ADTRAN®

2003 Annual Report

Access to today's high-speed communications networks

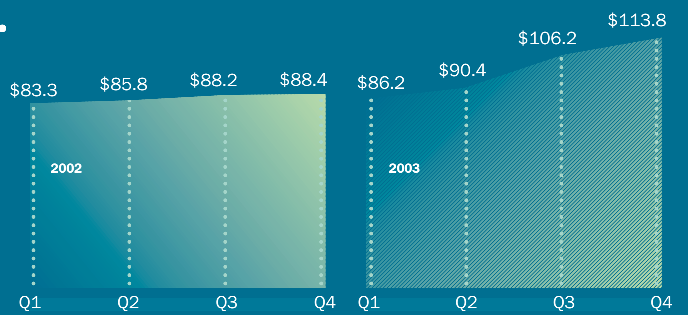
The Network Access Company

ADTRAN®, Inc. is one of the world's most successful networking equipment suppliers, with a 16-year history of profitability and a portfolio of more than 1,300 solutions for use in the last mile of today's telecommunications networks. Widely deployed by both service providers and enterprises alike, ADTRAN solutions enable voice, data, video, and Internet communications across copper, fiber, and wireless network infrastructures. ADTRAN solutions are currently in use by every major domestic service provider and many international ones, as well as by thousands of public, private, and government organizations worldwide. As a result, it is highly probable that some part of your daily communications activities involves an ADTRAN-enabled network.

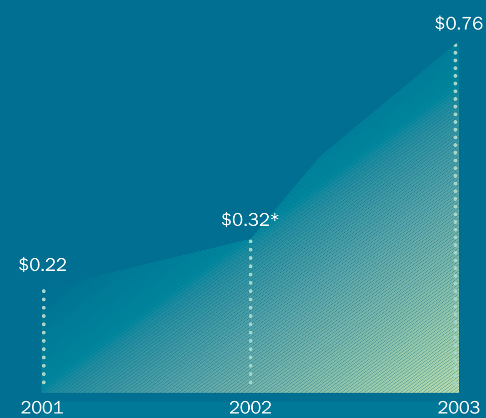
NASDAQ: ADTN

ADSL	Asymmetric Digital Subscriber Line
AOS	ADTRAN Operating System
ATM	Asynchronous Transfer Mode
DS3	Digital Signal Level 3
DLC	Digital Loop Carrier
DSL	Digital Subscriber Line
DSLAM	Digital Subscriber Line Access Multiplexer
E1	International equivalent of T1
EMS	Element Management System
HDSL	High-bit-rate Digital Subscriber Line
HDX	High Density eXpansion architecture
IAD	Integrated Access Device
ILEC	Incumbent Local Exchange Carrier
IP	Internet Protocol
IT	Information Technology
IXC	IntereXchange Carrier
OC-3	Optical Carrier Level 3
OC-12	Optical Carrier Level 12
PON	Passive Optical Network
SHDSL	Symmetrical High-bit-rate Digital Subscriber Line
SONET	Synchronous Optical NETwork
T1	Trunk Level 1
TDM	Time Division Multiplex
VoIP	Voice over Internet Protocol

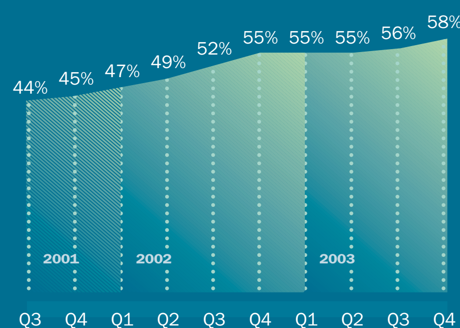
The numbers speak for themselves.



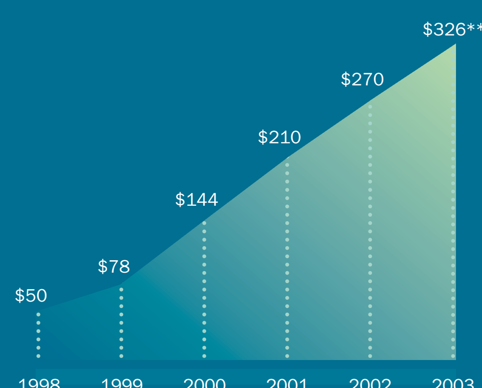
Quarterly Revenue ($ millions)



Annual Earnings Per Share



Gross Margin



Cash and Marketable Securities ($ million)

** Includes investment impairment charges of $7.4 million net of tax*

*** Net of $89 million in special and quarterly dividends paid in 2003*

Financial Highlights

($ millions, except earnings per share)

	1999	2000	2001	2002	2003
Revenue	$367.2	$462.9	$387.1	$345.7	$396.7
Net Income	$50.9	$120.8*	$17.3	$24.8**	$61.5
Diluted Earnings Per Share	$0.66	$1.52*	$0.22	$0.32**	$0.76
Total Assets	$556.3	$546.3	$522.5	$521.2	$593.9
Stockholders' Equity	$400.1	$434.4	$437.6	$435.2	$493.8

* Includes an after-tax net realized investment gain from sale of marketable securities of $55.4 million or $0.70 per share for 2000.

** Includes an after-tax investment impairment charge on equity securities of $7.4 million or $0.10 per share for 2002.

The momentum behind the numbers.

2003 in Review

Looking back on 2003, we were able to accomplish substantially more than we anticipated at its start. Momentum built throughout the year as the market for our network access products began to emerge from a protracted period of recession. Combined with the timely and successful introduction of important new products, our operating results improved steadily, and we were pleased to announce a sequence of upward revisions to our earnings guidance throughout the year.

Year over year, revenue in 2003 increased 14.7 percent to $396.7 million, up from $345.7 million last year. We attribute the increase to market share gains by key, established product families, as well as early success with newly introduced lines of systems products. We were especially pleased with the acceptance of our new DSL multiplexers, optical access multiplexers, and access routers. As the year drew to a close, we continued to experience a well-balanced mix of success, with traditional product sales supporting expanding sales of new systems and equipment.

Earnings improved significantly from $24.8 million in 2002 (includes an investment impairment charge of $7.4 million, net of tax) to $61.5 million this year, or an increase of 148.3 percent. Fully diluted earnings per share grew from $0.32 last year to $0.76 in 2003, taking into account the stock split we announced during the current year. Increased sales, disciplined expense controls, and improved margins combined to produce these favorable results for shareholders.

Our results were enhanced by an improvement in gross margin to a record 56.0 percent, up from 50.6 percent in 2002. This improvement was driven in large part by our release of many lower-cost versions of existing products and release of a series of successful, new system-level product families. We also leveraged our modern supply chain process, which contributed to record margins for our company.

In 2003, revenue increased 14.7 percent to $396.7 million, up from $345.7 million in 2002.

Operating expenses were tightly controlled throughout the year, although they do include the full effect of our restoring salaries to normal levels late in 2002. During the recession, we felt a graduated salary reduction program was more appropriate for ADTRAN® than the extensive staff reductions generally imposed throughout the telecommunications industry. Our staff responded to our novel but burdensome approach by bonding together and delivering strong financial results, a more imposing competitive posture, and an extensive stable of new products. The ADTRAN team is justifiably proud of those achievements.

Dividends declared; stock split declared

To enhance shareholder value and dampen market volatility for our shares, our board of directors, on July 14, declared both a one-time dividend of $1.00 per common share and a quarterly dividend of $0.075 per share (post-split). Quarterly dividends were paid in both our third and fourth quarters. We felt this was prudent since we held cash in excess of current needs, and recent legislation affecting tax treatment of cash dividends provided us a tax-efficient means to release value back to shareholders. Confident in our ability to continue generating earnings and surplus cash, we anticipate continuing our payment of cash dividends, provided their favorable tax treatment is not significantly diminished.

Subsequently, the board of directors also declared a two-for-one stock split effective on December 15, 2003, effected in the form of a stock dividend of one share of common stock for each outstanding common share held of record on December 1, 2003.

Operating cash flow for the year totaled $85 million, and at year's end we held $326 million in cash and marketable securities. We feel this is a more than ample position to fund an aggressive product development program, as well as to fund future working capital needs that may arise with sustained growth.

Corporate governance
At ADTRAN®, we have implemented a disciplined program of compliance with the standards mandated by the Sarbanes-Oxley Act. During the year, our board of directors adopted a strict Code of Business Conduct and Ethics. Every employee, officer, director, agent, consultant, and representative has signed that document, acknowledging their respective responsibilities to know and to abide by its principles and standards. In our view, this was a reaffirmation of the high standards of ethical conduct we have enforced since our founding 18 years ago.

Strategically positioned at the network edge
Our customers are served by two operating divisions: Carrier Networks and Enterprise Networks. Both are focused upon providing network access equipment at the edge of networks worldwide, and both divisions are built upon the notion that superbly engineered products will provide us sustainable competitive advantage. ADTRAN is a company built around a core team of design engineers and technologists committed to providing customers unmatched value with every product. Once we position our products in a chosen market segment, our engineers drive for market share by introducing succeeding versions of those products at substantially lower cost and with more robust performance. That fundamental notion has allowed us to remain profitable for the past 16 years.

Products from both divisions are delivered through a worldwide supply chain employing the latest processes and software tools to drive down costs. Having made substantial investments in our supply chain starting in 2001, we are gratified with its contribution to the 2003 results, including dramatic inventory reductions and cycle time improvements.

Superbly engineered products continue to provide a sustainable competitive advantage in a variety of market situations.

Carrier Networks accomplishments
Our Carrier Networks division had an exceptional year as our primary channel to network service providers. While increasing market share in existing product segments, we successfully consolidated our position in two new system markets: DSL Access Multiplexers (DSLAMs) and optical access multiplexers.

During the year, we continued to gain share in the market for HDSL equipment, a primary method for delivery of broadband access worldwide. HDSL equipment currently represents our largest product line. We believe we hold a dominant market share of approximately 74 percent* in the United States, and we intend to improve upon that figure in the coming year. The addition of ADTRAN's patented T-Scan™ technology to our HDSL product line helped make our products a compelling choice due to the dramatically lower operating costs for service providers that deploy it. Those cost savings have been so substantial that some service providers have replaced existing equipment solely to realize the savings available with ADTRAN HDSL products.

Among the important achievements recorded in the past year were approval and deployment of our DSLAM equipment by some of the largest service providers in the United States. In the latter half of the year, this achievement led to an incremental sales increase for this division. Further, we established a new product category by developing DSLAM products that make it cost effective for lower-tier central offices and remote terminals to begin service to areas with unfulfilled demand for DSL service. Our Total Access® 3000, and the new Total Access HDX and Total Access 1100 families of products, have received broad acceptance by large service providers like the Regional Bell Operating Companies (RBOCs) and national service providers overseas. We expect DSLAM

**Internal company estimate*

demand to expand in the coming year, despite challenges from broadband DLCs and expensive revolutions like PON. In the near term, we intend to consolidate our DSLAM market position by introducing more advanced versions targeted at our defined market segments, as well as facilitating low-cost IP access throughout the product line.

We have also begun to receive significant growth from our optical access multiplexer product line that began with the introduction of an OC-3 SONET optical multiplexer late in 2001: a solution that redefined this product category with its low cost and compact design. That market foothold has now been expanded with new additions to the product line that include both higher level multiplexing and Ethernet capability. We intend to consolidate our position with an aggressive investment in new optical access products in the coming year.

In general, we believe our Carrier Networks division may have, in 2004, the brightest prospects that it has had since its inception.

2003 Product Initiatives

In 2003, ADTRAN introduced several new DSL access devices to help service providers serve low- and medium-density markets. These devices require a very low initial investment, but allow room to grow as new subscribers come onboard.

The Total Access 3000/ 1200/1100 Series

High-Density DSLAMs
Mini-DSLAMs
Outside Plant DSLAMs

DSL Market Preview

Widespread Internet usage continues to drive demand for reliable, low-cost broadband services. In 2003, carriers seeking to improve competitive posture outfitted their networks to serve a greater percentage of potential customers, especially outside of metropolitan areas.

ADTRAN Response

ADTRAN expanded its DSL systems product line to include platforms for compact and non-traditional outside plant locations. These platforms enable DSL delivery to subscribers previously viewed as unreachable or uneconomical, at a cost that protects profitability on lower-priced service offerings.

Enterprise Networks accomplishments

Our Enterprise Networks division enjoyed success in 2003, serving as our primary channel to corporate end users and to unregulated service provider entities. Primary among this division's achievements was the charting of new product directions to augment a dominant presence in the market for wide area network access gear. By year's end, this division was well on its way to becoming a primary participant in the huge internetworking market.

Early last year, we confirmed our entry point into the vast internetworking market, making that decision based on our market-leading capabilities in product development, distribution, and customer service. We then embarked on a course to become the dominant supplier of Integrated Access Devices (IADs) and to become a preferred supplier of access routers and switches to a carefully selected set of customers.

We believe we have succeeded in the first of these goals: our IAD market share has grown to 59 percent.* Our third generation IADs, introduced during the year, appear to hold a clear cost advantage over any competitor, consistent with our continuing commitment to engineer the industry's lowest cost solutions. Popular with a diverse set of service providers, our IADs are now integral to their operations and are generally provided under volume purchase agreements.

We are now applying our market-leading product development, distribution, and customer service capabilities in new, high-growth markets.

Our NetVanta® Series of routers and switches has attracted a growing set of impressive customers, including both domestic and international service providers. Among our more important product announcements have been the NetVanta 3305 access router and the NetVanta 1224 managed Ethernet switch. The entire product line is built around a common software base, AOS, designed for scalability and flexibility as the product line expands. In domestic markets, we believe we are well positioned to compete with even the largest competitor, because we can leverage the large domestic distribution network we have built over many years, currently numbering more than 5,000 resellers.

In closing

We would be remiss if we were to close 2003 without acknowledging the outstanding contributions by our people. During the three-year downturn in the telecommunications market, they accepted the challenges it posed; endured the resulting financial constraints it made necessary; held together as a team; and prevailed. This level of commitment is indeed unique and a key element in ADTRAN's success.

Sincerely,

Mark C. Smith
Chairman and CEO

Howard A. Thrailkill
President and COO

**In-Stat/MDR, 2003*

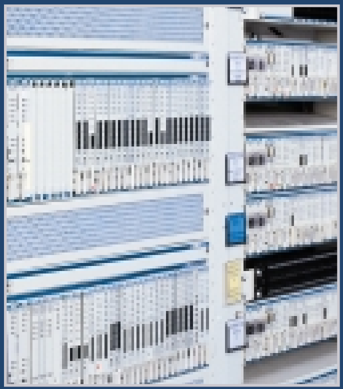
Business Transport

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

Our Carrier Networks division supplies telephone companies and other service providers with the equipment they need to connect their primary revenue source (subscribers) to expensive network infrastructure over the "last mile" of their networks.

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

2003 Product Initiatives
In 2003, ADTRAN introduced new generations of its HDSL2 and HDSL4 technologies. These releases significantly improved margin on high-volume product lines with significant remaining upside potential.



ADTRAN T1/HDSL Technologies

HDSL4
HDSL2

Business Transport Market Preview
The delivery of business data services over leased-line copper represents approximately 60 percent of revenue to key service provider customers. To maximize network performance and build customer satisfaction, service providers deploy the latest T1/HDSLx technologies.

ADTRAN Response
ADTRAN is the leading supplier of T1/HDSLx technologies in the United States, with approximately 74 percent market share. The company's strategy of continual re-engineering/cost reducing has proven successful in this market and others, and will be applied to newer product lines in 2004.

Extending broadband access throughout the network.

Carrier Networks

In 2003, ADTRAN® continued supplying service providers with innovative, cost-saving solutions to extend the functionality of networks originally designed for lower volume, voice-only traffic. Both domestic and global service providers face the challenge of meeting demand for an increasing variety of services, while reducing the cost of deploying those services, all in an increasingly competitive environment. ADTRAN specializes in systems to help service providers overcome these challenges.

Extending broadband services

Extending broadband services is a trend occuring in the United States and abroad. To meet residential demand for high-speed Internet access, and to meet the corresponding business demand to deliver bandwidth-intensive content, service providers must deploy packet-based DSL technologies. Our Total Access® DSLAMs make it possible to deliver these lower-priced services at a cost that protects margin.

Achieving greater DSL coverage numbers

In recent years, service providers have made great progress in outfitting their networks for the delivery of DSL services, especially in highly populated areas. During 2003, in response to competitive pressure, many service providers turned their attention to reaching a greater percentage of potential subscribers in less densely populated, but high-growth, areas.

We began addressing this market requirement in 2002 with a series of mini-DSLAMs. These devices involve a low initial investment, but can accommodate growth as subscribers are added, making DSL more affordable to deploy. Our products for this application gained wide acceptance in 2003 as service providers began realizing their price/performance benefits.

During 2003, service providers redistributed capital expenditures toward strategic growth areas such as DSL.

New outside plant DSLAMs extend addressable market

To further assist service providers in reaching DSL coverage goals, ADTRAN introduced a line of environmentally sealed, line-powered DSLAMs designed for outdoor environments such as telephone poles and cross-boxes. These devices allow service providers to reach a portion of the subscriber base that was, in the past, economically infeasible. ADTRAN is the first major networking supplier to offer this type of solution.

Voice, data, and video over IP

In 2003, we expanded our DSLAM portfolio to include models with the ability to deliver IP packets toward the network. Commonly used in local area networks at the customer premises, IP is now migrating into the last mile of the service providers' network as an alternative to ATM, the traditional DSL transport protocol. These new, IP-based DSLAMs immediately improve the economics of deploying broadband to businesses.

Strengthening our DSLAM competitive position

Also in 2003, we introduced a new high-density architecture for our Total Access DSLAMs. Already well established in mid-density central offices, Total Access DSLAMs can now be configured to accommodate 500 percent more ADSL subscribers on the same size network uplink (DS3), a metric that improves the competitive position of this product in the larger central offices of metropolitan service areas.

Cost reductions improve margin on critical business products

In accordance with our strategy of continual cost improvement on existing product lines, in 2003 we released new generations of our market-leading HDSL2 and HDSL4 technologies. By replacing older versions of HDSLx technologies with these newer versions, service providers overcome many of the engineering challenges associated with DSL deployment. ADTRAN is the leading supplier of T1/HDSL technologies in the United States, with equipment in use by every major ILEC and numerous independent and competitive providers.

New optical product provides strong cost replacement solution

We continued to expand our optical access products in 2003 with the introduction of the OPTI-MX, a higher-density, higher-capacity companion to the OPTI-3™ fiber multiplexer we introduced in December

2001. The OPTI-MX increases the network bandwidth of our optical offering to OC-12 (622 Mbps), and supports the widest range of customer services we have offered to-date, including Ethernet over SONET. Packaged in an extremely compact chassis, OPTI-MX overcomes many size and cost issues associated with traditional optical access equipment.

High-density, low-cost multiplexing alternative

In response to demand for improved space and network efficiency in copper networks, we introduced the MX2820™ multiplexer, a continuation of our MX2800 Series. The MX2820 offers innovations previously unavailable in this category, such as advanced cable management, one-to-one redundancy, and simplified network management. While this product performs the very commonplace function of merging T1 circuits onto a T3 circuit for transport to the central office, it does so in less space and at a lower cost than was previously available.

2003 Product Initiatives

In 2003, ADTRAN introduced new high-density optical multiplexers designed to lower the cost of connecting new subscribers. A single, compact device provides the connection point between the service provider's fiber infrastructure and today's most commonly deployed services.

The OPTI Series

High-Density SONET Multiplexers

Optical Access Market Preview

Service providers with a heavy investment in high-speed optical metro/regional rings must generate additional revenue by connecting new business subscribers to this valuable infrastructure. The subscriber often requires a fiber feed to support a variety of services.

ADTRAN Response

ADTRAN offers a series of optical multiplexers that overcome the size and cost issues normally associated with adding new customers to fiber infrastructure. These devices perform functions similar to traditional optical equipment in less space and at a fraction of the cost.

Addressing the needs of today's cost-conscious IT professional.

Enterprise Networks

In today's geographically dispersed business enterprise, IT professionals must implement reliable, high-speed voice, data, Internet, and video connectivity over diverse wide and local area networks, while keeping costs in check. We offer a variety of innovative solutions to help domestic and global IT professionals build the network necessary to connect branch offices, telecommuters, and mobile users to corporate information resources. Our solutions maximize network performance, lower ongoing costs, and help companies position themselves for the best return on investment.

Specific goals drive market activity

While overall IT spending remained relatively flat in 2003, many organizations continued to evaluate and buy networking products to achieve very specific goals. These goals included lowering equipment and service costs (sometimes in conjunction with service contract renewals), improving network performance, expanding network functionality, and increasing network security. Our strategy for enterprise networks is to provide the small-to-medium enterprise customer with the internetworking product set required to address these challenges. In line with that strategy, our work in 2003 centered around the cost-conscious mindset of the IT professional, and addressed the important trend toward value in the marketplace.

The value-driven enterprise market

Today's IT environment is characterized by a much more cautious attitude than in previous eras. The need for expanded communications services, combined with with level budgets, has led to an unprecedented interest in value as opposed to bleeding-edge technology. Companies are demonstrating a reliance on more established technologies and an increased willingness to consider lower-cost service and equipment alternatives.

Managing enterprise networks today is more about managing value than managing technology.

Internetworking portfolio targets market needs

ADTRAN® is addressing the new value-oriented enterprise networking market with a line of internetworking gear that now includes access routers, Ethernet switches, firewall/Internet security appliances, Frame Relay performance monitoring, and integrated access devices. These products function as the cornerstone of today's cost-conscious network architectures, and form the basis for growth in enterprise networks in the future. Each internetworking product line offers ways to lower equipment acquisition costs, lower recurring monthly service costs, or both.

The introduction of our NetVanta® 3000 Series of IP access routers in 2002, followed by the introduction of our new NetVanta 1000 Series of managed Ethernet switches in 2003, firmly established us in the internetworking space between the wide area circuit and the user's desktop. This portion of the network represents a significant market opportunity, where even small market share gains would represent meaningful revenue increases to our company.

New access router increases network capacity

In 2003, we expanded our NetVanta 3000 Series of access routers, adding the NetVanta 3305, a model that adds dual T1 network interfaces and dual local area network interfaces to the already full-featured functionality of this series. Dual T1 network interfaces allow a company to support inter-office communications and Internet access using a single device. Dual local area network interfaces allow companies to segment network operations to better secure corporate information resources.

The NetVanta 3305, following in the footsteps of its predecessors, is engineered to sell at a price point significantly below that of the leading brand name router. The entire NetVanta 3000 Series is attractive to distributors and resellers because it offers a viable means of helping to restore profit margins, which have dwindled under conditions of market dominance by a major competitor. This series is attractive to end users because of its low purchase price, low cost of ownership, rich feature set, and high-touch technical support from an established and reputable supplier.

Ethernet switch introduction strengthens internetworking portfolio

In the third quarter of 2003, we released the first products in our NetVanta 1000 Series of managed Ethernet switches. Switches are a widely deployed element in the local area networks of most businesses. The addressable market for this class of switch alone exceeded $2 billion in 2003. NetVanta 1000 switches are full-featured, well-equipped switches available at a price point normally associated with low-end, low-function switches, making it an extremely competitive entry in this market. NetVanta 1000 Series switches include functionality to support the newest IP telephony applications, such as voice and video over IP.

IAD market share increases
In 2003, we continued to win market share with our industry-leading lines of IADs, achieving 59 percent worldwide market share* for TDM IAD technology. IADs enable a service provider to address small- and medium-sized business customers with a high-speed voice, data, and Internet solution. Bundling agreements with ILECs and major IXCs contributed to our increase in market share, along with new feature releases that expanded our market opportunity in TDM, ATM, and IP networks. We also launched the next generation of two of our biggest sellers, reducing cost and improving margins.

**In-Stat/MDR, 2003*

The NetVanta 1000/2000/3000 Series

Ethernet Switches
VPN/Firewall Appliances
Access Routers

2003 Product Initiatives
In 2003, ADTRAN introduced several new internetworking devices to help businesses achieve their networking goals. These products address high-volume markets in which incremental market share gains would create substantial revenue for ADTRAN.

Market Preview
Today's business enterprise must enable high-speed communications between geographically dispersed locations, under firm budgetary constraints. In 2003, companies sought to reduce equipment acquisition and recurring service costs by closely evaluating equipment purchases.

ADTRAN Response
ADTRAN is addressing the value-oriented enterprise market with a highly competitive line of Ethernet switches, access routers, and other internetworking products. These products deliver an impressive return on investment, without compromising features, reliability, or support.

Financial Results

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

ADTRAN's common stock has been traded on the Nasdaq National Market under the symbol ADTN since our initial public offering of common stock in August 1994. Prior to the initial public offering, there was no established trading market for our common stock. As of January 31, 2004, ADTRAN® had 344 stockholders of record and approximately 15,500 beneficial owners of shares held in street name. On October 13, 2003, our board of directors declared a two-for-one stock split, effected in the form of a dividend of one share of common stock on each outstanding share of common stock held of record on December 1, 2003. The stock dividend was payable on December 15, 2003. The following table shows the high and low closing prices per share for the common stock as reported by Nasdaq for the periods indicated with all share and per share amounts restated to reflect the stock split.

Common Stock Prices

(In $)

2003 Quarters	High	Low
First	$20.18	$14.78
Second	$27.63	$18.04
Third	$34.63	$22.65
Fourth	$37.48	$30.43

2002 Quarters	High	Low
First	$14.44	$11.81
Second	$13.22	$ 9.41
Third	$10.29	$ 7.74
Fourth	$17.13	$ 7.50

On July 14, 2003, the board of directors declared a special cash dividend of $1.00 per common share and a quarterly cash dividend of $0.075 per common share, payable on August 29, 2003, to stockholders of record at the close of business on July 31, 2003. Prior to July 14, 2003, ADTRAN had not declared any cash dividends on its common stock. On October 13, 2003, the board of directors declared a quarterly cash dividend of $0.075 per common share, payable on November 17, 2003 to stockholders of record at the close of business on October 31, 2003. On January 20, 2004, the board of directors declared a quarterly cash dividend of $0.08 per common share, payable on February 17, 2004, to stockholders of record at the close of business on February 3, 2004.

The board of directors presently anticipates that it will declare a regular quarterly dividend so long as the present tax treatment of dividends exists and adequate levels of liquidity are maintained.

Selected Financial Data

The following selected consolidated financial data for, and as of the end, of each of the years in the five-year period ended December 31, 2003, are derived from the financial statements of ADTRAN, which have been audited by PricewaterhouseCoopers LLP, independent accountants. The selected financial data are qualified in their entirety by the more detailed information in the financial statements, including the notes thereto. The financial statements of ADTRAN as of December 31, 2003 and 2002 and for each of the years in the three-year period ended December 31, 2003, and the report of PricewaterhouseCoopers LLP thereon, are included elsewhere in this report.

Income Statement Data

(In thousands, except per share amounts)

Year Ended December 31,	2003	2002	2001	2000	1999
Sales					
Carrier Networks Division	$267,563	$218,912	$238,367	$315,228	$230,967
Enterprise Networks Division	129,113	126,813	148,714	147,721	136,240
Total sales	**396,676**	**345,725**	**387,081**	**462,949**	**367,207**
Cost of sales	174,681	170,789	213,760	233,430	178,629
Gross profit	**221,995**	**174,936**	**173,321**	**229,519**	**188,578**
Selling, general and administrative expenses	83,234	81,217	95,954	87,116	71,735
Research and development expenses	58,144	56,295	58,935	50,628	42,018
Operating income	**80,617**	**37,424**	**18,432**	**91,775**	**74,825**
Interest income	8,912	9,113	8,077	9,025	5,350
Interest expense	(2,534)	(2,572)	(2,069)	(1,802)	(2,312)
Other income (expense)	1,609	234	(29)	(4)	(673)
Net realized investment gains (losses)	226	(12,022)	(674)	84,040	0
Income before provision for income taxes	**88,830**	**32,177**	**23,737**	**183,034**	**77,190**
Provision for income taxes	27,315	7,401	6,408	62,232	26,244
Net income	**$61,515**	**$24,776**	**$17,329**	**$120,802**	**$50,946**
Earnings per common share - basic	$0.80	$0.33	$0.22	$1.56	$0.66
Earnings per common share assuming dilution (1)	$0.76	$0.32	$0.22	$1.52	$0.66
Weighted average shares outstanding - basic	76,942	76,090	77,135	77,294	76,670
Weighted average shares outstanding assuming dilution (1)	80,739	76,443	77,353	79,408	77,662

Balance Sheet Data

(In thousands)

At December 31,	2003	2002	2001	2000	1999
Working capital (2)	$220,069	$203,511	$217,387	$262,778	$181,147
Total assets	$593,900	$521,213	$522,537	$546,336	$556,296
Deferred income tax liabilities	$8,882	$3,955	$8,284	$15,342	$80,265
Total debt	$50,000	$50,000	$50,000	$50,000	$50,000
Stockholders' equity	$493,821	$435,212	$437,628	$434,425	$400,052

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

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

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

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

Overview

ADTRAN, Inc. designs, develops, manufactures, markets, and services a broad range of high-speed network access products utilized by providers of telecommunications services and enterprise end users. We currently sell our products to a large number of service providers, including all Regional Bell Operating Companies (RBOCs), and to private and public enterprises worldwide.

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

The year-over-year increase in our Systems revenue is primarily attributable to increasing sales of new products comprised of Digital Subscriber Line Access Multiplexers (DSLAMs), optical access products, and NetVanta® products. Our DSLAMs, consolidate broadband traffic together in one place, and provide the technology that allows phone companies to compete with cable companies in the high-speed Internet service market.

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

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

During the latter half of 2003, our results reflected what we believe to be an improving enterprise spending environment. We have seen indications of increasing activity levels across our customer base and across our product categories. On a sequential quarterly basis, HDSL/T1 revenues increased 23% from the third to the fourth quarter of 2003. This increase is primarily attributable to an increase in enterprise spending, market share gains, and T1 line growth.

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

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

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

Critical Accounting Policies

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

- We review customer contracts to determine if all of the requirements for revenue recognition have been met prior to recording revenues from sales transactions. We generally record sales revenue upon shipment of our products, net of any discounts, since: (i) we generally do not have significant post-delivery obligations, (ii) the product price is fixed and determinable, (iii) collection of the resulting receivable is probable, and (iv) product returns are reasonably estimable. We generally ship products upon receipt of a purchase order from a customer. We evaluate shipping terms and we record revenue on products shipped in accordance with the applicable terms of each respective contract. We participate in cooperative advertising and market development programs with certain customers. We use these programs to reimburse customers for certain forms of advertising, and in general, to allow our customers credits up to a specified percentage of their net purchases. Our costs associated with these programs are estimated and accrued at the time of sale and are included in marketing expenses in our consolidated statements of income. We also participate in rebate programs to provide sales incentives for certain products. Our costs associated with these programs are estimated and accrued at the time of sale, and are recorded as a reduction of sales in our consolidated statements of income. Sales returns are accrued based on historical sales return experience, which we believe provides a reasonable estimate of future returns. Product returns are generally only permitted by customers who purchase our products under specific sales agreements that govern their rights of return.

  Prior to accepting a new customer, we perform a detailed credit review of the customer. Credit limits are established for each new customer based on the results of this credit review. Payment terms are established for each new customer, and collection experience is reviewed periodically in order to determine if the customer's payment terms and credit limits need to be revised. We maintain allowances for doubtful accounts for losses resulting from the inability of our customers to make required payments. If the financial conditions of our customers were to deteriorate, resulting in an impairment of their ability to make payments, we may be required to make additional allowances. If circumstances change with regard to individual receivable balances that had previously been determined to be uncollectible (and for which a specific reserve had been established), a reduction in our allowance for doubtful accounts may be required. Our allowance for doubtful accounts was $1.7 million and $2.5 million at December 31, 2003 and 2002, respectively. We recorded $0, $2 million and $3.3 million of bad debt expense during the years ended December 31, 2003, 2002 and 2001, respectively. In addition, improving financial conditions in the telecom industry allowed us to reduce our allowance for doubtful accounts by $0.7 million.

- We carry our inventory at the lower of cost or market, with cost being determined using the first-in, first-out method. We use standard costs for material, labor, and manufacturing overhead to value our inventory. Our standard costs are updated on a monthly basis and any variances expensed in the current period. Therefore, our inventory costs approximate actual costs at the end of each reporting period. We write-down our inventory for estimated obsolescence or unmarketable inventory by an amount equal to the difference between the cost of inventory or the estimated market value based upon assumptions about future demand and market conditions. If actual future demand or market conditions are less favorable than those projected by management, we may be required to make additional inventory write-downs. Our reserve for excess and obsolete inventory was $3.1 million and $4.4 million at December 31, 2003 and 2002, respectively. Inventory write-downs charged to the reserve were $1.6 million, $5.7 million and $4.4 million for the years ended December 31, 2003, 2002 and 2001, respectively.
- The objective of our short-term investment policy is to preserve principal and maintain adequate liquidity with appropriate diversification, while emphasizing market returns on our monetary assets. The objective of our long-term investment policy is to emphasize total return; that is, the aggregate return from capital appreciation, dividend income, and interest income. This is achieved through investments with appropriate diversification in fixed and variable rate income, public equity, and private equity portfolios. During 2002, we changed our fixed income investment policy, shortening the maximum maturity from 15 years to five and one-half years, with consistent dollar maturities, year-to-year. We have experienced significant volatility in the market prices of our publicly traded equity investments. These investments are recorded on the consolidated balance sheets at fair value with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss), net of tax. The ultimate realized value on these equity investments is subject to market price volatility until they are sold.

  We review our investment portfolio for potential "other-than-temporary" declines in value on an individual investment basis. We assess, on a quarterly basis, significant declines in value which may be considered other-than-temporary and, if necessary, recognize and record the appropriate charge to write-down the carrying value of such investments. In making this assessment, we take into consideration a wide range of objective and subjective information, including but not limited to the following: the magnitude and duration of historical decline in market prices, credit rating activity, assessments of liquidity, public filings, and statements made by the issuer. We generally begin our identification of potential other-than-temporary impairments by reviewing any security with a market value that has declined from its original or adjusted cost basis by 25% for more than six months. We then evaluate the individual security based on the previously identified factors to determine the amount of the write-down, if any. Actual losses, if any, could ultimately differ from these estimates. Future adverse changes in market conditions or poor operating results of underlying investments could result in additional losses that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future. For 2003, 2002 and 2001, we recorded other-than-temporary write-downs of our marketable equity investments of $0, $9.6 million and $0, respectively. These write-downs are included in net realized investment gains (losses) in the accompanying consolidated statements of income.

  We also invest in privately held entities and record our investments in these entities at cost. We review our investments in these entities periodically in order to determine if circumstances (both financial and non-financial) exist that indicate that we will not recover our initial investment. Impairment charges are recorded on investments having a cost basis that is greater than the value that we would reasonably expect to receive in an arm's length sale of the investment. For 2003, 2002 and 2001, we recorded write-downs of our cost basis investments of $0, $2.0 million and $5.5 million, respectively. These write-downs are included in net realized investment gains (losses) in the accompanying consolidated statements of income.

- We estimate our income tax provision or benefit in each of the jurisdictions in which we operate, including estimating exposures related to examinations by taxing authorities. We must also make judgements regarding the realization of deferred tax assets. The carrying value of our net deferred tax asset is based on our belief that it is more likely than not that we will generate sufficient future taxable income in certain jurisdictions to realize these deferred tax assets. A valuation allowance has been established for deferred tax assets which we do not believe meet the more-likely-than-not criteria established by SFAS No. 109, *Accounting for Income Taxes*. Our estimates regarding future taxable income and income tax provision or benefit may vary due to changes in market conditions, changes in tax laws, or other factors. If our assumptions, and consequently our estimates, change in the future, the valuation allowances we have established may be increased or decreased, impacting future income tax expense.
- We estimate our cost to repair or replace defective products at the time revenue is recognized and include this cost in cost of goods sold in our consolidated statement of income. Our products generally include warranties of one to 10 years for product defects. The liability for warranty returns totaled $1.5 million and $1.4 million at December 31, 2003 and 2002, respectively. These liabilities are included in accrued expenses in the accompanying consolidated balance sheets. Our estimates regarding future warranty obligations may change due to product failure rates, shipment volumes, and other rework costs incurred in correcting a product failure. If our estimates change in the future, the liability for warranty returns we have established may be increased or decreased, impacting future cost of goods sold expense.

Results of Operations

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

(Stated as % of sales)

Year Ended December 31,	2003	2002	2001
Sales			
Carrier Networks Division	67.4%	63.3%	61.6%
Enterprise Networks Division	32.6	36.7	38.4
Total sales	**100.0**	**100.0**	**100.0**
Cost of sales	44.0	49.4	55.2
Gross profit	**56.0**	**50.6**	**44.8**
Selling, general and administrative expenses	21.0	23.5	24.8
Research and development expenses	14.7	16.2	15.2
Operating income	**20.3**	**10.9**	**4.8**
Interest income	2.3	2.6	2.2
Interest expenses	(0.6)	(0.7)	(0.5)
Other income (expenses)	0.4	0.0	(0.1)
Net realized investment gains (losses)	0.1	(3.5)	(0.2)
Income before provision for income taxes	**22.4**	**9.3**	**6.2**
Provision for income taxes	6.9	2.1	1.7
Net income	**15.5%**	**7.2%**	**4.5%**

2003 Compared to 2002

Sales

ADTRAN's sales increased 14.7% from $345.7 million in 2002 to $396.7 million in 2003. The increase is primarily the result of increasing unit volume and market share gains in the Carrier Networks Division. In particular, the increase in overall sales is attributable to an increase in sales of our Systems products, partially offset by decreased sales of our Digital Business Transport (DBT)/Total Reach and High-bit-rate Digital Subscriber Line (HDSL)/T1 products. The increase in Systems revenue is attributable to sales of new products comprised of DSLAMs, optical access, and NetVanta products. The decrease in HDSL/T1 revenue is primarily attributable to a decrease in Enterprise Networks Division sales of T1 CSU/DSU products, partially offset by an increase in Carrier Networks Division sales of HDSL products.

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

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

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

Cost of Sales

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

An important part of our strategy is to reduce the product cost of each succeeding product generation and then to lower the product's price based on the cost savings achieved. This strategy, as described above, sometimes results in variations in our gross profit margin due to timing differences between the recognition of cost reductions and the lowering of product selling prices. In view of the rapid pace of new product introductions by our company, this strategy may result in variations in gross profit margins that, for any particular financial period, can be difficult to predict.

Selling, General and Administrative Expenses

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

Research and Development Expenses

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

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

Interest and Dividend Income

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

Interest Expense

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

Net Realized Investment Gain (Loss)

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

Other Income (Expense)

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

Income Taxes

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

Net Income

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

2002 Compared to 2001

Sales

ADTRAN's sales decreased 10.7% from $387.1 million in 2001 to $345.7 million in 2002. The decrease was primarily the result of decreased spending by our customers, which we believe to be a result of both economic and industry-wide factors. In particular, the decrease in overall sales is attributable to a decrease in sales of our DBT/Total Reach and HDSL/T1 products, partially offset by increased sales of our Systems products. Carrier Networks sales decreased 8.2% from $238.4 million in 2001 to $218.9 million in 2002. Carrier Networks sales, as a percentage of total sales, increased from 61.6% in 2001 to 63.3% in 2002. Enterprise Networks sales decreased 14.7% from $148.7 million in 2001 to $126.8 million in 2002. Enterprise Networks sales, as a percentage of total sales, decreased from 38.4% in 2001 to 36.7% in 2002. Foreign sales increased 14.7% from $17.7 million in 2001 to $20.3 million in 2002. The increase in foreign sales is attributable to market acceptance of the Carrier Networks Division's Total Access System, which includes the Total Access 3000 and SHDSL (Symmetrical HDSL).

Cost of Sales

Cost of sales decreased 20.1% from $213.8 million in 2001 to $170.8 million in 2002. The cost of sales decrease is primarily related to the decrease in revenues in each respective period and product cost reductions in 2002. As a percentage of sales, cost of sales decreased from 55.2% in 2001 to 49.4% in 2002, and is primarily attributable to product cost reductions in excess of sales price reductions in the Carrier Networks Division. Carrier Networks cost of sales, as a percent of division sales, decreased from 60.7% in 2001 to 51.9% in 2002. Enterprise Networks cost of sales, as a percent of division sales, decreased from 46.4% in 2001 to 45.1% in 2002.

An important part of our strategy is to reduce the product cost of each succeeding product generation and then to lower the product's price based on the cost savings achieved. This strategy, as described above, sometimes results in variations in our gross profit margin due to timing differences between the recognition of cost reductions and the lowering of product selling prices. In view of the rapid pace of new product introductions by our company, this strategy may result in variations in gross profit margins that, for any particular financial period, can be difficult to predict.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased 15.4% from $96.0 million in 2001 to $81.1 million in 2002. This decrease is a result of a reduction in force, salary reductions, and other cost reductions implemented in the second half of 2001. In the second half of 2002, our operating margins returned to normal levels, allowing the rescission of the mandatory salary reductions, effective September 1, 2002. Selling, general and administrative expenses as a percentage of sales decreased from 24.8% in 2001 to 23.5% in 2002. Historically, we have experienced very little bad debt expense; however, due to the recent financial difficulties in the telecommunications industry, bad debt expense was $2.0 million and $3.3 million in 2002 and 2001, respectively. Selling, general and administrative expenses as a percent of sales will generally fluctuate whenever there is significant fluctuation in revenues during the periods being compared.

Research and Development Expenses

Research and development expenses decreased 4.4% from $58.9 million in 2001 to $56.3 million in 2002. As a percentage of sales, research and development expenses increased from 15.2% in 2001 to 16.2% in 2002. We continually evaluate new product opportunities and engage in intensive research and product development efforts. To date, we have expensed all product research and development costs as incurred. Additionally, we frequently invest heavily in up-front new product development efforts prior to the actual commencement of sales of a major new product. As a result, we may incur significant research and development expenses prior to the receipt of revenues from a major new product group. We are presently incurring research and development expenses in connection with new products and expansion into international markets. In today's challenging industry environment, we have maintained our level of investment in research and development during a period when many competitors have significantly reduced their investments in this area. This investment has provided for continued new product development, enhancement of current products, and product cost reductions. Research and development expenses as a percentage of sales will fluctuate whenever there is a significant fluctuation in revenues during the periods being compared.

Interest and Dividend Income

Interest and dividend income increased 12.3% from $8.1 million in 2001 to $9.1 million in 2002. This increase is primarily related to an increase in fixed income investments and related investment income and an increase in the interest rate earned on the collateral deposit associated with our $50.0 million revenue bond.

Interest Expense

Interest expense increased 30.0% from $2.0 million in 2001 to $2.6 million in 2002. This increase is primarily related to an increase in the interest rate on our $50.0 million revenue bond. See Note 5 of Notes to Consolidated Financial Statements for additional information on our revenue bond.

Other Income (Expense)

Other income (expense) increased from an expense of ($0.1) million in 2001 to income of $0.2 million in 2002. This increase is primarily related to an increase in realized foreign currency gains and scrap material sales.

Net Realized Investment Losses

Net realized investment losses increased from $0.7 million in 2001 to $12.0 million in 2002. This increase is primarily related to an impairment charge for other-than-temporary declines in the market value of investments. We recorded an impairment charge of $9.6 million of other-than-temporary investment impairment charges related to 19 marketable equity security investments. The remaining $2.4 million of net realized investment loss was related to write-downs of private securities and realized transactional gains and losses in 2002.

Income Taxes

Our effective tax rate decreased from 27.0% in 2001 to 23.0% in 2002. Pre-tax income for financial reporting purposes was substantially lower through 2002 due to the other-than-temporary declines in the market value of certain investments. The higher mix of non-taxable income, and higher research and development tax credits and economic incentive credits as a percent of taxable income resulted in a substantially lower effective tax rate.

Net Income

As a result of the above factors, net income increased 43.3% from $17.3 million in 2001 to $24.8 million in 2002. As a percentage of sales, net income increased from 4.5% in 2001 to 7.2% in 2002.

Liquidity and Capital Resources

Fifty million dollars of the expansion of Phase III of our corporate headquarters was approved for participation in an incentive program offered by the Alabama State Industrial Development Authority (the "Authority"). The incentive program enables participating companies to generate Alabama corporate income tax credits that can be used to reduce the amount of Alabama corporate income taxes that would otherwise be payable. We cannot be certain that the state of Alabama will continue to make these corporate income tax credits available in the future, and therefore, we may not realize the full benefit of these incentives. Through December 31, 2003, the Authority had issued $50.0 million of its taxable revenue bonds pursuant to the incentive program and loaned the proceeds from the sale of the bonds to ADTRAN. We are required to make payments to the Authority in the amounts necessary to pay the principal of and interest on the Authority's Taxable Revenue Bond, Series 1995, as amended, currently outstanding in the aggregate principal amount of $50.0 million. The bond matures on January 1, 2020, and bears interest at the rate of 5%. Included in long-term investments are $50.0 million of restricted funds, which is a collateral deposit against the principal amount of this bond. In conjunction with this program, we are eligible to receive certain economic incentives from the state of Alabama that reduce the amount of payroll withholdings that we are required to remit to the state for those employment positions that qualify under the program. Our economic incentives realized for the years ended December 31, 2003, 2002 and 2000 were $1.5 million, $1.2 million and $1.3 million, respectively.

In July 2003, the board of directors determined to begin declaring quarterly dividends on our common stock, and 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. On July 14, 2003, the board declared a special and quarterly cash dividend of $1.00 and $0.075 per common share, respectively, to be paid to stockholders of record at the close of business on July 31, 2003. The special and quarterly dividend payment, which was paid on August 29, 2003, totaled $83.0 million. On October 13, 2003, the board declared a second quarterly cash dividend of $0.075 per common share to be paid to stockholders of record at the close of business on October 31, 2003. The quarterly dividend payment was approximately $5.9 million and was paid on November 17, 2003. The board declared a third quarterly cash dividend on January 20, 2004. The quarterly cash dividend was $0.08 per common share to be paid to holders of record at the close of business on February 3, 2004, with a payment date of February 17, 2004. The quarterly dividend payment was approximately $6.3 million.

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

Our working capital, which consists of current assets less current liabilities, increased 8.2% from $203.5 million as of December 31, 2002 to $220.1 million as of December 31, 2003. The quick ratio, defined as cash, cash equivalents, short-term investments, and net accounts receivable divided by current liabilities, decreased from 5.73 as of December 31, 2002 to 4.87 as of December 31, 2003. The current ratio, defined as current assets divided by current liabilities, decreased from 7.35 as of December 31, 2002 to 6.46 as of December 31, 2003. The decrease in liquidity ratios is primarily a result of the special and quarterly dividend payments and a movement of monetary assets from cash and cash equivalents to long-term investments, partially offset by an increase in accounts receivable.

As of December 31, 2003, we had an income tax receivable of $11.6 million. This receivable was generated in the fourth quarter of 2003 from the tax benefit associated with the exercise of non-qualified stock options. We receive an income tax deduction for the difference between the exercise price and the market price of a non-qualified stock option upon exercise by the employee. We recorded $23.6 million during the year ended 2003 as an income tax deduction for the difference between the exercise price and the market price of non-qualified stock option exercises.

At December 31, 2003, our cash on hand of $132.1 million and short-term investments of $11.9 million placed our short-term liquidity in cash, cash equivalents, and short-term investments at $144.0 million. At December 31, 2002, cash on hand was $125.1 million and short-term investments were $19.7 million, which placed our short-term liquidity at $144.8 million. This decrease is primarily attributable to the $88.9 million of special and quarterly dividend payments and a movement of monetary assets from cash and cash equivalents to long-term investments, partially offset by our ability to generate cash from operations and proceeds received from the exercise of employee stock options.

At December 31, 2003, our long-term investments increased by 32.6% to $233.7 million from $176.3 million at December 31, 2002. This increase is primarily attributable to our ability to generate cash from operations, the investment of proceeds from stock option exercises, and increases in market value of long-term available-for-sale securities. The decrease in deferred tax assets and the increase in deferred tax liabilities is attributable to the increase in market value of our long-term investments. Long-term investments at December 31, 2003, and December 31, 2002, include a restricted balance of $50.0 million related to our revenue bonds, as discussed above. We intend to finance our operations in the future with cash flow from operations and our remaining borrowed taxable revenue bond proceeds. We believe these available sources of funds to be adequate to meet our operating and capital needs for the foreseeable future.

Accounts receivable increased 34.7% from December 31, 2002 to December 31, 2003. Quarterly accounts receivable days sales outstanding increased one day from 41 days as of December 31, 2002 to 42 days as of December 31, 2003. This increase in accounts receivable is caused by increased sales. Other receivables increased 56.7% from December 31, 2002 to December 31, 2003, primarily resulting from an increase in shipments of components to subcontractors due to an increase in business activity. Even with a 14.7% increase in sales, inventory remained relatively stable from December 31, 2002 to December 31, 2003. Quarterly inventory turnover increased from 3.93 turns as of December 31, 2002 to 4.86 turns as of December 31, 2003. The increase in inventory turnover is attributable to our continued efforts to streamline our production process, work closely and efficiently with our subcontractors, and increase manufacturing velocity. In addition, improvements in supply chain management due to the implementation of an advanced planning system and a web-based procurement process have reduced cycle times and increased our manufacturing flexibility. The deployment of these supply chain applications and initiatives has resulted in better inventory control and increased inventory turnover.

Accounts payable increased 57.3% from December 31, 2002 to December 31, 2003. Accrued expenses increased 43.6% from December 31, 2002 to December 31, 2003. These increases are primarily related to the variations of timing of payments, increased business activity, and a net increase in our warranty reserve related to the expanding base of ADTRAN products in the field under warranty. Capital expenditures totaled approximately $6.8 million, $2.6 million and $13.2 million for the years ended December 31, 2003, 2002 and 2001, respectively. These expenditures were primarily used to purchase computer hardware and software, manufacturing and test equipment, and in 2001 to expand our corporate headquarters.

In July 2001, the board of directors approved the repurchase of 2,000,000 shares of ADTRAN common stock on a pre-split basis. As of December 31, 2003, we had repurchased 1,676,522 shares of our common stock on a pre-split basis (3,353,104 shares post-split) at a total cost of $31.7 million and had the authority to purchase an additional 323,448 shares. No shares were purchased during the year ended December 31, 2003. We issued 4,125,242 shares of treasury stock and 404,029 newly issued shares of common stock for $55.1 million during the year ended December 31, 2003, to accommodate employee stock option exercises. During 2002 and 2001, we issued 375,500 and 73,340 shares of treasury stock, respectively, to accommodate employee stock option exercises.

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

We have various contractual obligations and commercial commitments. The following table sets forth, in millions, the annual payments, exclusive of interest payments, we are required to make under contractual cash obligations and other commercial commitments at December 31, 2003.

Contractual Obligations

(In millions)

	Total	2004	2005	2006	2007	2008	After 2008
Long-term debt	$50.0	-	-	-	-	-	$50.0
Investment commitments	$6.0	-	$1.7	-	$4.3	-	-
Operating lease obligations	$2.2	$0.7	$0.5	$0.4	$0.4	$0.2	-
Purchase obligations	$27.9	$27.9	-	-	-	-	-
Totals	**$86.1**	**$28.6**	**$2.2**	**$0.4**	**$4.7**	**$0.2**	**$50.0**

We do not have off-balance sheet financing arrangements and have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of or requirements for capital resources. See Notes 5 and 10 of Notes to Consolidated Financial Statements for additional information on our revenue bond and operating lease obligations, respectively. We have committed to invest an aggregate of $7.9 million in two private equity funds, of which $1.9 million has been invested to date. The duration of each of these commitments is five years with $2.9 million expiring in 2005 and $5.0 million expiring in 2007. At December 31, 2003, we had outstanding purchase agreements with vendors of approximately $27.9 million to purchase materials and services.

Effect of Recent Accounting Pronouncements

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("SFAS 150"). SFAS 150 establishes how an issuer classifies and measures certain freestanding financial instruments with characteristics of both liabilities and equity and requires that such instruments be classified as liabilities. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for those existing financial instruments subject to its provisions. We have not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003. Accordingly, SFAS 150 had no impact on our consolidated financial statements for the year ended December 31, 2003.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities.* In December 2003, the FASB issued FIN 46R (revised December 2003), which replaces FIN 46. FIN 46R clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do have sufficient equity at risk for the entity to finance its activities without additional subordinated support from other parties. FIN 46R is required to be applied to entities that are considered special-purpose entities no later than as of the end of the first reporting period that ends after December 15, 2003. Since we do not have any special-purpose entities, the accompanying consolidated financial statements for 2003 were not affected by FIN 46R. FIN 46R is required to be applied by March 31, 2004 to entities not considered to be special-purpose entities. We are currently evaluating this impact of FIN 46R and do not anticipate a material impact from such entities on our financial position, results of operations, or cash flows.

Management's Responsibility for Financial Reporting

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

Management maintains a comprehensive system of internal accounting controls and relies on the system to discharge its responsibility for the integrity of the financial statements. This system provides reasonable assurance that corporate assets are safeguarded, and that transactions are recorded in such a manner as to permit the preparation of reliable financial information. Reasonable assurance recognizes that the cost of a system of internal accounting controls should not exceed the related benefits. This system of internal accounting controls is augmented by written policies and procedures and the careful selection and training of qualified personnel. As of December 31, 2003, management was aware of no material weaknesses in the ADTRAN system of internal accounting controls.

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

Mark C. Smith
Chairman and Chief Executive Officer

James E. Matthews
Senior Vice President - Finance and Chief Financial Officer

Report of Independent Auditors

To the board of directors and stockholders of ADTRAN, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of ADTRAN, Inc. and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Birmingham, Alabama
February 16, 2004

Financial Statements

ADTRAN, Inc.

Consolidated Balance Sheets

December 31, 2003 and 2002

(In thousands, except per share amounts)

Assets	**2003**	**2002**
Current assets		
Cash and cash equivalents	$132,072	$125,092
Short-term investments	11,865	19,747
Accounts receivable, less allowance for doubtful accounts of $1,746 and $2,472 in 2003 and 2002, respectively	52,384	38,883
Other receivables	6,988	4,460
Income tax receivable	11,586	-
Inventory, net	39,975	39,926
Prepaid expenses	2,127	2,650
Deferred tax assets	3,381	4,799
Total current assets	**260,378**	**235,557**
Property, plant and equipment, net	97,667	106,174
Other assets	493	469
Deferred tax assets	1,628	2,682
Long-term investments	233,734	176,331
Total assets	**$593,900**	**$521,213**

Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$24,821	$15,555
Unearned revenue	3,209	2,234
Accrued expenses	2,476	2,193
Accrued payroll	9,658	6,257
Income tax payable	-	5,807
Other liabilities	145	-
Total current liabilities	**40,309**	**32,046**
Deferred tax liabilities	8,882	3,955
Other non-current liabilities	888	-
Bonds payable	50,000	50,000
Total liabilities	**100,079**	**86,001**
Commitments and contingencies (see Note 10)		
Stockholders' equity		
Common stock, par value $0.01 per share; 200,000 shares authorized; 79,294 and 39,445 shares issued in 2003 and 2002, respectively	793	394
Additional paid-in capital	135,814	96,982
Accumulated other comprehensive income	10,012	3,097
Retained earnings	347,202	375,010
Less treasury stock at cost: 4,125 shares in 2002	-	(40,271)
Total stockholders' equity	**493,821**	**435,212**
Total liabilities and stockholders' equity	**$593,900**	**$521,213**

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

ADTRAN, Inc.
Consolidated Statements of Income
Years ended December 31, 2003, 2002 and 2001

(In thousands, except per share amounts)	2003	2002	2001
Sales	$396,676	$345,725	$387,081
Cost of sales	174,681	170,789	213,760
Gross profit	**221,995**	**174,936**	**173,321**
Selling, general and administrative expenses	83,234	81,217	95,954
Research and development expenses	58,144	56,295	58,935
Operating income	**80,617**	**37,424**	**18,432**
Interest and dividend income	8,912	9,113	8,077
Interest expense	(2,534)	(2,572)	(2,069)
Other income (expense)	1,609	234	(29)
Net realized investment gains (losses)	226	(12,022)	(674)
Income before provision for income taxes	**88,830**	**32,177**	**23,737**
Provision for income taxes	27,315	7,401	6,408
Net income	**$61,515**	**$24,776**	**$17,329**
Weighted average shares outstanding	76,942	76,090	77,135
Weighted average shares outstanding assuming dilution (1)	80,739	76,443	77,353
Earnings per common share – basic	$0.80	$0.33	$0.22
Earnings per common share – assuming dilution (1)	$0.76	$0.32	$0.22

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

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

ADTRAN, Inc.
Consolidated Statements of Changes in Stockholders' Equity
Years ended December 31, 2003, 2002 and 2001

(In thousands)

	Common Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance, December 31, 2000	**39,445**	**$394**	**$96,707**	**$332,905**	**($15,452)**	**$19,870**	**$434,425**
Net income				17,329			17,329
Change in unrealized gain on marketable equity securities (net of deferred tax of $4,077)						(7,220)	(7,220)
Reclassification adjustment for amounts included in net income (net of income tax of $1,849)						(3,276)	(3,276)
Stock options exercised: various prices per share			(340)		793		453
Purchase of treasury stock: 215 shares					(4,100)		(4,100)
Income tax benefit from exercise of non-qualified stock options			17				17
Balance, December 31, 2001	**39,445**	**$394**	**$96,384**	**$350,234**	**($18,759)**	**$9,375**	**$437,628**
Net Income				24,776			24,776
Change in unrealized gain on marketable securities (net of deferred tax of $4,002)						(7,088)	(7,088)
Reclassification adjustment for amounts included in net income (net of income tax of $457)						810	810
Stock options exercised: various prices per share			1		3,695		3,696
Purchase of treasury stock: 1,340 shares					(25,207)		(25,207)
Income tax benefit from exercise of non-qualified stock options			597				597
Balance, December 31, 2002	**39,445**	**$394**	**$96,982**	**$375,010**	**($40,271)**	**$3,097**	**$435,212**
Net Income				61,515			61,515
Dividend payments				(88,926)			(88,926)
Change in unrealized gain on marketable securities (net of deferred tax of $4,484)						7,618	7,618
Reclassification adjustment for amounts included in net income (net of income tax of $576)						(997)	(997)
Unrealized foreign exchange translation (net of deferred tax $141)						294	294
Stock options exercised: various prices per share	214	2	14,814		40,271		55,087
100% stock dividend	39,635	397		(397)			0
Income tax benefit from exercise of non-qualified stock options			23,637				23,637
Issue of options below fair market value			381				381
Balance, December 31, 2003	**79,294**	**$793**	**$135,814**	**$347,202**	**$0**	**$10,012**	**$493,821**

ADTRAN issued 4,125 shares, 375 shares and 76 shares of treasury stock to accommodate employee stock option exercises during 2003, 2002 and 2001, respectively, and issued 214 shares of common stock to accommodate employee stock option exercises during 2003.

Comprehensive income in 2003 of $68,430 consists of net income of $61,515 and unrealized gains on marketable securities of $6,621 (net of deferred tax) and foreign currency translation adjustments of $294 (net of deferred tax).

Comprehensive income in 2002 of $18,498 consists of net income of $24,776 and unrealized losses on marketable securities of $6,278 (net of deferred tax).

Comprehensive income in 2001 of $6,833 consists of net income of $17,329 and unrealized losses on marketable securities of $10,496 (net of deferred tax).

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

ADTRAN, Inc.
Consolidated Statements of Cash Flows
Years ended December 31, 2003, 2002 and 2001

(In thousands)	2003	2002	2001
Cash flows from operating activities			
Net income	$61,515	$24,776	$17,329
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	15,247	16,406	16,799
Loss on sale of property, plant and equipment	3	101	-
Loss (gain) on sale of short-term investments	-	(31)	180
Loss (gain) on sale of long-term investments	(226)	426	(5,159)
Write-down of other equity and debt securities	-	11,627	5,653
Non-cash compensation expense	381	-	-
Deferred income taxes	2,812	1,210	(2,527)
Income tax benefit from exercise of non-qualified stock options	23,638	597	16
Change in operating assets and liabilities:			
Accounts receivable, net	(13,502)	21,716	21,535
Other receivables	(2,528)	5,150	26,250
Income tax receivable	(11,586)	-	-
Inventory, net	(49)	16,923	32,403
Prepaid expenses and other assets	498	857	526
Accounts payable	10,241	2,237	(18,562)
Accrued expenses	3,683	728	(839)
Income taxes payable	(4,773)	2,455	(382)
Net cash provided by operating activities	**85,354**	**105,178**	**93,222**
Cash flows from investing activities			
Expenditures for property, plant and equipment	(6,782)	(2,647)	(13,216)
Proceeds from the disposition of property, plant and equipment	38	100	-
Proceeds from sale of available-for-sale investments	68,496	145,510	36,282
Purchases of available-for-sale investments	(114,462)	(189,386)	(97,793)
Proceeds from maturities of held-to-maturity investments	18,738	42,377	59,228
Purchases of held-to-maturity investments	(10,856)	(35,810)	(53,544)
Net cash used in investing activities	**(44,828)**	**(39,856)**	**(69,043)**
Cash flows from financing activities			
Proceeds from issuance of common stock	55,087	3,696	453
Purchase of treasury stock	-	(25,206)	(4,100)
Dividend payments	(88,927)	-	-
Net cash used in financing activities	**(33,840)**	**(21,510)**	**(3,647)**
Net increase in cash and cash equivalents	6,686	43,812	20,532
Effect of exchange rate changes	294	-	-
Cash and cash equivalents, beginning of year	**125,092**	**81,280**	**60,748**
Cash and cash equivalents, end of year	**$132,072**	**$125,092**	**$81,280**
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	$2,576	$2,529	$1,867
Cash paid during the year for income taxes	$14,061	$8,498	$11,761

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

Notes to Consolidated Financial Statements

1 Nature of Business and Summary of Significant Accounting Policies

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

Principles of Consolidation

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

Cash and Cash Equivalents

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

Financial Instruments

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

Investments represent re-marketed preferred stocks, municipal bonds, and marketable equity securities. Re-marketed preferred stocks and variable rate municipal bonds are designed to be marketed as money market instruments. These instruments' dividend rates reset on a short-term basis to maintain the price of the instruments at par. These instruments may be redeemed on the date the interest rate resets. The fair value of short-term investments is estimated based on quoted market prices (see Note 2).

Long-term investments represent restricted money market funds, municipal bonds, marketable equity securities, and other equity and debt investments (see Note 2). The fair value of the restricted money market funds approximates fair value due to a variable interest rate. Marketable equity securities are reported at market value as determined by the most recently traded price of the securities at the balance sheet date, although the securities may not be readily marketable due to the size of the available market. Unrealized gains and losses, net of tax, are reported as a separate component of stockholders' equity. Realized gains and losses on sales of securities are computed under the specific identification method and are included in current income. We periodically review our investment portfolio for investments considered to have sustained an other-than-temporary decline in value. Impairment charges for other-than-temporary declines in value are recorded as realized losses in the accompanying consolidated statements of income (see Note 2). Our investments at December 31, 2003 and 2002 are classified as available-for-sale or held-to-maturity.

Other Receivables

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

Inventory

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

Property, Plant and Equipment

Property, plant and equipment, which are stated at cost, are depreciated using methods which approximate straight-line depreciation over the estimated useful lives of the assets. We depreciate building and land improvements from five to 39 years, office machinery and equipment from three to seven years, and engineering machinery and equipment from three to seven years. Expenditures for repairs and maintenance are charged to expense as incurred. Betterments that materially prolong the lives of the assets are capitalized. The cost of assets retired or otherwise disposed of and the related accumulated depreciation are removed from the accounts, and the gain or loss on such disposition is included in selling, general and administrative expenses in the accompanying consolidated statements of income.

Liability for Warranty Returns

Our products generally include warranties of one to 10 years for product defects. We accrue for warranty returns at the cost to repair or replace the defective products at the time revenue is recognized. We engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers. Our warranty obligation is affected by product failure rates, material usage, and other rework costs incurred in correcting a product failure. The liability for warranty returns totaled $1.5 million and $1.4 million at December 31, 2003 and 2002, respectively. These liabilities are included in accrued expenses in the accompanying consolidated balance sheets.

		Additions			
(In thousands)	Balance at Beginning of Period	Charged (Credited) to Costs & Expenses	Charged (Credited) to Other Accounts	Deductions	Balance at End of Period
Year ended December 31, 2003					
Warranty liability	$1,384	$3,034	-	$2,877	$1,541
Year ended December 31, 2002					
Warranty liability	$1,277	$3,846	-	$3,739	$1,384

Impairment of Long-Lived Assets

We review long-lived assets for impairment under the guidance prescribed by SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. We evaluate long-lived assets used in operations for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying values. An impairment loss would be recognized in the amount by which the recorded value of the asset exceeds the fair value of the asset, measured by the quoted market price of an asset or an estimate based on the best information available in the circumstances. There were no such losses recognized during 2003, 2002 and 2001.

Research and Development Costs

Research and development costs are expensed as incurred and include compensation for engineers, support personnel, outside contracted services, and material costs associated with new product development, the enhancement of current products, and product cost reductions. We continually evaluate new product opportunities and engage in intensive research and product development efforts. Research and development costs totaled $58.1 million, $56.3 million and $58.9 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense was $2.2 million, $2.8 million and $2.9 million for the years ended December 31, 2003, 2002 and 2001, respectively.

Comprehensive Income

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

Income Taxes

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

Foreign Currency

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

Revenue Recognition

Revenue is generally recognized upon shipment of the product to the customer in accordance with the terms of the sales agreement, or in the case of remote customer-located warehouses, upon delivery to the customer. Shipping fees are recorded as revenue and the related cost is included in cost of sales. Revenue is recorded net of discounts. Also, revenue is recorded when the product price is fixed and determinable, collection of the resulting receivable is probable, and product returns are reasonably estimable.

We participate in cooperative advertising and market development programs with certain customers. These programs are used to reimburse customers for certain forms of advertising and to provide sales incentives, and in general, allow customers credit up to a specified percentage of their net purchases. The costs associated with these programs are estimated and accrued at the time of sale, and are included in either marketing expenses or as a reduction of sales in the accompanying consolidated statements of income.

Unearned Revenue

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

Other Income (Expense)

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

Stock-Based Compensation

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

We apply APB Opinion No. 25 and related interpretations in accounting for our stock option plans. Had compensation cost for our stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method prescribed in SFAS No. 123, net income and earnings per share would have been reduced to the pro forma amounts indicated below:

Pro Forma Net Income (Loss) & Earnings (Loss) Per Share

(In thousands, except per share amounts)	2003	2002	2001
Net income - as reported	$61,515	$24,776	$17,329
Add: stock-based compensation expense, included in reported net income, net of tax	216	-	-
Less: stock-based compensation expense, net of tax	(22,755)	(21,998)	(17,869)
Net income (loss) - pro forma	$38,976	$2,778	($540)
Earnings (loss) per share			
Basic - as reported	$0.80	$0.33	$0.22
Basic - pro forma	$0.50	$0.04	($0.01)
Diluted - as reported	$0.76	$0.32	$0.22
Diluted - pro forma	$0.48	$0.04	($0.01)

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

Weighted Average Assumption

	2003	2002	2001
Expected dividend yield	0.93%	0%	0%
Expected life (years)	5.00	4.21	5.00
Expected volatility	55.9%	49.6%	53.1%
Risk-free interest rate	3.20%	3.30%	4.72%

Earnings Per Share

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

Dividends

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. On January 20, 2004, the board of directors declared a quarterly cash dividend. The quarterly cash dividend is $0.08 per common share to be paid to holders of record at the close of business on February 3, 2004. The ex-dividend date was January 30, 2004 and the payment date was February 17, 2004. The quarterly dividend payment was approximately $6.3 million.

Stock Split

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

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. The more significant estimates include the bad debt allowance, obsolete and excess inventory reserves, warranty reserve, and estimated income tax contingencies. Actual results could differ from those estimates.

Reclassifications

Certain reclassifications have been made to the 2002 and 2001 consolidated financial statements in order to conform to the 2003 presentation. These reclassifications had no effect on previously reported net income, cash flows from operations, cash flows from investing activities, or total stockholders' equity.

Recently Issued Accounting Standards

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* ("SFAS 150"). SFAS 150 establishes how an issuer classifies and measures certain freestanding financial instruments with characteristics of both liabilities and equity and requires that such instruments be classified as liabilities. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for those existing financial instruments subject to its provisions. We have not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003. Accordingly, SFAS 150 had no impact on our consolidated financial statements for the year ended December 31, 2003.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*. In December 2003, the FASB issued FIN 46R (revised December 2003), which replaces FIN 46. FIN 46R clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do have sufficient equity at risk for the entity to finance its activities without additional subordinated support from other parties. FIN 46R is required to be applied to entities that are considered special-purpose entities no later than as of the end of the first reporting period that ends after December15, 2003. Since we do not have any special-purpose entities, the accompanying consolidated financial statements for 2003 were not affected by FIN 46R. FIN 46R is required to be applied by March 31, 2004, to entities not considered to be special-purpose entities. We are currently evaluating this impact of FIN 46R and do not anticipate a material impact from such entities on our financial position, results of operations, or cash flows.

2 Investments

We classify our securities as either available-for-sale or held-to-maturity. At December 31, 2003 and 2002, we held the following securities, recorded at either fair value or amortized cost, which approximates fair value.

December 31, 2003

(In thousands) Available-for-sale securities	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Restricted money market funds	$50,000			$50,000
Municipal bonds and fixed income mutual funds	159,055	$2,002	($356)	160,701
Marketable equity securities	15,939	13,741	(177)	29,503
Other equity securities	1,976			1,976
Total available-for-sale securities	**$226,970**	**$15,743**	**($533)**	**$242,180**
Held-to-maturity securities				
Municipal bonds and other government fixed income securities	$3,069			$3,069
Other debt securities	350			350
Total held-to-maturity securities	**$3,419**			**$3,419**

December 31, 2002

(In thousands) **Available-for-sale securities**	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Restricted money market funds	$50,000			$50,000
Municipal bonds and fixed income mutual funds	103,849	$2,073	($237)	105,685
Marketable equity securities	22,669	3,831	(1,100)	25,400
Other equity securities	911			911
Total available-for-sale securities	**$177,429**	**$5,904**	**($1,337)**	**$181,996**
Held-to-maturity securities				
Municipal bonds and other government fixed income securities	$13,679			$13,679
Other debt securities	404			404
Total held-to-maturity securities	**$14,083**			**$14,083**

Gross realized gains on the sale of securities were approximately $2.2 million, $1.4 million and $6.0 million for the years ended December 31, 2003, 2002 and 2001, respectively. Gross realized losses on the sale of securities were approximately $2.0 million, $1.7 million and $1.2 million for the years ended December 31, 2003, 2002 and 2001, respectively. As of December 31, 2003 and 2002, we had no unrealized losses with a duration greater than 12 months. The fair values of investments with unrealized losses were $86.5 million and $29.9 million at December 31, 2003 and 2002, respectively. During 2002, we recognized gross losses of $9.6 million on available-for-sale equity investments due to impairments that were deemed to be other-than-temporary.

We also invest in privately held companies and record our investments in these entities at cost. As of December 31, 2003 and 2002, we had $2.3 million and $1.3 million, respectively, of investments carried at cost. These investments are included in our total long-term investments in the accompanying consolidated balance sheets. We review our investments in these entities periodically in order to determine if circumstances (both financial and non-financial) exist that indicate that we will not recover our initial investment. Impairment charges are recorded on investments having a cost basis that is greater than the value that we would reasonably expect to receive in an arm's length sale of the investment. During 2003, 2002 and 2001, we recognized gross losses of $0, $2.0 million and $5.5 million, respectively, on cost-basis investments.

We have committed to invest an aggregate of $7.9 million in two private equity funds, of which $1.9 million has been invested to date. The duration of each of these commitments is five years, with $2.9 million expiring in 2005 and $5.0 million expiring in 2007. This investment is included in our total available-for-sale investments, and is classified in long-term investments in the accompanying consolidated balance sheets.

3 Inventory

At December 31, 2003 and 2002, inventory was comprised of the following:

(In thousands)	**2003**	**2002**
Raw materials	$19,526	$23,259
Work in process	3,937	2,839
Finished goods	19,614	18,265
Inventory reserve	(3,102)	(4,437)
Total	**$39,975**	**$39,926**

4 Property, Plant and Equipment

At December 31, 2003 and 2002, property, plant and equipment was comprised of the following:

(In thousands)	2003	2002
Land	$4,263	$4,263
Building	70,430	70,296
Land improvements	14,442	14,442
Office machinery and equipment	55,560	51,123
Engineering machinery and equipment	53,312	51,145
Total property, plant and equipment	**198,007**	**191,269**
Less accumulated depreciation	(100,340)	(85,095)
Total property, plant and equipment (net)	**$97,667**	**$106,174**

Depreciation expense was $15.2 million, $16.4 million and $16.8 million in 2003, 2002 and 2001, respectively.

5 Alabama State Industrial Development Authority Financing and Economic Incentives

In conjunction with an expansion of our Huntsville, Alabama, facility, we were approved for participation in an incentive program offered by the State of Alabama Industrial Development Authority (the "Authority"). Pursuant to the program, on January 13, 1995, the Authority issued $20.0 million of its taxable revenue bonds and loaned the proceeds from the sale of the bonds to ADTRAN. The bonds were originally purchased by AmSouth Bank of Alabama, Birmingham, Alabama, (the "Bank"). First Union National Bank of Tennessee, Nashville, Tennessee, (the "Bondholder") purchased the original bonds from the Bank and made further advances to the Authority, bringing the total amount outstanding to $50.0 million. An Amended and Restated Taxable Revenue Bond ("Amended and Restated Bond"), was issued and the original financing agreement was amended. The Amended and Restated Bond bears interest, payable monthly. In 2003, the interest rate was 5%. The Amended and Restated Bond matures on January 1, 2020. The estimated market value of the bond at December 31, 2003, was approximately $46.7 million. We are required to make payments to the Authority in amounts necessary to pay the principal of and interest on the Amended and Restated Bond. Included in long-term investments is $50.0 million, which is invested in restricted money market funds. These funds serve as collateral deposit against the principal of this bond. In conjunction with this program, we are eligible to receive certain economic incentives from the state of Alabama that reduce the amount of payroll withholdings that we are required to remit to the state for those employment positions that qualify under the program. Our economic incentives realized for the years ended December 31, 2003, 2002 and 2001 were $1.5 million, $1.2 million and $1.3 million, respectively.

6 Income Taxes

A summary of the components of the provision for income taxes as of December 31, 2003, 2002 and 2001 is as follows:

(In thousands)	2003	2002	2001
Current			
Federal	$23,247	$5,695	$6,919
State	1,256	496	2,017
Total Current	**24,503**	**6,191**	**8,936**
Deferred tax provision (benefit)	2,812	1,210	(2,527)
Total provision for income taxes	**$27,315**	**$7,401**	**$6,409**

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

(In thousands)	2003	2002	2001
Tax provision computed at the Federal statutory rate (35% in 2003, 2002 and 2001)	$31,091	$11,262	$8,308
State income tax provision, net of Federal benefit	2,028	1,380	2,314
Federal research credits	(2,270)	(2,200)	(2,386)
Tax-exempt income	(1,546)	(1,724)	(898)
State tax incentives	(1,539)	(1,156)	(1,326)
Other	(449)	(161)	397
Total provision for income taxes	**$27,315**	**$7,401**	**$6,409**

Temporary differences which created deferred tax assets and liabilities at December 31, 2003 and 2002 are as follows:

(In thousands)	2003		2002	
	Current	Non-Current	Current	Non-Current
Accumulated depreciation		($5,185)		($4,651)
Investments		(2,069)		3,799
Accounts receivable	$639		$892	
Inventory	1,687		1,807	
Accruals	1,055		2,100	(421)
State research credits		441		
Valuation allowance		(441)		
Deferred tax asset (liability)	**$3,381**	**($7,254)**	**$4,799**	**($1,273)**

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

We recorded $23.6 million, $0.6 million and $0.1 million during the years ended 2003, 2002 and 2001, respectively, as an income tax deduction for the difference between the exercise price and the market price of nonqualified stock option exercises.

7 Stock Option Plans

Our board of directors adopted the 1996 Employees Incentive Stock Option Plan (the "1996 Plan") effective February 14, 1996, as amended, under which 16,976,200 shares of common stock were reserved for issuance to certain employees and officers through incentive stock options and non-qualified stock options. We currently have options outstanding under the 1986 Employee Incentive Stock Option Plan (the "1986 Plan"), which expired on February 14, 1996. Options granted under the 1996 Plan or the 1986 Plan become exercisable after one year of continued employment, normally pursuant to a four or five-year vesting schedule beginning on the first anniversary of the grant date. Expiration dates of options outstanding under the 1996 Plan and the 1986 Plan at December 31, 2003, range from 2005 to 2013.

The board of directors adopted the 1995 Directors Stock Option Plan ("Directors Plan") effective October 31, 1995, as amended, under which 400,000 shares of common stock have been reserved. The Directors Plan is a formula plan to provide options to our non-employee directors. At December 31, 2003, 394,500 options had been granted under the Directors Plan, 72,000 options had been cancelled or forfeited, and 77,500 options remained available for grant. Expiration dates of options outstanding under the Directors Plan at December 31, 2003, range from 2006 to 2013.

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

Pertinent information regarding our stock option plans is as follows:

(In thousands, except per share amounts)	Number of Options	Range of Exercise Prices	Weighted Average Exercise Price	Vesting Provisions
Options outstanding, December 31, 2000	**8,087**	**$0.84 - $34.91**	**$22.01**	**Various**
Options granted	2,886	$9.62 - $14.04	$12.77	Various
Options cancelled/forfeited	(534)	$10.65 - $34.91	$22.02	Various
Options exercised	(73)	$0.84 - $12.69	$6.18	Various
Options outstanding, December 31, 2001	**10,366**	**$0.84 - $34.91**	**$13.66**	**Various**
Options granted	4,312	$8.69 - $16.45	$9.82	Various
Options cancelled/forfeited	(3,297)	$8.70 - $34.91	$31.75	Various
Options exercised	(397)	$1.25 - $15.18	$9.97	Various
Options outstanding, December 31, 2002	**10,984**	**$1.67 - $34.91**	**$12.43**	**Various**
Options granted	747	$18.04 - $36.64	$31.44	Various
Options cancelled/forfeited	(118)	$1.67 - $34.91	$14.28	Various
Options exercised	(4,550)	$1.67 - $34.91	$12.23	Various
Options outstanding, December 31, 2003	**7,063**	**$8.69 - $36.64**	**$14.53**	**Various**

The following table summarizes information about stock options outstanding at December 31, 2003:

Options Outstanding at December 31, 2003

(In thousands, except per share amounts)

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$8.69 - $9.72	757	6.48	$8.73	337	$8.75
$9.90 - $13.75	4,253	7.70	$11.53	1,421	$11.56
$14.03 - $17.94	204	7.62	$14.99	92	$15.98
$18.03 - $24.78	1,109	5.65	$18.15	716	$18.12
$28.18 - $36.64	740	9.75	$32.20	23	$34.17
Total	**7,063**			**2,589**	

Of the options above, 7,056,907 were issued at exercise prices that approximate fair market value at the date of grant and 6,000 were issued below fair market value at the date of grant. At December 31, 2003, 4,824,500 options were available for grant under the plans.

8 Employee Benefit Plan

Effective January 1, 1990, we adopted a savings plan (the "Savings Plan") for the benefit of eligible employees. The Savings Plan allows employees to contribute part of their compensation to the plan on a tax-deferred basis, and requires us to contribute an amount equal to 3% of compensation each year for eligible employees who have completed a year of service. The Savings Plan is intended to qualify under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended (the "Code"), and is intended to be a "safe harbor" 401(k) plan under code Section 401(k)(12). Prior to January 1, 2001, we contributed matching contributions in an amount equal to 50% of each eligible employee's elective deferrals under the Savings Plan, up to 5% of the employee's compensation for the plan year. Effective January 1, 2001, the plan requires us to contribute a "safe harbor" amount equal to 3% of compensation each year for eligible employees who have completed a year of service up to the statutory maximum compensation ($200,000 for 2003). Employees who become eligible for the safe harbor contribution during the plan year are eligible for 3% of compensation, including compensation earned during any portion of the plan year during which the employee was eligible to defer, but not yet eligible for the safe harbor contribution. All contributions under the Savings Plan are 100% vested. Charges to operations for employer contributions and plan administration for the Savings Plan amounted to approximately $2.5 million, $2.1 million and $2.5 million in 2003, 2002 and 2001, respectively.

9 Segment Information and Major Customers

ADTRAN operates two reportable segments: (1) Carrier Networks Division and (2) Enterprise Networks Division. The accounting policies of the segments are the same as those described in the "Summary of Significant Accounting Policies" (see Note 1) to the extent that such policies affect the reported segment information. We evaluate the performance of our segments based on gross profit; therefore, selling, general and administrative costs, as well as research and development, other income, interest income/expense, net realized investment gains (losses), and provision for taxes are reported on an entity-wide basis only. There are no inter-segment revenues.

The following table presents information about the reported sales and gross profit of our reportable segments for each of the years ended December 31, 2003, 2002 and 2001. Asset information by reportable segment is not reported, since we do not produce such information internally.

Sales by Market Segment

(In thousands)	2003		2002		2001	
	Sales	Gross Profit	Sales	Gross Profit	Sales	Gross Profit
Carrier Networks	$267,563	$145,007	$218,912	$105,277	$238,367	$93,644
Enterprise Networks	129,113	76,988	126,813	69,659	148,714	79,677
Total	**$396,676**	**$221,995**	**$345,725**	**$174,936**	**$387,081**	**$173,321**

Sales by Product

The Digital Business Transport (DBT)/Total Reach category is comprised of revenue from ISDN and DDS transport and connectivity products sold to carrier and enterprise customers. The High-bit-rate Digital Subscriber Line (HDSL)/T1 category is comprised of revenue from HDSL-related carrier products and T1 CSU/DSU enterprise products. The Systems category includes revenue from Total Access narrowband products, M13 multiplexers, integrated access devices and new products comprised of NetVanta routers, Internet security products, DSLAM products, and optical access products.

The following is sales information by product for the years ended December 31, 2003, 2002 and 2001:

(In thousands)	2003	2002	2001
Digital Business Transport (DBT)/Total Reach	$31,850	$44,932	$86,794
High-bit-rate Digital Subscriber Line (HDSL)/T1	193,235	196,892	200,919
Systems	171,591	103,901	99,368
Total	**$396,676**	**$345,725**	**$387,081**

Sales by Geographic Region

The following is sales information by geographic area for the years ended December 31, 2003, 2002 and 2001:

(In thousands)	2003	2002	2001
United States	$377,060	$325,429	$369,422
All other	19,616	20,296	17,659
Total	**$396,676**	**$345,725**	**$387,081**

Single customers comprising more than 10% of our revenue in 2003 included SBC Communications, Inc. at 22.9%, Verizon Communications, Inc. at 15.0%, and Sprint Corporation at 13.8%. No other customer accounted for 10% or more of our sales in 2003. Sales of network access equipment to Incumbent Local Exchange Carriers (ILECs) and major independent telecommunications companies amounted to approximately 60%, 57% and 59% of total sales during the years ended December 31, 2003, 2002 and 2001, respectively. Our Enterprise Networks Division sells a significant portion of products to value-added resellers through a multi-tier distribution system. Our total sales of this type amounted to 25%, 25% and 26% of our revenue for each of the years ended December 31, 2003, 2002 and 2001, respectively, and were routed through four primary fulfillment distributors.

As of December 31, 2003, long-lived assets totaled $97.7 million, which includes $97.5 million held in the United States and $0.2 million held outside the United States. As of December 31, 2002, long-lived assets totaled $106.2 million, which includes $106.0 million held in the United States and $0.2 million held outside the United States.

10 Commitments and Contingencies

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

We lease office space and equipment under operating leases which expire at various dates through 2008. As of December 31, 2003, future minimum rental payments under non-cancelable operating leases with original maturities of greater than 12 months are approximately as follows:

(In thousands)	
2004	$684
2005	489
2006	410
2007	356
2008	152
Total	**$2,091**

Rental expense was approximately $1.9 million, $2.1 million and $2.2 million in 2003, 2002 and 2001, respectively.

We have various contractual obligations and commercial commitments. The following table sets forth, in millions, the annual payments, exclusive of interest payments, we are required to make under contractual cash obligations and other commercial commitments at December 31, 2003.

Contractual Obligations

(In millions)

	Total	2004	2005	2006	2007	2008	After 2008
Long-term debt	$50.0	-	-	-	-	-	$50.0
Investment commitments	$6.0	-	$1.7	-	$4.3	-	-
Operating lease obligations	$2.2	$0.7	$0.5	$0.4	$0.4	$0.2	-
Purchase obligations	$27.9	$27.9	-	-	-	-	-
Totals	**$86.1**	**$28.6**	**$2.2**	**$0.4**	**$4.7**	**$0.2**	**$50.0**

We do not have off-balance sheet financing arrangements. At December 31, 2003, we had outstanding purchase agreements with vendors of approximately $27.9 million to purchase materials and services. Additionally, we have committed to invest an aggregate of $7.9 million in two private equity funds, of which $1.9 million has been invested to date. The duration of each of these commitments is five years with $2.9 million expiring in 2005 and $5.0 million expiring in 2007.

11 Earnings Per Share

A summary of the calculation of basic and diluted earnings per share (EPS) for the years ended December 31, 2003, 2002 and 2001 is as follows:

(In thousands, except per share amounts)

For the Year Ended December 31, 2003

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

For the Year Ended December 31, 2002

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

For the Year Ended December 31, 2001

Basic EPS			
Net income	$17,329	77,135	$0.22
Effect of dilutive securities			
Stock options		218	
Diluted EPS			
Income available to common stockholders (with dilution) for assumed options exercised	$17,329	77,353	$0.22

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

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

Outstanding Options

(In thousands, except per share amounts)

2003			2002			2001		
Options Granted	Exercise Price	Expiration	Options Granted	Exercise Price	Expiration	Options Granted	Exercise Price	Expiration
2	$32.88	2006	44	$15.88 - $20.50	2005	69	$15.25 - $23.13	2005
28	$34.91	2010	28	$15.25 - $20.75	2006	448	$15.25 - $32.88	2006
740	$28.18 - $36.64	2013	847	$12.69 - $21.36	2007	945	$12.69 - $21.19	2007
			20	$13.13 - $15.50	2008	23	$13.13 - $15.50	2008
			1,749	$17.93 - $19.85	2009	1,934	$12.69 - $25.72	2009
			120	$19.50 - $34.91	2010	2,549	$19.50 - $34.91	2010
			2,621	$12.67 - $14.04	2011	2,792	$12.67 - $14.04	2011
			171	$12.99 - $16.45	2012			

12 Summarized Quarterly Financial Data (Unaudited)

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

Unaudited Quarterly Operating Results

(In thousands, except for per share amounts)

Three months ended	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Net sales	$86,223	$90,437	$106,201	$113,815
Gross profit	$47,073	$49,670	$58,917	$66,304
Operating income	$12,650	$15,715	$23,305	$30,315
Net income	$10,539	$12,379	$17,165	$21,432
Earnings per common share assuming dilution (2)	$0.14	$0.15	$0.21	$0.26
Earnings per common share	$0.14	$0.16	$0.22	$0.27

Three months ended	March 31, 2002	June 30, 2002	September 30, 2002	December 31, 2002
Net sales	$83,342	$85,784	$88,180	$88,419
Gross profit	$39,359	$41,623	$45,525	$48,429
Operating income	$4,735	$6,710	$11,930	$14,150
Net income (1)	$4,341	$4,967	$3,358	$12,110
Earnings per common share assuming dilution (2)	$0.06	$0.06	$0.04	$0.16
Earnings per common share	$0.06	$0.06	$0.04	$0.16

(1) Net Income for the three months ended June 30, 2002, and September 30, 2002, includes other-than-temporary investment impairment charges, amounting to an after-tax loss of $0.9 million and $6.6 million, respectively.

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

13 Related Party Transactions

We paid the law firm of one of our directors emeritus $120,000 in fees for legal services rendered to us during 2003. 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.

One of our non-employee directors is the President – Customer Markets, of one of our significant customers. For fiscal year 2003, we received payments, directly and indirectly, from this customer in the amount of approximately $22.8 million for products supplied to this customer. We also paid to this customer $566,938 for services provided to us.

Directors and Executive Officers

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

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

Richard A. Anderson
Director of the Company, President of Customer Markets for BellSouth Corporation

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

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

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

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

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

Lonnie S. McMillian
Director Emeritus, retired Senior Vice President of the Company

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

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

Peter C. Voetsch
Senior Vice President – Operations

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

Robert A. Fredrickson
Vice President – Carrier Networks Sales

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

P. Steven Locke
Vice President – Carrier Networks Marketing

Everette R. Ramage
Vice President – Enterprise Networks Engineering

Kevin W. Schneider
Chief Technology Officer

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

Independent Auditors
PricewaterhouseCoopers LLP
Birmingham, Alabama

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

Special Counsel
McKenna Long & Aldridge LLP
Atlanta, Georgia

Form 10-K
ADTRAN's 2003 Annual Report on Form 10-K (without exhibits) as filed with the Securities and Exchange Commission is available to stockholders without charge upon written request to:

Investor Relations
ADTRAN, Inc.
901 Explorer Blvd.
P.O. Box 140000
Huntsville, Alabama 35814-4000
256 963-8611 or 256 963-8220
investorrelations@adtran.com (e-mail)

Annual Meeting
The 2004 Annual Meeting of Shareholders will be held at ADTRAN corporate headquarters, 901 Explorer Boulevard, Huntsville, Alabama, on Thursday, April 15, 2004, at 10:30 a.m. Central time.

Forward-Looking Statements

This Annual Report contains forward-looking statements which reflect management's best judgment based on factors currently known. However, these statements involve risks and uncertainties, including the successful development and market acceptance of new products, the degree of competition in the market for such products, the product and channel mix, component costs, manufacturing efficiencies, and other risks discussed in this Annual Report under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" and detailed in our annual report on Form 10-K for the year ended December 31, 2003 and in our other filings with the Securities and Exchange Commission. These risks and uncertainties could cause actual results to differ materially from those in the forward-looking statements included in this Annual Report.

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

Experts choose ADTRAN.™

ADTRAN®

Corporate Headquarters

ADTRAN, Inc.
901 Explorer Boulevard
Huntsville, AL 35806
USA

P.O. Box 140000
Huntsville, AL 35814-4000

+1 800 9ADTRAN
+1 256 963-8000 voice
+1 256 963-8004 fax
investorrelations@adtran.com e-mail

For the addresses, phone numbers, and contact information for ADTRAN domestic branch offices, visit *www.adtran.com/regional*

Global Offices

Asia Pacific—Beijing, China
+86 10 8527 5011 voice

Asia Pacific—Guangzhou, China
+86 20 8384 6015 voice

Asia Pacific—Hong Kong, China
+852 2824 8283 voice

Asia Pacific—Melbourne, Australia
+61 3 9658 0500 voice

Canada—Montreal, Quebec
+1 877 923 8726 voice

Canada—Toronto, Ontario
+1 416 290 0585 voice

EMEA Regional Headquarters—
Dublin, Ireland
+353 1 699 4790 voice

EMEA Sales Office—
Bad Homburg, Germany
+49 6172 483 2304 voice

Latin America/Caribbean*
+1 954 474 4424 voice

Mexico/Brazil*
+1 909 738 0907 voice

*Gateway office located in south Florida, USA.

ISO 9001:2000 QUALITY

ADTRAN is an ISO 9001:2000 certified supplier.

TL 9000 TELECOMMUNICATIONS

ADTRAN is a TL 9000 3.0 certified supplier.

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

Experts choose ADTRAN.™ ADTRAN®

www.adtran.com