | 70,667                       |
| Other receivables   | 2,787   | 3,085                        |
| Inventory, net  | 48,320  | 48,546                       |
| Prepaid expenses  | 3,232   | 2,023                        |
| Deferred tax assets, net  | 7,771   | 7,659                        |
| <b>Total current assets</b>   | <b>267,672</b>                                | <b>294,337</b>               |
| Property, plant and equipment, net  | 75,502  | 75,969                       |
| Deferred tax assets, net  | 4,475   | 1,113                        |
| Other assets  | 113   | 505                          |
| Long-term investments   | 127,153                                       | 107,296                      |
| <b>Total assets</b>   | <b>\$ 474,915</b>                             | <b>\$ 479,220</b>            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |   |                              |
| <b>Current Liabilities</b>  |   |                              |
| Accounts payable  | \$ 24,604                                     | \$ 22,200                    |
| Unearned revenue  | 6,157   | 5,361                        |
| Accrued expenses  | 4,405   | 3,801                        |
| Accrued wages and benefits  | 9,157   | 10,497                       |
| Income tax payable, net   | 2,293   | 1,217                        |
| <b>Total current liabilities</b>  | <b>46,616</b>                                 | <b>43,076</b>                |
| Other non-current liabilities   | 10,123  | 9,213                        |
| Bonds payable   | 48,250  | 48,500                       |
| <b>Total liabilities</b>  | <b>104,989</b>                                | <b>100,789</b>               |
| Commitments and contingencies (see Note 10)   |   |                              |
| <b>Stockholders Equity</b>  |   |                              |
| Common stock, par value \$0.01 per share; 200,000 shares authorized; 79,652 shares issued at September 30, 2008 and December 31, 2007 | 797   | 797                          |
| Additional paid-in capital  | 171,409                                       | 164,385                      |
| Accumulated other comprehensive income (loss)   | (4)   | 5,704                        |

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|   |                   |                   |
|---|-------------------|-------------------|
| Retained earnings   | 592,733           | 551,764           |
| Less treasury stock at cost: 17,110 shares at September 30, 2008 and 14,739 shares at December 31, 2007 | (395,009)         | (344,219)         |
| <b>Total stockholders equity</b>  | <b>369,926</b>    | <b>378,431</b>    |
| <b>Total liabilities and stockholders equity</b>  | <b>\$ 474,915</b> | <b>\$ 479,220</b> |

See notes to condensed consolidated financial statements

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## ADTRAN, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

|   | Three Months Ended<br>September 30, |                  | Nine Months Ended<br>September 30, |                  |
|---|-------------------------------------|------------------|------------------------------------|------------------|
|   | 2008                                | 2007             | 2008                               | 2007             |
| Sales   | \$ 137,195                          | \$ 123,821       | \$ 388,263                         | \$ 357,807       |
| Cost of sales                                   | 55,512                              | 49,703           | 156,946                            | 144,340          |
| <b>Gross profit</b>                             | <b>81,683</b>                       | <b>74,118</b>    | <b>231,317</b>                     | <b>213,467</b>   |
| Selling, general and administrative expenses    | 26,317                              | 25,335           | 77,573                             | 77,966           |
| Research and development expenses               | 21,688                              | 18,735           | 61,456                             | 56,639           |
| <b>Operating income</b>                         | <b>33,678</b>                       | <b>30,048</b>    | <b>92,288</b>                      | <b>78,862</b>    |
| Interest and dividend income                    | 2,187                               | 2,842            | 6,689                              | 8,756            |
| Interest expense                                | (626)                               | (631)            | (1,905)                            | (1,876)          |
| Net realized investment gain (loss)             | (47)                                | 240              | (151)                              | 508              |
| Other income, net                               | 243                                 | 203              | 709                                | 700              |
| Life insurance proceeds                         |                                     |                  |                                    | 1,000            |
| <b>Income before provision for income taxes</b> | <b>35,435</b>                       | <b>32,702</b>    | <b>97,630</b>                      | <b>87,950</b>    |
| Provision for income taxes                      | (13,024)                            | (11,249)         | (35,758)                           | (29,726)         |
| <b>Net income</b>                               | <b>\$ 22,411</b>                    | <b>\$ 21,453</b> | <b>\$ 61,872</b>                   | <b>\$ 58,224</b> |
| Weighted average shares outstanding basic       | 63,096                              | 67,526           | 63,975                             | 68,554           |
| Weighted average shares outstanding diluted     | 64,101                              | 68,872           | 64,961                             | 70,009           |
| Earnings per common share basic                 | \$ 0.36                             | \$ 0.32          | \$ 0.97                            | \$ 0.85          |
| Earnings per common share diluted               | \$ 0.35                             | \$ 0.31          | \$ 0.95                            | \$ 0.83          |
| Dividend per share                              | \$ 0.09                             | \$ 0.09          | \$ 0.27                            | \$ 0.27          |

See notes to condensed consolidated financial statements

**Table of Contents****ADTRAN, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

|   | <b>Nine Months Ended<br/>September 30,</b> |                 |
|---|--|-----------------|
|   | <b>2008</b>                                | <b>2007</b>     |
| <b>Cash flows from operating activities:</b>                                      |  |                 |
| Net income  | \$ 61,872                                  | \$ 58,224       |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                 |
| Depreciation and amortization   | 7,387                                      | 8,049           |
| Amortization of net premium on available-for-sale investments                     | 1,482                                      | 1,664           |
| Net realized loss (gain) on long-term investments                                 | 151  | (508)           |
| Loss on disposal of property, plant and equipment                                 | 62   | 64              |
| Stock-based compensation expense  | 6,001                                      | 6,740           |
| Deferred income taxes   | (587)                                      | (3,090)         |
| Tax benefits from stock option exercises  | 1,023                                      | 4,220           |
| Excess tax benefits from stock-based compensation arrangements                    | (637)                                      | (3,132)         |
| Changes in operating assets and liabilities:                                      |  |                 |
| Accounts receivable, net  | 11,453                                     | (12,531)        |
| Other receivables   | 298  | 3,114           |
| Income tax receivable, net  |  | 1,446           |
| Inventory, net  | 226  | 5,243           |
| Prepaid expenses and other assets   | (817)                                      | 620             |
| Accounts payable  | 2,404                                      | (1,580)         |
| Accrued expenses and other liabilities  | 970  | 598             |
| Income tax payable, net   | 1,076                                      | 352             |
| <b>Net cash provided by operating activities</b>                                  | <b>92,364</b>                              | <b>69,493</b>   |
| <b>Cash flows from investing activities:</b>                                      |  |                 |
| Purchases of property, plant and equipment  | (6,982)                                    | (5,231)         |
| Proceeds from sales and maturities of available-for-sale investments              | 212,840                                    | 177,572         |
| Purchases of available-for-sale investments                                       | (199,249)                                  | (152,310)       |
| <b>Net cash provided by investing activities</b>                                  | <b>6,609</b>                               | <b>20,031</b>   |
| <b>Cash flows from financing activities:</b>                                      |  |                 |
| Proceeds from stock option exercises  | 3,520                                      | 15,045          |
| Purchases of treasury stock   | (57,923)                                   | (96,599)        |
| Dividend payments   | (17,290)                                   | (18,628)        |
| Payments on long-term debt  | (250)                                      | (500)           |
| Excess tax benefits from stock-based compensation arrangements                    | 637  | 3,132           |
| <b>Net cash used in financing activities</b>                                      | <b>(71,306)</b>                            | <b>(97,550)</b> |
| Net increase (decrease) in cash and cash equivalents                              | 27,667                                     | (8,026)         |
| Effect of exchange rate changes   | (843)                                      | 729             |
| <b>Cash and cash equivalents, beginning of period</b>                             | <b>13,941</b>                              | <b>40,147</b>   |

|   |                  |                  |
|---|------------------|------------------|
| <b>Cash and cash equivalents, end of period</b> | <b>\$ 40,765</b> | <b>\$ 32,850</b> |
|---|------------------|------------------|

See notes to condensed consolidated financial statements



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**ADTRAN, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**(In thousands, except per share amounts)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements of ADTRAN®, Inc. and its subsidiaries (ADTRAN) have been prepared pursuant to the rules and regulations for reporting on Quarterly Reports on Form 10-Q. Accordingly, certain information and notes required by generally accepted accounting principles for complete financial statements are not included herein. The December 31, 2007 Condensed Consolidated Balance Sheet is derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

In the opinion of management, all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for an interim period are not necessarily indicative of the results for the full year. The interim statements should be read in conjunction with the financial statements and notes thereto included in ADTRAN's Annual Report on Form 10-K for the year ended December 31, 2007.

*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 expense during the reporting period. ADTRAN's more significant estimates include the allowance for doubtful accounts, obsolete and excess inventory reserves, warranty reserves, customer rebates, allowance for sales returns, determination of the deferred revenue components of multiple element sales agreements, estimated income tax contingencies, the fair value of stock-based compensation and the evaluation of other-than-temporary declines in the value of investments. Actual amounts could differ significantly from these estimates.

*Recent Accounting Pronouncements*

Updates to recent accounting standards as disclosed in ADTRAN's Annual Report on Form 10-K for the year ended December 31, 2007 are as follows:

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007), *Business Combinations*, (SFAS 141R) which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, liabilities assumed, and any non-controlling interest in the acquiree in a business combination. SFAS 141R establishes principles stipulating how goodwill acquired in a business combination or a gain from a bargain purchase should be recognized and measured. The statement also expands the disclosure requirements related to the nature and financial impact of business combinations. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. We are currently evaluating the impact the adoption of SFAS 141R might have on our consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements- an Amendment of ARB No. 51* (SFAS 160), which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 also provides guidance when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and



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distinguish between the interests of the parent and the interests of the noncontrolling owners of a subsidiary. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We are currently evaluating the impact the adoption of SFAS 160 might have on our consolidated results of operations and financial condition.

During the first quarter of 2008, we adopted the following accounting standards, neither of which had a material effect on our consolidated results of operations or financial condition:

FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115* (SFAS 159) provides entities the option to measure certain financial assets and financial liabilities at fair value, with changes in fair value recognized in earnings each period. SFAS 159 permits the fair value option election on an instrument-by-instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. We adopted SFAS 159 as of January 1, 2008. We elected not to apply the provisions of SFAS 159 to our eligible financial assets and financial liabilities on the date of adoption. Accordingly, the initial application of SFAS 159 had no effect on our consolidated results of operations and financial condition.

FASB Statement No. 157, *Fair Value Measurements* (SFAS 157) establishes a definition of fair value and a framework for measuring fair value, and expands disclosures about fair value measurements. The definition of fair value focuses on the price that would be received upon the sale of an asset or the amount paid to transfer a liability. Under SFAS 157, the fair value measurement should reflect all of the assumptions that market participants would use in pricing the asset or liability. SFAS 157 establishes a three-level hierarchy to prioritize the inputs used in valuation techniques for fair value, consisting of: 1) observable inputs that reflect quoted prices in active markets; 2) inputs other than quoted prices with observable market data; and 3) unobservable data. SFAS 157 requires disclosures detailing the extent to which we measure assets and liabilities at fair value, the methods and assumptions used to measure fair value and the effect of fair value measurements on earnings. We adopted SFAS 157 in its entirety, including fair value measurements for nonfinancial assets and nonfinancial liabilities, and the initial application of SFAS 157 had no effect on our consolidated results of operations and financial condition. See Note 3 to the Condensed Consolidated Financial Statements for more information.

**Table of Contents****2. STOCK-BASED COMPENSATION**

The following table summarizes the stock-based compensation expense related to stock options under SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), for the three and nine months ended September 30, 2008 and 2007, which was recognized as follows:

| <i>(In thousands)</i>  | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
|  | 2008                                | 2007            | 2008                               | 2007            |
| <b>Stock-based compensation expense included in cost of sales</b>      | <b>\$ 79</b>                        | <b>\$ 96</b>    | <b>\$ 237</b>                      | <b>\$ 283</b>   |
| Selling, general and administrative expense                            | 912                                 | 1,023           | 2,755                              | 3,222           |
| Research and development expense                                       | 1,011                               | 1,086           | 3,009                              | 3,235           |
| <b>Stock-based compensation expense included in operating expenses</b> | <b>1,923</b>                        | <b>2,109</b>    | <b>5,764</b>                       | <b>6,457</b>    |
| <b>Total stock-based compensation expense</b>                          | <b>2,002</b>                        | <b>2,205</b>    | <b>6,001</b>                       | <b>6,740</b>    |
| Tax benefit for expense associated with non-qualified options          | (196)                               | (263)           | (600)                              | (679)           |
| <b>Total stock-based compensation expense, net of tax</b>              | <b>\$ 1,806</b>                     | <b>\$ 1,942</b> | <b>\$ 5,401</b>                    | <b>\$ 6,061</b> |

The fair value of ADTRAN's options was estimated using the Black-Scholes Model. The determination of the fair value of stock options on the date of grant using the Black-Scholes Model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables that may have a significant impact on the fair value estimate.

The weighted-average assumptions and value of options granted for the three and nine months ended September 30, 2008 and 2007 are summarized as follows:

|                                  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|----------------------------------|-------------------------------------|----------|------------------------------------|----------|
|                                  | 2008                                | 2007     | 2008                               | 2007     |
| Expected volatility              | 40.24%                              | 44.37%   | 41.45%                             | 45.55%   |
| Risk-free interest rate          | 2.88%                               | 4.97%    | 3.06%                              | 4.75%    |
| Expected dividend yield          | 1.42%                               | 1.32%    | 1.57%                              | 1.39%    |
| Expected life (in years)         | 4.56                                | 5.05     | 4.89                               | 5.06     |
| Weighted-average estimated value | \$ 8.42                             | \$ 11.11 | \$ 8.05                            | \$ 10.69 |

Stock-based compensation expense recognized in our Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2008 is based on options ultimately expected to vest, and has been reduced for estimated forfeitures. Estimated forfeitures were based upon historical experience and approximate 5.0% annually.

As of September 30, 2008, total compensation cost related to non-vested stock options not yet recognized was approximately \$9.5 million, which is expected to be recognized over an average remaining recognition period of 2.2 years using the ratable single-option approach.

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The following schedule summarizes the activity in our stock-based compensation plans for the nine months ended September 30, 2008:

| <i>(In thousands, except per share amounts)</i> | Number of<br>Options | Weighted Avg.<br>Exercise<br>Price | Weighted Avg.<br>Remaining<br>Contractual<br>Life in Years | Aggregate<br>Intrinsic<br>Value |
|---|----------------------|------------------------------------|--|---------------------------------|
| <b>Options outstanding, December 31, 2007</b>   | <b>6,375</b>         | <b>\$ 19.79</b>                    | <b>5.94</b>  | <b>\$ 24,737</b>                |
| Options granted                                 | 23                   | \$ 23.12                           |  |                                 |
| Options cancelled/forfeited                     | (133)                | \$ 25.73                           |  |                                 |
| Options exercised                               | (317)                | \$ 11.76                           |  |                                 |
| <b>Options outstanding, September 30, 2008</b>  | <b>5,948</b>         | <b>\$ 20.10</b>                    | <b>5.42</b>  | <b>\$ 16,833</b>                |
| <b>Options exercisable, September 30, 2008</b>  | <b>4,010</b>         | <b>\$ 18.26</b>                    | <b>4.03</b>  | <b>\$ 16,829</b>                |

The aggregate intrinsic values in the table above represent the total pre-tax intrinsic value (the difference between ADTRAN's closing stock price on the last trading day of the quarter and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. The aggregate intrinsic value will change based on the fair market value of ADTRAN's stock. The total pre-tax intrinsic value of options exercised during the three and nine month period ended September 30, 2008 was \$2.1 million and \$3.6 million, respectively.

**3. INVESTMENTS**

At September 30, 2008, we held the following securities and investments, recorded at either fair value or cost.

| <i>(In thousands)</i>  | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses            | Fair Value /<br>Carrying<br>Value |
|--|-------------------|---------------------------|-------------------|-----------------------------------|
| Restricted investments   | \$ 3,110          | \$                        | \$ (355)          | \$ 2,755                          |
| Municipal fixed-rate bonds   | 109,889           | 165                       | (190)             | 109,864                           |
| Municipal variable rate demand notes   | 53,284            |                           |                   | 53,284                            |
| Marketable equity securities   | 16,276            | 2,272                     | (2,630)           | 15,918                            |
| <b>Available-for-sale securities held at fair value</b>                      | <b>\$ 182,559</b> | <b>\$ 2,437</b>           | <b>\$ (3,175)</b> | <b>\$ 181,821</b>                 |
| <b>Restricted investments held at cost</b>                                   |                   |                           |                   | <b>49,000</b>                     |
| <b>Other investments held at cost</b>  |                   |                           |                   | <b>1,915</b>                      |
| <b>Total carrying value of available-for-sale securities and investments</b> |                   |                           |                   | <b>\$ 232,736</b>                 |

At September 30, 2008, we held \$2.8 million of restricted deferred compensation plan assets, carried at fair value.

At September 30, 2008, we held \$109.9 million of municipal fixed-rate bonds. Approximately 44% of our municipal fixed-rate bond portfolio had a credit rating of AAA, 55% had a credit rating of AA and the balance had a credit rating of A. These bonds are classified as available-for-sale investments and had an average duration of 0.8 years at September 30, 2008. Because our bond portfolio has a high quality rating and contractual maturities of a short duration, we are able to obtain prices for these bonds derived from observable market inputs, or for similar securities traded in an active market, on a daily basis.



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At September 30, 2008, we held \$53.3 million of municipal variable rate demand notes, all of which are classified as available-for-sale short-term investments and had a credit rating of A-1+ or VMIG-1. Despite the long-term nature of their stated contractual maturities, we believe we have the ability to quickly liquidate these securities. Our investments in these securities are recorded at fair value, and the interest rates reset every seven days. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these investments. All income generated from these investments was recorded as interest income. We have not been required to record any losses relating to municipal variable rate demand notes or municipal auction rate securities, and we have held no municipal auction rate securities since February 7, 2008.

At September 30, 2008, we held \$15.9 million of marketable equity securities, including a single security, of which we held 2.5 million shares, carried at a fair value of \$2.7 million. The single security traded approximately 37,000 shares per day during the third quarter of 2008 in an active market on a European stock exchange. This single security carried \$1.8 million of the gross unrealized gains included in the fair market value of our marketable equity securities. The remaining \$0.4 million of unrealized gains and \$2.6 million of gross unrealized losses were spread amongst more than 350 issues.

At September 30, 2008, we held a \$49.0 million restricted certificate of deposit, carried at cost. This investment serves as a collateral deposit against the principal amount outstanding under loans made to ADTRAN pursuant to an Alabama State Industrial Development Authority revenue bond (the Bond). ADTRAN has the right to set-off the balance of the Bond with the collateral deposit in order to reduce the balance of the indebtedness. For more information on the Bond, see *Debt* under *Liquidity and Capital Resources* in *Management's Discussion and Analysis of Financial Condition and Results of Operations* contained in Item 2 of Part I of this report.

At September 30, 2008, we held \$1.9 million of other investments carried at cost consisting of two private equity funds and a direct investment in a telecommunications equipment manufacturer. The fair value of these investments was estimated to be approximately \$17.9 million at September 30, 2008, based on unobservable inputs including information supplied by the investees. We have committed to invest up to an aggregate of \$7.8 million in the two private equity funds, and we have contributed \$7.7 million to date, of which \$7.2 million has been applied toward these commitments. As of September 30, 2008, we have received cumulative distributions related to these two private equity funds of \$6.1 million, of which \$0.3 million was recorded as a realized investment gain. These investments are carried at cost, net of distributions, with distributions in excess of our investment recorded as a realized investment gain. The duration of each of these commitments is ten years with \$0.2 million expiring in 2010 and \$0.4 million expiring in 2012.

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 qualitative and quantitative information, including but not limited to the following: the magnitude and duration of historical declines 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. For the three and nine months ended September 30, 2008, we had charges of \$0.1 million and \$0.6 million, respectively, related to the other than temporary impairment of certain publicly traded equity securities. There were no such charges in the nine months ended September 30, 2007. Although we believe our marketable equity security portfolio is diversified, if the market conditions experienced at and subsequent to September 30, 2008 prove to be other than temporary, we may be required to make additional impairments in future quarters.

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In accordance with SFAS 157, we have categorized our investments held at fair value into a three-level fair value hierarchy based on the priority of the inputs to the valuation technique for the investments as follows: Level 1 Investment values based on unadjusted quoted prices for identical assets or liabilities in an active market; Level 2 Investment values based on quoted prices in markets that are not active or model inputs that are observable either directly or indirectly for substantially the full term of the asset or liability; Level 3 Investment values based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs include information supplied by investees.

| <i>(In thousands)</i>                                   | Fair Value Measurements at September 30, 2008 Using |  |   |   |
|---|---|--|---|---|
|   | Fair Value  | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Restricted investments                                  | \$ 2,755  | \$ 2,755   | \$  | \$  |
| Municipal fixed-rate bonds                              | 109,864   |  | 109,864                                       |   |
| Municipal variable rate demand notes                    | 53,284  |  | 53,284  |   |
| Marketable equity securities                            | 15,918  | 15,918   |   |   |
| <b>Available-for-sale securities held at fair value</b> | <b>\$ 181,821</b>                                   | <b>\$ 18,673</b>   | <b>\$ 163,148</b>                             | <b>\$</b>                                 |

**4. INVENTORY**

At September 30, 2008 and December 31, 2007, inventory consisted of the following:

| <i>(In thousands)</i> | September 30, 2008 | December 31, 2007 |
|-----------------------|--------------------|-------------------|
| Raw materials         | \$ 32,949          | \$ 30,519         |
| Work in progress      | 1,878              | 2,552             |
| Finished goods        | 20,989             | 21,899            |
| Inventory reserves    | (7,496)            | (6,424)           |
| <b>Inventory, net</b> | <b>\$ 48,320</b>   | <b>\$ 48,546</b>  |

**5. STOCKHOLDERS EQUITY**

A summary of the changes in stockholders equity for the nine months ended September 30, 2008 is as follows:

| <i>(In thousands)</i>   | Stockholders Equity |
|---|---------------------|
| <b>Balance, December 31, 2007</b>   | <b>\$ 378,431</b>   |
| Net income  | 61,872              |
| Dividend payments   | (17,290)            |
| Change in unrealized loss on marketable securities (net of deferred taxes)  | (5,056)             |
| Reclassification adjustment for amounts included in net income (net of tax) | 191                 |
| Foreign currency translation adjustment                                     | (843)               |
| Proceeds from stock option exercises  | 3,520               |
| Tax benefits from stock option exercises                                    | 1,023               |
| Stock-based compensation expense  | 6,001               |
| Purchases of treasury stock   | (57,923)            |



|                                    |           |                |
|------------------------------------|-----------|----------------|
| <b>Balance, September 30, 2008</b> | <b>\$</b> | <b>369,926</b> |
|------------------------------------|-----------|----------------|

**Table of Contents***Stock Repurchase Program*

Since 1997, our Board of Directors has approved multiple share repurchase programs that have authorized open market repurchase transactions. As of September 30, 2008, the Board of Directors had authorized cumulative repurchases of up to 34 million shares of our common stock. During the nine months ended September 30, 2008, we repurchased 2.7 million shares of our common stock at an average price of \$21.62 per share. We currently have the authority to purchase an additional 3.9 million shares of our common stock under the plan approved by the Board of Directors on April 14, 2008.

*Stock Option Exercises*

We issued 0.3 million shares of treasury stock during the nine months ended September 30, 2008 to accommodate employee stock option exercises. The stock options had exercise prices ranging from \$8.70 to \$22.53. We received proceeds totaling \$3.5 million from the exercise of these stock options during the first nine months of 2008.

*Dividend Payments*

During 2008, ADTRAN has paid cash dividends as follows (in thousands except per share amounts):

| Record Date      | Payment Date      | Per Share Amount | Total Dividend Paid |
|------------------|-------------------|------------------|---------------------|
| February 7, 2008 | February 21, 2008 | \$ 0.09          | \$ 5,846            |
| May 1, 2008      | May 15, 2008      | \$ 0.09          | \$ 5,778            |
| July 31, 2008    | August 14, 2008   | \$ 0.09          | \$ 5,666            |

*Comprehensive Income*

Comprehensive income consists of net income, foreign currency translation adjustments, reclassification adjustments for amounts included in net income and changes in unrealized gains and losses on marketable securities.

| <i>(In thousands)</i>   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Net income  | \$ 22,411          | \$ 21,453          | \$ 61,872          | \$ 58,224          |
| Foreign currency translation gain (loss), net of deferred taxes                                 | (1,468)            | 326                | (843)              | 729                |
| Reclassification adjustment for amounts included in net income                                  | 48                 |                    | 191                |                    |
| Change in net unrealized gains (losses) on available-for-sale securities, net of deferred taxes | (2,994)            | 1,097              | (5,056)            | 3,037              |
| <b>Total comprehensive income</b>   | <b>\$ 17,997</b>   | <b>\$ 22,876</b>   | <b>\$ 56,164</b>   | <b>\$ 61,990</b>   |

**Table of Contents****6. EARNINGS PER SHARE**

A summary of the calculation of basic and diluted earnings per share for the three and nine months ended September 30, 2008 and 2007 is as follows:

| <i>(In thousands, except per share amounts)</i> | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| <b>Numerator</b>                                |                    |                    |                    |                    |
| Net income                                      | \$ 22,411          | \$ 21,453          | \$ 61,872          | \$ 58,224          |
| <b>Denominator</b>                              |                    |                    |                    |                    |
| Weighted average number of shares basic         | 63,096             | 67,526             | 63,975             | 68,554             |
| Effect of dilutive securities stock options     | 1,005              | 1,346              | 986                | 1,455              |
| Weighted average number of shares diluted       | 64,101             | 68,872             | 64,961             | 70,009             |
| Net income per share basic                      | \$ 0.36            | \$ 0.32            | \$ 0.97            | \$ 0.85            |
| Net income per share diluted                    | \$ 0.35            | \$ 0.31            | \$ 0.95            | \$ 0.83            |

Anti-dilutive options to purchase common stock outstanding were excluded from the above calculations. Anti-dilutive options totaled 3.3 million and 2.2 million for the three months ended September 30, 2008 and 2007, respectively. Anti-dilutive options totaled 3.5 million and 2.6 million for the nine months ended September 30, 2008 and 2007, respectively.

**7. SEGMENT INFORMATION**

ADTRAN operates in two reportable segments: (1) the Carrier Networks Division and (2) the Enterprise Networks Division. We evaluate the performance of our segments based on gross profit; therefore, selling, general and administrative expenses, research and development expenses, interest and dividend income, interest expense, net realized investment gain/loss, other income, net and provision for income 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 the three and nine months ended September 30, 2008 and 2007. Asset information by reportable segment is not reported, since ADTRAN does not produce such information internally.

| <i>(In thousands)</i> | Three Months Ended |                  |                    |                  |
|-----------------------|--------------------|------------------|--------------------|------------------|
|                       | September 30, 2008 |                  | September 30, 2007 |                  |
|                       | Sales              | Gross Profit     | Sales              | Gross Profit     |
| Carrier Networks      | \$ 106,394         | \$ 63,549        | \$ 93,090          | \$ 55,136        |
| Enterprise Networks   | 30,801             | 18,134           | 30,731             | 18,982           |
| <b>Total</b>          | <b>\$ 137,195</b>  | <b>\$ 81,683</b> | <b>\$ 123,821</b>  | <b>\$ 74,118</b> |

| <i>(In thousands)</i> | Nine Months Ended  |                   |                    |                   |
|-----------------------|--------------------|-------------------|--------------------|-------------------|
|                       | September 30, 2008 |                   | September 30, 2007 |                   |
|                       | Sales              | Gross Profit      | Sales              | Gross Profit      |
| Carrier Networks      | \$ 305,457         | \$ 183,507        | \$ 270,824         | \$ 161,808        |
| Enterprise Networks   | 82,806             | 47,810            | 86,983             | 51,659            |
| <b>Total</b>          | <b>\$ 388,263</b>  | <b>\$ 231,317</b> | <b>\$ 357,807</b>  | <b>\$ 213,467</b> |



**Table of Contents****Sales by Geographic Region**

The table below presents sales information by geographic region for the three and nine months ended September 30, 2008 and 2007.

| <i>(In thousands)</i> | Three Months Ended    |                       | Nine Months Ended     |                       |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                       | September 30,<br>2008 | September 30,<br>2007 | September 30,<br>2008 | September 30,<br>2007 |
| United States         | \$ 129,357            | \$ 116,021            | \$ 366,218            | \$ 333,912            |
| International         | 7,838                 | 7,800                 | 22,045                | 23,895                |
| <b>Total</b>          | <b>\$ 137,195</b>     | <b>\$ 123,821</b>     | <b>\$ 388,263</b>     | <b>\$ 357,807</b>     |

**Sales by Product**

Our three major product categories are Loop Access, Carrier Systems and Business Networking.

**Loop Access** products are used by carrier and enterprise customers for access to copper-based telecommunications networks. The Loop Access category includes products such as Digital Data Service (DDS) and Integrated Services Digital Network (ISDN) (Total Reach®) products, High bit-rate Digital Subscriber Line (HDSL) products including Total Access® 3000 based HDSL and Time Division Multiplexed-Symmetrical HDSL (TDM-SHDSL) products, T1/E1/T3, Channel Service Units/Data Service Units (CSUs/DSUs), and TRACER® fixed wireless products.

**Carrier Systems** products are used by telecommunications service providers to provide last mile access in support of data, voice and video services to consumers and enterprises. The Carrier Systems category includes our broadband access products comprising Digital Subscriber Line Access Multiplexer (DSLAM) products, Total Access® 5000 multi-access and aggregation platform products, and Fiber-To-The-Node (FTTN) products. Our broadband access products are used by service providers to deliver high speed Internet access, Voice over Internet Protocol (VoIP), IPTV, and/or Ethernet services from central office or remote terminal locations to customer premises. The Carrier Systems category also includes our optical access products. These products consist of optical access multiplexers including our family of OPTI products. Optical access products are used to deliver higher bandwidth services, or to aggregate large numbers of low bandwidth services for transportation across fiber optic infrastructure. Total Access® 1500 systems, 303 concentrator products, M13 multiplexer products and wireless network backhaul products are also included in the Carrier Systems product category.

**Business Networking** products provide enterprises access to telecommunication networks and facilitate networking capabilities for voice, data and video networks. The Business Networking category includes integrated access devices (IAD) and Internetworking products. Internetworking products consist of our NetVanta® product lines, including IP access routers, Ethernet switches, Internet security/firewall appliances, IP Private Branch Exchange (PBX) products, Carrier Ethernet Network Terminating Equipment (NTE) and IP Business Gateways.

The table below presents sales information by product category for the three and nine months ended September 30, 2008 and 2007.

| <i>(In thousands)</i> | Three Months Ended    |                       | Nine Months Ended     |                       |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                       | September 30,<br>2008 | September 30,<br>2007 | September 30,<br>2008 | September 30,<br>2007 |
| Loop Access           | \$ 57,930             | \$ 56,282             | \$ 157,355            | \$ 162,533            |
| Carrier Systems       | 53,880                | 44,587                | 162,766               | 130,642               |
| Business Networking   | 25,385                | 22,952                | 68,142                | 64,632                |
| <b>Total</b>          | <b>\$ 137,195</b>     | <b>\$ 123,821</b>     | <b>\$ 388,263</b>     | <b>\$ 357,807</b>     |

In addition, we identify sub-categories of product revenues, which we divide into growth products, representing our primary growth areas, and traditional products. Our growth products consist of broadband access and optical access products (included in Carrier Systems) and Internetworking products (included in Business Networking) and our traditional products include HDSL products (included in Loop Access) and other products.



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Subcategory revenues included in the above are as follows:

| <i>(In thousands)</i>  | Three Months Ended    |                       | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September 30,<br>2008 | September 30,<br>2007 | September 30,<br>2008 | September 30,<br>2007 |
| Broadband Access (included in Carrier Systems)   | \$ 22,958             | \$ 18,241             | \$ 82,869             | \$ 56,675             |
| Optical Access (included in Carrier Systems)   | 16,707                | 13,854                | 41,256                | 32,304                |
| Internetworking (NetVanta & Multi-service Access Gateways) (included in Business Networking) | 19,185                | 14,462                | 50,084                | 39,145                |
| <b>Growth Products</b>   | <b>58,850</b>         | <b>46,557</b>         | <b>174,209</b>        | <b>128,124</b>        |
| HDSL (does not include T1) (included in Loop Access)   | 50,806                | 47,196                | 138,104               | 137,267               |
| Other products (included in the above table)   | 27,539                | 30,068                | 75,950                | 92,416                |
| <b>Traditional Products</b>  | <b>78,345</b>         | <b>77,264</b>         | <b>214,054</b>        | <b>229,683</b>        |
| <b>Total</b>   | <b>\$ 137,195</b>     | <b>\$ 123,821</b>     | <b>\$ 388,263</b>     | <b>\$ 357,807</b>     |

**8. LIABILITY FOR WARRANTY RETURNS**

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. Our 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 could require more warranty cost to be incurred 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, may cause warranty incidences, 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 recorded if unforeseen problems arise. Should our actual experience relative to these factors be higher than our estimates, we will be required to record additional warranty expense. Alternatively, if we provide for more reserves than we require, we will reverse a portion of such provisions in future periods.

The liability for warranty returns totaled \$2.9 million at September 30, 2008 and December 31, 2007. These liabilities are included in accrued expenses in the accompanying Condensed Consolidated Balance Sheets.

| Nine Months Ended September 30,<br><i>(In thousands)</i> | 2008            | 2007            |
|--|-----------------|-----------------|
| Balance at beginning of period                           | \$ 2,944        | \$ 3,045        |
| Plus: amounts acquired or charged to cost and expenses   | 1,731           | 1,498           |
| Less: deductions   | (1,780)         | (1,394)         |
| <b>Balance at end of period</b>                          | <b>\$ 2,895</b> | <b>\$ 3,149</b> |

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**9. 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 comparable to those charged by other firms for services rendered to us. We paid \$30 thousand during each of the three month periods ended September 30, 2008 and 2007 for legal services rendered. We paid \$90 thousand during each of the nine month periods ended September 30, 2008 and 2007 for legal services rendered.

**10. COMMITMENTS AND CONTINGENCIES**

In the ordinary course of business, we may be subject to various legal proceedings and claims, including employment disputes, patent claims, disputes over contractual agreements with customers or suppliers, liquidated damages related to our delivery or product performance under customer contracts and other commercial disputes. In some cases, claimants seek damages, or other relief, such as royalty payments related to patents, which, if granted, could require significant expenditures. Although the outcome of any claim or litigation can never be certain, it is our opinion that the outcome of all contingencies of which we are currently aware will not materially affect our business, operations, financial condition or cash flows.

We have committed to invest up to an aggregate of \$7.8 million in two private equity funds, and we have contributed \$7.7 million to date, of which \$7.2 million has been applied to these commitments. See Note 3 to the Condensed Consolidated Financial Statements for additional information.

**11. SUBSEQUENT EVENTS**

On October 13, 2008, ADTRAN announced that its Board of Directors declared a quarterly cash dividend of \$0.09 per common share to be paid to stockholders of record at the close of business on October 30, 2008. The payment date will be November 13, 2008. The quarterly dividend payment will be approximately \$5.6 million. 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.

In October 2008, ADTRAN repurchased 0.3 million shares of its common stock through open market purchases at an average cost of \$14.21 per share and has the authority to repurchase an additional 3.6 million shares under the plan approved by the Board of Directors on April 14, 2008.

Our effective tax rate for the first nine months of 2008 was unusually high due to the delay in legislation extending research tax credits that expired December 31, 2007. Federal legislation to extend the research tax credits to the tax years 2008 and 2009 was signed into law on October 3, 2008. As a result, we estimate that our effective tax rate for the twelve months ended December 31, 2008 will be reduced by approximately two percentage points. A two percentage point decrease to our effective tax rate for the nine months ended September 30, 2008 would have resulted in a \$0.03 increase in earnings per share, assuming dilution, for the nine months ended September 30, 2008.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and the related notes that appear elsewhere in this document.*

**OVERVIEW**

ADTRAN, Inc. designs, manufactures, markets and services network access solutions for communications networks. Our solutions are widely deployed by providers of telecommunications services (serviced by our Carrier Networks Division), and small and mid-sized businesses and enterprises (serviced by our Enterprise Networks Division), and enable voice, data, video and Internet communications across copper, fiber and wireless networks. Many of these solutions are currently in use by every major United States service provider and many global ones, as well as by many public, private and governmental organizations worldwide.



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Our success depends upon our ability to increase 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 lower the product's selling price based on the cost savings achieved in order to gain market share and/or improve gross margins. 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.

Our three major product categories are Loop Access, Carrier Systems and Business Networking. Loop Access products are used by carrier and enterprise customers for access to copper-based telecommunications networks. Carrier Systems products are used by telecommunications service providers to provide last mile access in support of data, voice and video services to consumers and enterprises. Business Networking products provide enterprises access to telecommunication networks and facilitate networking capabilities for voice, data and video networks.

In addition, we identify sub-categories of product revenues, which we divide into growth products, representing our primary growth areas, and traditional products. Our growth products consist of broadband access and optical access products (included in Carrier Systems) and Internetworking products (included in Business Networking) and our traditional products include HDSL products (included in Loop Access) and other products. Many of our customers are migrating their networks to deliver higher bandwidth services by utilizing newer technologies. We believe that products in our primary growth areas position us well for this migration. We anticipate that revenues of many of our traditional products, including HDSL, may continue for years because of the time required for our customers to transition to newer technologies.

See Note 7 of the Notes to Condensed Consolidated Financial Statements in this report for further information regarding these product categories.

Sales increased 10.8% and 8.5% for three and nine months ended September 30, 2008 compared to the three and nine months ended September 30, 2007 due mainly to increased product sales in our three primary growth areas, Broadband Access, Optical Access and Internetworking. Total sales of products in these growth areas were \$58.9 million and \$174.2 million for the three and nine months ended September 30, 2008 compared to \$46.6 million and \$128.1 million for the three and nine months ended September 30, 2007. For the three months ended September 30, 2008 and September 30, 2007, our gross margins decreased to 59.5% from 59.9%, respectively, and our operating margins increased to 24.6% from 24.3%, respectively. For the nine months ended September 30, 2008 and September 30, 2007, our gross margins decreased slightly to 59.6% from 59.7%, respectively, and our operating margins increased to 23.8% from 22.0%, respectively. Earnings per share, assuming dilution, were \$0.35 and \$0.95 for the three and nine months ended September 30, 2008 compared to \$0.31 and \$0.83 for the three and nine months ended September 30, 2007.

The results for the nine months ended September 30, 2007 included a benefit of \$0.9 million in Provision for Income Taxes primarily relating to closure of tax audits from prior years and also included a pre-tax life insurance benefit of \$1.0 million. These two items increased earnings per share, assuming dilution, by approximately \$0.02 in the nine months ended September 30, 2007. The higher earnings per share for the three and nine months ended September 30, 2008 compared to the same period in 2007 reflects higher net income as well as a lower weighted average number of shares outstanding in 2008 due to stock repurchases under the share repurchase plans approved by our Board of Directors.

Our operating results have fluctuated on a quarterly basis in the past, and may vary significantly in future periods due to a number of factors. We normally operate with very little order backlog. A 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

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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.

In the latter part of the third quarter of 2008, we experienced an overall decline in order rates across most of our traditional product categories. We believe this decline in order rates was the result of slowing macroeconomic conditions. Additionally, our sales in the fourth quarter of each year have typically been lower than our sales in the preceding third quarter due to seasonality. If the decline in order rates experienced in the latter part of the third quarter persists, we believe it is likely that ADTRAN will experience revenue levels lower than typical seasonality in the fourth quarter of 2008.

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. Additionally, maintaining sufficient inventory levels to assure prompt delivery of our products increases the amount of inventory that may become obsolete and increases the risk that the obsolescence of such inventory may have an adverse effect on our business and operating results. Also, not maintaining sufficient inventory levels to assure prompt delivery of our products may cause us to incur expediting costs to meet customer delivery requirements which may impact our operating results in a given quarter. 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. A list of factors that could materially affect our business, financial condition or operating results is included under *Factors That Could Affect Our Future Results* in *Management's Discussion and Analysis of Financial Condition and Results of Operations* contained in Item 2 of Part I of this report. These factors have also been discussed in more detail in Item 1A of Part I in our most recent Annual Report on Form 10-K filed on February 28, 2008 with the SEC.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our critical accounting policies and estimates have not changed significantly from those detailed in our most recent Annual Report on Form 10-K for the year ended December 31, 2007.

**EFFECT OF RECENT ACCOUNTING PRONOUNCEMENTS**

See Note 1 to the Notes to Condensed Consolidated Financial Statements in Item 1 of this Form 10-Q for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operation and financial condition, which is incorporated herein by reference.

**RESULTS OF OPERATIONS THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 COMPARED TO THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007**

***SALES***

ADTRAN's sales increased 10.8% from \$123.8 million in the three months ended September 30, 2007 to \$137.2 million in the three months ended September 30, 2008, and increased 8.5% from \$357.8 million in the nine months ended September 30, 2007 to \$388.3 million in the nine months ended September 30, 2008.

The increase in sales for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 is primarily attributable to a \$4.7 million increase in sales of our Broadband Access products, a \$2.9 million increase in sales of our Optical Access products and a \$4.7 million increase in sales of our Internetworking products. HDSL product revenues increased 7.6% or \$3.6 million and other traditional products decreased 8.4% or \$2.5 million.

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Carrier Systems product sales increased \$9.3 million in the three months ended September 30, 2008 compared to the three months ended September 30, 2007 due to a \$4.7 million increase in Broadband Access product sales, primarily attributable to increased shipments of our 1100 series fiber-to-the-node products and our Total Access 5000 products. Carrier Systems products sales also increased due to a \$2.9 million increase in Optical Access product sales, resulting from continuing market share gains across numerous customers including the top three U.S. carriers. Additionally, we had increased shipments of traditional carrier TDM products during the three months ended September 30, 2008 compared to the three months ended September 30, 2007.

Business Networking product sales increased \$2.4 million in the three months ended September 30, 2008 compared to the three months ended September 30, 2007 due to a \$4.7 million increase in Internetworking product sales, primarily as a result of market share gains due to our efforts to improve our focus on addressing traditional enterprise channels and leveraging our carrier distribution channels. Partially offsetting this increase in Internetworking product sales was a decline in shipments of traditional IAD products as customers shifted to newer technologies. Many of these newer technologies are integral to our Internetworking product area.

Loop Access product sales increased \$1.6 million in the three months ended September 30, 2008 compared to the three months ended September 30, 2007 primarily due to a 7.6% or \$3.6 million increase in HDSL product revenues, partially offset by declines in Enterprise T1 product sales and DDS product sales.

The increase in sales for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007 is primarily attributable to a \$26.2 million increase in sales of our Broadband Access products, a \$9.0 million increase in sales of our Optical Access products and a \$10.9 million increase in sales of our Internetworking products. HDSL product revenues increased 0.6% or \$0.8 million and other traditional products decreased 17.8% or \$16.5 million.

Carrier Networks sales increased 14.3% from \$93.1 million in the three months ended September 30, 2007 to \$106.4 million in the three months ended September 30, 2008. Carrier Networks sales increased 12.8% from \$270.8 million in the nine months ended September 30, 2007 to \$305.5 million in the nine months ended September 30, 2008. The increase in Carrier Networks sales for the three and nine months ended September 30, 2008 compared to the three and nine months ended September 30, 2007 is primarily attributable to increases in Broadband Access and Optical Access products sales, as well as an increase in HDSL product sales.

Enterprise Networks sales increased 0.2% from \$30.7 million in the three months ended September 30, 2007 to \$30.8 million in the three months ended September 30, 2008 and decreased 4.8% from \$87.0 million in the nine months ended September 30, 2007 to \$82.8 million in the nine months ended September 30, 2008. The increase in Enterprise Network sales for the three month period of 2008 compared to the three month period of 2007 is attributable to an increase in sales of Internetworking products, partially offset by a decrease in sales of traditional enterprise products. The decrease in Enterprise Network sales for the nine month period of 2008 compared to the nine month period of 2007 is primarily attributable to declines in sales of traditional IAD products, Enterprise T1 products and DDS products, partially offset by an increase in sales of Internetworking products. Internetworking product sales were 62.3% and 60.5% of Enterprise Network sales in the three and nine months ended September 30, 2008 compared with 47.1% and 45.0% in the three and nine months ended September 30, 2007. Traditional products primarily comprise the remainder of Enterprise Networks sales. Enterprise Networks sales as a percentage of total sales decreased from 24.8% for the three months ended September 30, 2007 to 22.4% for the three months ended September 30, 2008 and decreased from 24.3% for the nine months ended September 30, 2007 to 21.3% for the nine months ended September 30, 2008.

International sales, which are included in the Carrier Networks and Enterprise Networks amounts discussed above, were \$7.8 million in both the three months ended September 30, 2007 and 2008 and decreased 8.0% from \$23.9 million in the nine months ended September 30, 2007 to \$22.0 million in the nine months ended September 30, 2008. International sales, as a percentage of total sales, decreased from 6.3% for the three months ended September 30, 2007 to 5.7% for the three months ended September 30, 2008, and decreased from 6.7% for the nine months ended September 30, 2007 to 5.7% for the nine months ended September 30, 2008. International sales decreased in the nine month period of 2008 compared to the 2007 period primarily due to a reduction in product shipments to the Asia Pacific region.

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***COST OF SALES***

As a percentage of sales, cost of sales increased from 40.1% in the three months ended September 30, 2007 to 40.5% in the three months ended September 30, 2008 and increased from 40.3% in the nine months ended September 30, 2007 to 40.4% in the nine months ended September 30, 2008. The increase in cost of sales as a percentage of sales for the three and nine month periods is primarily related to higher freight costs largely resulting from increased fuel surcharges, and charges for inventory obsolescence.

Carrier Networks cost of sales, as a percent of division sales, decreased from 40.8% in the three months ended September 30, 2007 to 40.3% in the three months ended September 30, 2008 and decreased from 40.3% in the nine months ended September 30, 2007 to 39.9% in the nine months ended September 30, 2008. These decreases were primarily related to more favorable product mix and the impact of higher sales volume on allocated cost of sales elements to the division, partially offset by the cost increases noted above.

Enterprise Networks cost of sales, as a percent of division sales, increased from 38.2% in the three months ended September 30, 2007 to 41.1% in the three months ended September 30, 2008 and increased from 40.6% in the nine months ended September 30, 2007 to 42.3% in the nine months ended September 30, 2008. These increases were primarily related to the cost increases noted above plus the impact of allocated manufacturing costs to the division.

***SELLING, GENERAL AND ADMINISTRATIVE EXPENSES***

Selling, general and administrative expenses increased 3.9% from \$25.3 million in the three months ended September 30, 2007 to \$26.3 million in the three months ended September 30, 2008 and decreased 0.5% from \$78.0 million in the nine months ended September 30, 2007 to \$77.6 million in the nine months ended September 30, 2008. The increase in selling, general and administrative expenses for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 is due to increased travel costs, primarily related to selling activities, and to increased healthcare costs. The decrease in selling, general and administrative expenses for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007 is related to a decrease in certain senior management compensation costs and, to a lesser extent, a reduction in stock option expense and insurance expense, partially offset by increases in travel costs, primarily related to selling activities, and increased healthcare costs.

Selling, general, and administrative expenses as a percentage of sales decreased from 20.5% in the three months ended September 30, 2007 to 19.2% in the three months ended September 30, 2008 and decreased from 21.8% in the nine months ended September 30, 2007 to 20.0% in the nine months ended September 30, 2008. These decreases are the result of higher sales in the current periods in relation to selling, general and administrative costs that are largely fixed.

***RESEARCH AND DEVELOPMENT EXPENSES***

Research and development expenses increased 16.0% from \$18.7 million in the three months ended September 30, 2007 to \$21.7 million in the three months ended September 30, 2008 and increased 8.7% from \$56.6 million in the nine months ended September 30, 2007 to \$61.5 million in the nine months ended September 30, 2008. The increase in research and development expenses primarily reflects increased staffing expense related to customer specific product development and approval activities and increased healthcare costs.

As a percentage of sales, research and development expenses increased from 15.1% in the three months ended September 30, 2007 to 15.8% in the three months ended September 30, 2008 and were 15.8% in each of the nine months ended September 30, 2007 and 2008.

ADTRAN expects to continue to incur research and development expenses in connection with its new and existing products and its expansion into international markets. ADTRAN continually evaluates new product opportunities and engages in intensive research and product development efforts which provide for new product development, enhancement of existing products and product cost reductions. ADTRAN expenses all product research and development costs as incurred. As a result, ADTRAN may incur significant research and development expenses prior to the receipt of revenues from a major new product group or market expansion.

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**Table of Contents*****INTEREST AND DIVIDEND INCOME***

Interest and dividend income decreased 21.4% from \$2.8 million in the three months ended September 30, 2007 to \$2.2 million in the three months ended September 30, 2008 and decreased 23.9% from \$8.8 million in the nine months ended September 30, 2007 to \$6.7 million in the nine months ended September 30, 2008. The decreases in interest and dividend income were driven primarily by a reduction in our investment balances as a result of our share repurchase activity and a reduction in interest rates.

***INTEREST EXPENSE***

Interest expense, which is primarily related to our taxable revenue bond, remained relatively constant at \$0.6 million in each of the three months ended September 30, 2008 and 2007, and \$1.9 million in each of the nine month periods ended September 30, 2008 and 2007. See [Liquidity and Capital Resources](#) below for additional information on our revenue bond.

***NET REALIZED INVESTMENT GAIN (LOSS)***

Net realized investment gain decreased from a \$0.2 million gain in the three months ended September 30, 2007 to a \$47 thousand loss in the three months ended September 30, 2008 and decreased from a \$0.5 million gain in the nine months ended September 30, 2007 to a \$0.2 million loss in the nine months ended September 30, 2008. These changes primarily resulted from the impairment of certain securities in our equity portfolio. See Note 3 of Notes to Condensed Consolidated Financial Statements included in this report.

***OTHER INCOME, NET***

Other income, net, comprised primarily of miscellaneous income, gains and losses on foreign currency transactions, investment account management fees and scrap raw material sales, remained constant at \$0.2 million in the three months ended September 30, 2007 and 2008 and remained constant at \$0.7 million in the nine months ended September 30, 2007 and 2008.

***LIFE INSURANCE PROCEEDS***

We realized a gain on life insurance proceeds of \$1.0 million during the first quarter of 2007 as a result of the death of our co-founder and then Chairman of the Board, Mark Smith.

***INCOME TAXES***

Our effective tax rate increased from 34.4% in the three months ended September 30, 2007 to 36.7% in the three months ended September 30, 2008 and from 33.8% in the nine months ended September 30, 2007 to 36.6% in the nine months ended September 30, 2008. The lower effective tax rate in the first nine months of 2007 included a benefit recorded in the first quarter of 2007 relating to the closure of tax audits from prior years, which resulted in approximately a 0.9 percentage point decrease in our effective tax rate. The effective tax rate for the first nine months of 2008 was unusually high due to the delay in legislation extending research tax credits that expired December 31, 2007, which resulted in approximately a two percentage point increase in our effective tax rate assuming the same basis for research and development credits used in 2007. Federal legislation to extend the research tax credits to the years 2008 and 2009 was signed into law on October 3, 2008. As a result, we estimate that our effective tax rate for the twelve months ended December 31, 2008 will be reduced by approximately two percentage points.

***NET INCOME***

As a result of the above factors, net income increased \$0.9 million from \$21.5 million in the three months ended September 30, 2007 to \$22.4 million in the three months ended September 30, 2008 and increased \$3.7 million from \$58.2 million in the nine months ended September 30, 2007 to \$61.9 million in the nine months ended September 30, 2008.

As a percentage of sales, net income decreased from 17.3% in the three months ended September 30, 2007 to 16.3% in the three months ended September 30, 2008 and decreased from 16.3% in the nine months ended September 30, 2007 to 15.9% in the nine months ended September 30, 2008.

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**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES***Liquidity*

At September 30, 2008, cash on hand was \$40.8 million and short-term investments were \$105.6 million, which resulted in available short-term liquidity of \$146.4 million. At December 31, 2007, our cash on hand of \$13.9 million and short-term investments of \$148.4 million resulted in available short-term liquidity of \$162.3 million.

*Operating Activities*

Our working capital, which consists of current assets less current liabilities, decreased 12.0% from \$251.3 million as of December 31, 2007 to \$221.1 million as of September 30, 2008. The quick ratio, defined as cash, cash equivalents, short-term investments, and net accounts receivable, divided by current liabilities, decreased from 5.41 as of December 31, 2007 to 4.41 as of September 30, 2008. The current ratio, defined as current assets divided by current liabilities, decreased from 6.83 as of December 31, 2007 to 5.74 as of September 30, 2008. The quick ratio and the current ratio decreased from 2007 to 2008 mainly due to a \$15.9 million decrease in short-term liquidity in 2008 as we realigned our investment portfolio and increased long-term investments by \$19.9 million.

Net accounts receivable decreased from \$70.7 million at December 31, 2007 to \$59.2 million at September 30, 2008. Our allowance for doubtful accounts was \$0.1 million at December 31, 2007 and \$25 thousand at September 30, 2008. Quarterly accounts receivable days sales outstanding (DSO) decreased from 55 days as of December 31, 2007 to 40 days as of September 30, 2008. Net accounts receivables and DSO decreased for the quarter ended September 30, 2008 primarily because sales were recognized more evenly throughout the quarter and were therefore weighted less in the last month of the quarter compared to the quarter ended December 31, 2007.

Quarterly inventory turnover was 4.1 turns as of December 31, 2007 and 4.5 turns as of September 30, 2008. We expect inventory levels to fluctuate as we attempt to maintain sufficient inventory to ensure competitive lead times while managing the risk of inventory obsolescence that may occur due to rapidly changing technology and customer demand.

Accounts payable increased 10.8% from \$22.2 million at December 31, 2007 to \$24.6 million at September 30, 2008. The lower balance at December 31, 2007 was primarily attributable to the timing of receipt and subsequent payment for finished product assemblies manufactured by our subcontractors. Generally, the change in accounts payable is due to variations in the timing of the receipt of supplies, inventory and services and our subsequent payments for these purchases.

*Investing Activities*

Capital expenditures totaled approximately \$7.0 million and \$5.2 million for the nine months ended September 30, 2008 and 2007, respectively. These expenditures were primarily used to purchase computer hardware, software and manufacturing and test equipment.

Our combined short-term and long-term investments decreased \$23.0 million from \$255.7 million at December 31, 2007 to \$232.7 million at September 30, 2008. Net proceeds from the purchases and sales and redemptions of investments of \$13.6 million were used primarily to fund our share repurchase program and contributed to this decrease. The balance of this decrease is primarily due to the change in net unrealized gains and losses on available for sale securities. The change in net unrealized gains and losses on available for sales securities, net of taxes, reflected a net loss of \$5.1 million during the nine months ended September 30, 2008 compared to a net gain of \$3.0 million for the same period in the prior year.

We invest all available cash not required for immediate use in operations primarily in securities that we believe bear minimal risk of loss. At September 30, 2008, these investments included municipal variable rate demand notes of \$53.3 million and municipal fixed-rate bonds of \$109.9 million. At December 31, 2007, these investments included municipal variable rate demand notes of \$47.5 million, municipal auction rate securities of \$9.0 million and municipal fixed-rate bonds of \$122.1 million.

Our municipal variable rate demand notes are classified as available-for-sale short-term investments and had a credit rating of A-1+ or VMIG-1 at September 30, 2008. Despite the long-term nature of their stated contractual maturities, we

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believe that we have the ability to quickly liquidate these securities. Our investments in these securities are recorded at fair value and the interest rates reset every seven days. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these investments. All income generated from these investments was recorded as interest income. Further, we have not been required to record any losses relating to municipal variable rate demand notes or municipal auction rate securities, and we have held no municipal auction rate securities since February 7, 2008.

At September 30, 2008, approximately 44% of our municipal fixed-rate bonds had a credit rating of AAA, 55% had a credit rating of AA and the balance had a credit rating of A. These bonds are classified as available-for-sale investments and had an average duration of 0.8 years at September 30, 2008. Because our bond portfolio has a high quality rating and contractual maturities of a short duration, we are able to obtain prices for these bonds derived from observable market inputs, or for similar securities traded in an active market, on a daily basis.

Our long-term investments increased 18.5% from \$107.3 million at December 31, 2007 to \$127.2 million at September 30, 2008. Municipal fixed-rate bonds classified as long-term investments increased \$27.4 million from \$30.2 million at December 31, 2007 to \$57.6 million at September 30, 2008. Long-term investments at September 30, 2008 and December 31, 2007 included an investment in a certificate of deposit of \$49.0 million which serves as collateral for our revenue bonds, as discussed below. We have various equity investments included in long-term investments at a cost of \$16.3 million and \$16.1 million, and with a fair value of \$15.9 million and \$22.9 million, at September 30, 2008 and December 31, 2007, respectively, including a single equity security, of which we held 2.5 million shares, carried at \$2.7 million and \$6.7 million of fair value at September 30, 2008 and December 31, 2007, respectively. The single security traded approximately 37,000 shares per day during the third quarter of 2008 in an active market on a European stock exchange. This single security carried \$1.8 million of the gross unrealized gains included in the fair market value of our marketable securities at September 30, 2008. The remaining \$0.4 million of unrealized gains and \$2.6 million in gross unrealized losses were spread amongst more than 350 issues. Long-term investments at September 30, 2008 and December 31, 2007 also include \$2.8 million and \$3.1 million, respectively, related to our deferred compensation plan.

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 qualitative and quantitative information, including but not limited to the following: the magnitude and duration of historical declines 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. For the three and nine months ended September 30, 2008, we had charges of \$0.1 million and \$0.6 million, respectively, related to the other than temporary impairment of certain publicly traded equity securities. There were no such charges in the nine months ended September 30, 2007. Although we believe our marketable equity security portfolio is diversified, if the market conditions experienced at and subsequent to September 30, 2008 prove to be other than temporary, we may be required to make additional impairments in future quarters.

*Financing Activities**Dividends*

In July 2003, our Board of Directors elected to begin declaring quarterly dividends on our common stock, and 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. During the nine months ended September 30, 2008, ADTRAN paid dividends totaling \$17.3 million.

*Debt*

We have amounts outstanding under loans made pursuant to an Alabama State Industrial Development Authority revenue bond (the Bond) which totaled \$48.7 million at September 30, 2008 and \$49.0 million at December 31, 2007. Included in long-term investments are restricted funds in the amount of \$49.0 million at September 30, 2008

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and December 31, 2007, which is a collateral deposit against the principal amount of the Bond. We have the right to set-off the balance of the Bond with the collateral deposit in order to reduce the balance of the indebtedness. The Bond matures on January 1, 2020, and bears interest at the rate of 5% per annum. 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 we are required to remit to the state for those employment positions that qualify under this program.

We are required to make payments in the amounts necessary to pay the principal and interest on the amounts currently outstanding. Due to continued positive cash flow from operating activities, we made a business decision to begin an early partial redemption of the Bond. It is our intent to make annual principal payments up to \$5.0 million in addition to the interest amounts that are due. In connection with this decision, \$0.5 million of the Bond debt has been reclassified to a current liability in the Condensed Consolidated Balance Sheet.

### *Stock Repurchase Program*

During the nine months ended September 30, 2008, we repurchased 2.7 million shares of our common stock at an average price of \$21.62 per share under the repurchase plans approved by our Board of Directors. Since 1997, our Board of Directors has approved multiple share repurchase programs that have authorized open market repurchase transactions. We have the authority to purchase an additional 3.9 million shares of our common stock under the plan approved by the Board of Directors on April 14, 2008. During 2007, we repurchased 5.8 million shares of our common stock at an average price of \$24.08 per share.

To accommodate employee stock option exercises, we issued 0.3 million shares of treasury stock for \$3.5 million during the nine months ended September 30, 2008. During the nine months ended September 30, 2007, we issued 1.2 million shares of treasury stock for \$15.0 million.

### *Off-Balance Sheet Arrangements and Contractual Obligations*

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. During the nine months ended September 30, 2008, there have been no material changes in contractual obligations and commercial commitments from those discussed in our most recent Form 10-K filed on February 28, 2008.

We have committed to invest up to an aggregate of \$7.8 million in two private equity funds, and we have contributed \$7.7 million to date, of which \$7.2 million has been applied to these commitments. See Note 3 to the Condensed Consolidated Financial Statements for additional information.

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, purchases of treasury stock, 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 our cash and cash equivalents, investments and cash generated from operations to be adequate to meet our operating and capital needs for the foreseeable future.

## **FACTORS THAT COULD AFFECT OUR FUTURE RESULTS**

The following are some of the risks that could affect our financial performance or could cause actual results to differ materially from those expressed or implied in our forward-looking statements:

Our operating results may fluctuate in future periods, which may adversely affect our stock price.

Our revenue for a particular period can be difficult to predict, and a shortfall in revenue may harm our operating results.

Our exposure to the credit risks of our customers and distributors may make it difficult to collect accounts receivable and could adversely affect our operating results and financial condition.





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We expect gross margin to vary over time, and our level of product gross margin may not be sustainable.

We must continue to update and improve our products and develop new products in order to compete and to keep pace with improvements in telecommunications technology.

Our products may not continue to comply with the regulations governing their sale, which may harm our business.

If our products do not interoperate with our customers' networks, installations will be delayed or cancelled and could harm our business.

We do not engage in long-term research and development processes, and as a consequence may miss certain market opportunities enjoyed by larger companies with substantially greater research and development efforts.

We depend heavily on sales to certain customers; the loss of any of these customers would significantly reduce our revenues and net income.

The lengthy approval process required by Incumbent Local Exchange Carriers (ILECs) and other service providers could result in fluctuations in our revenue.

Our strategy of outsourcing a portion of our manufacturing requirements to subcontractors located in Asia may result in us not meeting our cost, quality or performance standards.

Our dependence on a limited number of suppliers may prevent us from delivering our products on a timely basis, which could have a material adverse effect on customer relations and operating results.

We compete in markets that have become increasingly competitive, which may result in reduced gross profit margins and market share.

Our estimates regarding future warranty obligations may change due to product failure rates, shipment volumes, field service obligations and other rework costs incurred in correcting product failures. If our estimates change, the liability for warranty obligations may be increased or decreased, impacting future cost of goods sold.

Managing our inventory is complex and may include write-downs of excess or obsolete inventory.

Increased sales volume in international markets could result in increased costs or loss of revenue due to factors inherent in these markets.

We may be adversely affected by fluctuations in currency exchange rates.

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Our success depends on our ability to reduce the selling prices of succeeding generations of our products.

Our failure to maintain rights to intellectual property used in our business could adversely affect the development, functionality and commercial value of our products.

We may incur liabilities or become subject to litigation that would have a material effect on our business.

Consolidation and deterioration in the competitive service provider market could result in a significant decrease in our revenue.

We depend on distributors who maintain inventories of our products. If the distributors reduce their inventories of these products, our sales could be adversely affected.

If we are unable to successfully develop relationships with system integrators, service providers, and enterprise value added resellers, our sales may be negatively affected.

If we fail to manage our exposure to worldwide financial and securities markets successfully, our operating results and financial statements could be materially impacted.

Changes in our effective tax rate or assessments arising from tax audits may have an adverse impact on our results.

Our success depends on attracting and retaining key personnel.

While we believe our controls over financial reporting are adequate, a failure to maintain effective internal control over financial reporting as our business expands could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.

The price of our common stock has been volatile and may continue to fluctuate significantly.

The foregoing list of risks is not exclusive. For a more detailed description of the risk factors associated with our business, see Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Details of the fair value of our available-for-sale investments as of September 30, 2008 are discussed in Note 3 of Notes to Condensed Consolidated Financial Statements.

We are exposed to financial market risks, including changes in interest rates and prices of marketable equity and fixed-income securities. The primary objective of the large majority of our investment activities is to preserve principal while at the same time achieving appropriate yields without significantly increasing risk. To achieve this objective, a majority of our marketable securities are investment grade municipal fixed-rate bonds, municipal variable rate demand notes and municipal money market instruments denominated in United States dollars. At September 30, 2008, our municipal variable rate demand notes had a credit rating of VMIG-1 or A-1+. Approximately 44% of our municipal fixed-rate bonds had a credit rating of AAA, 55% had a credit rating of AA and the balance had a credit rating of A.

As of September 30, 2008, interest income on approximately \$89.8 million of our cash and investments may be directly affected by changes in interest rates. We have performed a hypothetical sensitivity analysis assuming market interest rates increase or decrease by 50 basis points (bps), 100 bps and 150 bps, while all other variables remain constant. Hypothetical 50 bps, 100 bps and 150 bps declines in interest rates as of September 30, 2008 would reduce annualized interest income on our cash, money market instruments and municipal variable rate demand notes by approximately \$0.4 million, \$0.9 million and \$1.3 million, respectively. In addition, hypothetical 50 bps, 100 bps and 150 bps increases in interest rates as of September 30, 2008 would reduce the fair value of our municipal fixed-rate bonds by approximately \$0.4 million, \$0.9 million and \$1.3 million, respectively.

We are directly exposed to changes in foreign currency exchange rates to the extent that such changes affect our revenue derived from international customers, expenses related to our foreign sales offices, and our foreign assets and liabilities. We attempt to manage these risks by primarily denominating contractual and other foreign arrangements in U.S. dollars. Our primary exposure in regard to our foreign assets and liabilities is with our Australian subsidiary whose functional currency is the Australian dollar. If the decline in the exchange rate of the Australian dollar to the U.S. dollar experienced subsequent to September 30, 2008 continues, we would be required to record a reduction in our Australian assets, primarily cash, and accumulated other comprehensive income, in future quarters. We are indirectly exposed to changes in foreign currency exchange rates to the extent of our use of foreign contract manufacturers and foreign raw material suppliers who we pay in U.S. dollars. As a result, changes in the local currency rates of these vendors in relation to the U.S. dollar could cause an increase in the price of products that we purchase.

**ITEM 4. CONTROLS AND PROCEDURES**

(a) *Evaluation of disclosure controls and procedures.* Our chief executive officer and chief financial officer are responsible for establishing and maintaining disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) for ADTRAN. Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report, have concluded that our disclosure controls and procedures are effective.

(b) *Changes in internal control over financial reporting.* There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1A. RISK FACTORS**

A list of factors that could materially affect our business, financial condition or operating results is included under "Factors That Could Affect Our Future Results" in "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in Item 2 of Part I of this report. There have been no material changes to the risk factors as disclosed in Item 1A of Part I of our most recent Annual Report on Form 10-K filed on February 28, 2008.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table sets forth ADTRAN's repurchases of its common stock for the months indicated.

| <b>Period</b>                          | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average<br/>Price<br/>Paid per<br/>Share</b> | <b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Plans<br/>or Programs (1)</b> | <b>Maximum Number<br/>of Shares that May<br/>Yet Be Purchased<br/>Under the Plans or<br/>Programs</b> |
|--|---|---|---|---|
| July 1, 2008 – July 31, 2008           | 1,334,475   | \$ 22.64  | 1,334,475   | 4,426,834   |
| August 1, 2008 – August 31, 2008       | 582,578(2)  | \$ 22.38(2)                                     | 574,029   | 3,852,805   |
| September 1, 2008 – September 30, 2008 | 732(2)  | \$ 20.37(2)                                     |   | 3,852,805   |
| <b>Total</b>                           | <b>1,917,785</b>                                    |   | <b>1,908,504</b>  |   |

- (1) On April 14, 2008, ADTRAN's Board of Directors approved the repurchase of up to 5,000,000 shares of its common stock, under which ADTRAN had the remaining authority to purchase 3,852,805 shares as of September 30, 2008. This plan will be implemented through open market purchases from time to time as conditions warrant.
- (2) Includes an aggregate of 9,281 shares delivered to ADTRAN 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 is based on the closing price of the common stock on the NASDAQ Global Market on the date of the transaction.

**ITEM 6. EXHIBITS**

Exhibits.

| <b>Exhibit No.</b> | <b>Description</b>                      |
|--------------------|---|
| 31                 | Rule 13a-14(a)/15d-14(a) Certifications |
| 32                 | Section 1350 Certifications             |

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ADTRAN, INC.**

*(Registrant)*

Date: November 3, 2008

/s/ James E. Matthews

James E. Matthews

Senior Vice President Finance,

Chief Financial Officer, Treasurer,

Secretary and Director

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