

ADTRAN INC
Form 10-Q
August 01, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended June 30, 2007

OR

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

Commission File Number 0-24612

ADTRAN, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State of Incorporation)

63-0918200
(I.R.S. Employer

Identification No.)

901 Explorer Boulevard, Huntsville, Alabama 35806-2807

(Address of principal executive offices, including zip code)

(256) 963-8000

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(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer Accelerated Filer Non-accelerated Filer

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

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

| Class | Outstanding at July 26, 2007 |
|-------------------------------|------------------------------|
| Common Stock, \$.01 Par Value | 68,450,155 shares |

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The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by or on behalf of ADTRAN. ADTRAN and its representatives may from time to time make written or oral forward-looking statements, including statements contained in this report, our other filings with the Securities and Exchange Commission (SEC) and in our reports to our stockholders. Generally, the words, believe, expect, intend, estimate, anticipate, will, may, could and similar expressions identify forward-looking statements. We caution that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. A list of factors that could materially affect our business, financial condition or operating results is included under "Factors that Could Affect Our Future Results" in "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in Item 2 of Part I of this report. They have also been discussed in Item 1A of Part I in our most recent Annual Report on Form 10-K filed on February 28, 2007 with the SEC. Though we have attempted to list comprehensively these important factors, we caution investors that other factors may prove to be important in the future in affecting our operating results. New factors emerge from time to time, and it is not possible for us to predict all of these factors, nor can we assess the impact each factor or a combination of factors may have on our business.

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

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ADTRAN, INC.****CONSOLIDATED BALANCE SHEETS**

(In thousands, except per share amounts)

| | June 30, 2007 (Unaudited) | December 31, 2006 |
|--|---------------------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 22,061 | \$ 40,147 |
| Short-term investments | 152,494 | 99,700 |
| Accounts receivable, less allowance for doubtful accounts of \$302 at June 30, 2007 and \$210 at December 31, 2006 | 66,422 | 56,769 |
| Other receivables | 4,351 | 7,481 |
| Income tax receivable, net | | 1,446 |
| Inventory, net | 42,790 | 53,117 |
| Prepaid expenses | 1,668 | 2,590 |
| Deferred tax assets, net | 7,930 | 7,915 |
| Total current assets | 297,716 | 269,165 |
| Property, plant and equipment, net | 78,604 | 80,194 |
| Deferred tax assets, net | 298 | |
| Other assets | 527 | 534 |
| Long-term investments | 156,848 | 189,765 |
| Total assets | \$ 533,993 | \$ 539,658 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 27,226 | \$ 30,321 |
| Unearned revenue | 5,572 | 5,802 |
| Accrued expenses | 4,611 | 3,827 |
| Accrued wages and benefits | 9,605 | 9,579 |
| Income tax payable, net | 149 | |
| Total current liabilities | 47,163 | 49,529 |
| Deferred tax liabilities, net | | 694 |
| Other non-current liabilities | 7,649 | 4,667 |
| Bonds payable | 48,812 | 48,812 |
| Total liabilities | 103,624 | 103,702 |
| Commitments and contingencies (see Note 10) | | |
| Stockholders Equity | | |

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| | | |
|--|-------------------|-------------------|
| Common stock, par value \$0.01 per share; 200,000 shares authorized; 79,652 shares issued at June 30, 2007 and December 31, 2006 | 797 | 797 |
| Additional paid in capital | 160,484 | 152,162 |
| Accumulated other comprehensive income | 5,039 | 2,696 |
| Retained earnings | 526,181 | 513,515 |
| Less treasury stock at cost: 11,279 shares at June 30, 2007 and 10,180 shares at December 31, 2006 | (262,132) | (233,214) |
| Total stockholders' equity | 430,369 | 435,956 |
| Total liabilities and stockholders' equity | \$ 533,993 | \$ 539,658 |

See notes to consolidated financial statements

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ADTRAN, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Sales | \$ 123,674 | \$ 122,296 | \$ 233,986 | \$ 230,944 |
| Cost of sales | 50,115 | 49,865 | 94,637 | 94,005 |
| Gross profit | 73,559 | 72,431 | 139,349 | 136,939 |
| Selling, general and administrative expenses | 26,155 | 26,344 | 52,631 | 51,031 |
| Research and development expenses | 19,546 | 17,469 | 37,904 | 35,235 |
| Operating income | 27,858 | 28,618 | 48,814 | 50,673 |
| Interest income | 3,006 | 3,413 | 5,914 | 6,911 |
| Interest expense | (626) | (633) | (1,245) | (1,267) |
| Net realized investment gain | 185 | 474 | 268 | 1,074 |
| Other income, net | 199 | 410 | 497 | 349 |
| Life insurance proceeds | | | 1,000 | |
| Income before provision for income taxes | 30,622 | 32,282 | 55,248 | 57,740 |
| Provision for income taxes | (10,779) | (11,468) | (18,477) | (20,671) |
| Net income | \$ 19,843 | \$ 20,814 | \$ 36,771 | \$ 37,069 |
| Weighted average shares outstanding - basic | 68,797 | 75,324 | 69,073 | 75,986 |
| Weighted average shares outstanding - diluted | 70,267 | 77,284 | 70,583 | 78,098 |
| Earnings per common share - basic | \$ 0.29 | \$ 0.28 | \$ 0.53 | \$ 0.49 |
| Earnings per common share - diluted | \$ 0.28 | \$ 0.27 | \$ 0.52 | \$ 0.47 |
| Dividend per share | \$ 0.09 | \$ 0.09 | \$ 0.18 | \$ 0.18 |

See notes to consolidated financial statements

Table of Contents**ADTRAN, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(In thousands)

| | Six Months Ended | |
|---|------------------|------------------|
| | 2007 | June 30, 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 36,771 | \$ 37,069 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 5,336 | 5,494 |
| Amortization of net premium on available-for-sale investments | 1,153 | 1,730 |
| Gain on sale of long-term investments | (268) | (1,074) |
| Loss on disposal of property, plant and equipment | 70 | 8 |
| Stock-based compensation expense | 4,535 | 4,029 |
| Deferred income taxes | (2,159) | (1,232) |
| Tax benefits from stock option exercises | 3,787 | 1,271 |
| Excess tax benefits from stock-based compensation arrangements | (2,842) | (818) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (9,653) | 1,796 |
| Other receivables | 3,130 | (1,480) |
| Income tax receivable, net | 1,446 | |
| Inventory, net | 10,327 | 3,402 |
| Prepaid expenses and other assets | 929 | (667) |
| Accounts payable | (3,095) | 867 |
| Accrued expenses and other liabilities | 2,082 | (1,452) |
| Income tax payable | 439 | (191) |
| Net cash provided by operating activities | 51,988 | 48,752 |
| Cash flows from investing activities: | | |
| Purchases of property, plant and equipment | (3,816) | (3,547) |
| Proceeds from sales and maturities of available-for-sale investments | 98,980 | 126,427 |
| Purchases of available-for-sale investments | (116,650) | (157,353) |
| Acquisition of business | | (400) |
| Net cash used in investing activities | (21,486) | (34,873) |
| Cash flows from financing activities: | | |
| Proceeds from stock option exercises | 12,921 | 3,294 |
| Purchases of treasury stock | (52,289) | (82,710) |
| Dividend payments | (12,465) | (13,779) |
| Excess tax benefits from stock-based compensation arrangements | 2,842 | 818 |
| Net cash used in financing activities | (48,991) | (92,377) |
| Net decrease in cash and cash equivalents | (18,489) | (78,498) |
| Effect of exchange rate changes | 403 | 372 |

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| | | |
|--|-----------|-----------|
| Cash and cash equivalents, beginning of period | 40,147 | 112,794 |
| Cash and cash equivalents, end of period | \$ 22,061 | \$ 34,668 |

See notes to consolidated financial statements

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ADTRAN, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(In thousands, except per share amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements of ADTRAN[®], Inc. and its subsidiaries (ADTRAN) have been prepared pursuant to the rules and regulations for reporting on Quarterly Reports on Form 10-Q. Accordingly, certain information and notes required by generally accepted accounting principles for complete financial statements are not included herein. The December 31, 2006 Consolidated Balance Sheet is derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

In the opinion of management, all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for an interim period are not necessarily indicative of the results for the full year. The interim statements should be read in conjunction with the financial statements and notes thereto included in ADTRAN's Annual Report on Form 10-K for the year ended December 31, 2006.

Changes in Classifications

Certain changes in classifications have been made to the prior period balances in order to conform to the current period's presentation. These reclassifications have no effect on previously reported total assets, total liabilities, stockholders' equity or net income.

Revision of Classification of Treasury Stock Losses

During the three months ended June 30, 2007, we identified a cumulative understatement of additional paid in capital and a corresponding overstatement of retained earnings resulting from losses incurred at the re-issuance of treasury shares from stock option exercises. These cumulative amounts were \$15.2 million as of March 31, 2007 and \$10.6 million as of December 31, 2006. We believe these amounts are not material to the consolidated financial statements for the periods affected and as a result, we have revised these amounts for the periods presented. These reclassifications have no effect on previously reported total assets, total liabilities, net stockholders' equity or net income.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expense during the reporting period. ADTRAN's most significant estimates include the allowance for doubtful accounts, obsolete and excess inventory reserves, warranty reserves, rebates, allowance for sales returns, determination of the deferred revenue components of multiple element sales agreements, estimated income tax contingencies and the fair value of stock-based compensation. Actual amounts could differ significantly from these estimates.

Recent Accounting Pronouncements

Updates to recent accounting standards as disclosed in ADTRAN's Annual Report on Form 10-K for the year ended December 31, 2006 are as follows:

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for

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financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide warranty goods or services. If the use of fair value is elected, any upfront cost and fees related to the item must be recognized in earnings and cannot be deferred. The fair value election is irrevocable and generally made on an instrument-by-instrument basis even if a company has similar instruments that it elects not to measure at fair value. At the adoption date, unrealized gains and losses on existing items for which the fair value option has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes to fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by ADTRAN in the first quarter of 2008. We are currently determining whether fair value accounting is appropriate for any of our eligible items and cannot currently estimate the impact, if any, which SFAS 159 will have on our consolidated results of operation and financial condition.

During the first quarter of 2007, we adopted the following accounting standards, none of which had a material effect on our consolidated results of operation or financial condition:

Emerging Issues Task Force (EITF) Issue 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* (EITF 06-3). We present these items within the scope of EITF 06-3 on a gross basis, and the amounts are not significant.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement 109* (FIN 48). See Note 2 to the Consolidated Financial Statements for more information.

2. INCOME TAXES

On January 1, 2007, ADTRAN adopted the provisions of FIN 48, which requires a company to recognize the benefit of a tax position in its financial statements only if that position is more likely than not of being sustained on an audit basis solely on the technical merit of the position. In addition, FIN 48 requires annual qualitative and quantitative disclosures including a discussion of reasonably possible significant changes that might occur in the recognized tax benefits over the next twelve months as well as an annual roll-forward of all unrecognized tax benefits.

The adoption of FIN 48 resulted in a decrease to stockholders' equity of \$1.2 million on January 1, 2007 for unrecognized tax expense, of which \$0.5 million is related to estimated interest and penalties. We will continue to account for interest and penalties as a part of income tax expense. Had these amounts been recognized in the income statement, it would have resulted in a 0.9 percentage point increase in the effective tax rate for the year ended December 31, 2006. The total liability for unrecognized tax positions as of January 1, 2007 amounted to \$2.1 million. Subsequent to adoption of FIN 48, recognition, derecognition and changes in measurement in our unrecognized tax expense will be adjusted through the applicable period's income statement.

As required, we analyze our uncertain tax positions on a more likely than not basis. This type of analysis requires estimates and assumptions to be made by management and is based on information available at that time. These estimates and assumptions may change as new information becomes available. We do not foresee any events in the next twelve months that would significantly change our current unrecognized tax expense balance. In addition, we have been audited by the Internal Revenue Service through the 2004 tax year and by the State of Alabama through the 2005 tax year.

3. STOCK-BASED COMPENSATION

The following table summarizes the stock-based compensation expense related to stock options under SFAS No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123R), for the three and six months ended June 30, 2007 and 2006, which was allocated as follows:

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-----------------|------------------------------|-----------------|
| | 2007 | 2006 | 2007 | 2006 |
| Stock-based compensation expense included in cost of sales | \$ 94 | \$ 87 | \$ 187 | \$ 170 |
| Selling, general and administrative expense | 1,120 | 1,003 | 2,199 | 1,960 |
| Research and development expense | 1,082 | 972 | 2,149 | 1,899 |
| Stock-based compensation expense included in operating expenses | 2,202 | 1,975 | 4,348 | 3,859 |
| Total stock-based compensation expense | 2,296 | 2,062 | 4,535 | 4,029 |
| Tax benefit for expense associated with non-qualified options | (230) | (257) | (416) | (513) |
| Total stock-based compensation expense, net of tax | \$ 2,066 | \$ 1,805 | \$ 4,119 | \$ 3,516 |

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

The significant weighted-average assumptions relating to the valuation of ADTRAN's stock options and the value of options granted for the three and six months ended June 30, 2007 and 2006, respectively, are summarized as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------------|------------------------------|-----------------|
| | 2007 | 2006 | 2007 | 2006 |
| Expected volatility | 46.56% | 49.15% | 46.46% | 49.16% |
| Risk-free interest rate | 4.54% | 5.01% | 4.58% | 4.88% |
| Expected dividend yield | 1.41% | 1.38% | 1.45% | 1.33% |
| Expected life (in years) | 5.18 | 4.64 | 5.07 | 4.61 |
| Weighted-average estimated value | \$ 10.72 | \$ 11.12 | \$ 10.37 | \$ 11.50 |

Stock-based compensation expense recognized in our Consolidated Statements of Income for the three and six months ended June 30, 2007 is based on options ultimately expected to vest, and has been reduced for estimated forfeitures. These estimates were based upon historical experience and approximate 2.0% annually.

As of June 30, 2007, total compensation cost related to non-vested stock options not yet recognized was approximately \$17.2 million, which is expected to be recognized over an average remaining recognition period of 2.4 years using the ratable single-option approach.

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The following schedule summarizes the activity in our stock-based compensation plans for the six months ended June 30, 2007:

| | Number of Options | Weighted Avg. Exercise Price | Weighted Avg. Remaining Contractual Life In years | Aggregate Intrinsic Value |
|---|----------------------|---------------------------------|--|---------------------------------|
| Options outstanding, December 31, 2006 | 7,019 | \$ 18.58 | 5.51 | \$ 40,896 |
| Options granted | 25 | \$ 25.06 | | |
| Options cancelled/forfeited | (331) | \$ 26.84 | | |
| Options exercised | (1,022) | \$ 12.78 | | |
| Options outstanding, June 30, 2007 | 5,691 | \$ 19.17 | 5.72 | \$ 45,023 |
| Options exercisable, June 30, 2007 | 3,941 | \$ 16.46 | 4.48 | \$ 41,102 |

The aggregate intrinsic values in the table above represent the total pre-tax intrinsic value (the difference between ADTRAN's closing stock price on the last trading day of the quarter and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2007. The aggregate intrinsic value will change based on the fair market value of ADTRAN's stock. The total pretax intrinsic value of options exercised during the three and six month periods ended June 30, 2007 was \$7.5 million and \$12.1 million, respectively.

4. INVENTORY

At June 30, 2007 and December 31, 2006, inventory consisted of the following:

| | June 30, 2007 | December 31, 2006 |
|-----------------------|------------------|----------------------|
| Raw materials | \$ 30,317 | \$ 30,136 |
| Work in progress | 1,748 | 4,870 |
| Finished goods | 17,738 | 25,153 |
| Inventory reserves | (7,013) | (7,042) |
| Inventory, net | \$ 42,790 | \$ 53,117 |

5. STOCKHOLDERS' EQUITY

A summary of the changes in stockholders' equity for the six months ended June 30, 2007 is as follows:

| | Stockholders' Equity |
|---|----------------------|
| Balance, December 31, 2006 | \$ 435,956 |
| Net income | 36,771 |
| Dividend payments | (12,465) |
| Net unrealized gains on marketable securities (net of deferred taxes) | 1,940 |
| Unrealized foreign currency translation (net of deferred taxes) | 403 |
| Adoption of FIN 48 | (1,190) |
| Exercise of stock options | 12,921 |
| Income tax benefit from exercise of stock options | 3,787 |

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| | |
|-------------------------------|-------------------|
| Stock-based compensation | 4,535 |
| Purchase of treasury stock | (52,289) |
| Balance, June 30, 2007 | \$ 430,369 |

Table of Contents*Stock Repurchase Program*

Since 1997, our Board of Directors has approved multiple share repurchase programs that have authorized open market repurchase transactions. As of June 30, 2007, the Board of Directors had authorized cumulative repurchases of up to 24 million shares of common stock. During the six months ended June 30, 2007, we repurchased 2.1 million shares at an average price of \$24.72 per share under the repurchase plan approved by the Board of Directors on July 17, 2006. We currently have the authority to purchase an additional 0.2 million shares under this plan. On July 16, 2007 the Board of Directors approved a plan to repurchase an additional 5.0 million shares in open market or private transactions as market conditions warrant.

We issued 1.0 million shares of treasury stock during the six months ended June 30, 2007 to accommodate employee stock option exercises. The stock options had exercise prices ranging from \$8.70 to \$22.70. We received proceeds totaling \$12.9 million from the exercise of these stock options during the first six months of 2007.

Dividend Payments

During 2007, ADTRAN has paid cash dividends as follows:

| Record Date | Payment Date | Per Share Amount | Total Dividend Paid |
|------------------|-------------------|------------------|---------------------|
| February 8, 2007 | February 22, 2007 | \$ 0.09 | \$ 6,236 |
| May 3, 2007 | May 17, 2007 | \$ 0.09 | \$ 6,229 |

Comprehensive Income

Comprehensive income consists of net income, unrealized foreign currency translation adjustments and unrealized gains and losses on marketable securities.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 19,843 | \$ 20,814 | \$ 36,771 | \$ 37,069 |
| Foreign currency translation gain, net of deferred taxes | 284 | 620 | 403 | 372 |
| Net unrealized gains (losses) on available-for-sale securities, net of deferred taxes | 1,114 | (2,831) | 1,940 | (3,296) |
| Total comprehensive income | \$ 21,241 | \$ 18,603 | \$ 39,114 | \$ 34,145 |

6. EARNINGS PER SHARE

A summary of the calculation of basic and diluted earnings per share for the three and six months ended June 30, 2007 and 2006 is as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Numerator | | | | |
| Net income | \$ 19,843 | \$ 20,814 | \$ 36,771 | \$ 37,069 |
| Denominator | | | | |
| Weighted average number of shares - basic | 68,797 | 75,324 | 69,073 | 75,986 |
| Effect of dilutive securities - stock options | 1,470 | 1,960 | 1,510 | 2,112 |
| Weighted average number of shares - diluted | 70,267 | 77,284 | 70,583 | 78,098 |

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| | | | | |
|--------------------------------|---------|---------|---------|---------|
| Net income per share - basic | \$ 0.29 | \$ 0.28 | \$ 0.53 | \$ 0.49 |
| Net income per share - diluted | \$ 0.28 | \$ 0.27 | \$ 0.52 | \$ 0.47 |

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Anti-dilutive options to purchase common stock outstanding were excluded from the above calculations. Anti-dilutive options totaled 2,603 and 2,032 for the three months ended June 30, 2007 and 2006, respectively. Anti-dilutive options totaled 2,672 and 1,955 for the six months ended June 30, 2007 and 2006, respectively.

7. SEGMENT INFORMATION

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

The following table presents information about the sales and gross profit of our reportable segments for the three and six months ended June 30, 2007 and 2006. Asset information by reportable segment is not reported, since ADTRAN does not produce such information internally.

| | Three Months Ended | | | |
|---------------------|--------------------|------------------|-------------------|------------------|
| | June 30, 2007 | | June 30, 2006 | |
| | Sales | Gross Profit | Sales | Gross Profit |
| Carrier Networks | \$ 93,288 | \$ 55,243 | \$ 94,640 | \$ 56,232 |
| Enterprise Networks | 30,386 | 18,316 | 27,656 | 16,199 |
| | \$ 123,674 | \$ 73,559 | \$ 122,296 | \$ 72,431 |

| | Six Months Ended | | | |
|---------------------|-------------------|-------------------|-------------------|-------------------|
| | June 30, 2007 | | June 30, 2006 | |
| | Sales | Gross Profit | Sales | Gross Profit |
| Carrier Networks | \$ 177,734 | \$ 106,032 | \$ 175,859 | \$ 104,244 |
| Enterprise Networks | 56,252 | 33,317 | 55,085 | 32,695 |
| | \$ 233,986 | \$ 139,349 | \$ 230,944 | \$ 136,939 |

Sales by Geographic Region

The table below presents sales information by geographic region for the three and six months ended June 30, 2007 and 2006.

| | Three Months Ended | | Six Months Ended | |
|---------------|--------------------|-------------------|-------------------|-------------------|
| | June 30, 2007 | June 30, 2006 | June 30, 2007 | June 30, 2006 |
| | United States | \$ 115,419 | \$ 114,697 | \$ 217,891 |
| International | 8,255 | 7,599 | 16,095 | 13,316 |
| Total | \$ 123,674 | \$ 122,296 | \$ 233,986 | \$ 230,944 |

Sales by Product

In January 2007, we announced we would begin reporting new product categories in order to increase transparency in major product areas. The new product categories are:

Loop Access,

Carrier Systems, and

Business Networking.

Loop Access products are used by carrier and enterprise customers for access to today's copper-based telecommunications network. Loop Access includes DDS and ISDN Total Reach products, HDSL products including Total Access 3000 based HDSL and TDM-SHDSL products, T1/E1/T3, CSUs/DSUs, and Tracer fixed wireless products.

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Carrier Systems products are used by carrier customers for increasing bandwidth and for delivery of carrier services to consumers and enterprises. Carrier Systems includes all broadband access products, including DSLAM products and Total Access 5000 products. This category also includes optical access products, narrowband access platforms, 303 concentrator products, M13 multiplexer products, and wireless backhaul grooming products.

Business Networking products provide enterprises access to today's telecommunication networks and facilitate networking capabilities for voice and data. Business Networking includes integrated access devices and Internetworking products. Internetworking products include IP access routers, Ethernet switches, IP PBX products, and multi-service access gateways.

The table below presents sales information by product for the three and six months ended June 30, 2007 and 2006.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------|--------------------------------|-------------------|------------------------------|-------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Loop Access | \$ 55,003 | \$ 55,427 | \$ 106,251 | \$ 98,687 |
| Carrier Systems | 46,491 | 46,369 | 86,055 | 90,420 |
| Business Networking | 22,180 | 20,500 | 41,680 | 41,837 |
| Total | \$ 123,674 | \$ 122,296 | \$ 233,986 | \$ 230,944 |

Additionally, we are providing sub-categories of product revenues for broadband access and optical access products (included in Carrier Systems) and Internetworking products (included in Business Networking) to provide greater transparency into our primary growth areas. Also, we are providing HDSL revenues (included in Loop Access) as a sub-category.

Subcategory revenues included in the above are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------------------|------------------------------|-------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Broadband Access (included in Carrier Systems) | \$ 20,163 | \$ 21,490 | \$ 38,434 | \$ 42,492 |
| Optical Access (included in Carrier Systems) | 9,833 | 9,078 | 18,450 | 17,502 |
| Internetworking (Netvanta & Multi-service Access Gateways) (included in Business Networking) | 13,591 | 7,599 | 24,683 | 16,028 |
| HDSL (does not include T1) (included in Loop Access) | 46,319 | 45,979 | 90,071 | 81,643 |
| Other products (included in the above table) | 33,768 | 38,150 | 62,348 | 73,279 |
| Total | \$ 123,674 | \$ 122,296 | \$ 233,986 | \$ 230,944 |

8. LIABILITY FOR WARRANTY RETURNS

Our products generally include warranties of one to ten years for product defects. We accrue for warranty returns based on our estimate of the cost to repair or replace the defective products at the time revenue is recognized. We engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers. Our products continue to become more complex in both size and functionality as many of our product offerings migrate from line card applications to systems products. These products could require more warranty cost to be incurred at the installed location due to their size and complexity, rather than at a manufacturing site or repair depot. This field service obligation, as well as the increasing complexity of our products, will cause warranty incidences, when they arise, to be more costly. Our estimates regarding future warranty obligations may change due to product failure rates, material usage, and other rework costs incurred in correcting a product failure. In addition, from time to time, specific warranty accruals may be recorded if unforeseen problems arise. Should our actual experience relative to these factors be higher than our estimates, we will be required to record additional warranty expense. Alternatively, if we

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provide for more reserves than we require, we will reverse a portion of such provisions in future periods. The liability for warranty returns totaled \$3,231 and \$3,045 at June 30, 2007 and December 31, 2006, respectively. These liabilities are included in accrued expenses in the accompanying Consolidated Balance Sheets.

| | June 30, 2007 |
|--|----------------------|
| Balance at beginning of period | \$ 3,045 |
| Plus: amounts charged to cost and expenses | 1,121 |
| Less: deductions | (935) |
| Balance at end of period | \$ 3,231 |

9. RELATED PARTY TRANSACTIONS

We employ the law firm of our director emeritus for legal services. All bills for services rendered by this firm are reviewed and approved by our chief financial officer. We believe that the fees for such services are comparable to those charged by other firms for services rendered to us. We paid \$30 thousand during each of the three month periods ended June 30, 2007 and 2006 for legal services rendered. We paid \$60 thousand during each of the six month periods ended June 30, 2007 and 2006 for legal services rendered.

10. COMMITMENTS AND CONTINGENCIES

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

We have committed to invest up to an aggregate of \$7,850 in two private equity funds, of which \$6,772 has been invested to date. The duration of each of these commitments is ten years with \$251 expiring in 2010 and \$827 expiring in 2012.

11. SUBSEQUENT EVENTS

On July 16, 2007, ADTRAN announced that its board of directors declared a quarterly cash dividend of \$0.09 per common share to be paid to stockholders of record at the close of business on August 2, 2007. The payment date will be August 16, 2007. The quarterly dividend payment will be approximately \$6.2 million. The board of directors presently anticipates that it will declare a regular quarterly dividend so long as the present tax treatment of dividends exists and adequate levels of liquidity are maintained.

On July 16, 2007, ADTRAN announced that its board of directors had authorized the repurchase of an additional 5.0 million shares of our common stock to commence upon completion of the repurchase plan announced on July 17, 2006. Upon completion of the current plan, under which ADTRAN has the remaining authority to purchase 0.2 million shares, the new plan to repurchase 5.0 million shares will be implemented through open market or private purchases from time to time as conditions warrant.

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

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

OVERVIEW

On April 26, 2007, ADTRAN elected Chief Executive Officer, Tom Stanton, chairman of our board of directors. Mr. Stanton had been acting Chairman since the death of Chairman and co-founder Mark C. Smith on March 27, 2007. Mr. Stanton has served as our CEO since September 2005 and has been with the company since 1995.

ADTRAN develops and provides network access solutions for communications networks. Widely deployed by carriers, small and mid-sized businesses and enterprises, our solutions enable voice, data, video, and Internet communications across copper, fiber and wireless networks. Many of these solutions are currently in use by every major U.S. service provider and many global ones, as well as by many public, private and governmental organizations worldwide.

An important part of ADTRAN's 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 the 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 ADTRAN to sell succeeding generations of products to existing customers, while increasing our market share by selling these enhanced products to new customers.

In January 2007, we announced we would begin reporting new product categories in order to increase transparency in major product areas. The new product categories are:

Loop Access,

Carrier Systems, and

Business Networking.

Loop Access products are used by carrier and enterprise customers for access to today's copper-based telecommunications network. Loop Access includes DDS and ISDN Total Reach products, HDSL products including Total Access 3000 based HDSL and TDM-SHDSL products, T1/E1/T3, CSUs/DSUs, and Tracer fixed wireless products.

Carrier Systems products are used by carrier customers for increasing bandwidth and for delivery of carrier services to consumers and enterprises. Carrier Systems includes all broadband access products, including DSLAM products and Total Access 5000 products. This category also includes optical access products, narrowband access platforms, 303 concentrator products, M13 multiplexer products, and wireless backhaul grooming products.

Business Networking products provide enterprises access to today's telecommunication networks and facilitate networking capabilities for voice and data. Business Networking includes integrated access devices and Internetworking products. Internetworking products include IP access routers, Ethernet switches, IP PBX products, and multi-service access gateways.

Sales were \$123.7 million and \$234.0 million for the three and six months ended June 30, 2007 compared to \$122.3 million and \$230.9 million for the three and six months ended June 30, 2006. Net income was \$19.8 million and \$36.8 million for the three and six months ended June 30, 2007 compared to \$20.8 million and \$37.1 million for the three and six months ended June 30, 2006. Earnings per share, assuming dilution, were \$0.28 and \$0.52 for the three and six months ended June 30, 2007 compared to \$0.27 and \$0.47 for the three and six months ended June 30, 2006. The results for the six months ended June 30, 2007 included a benefit of \$0.9 million in Provision for Income Taxes primarily relating to closure of tax audits from prior years and also included a one-time, pre-tax life insurance benefit of \$1.0

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million. These two items increased earnings per share, assuming dilution, by approximately \$0.02 in the six months ended June 30, 2007. The increase in earnings per share for the three and six months ended June 30, 2007 compared to the same periods in 2006 reflects the repurchase of 7.4 million and 2.1 million shares of our stock in 2006 and 2007, respectively.

Our operating results have fluctuated on a quarterly basis in the past, and may vary significantly in future periods due to a number of factors. We normally operate with very little order backlog. A majority of our sales in each quarter result from orders booked in that quarter and firm purchase orders released in that quarter by customers under agreements containing non-binding purchase commitments. Furthermore, a majority of customers typically 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 ADTRAN's 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 ADTRAN's financial results in a given quarter. Furthermore, maintaining sufficient inventory levels to assure prompt delivery of our products increases the amount of inventory that may become obsolete and increases the risk that the obsolescence of such inventory may have an adverse effect on our business and operating results.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Except as set forth below, our critical accounting policies and estimates have not changed significantly from those detailed in our most recent Annual Report on Form 10-K for the year ended December 31, 2006.

For purposes of recording and analyzing our uncertain tax provisions, we recognize the benefit of a tax position in our financial statements only if that position is more likely than not of being sustained on an audit basis solely on the technical merit of the position as is required by FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement 109* (FIN 48). This type of analysis requires estimates and assumptions to be made by management and is based on information available at that time.

Circumstances may change and additional data may become available over time, which could result in changes to these estimates and assumptions and thereby materially impact our tax provision. If estimates change and we use different assumptions in the application of FIN 48 in future periods, it could materially impact our future results of operations and financial condition. Refer to Note 2 to the

Consolidated Financial Statements in this Form 10-Q for more information regarding uncertain tax provisions.

EFFECT OF RECENT ACCOUNTING PRONOUNCEMENTS

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

RESULTS OF OPERATIONS THREE AND SIX MONTHS ENDED JUNE 30, 2007 COMPARED TO THREE AND SIX MONTHS ENDED JUNE 30, 2006

SALES

ADTRAN's sales increased 1.1% from \$122.3 million in the three months ended June 30, 2006 to \$123.7 million in the three months ended June 30, 2007. ADTRAN's sales increased 1.3% from \$230.9 million in the six months ended June 30, 2006 to \$234.0 million in the six months ended June 30, 2007. The quarter-over-quarter increase in sales is primarily attributable to an increase in sales of our Business Networking products. Business Networking product sales increased primarily due to growth in sales of Netvanta and IP Business Gateway products partially offset by a decline in traditional

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integrated access device (IAD) revenues. The increase in sales for the six month period of 2007 compared to the 2006 period is attributable to an increase in sales of our Loop Access products, partially offset by a decline in our Carrier Systems products. Loop Access product sales increased due to improved sales of HDSL products, primarily in the first quarter of 2007. The decrease in Carrier Systems product sales is primarily attributable to a decline in spending at one of our major customers.

Carrier Networks sales decreased 1.4% from \$94.6 million in the three months ended June 30, 2006 to \$93.3 million in the three months ended June 30, 2007. Carrier Networks sales increased 1.0% from \$175.9 million in the six months ended June 30, 2006 to \$177.7 million in the six months ended June 30, 2007. The quarter-over-quarter decrease in Carrier Networks sales is primarily attributable to a decline in Broadband Access product sales. The increase in Carrier Network sales for the six month period of 2007 compared to the 2006 period is primarily attributable to an increase in sales of HDSL products.

Enterprise Networks sales increased 9.7% from \$27.7 million in the three months ended June 30, 2006 to \$30.4 million in the three months ended June 30, 2007 and increased 2.2% from \$55.1 million in the six months ended June 30, 2006 to \$56.3 million in the six months ended June 30, 2007. The increase in Enterprise Networks sales is primarily attributable to increased sales of Netvanta and IP Business Gateway products, partially offset by a decline in sales of traditional IAD revenues. Enterprise Networks sales as a percentage of total sales increased from 22.6% for the three months ended June 30, 2006 to 24.6% for the three months ended June 30, 2007 and increased from 23.9% for the six months ended June 30, 2006 to 24.1% for the six months ended June 30, 2007.

International sales, which are included in the Carrier Networks and Enterprise Networks amounts discussed above, increased 9.2% from \$7.6 million in the three months ended June 30, 2006 to \$8.3 million in the three months ended June 30, 2007 and increased 21.1% from \$13.3 million in the six months ended June 30, 2006 to \$16.1 million in the six months ended June 30, 2007. International sales, as a percentage of total sales, increased from 6.2% for the three months ended June 30, 2006 to 6.7% for the three months ended June 30, 2007, and increased from 5.8% for the six months ended June 30, 2006 to 6.9% for the six months ended June 30, 2007. International sales increased primarily due to improved sales distribution achieved in the Asian Pacific customer base.

COST OF SALES

As a percentage of sales, cost of sales decreased slightly from 40.8% in the three months ended June 30, 2006 to 40.5% in the three months ended June 30, 2007 and from 40.7% in the six months ended June 30, 2006 to 40.4% in the six months ended June 30, 2007. The decrease in cost of sales as a percentage of sales is primarily related to the impact of higher sales volume on cost absorptions and a more favorable product mix.

Carrier Networks cost of sales, as a percent of division sales, increased slightly from 40.6% in the three months ended June 30, 2006 to 40.8% in the three months ended June 30, 2007 and decreased slightly from 40.7% in the six months ended June 30, 2006 to 40.3% in the six months ended June 30, 2007.

Enterprise Networks cost of sales, as a percent of division sales, decreased from 41.4% in the three months ended June 30, 2006 to 39.7% in the three months ended June 30, 2007 and increased slightly from 40.6% in the six months ended June 30, 2006 to 40.8% in the six months ended June 30, 2007. The decrease quarter-over-quarter is primarily related to the impact of higher sales volume on cost absorptions and a more favorable product mix.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses decreased 0.4% from \$26.3 million in the three months ended June 30, 2006 to \$26.2 million in the three months ended June 30, 2007 and increased 3.1% from \$51.0 million in the six months ended June 30, 2006 to \$52.6 million in the six months ended June 30, 2007. The increase in selling, general and administrative expenses for the six month period of 2007 compared to 2006 is primarily related to expenses associated with increased domestic and international sales and marketing activities.

Selling, general, and administrative expenses as a percentage of sales decreased slightly from 21.5% in the three months ended June 30, 2006 to 21.2% in the three months ended June 30, 2007 and increased slightly from 22.1% in the six months ended June 30, 2006 to 22.5% in the six months ended June 30, 2007.

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RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses increased 11.4% from \$17.5 million in the three months ended June 30, 2006 to \$19.5 million in the three months ended June 30, 2007 and increased 7.7% from \$35.2 million in the six months ended June 30, 2006 to \$37.9 million in the six months ended June 30, 2007.

As a percentage of sales, research and development expenses increased from 14.3% in the three months ended June 30, 2006 to 15.8% in the three months ended June 30, 2007 and increased from 15.3% in the six months ended June 30, 2006 to 16.2% in the six months ended June 30, 2007. Increases in research and development expenses reflect increased staffing, engineering and testing expense primarily related to customer specific product development activities.

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

INTEREST INCOME

Interest income decreased 11.8% from \$3.4 million in the three months ended June 30, 2006 to \$3.0 million in the three months ended June 30, 2007 and decreased 14.5% from \$6.9 million in the six months ended June 30, 2006 to \$5.9 million in the six months ended June 30, 2007. This decrease is primarily related to lower investment balances due to our use of cash to repurchase our stock.

INTEREST EXPENSE

Interest expense on our taxable revenue bond remained relatively constant at \$0.6 million in each of the three months ended June 30, 2007 and 2006, and \$1.2 million and \$1.3 million, respectively in the six month periods ended June 30, 2007 and 2006. See [Liquidity and Capital Resources](#) below for additional information on our revenue bond.

NET REALIZED INVESTMENT GAIN

Net realized investment gain decreased from \$0.5 million in the three months ended June 30, 2006 to \$0.2 million in the three months ended June 30, 2007 and decreased from \$1.1 million in the six months ended June 30, 2006 to \$0.3 million in the six months ended June 30, 2007. These changes primarily resulted from the sale of securities associated with the realignment of our investment portfolio.

OTHER INCOME, NET

Other income, net, comprised primarily of miscellaneous income, gains and losses on foreign currency transactions, investment account management fees and scrap raw material sales, decreased from \$0.4 million in the three months ended June 30, 2006 to \$0.2 million in the three months ended June 30, 2007 and increased from \$0.3 million in the six months ended June 30, 2006 to \$0.5 million in the six months ended June 30, 2007.

LIFE INSURANCE PROCEEDS

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

INCOME TAXES

Our effective tax rate decreased from 35.5% in the three months ended June 30, 2006 to 35.2% in the three months ended June 30, 2007 and from 35.8% in the six months ended June 30, 2006 to 33.4% in the six months ended June 30, 2007. The decrease for the six months is primarily due to the first quarter impact of research and development tax credits enacted in late 2006, and therefore available in 2007, and the closure of tax audits from prior years.

Additionally, the recognition of stock-based compensation expense associated with the adoption of SFAS 123R has created unfavorable permanent differences that must be considered when calculating the effective tax rate for the year. These unfavorable differences are related to

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the portion of stock-based compensation for which a tax deduction is not generally available (incentive stock options). Disqualifying dispositions of these incentive stock options will give rise to a tax deduction and a favorable permanent difference in the period of exercise. However, we cannot estimate when, or guarantee that, disqualifying dispositions will occur.

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NET INCOME

As a result of the above factors, net income decreased \$1.0 million from \$20.8 million in the three months ended June 30, 2006 to \$19.8 million in the three months ended June 30, 2007 and decreased \$0.3 million from \$37.1 million in the six months ended June 30, 2006 to \$36.8 million in the six months ended June 30, 2007.

As a percentage of sales, net income decreased from 17.0% in the three months ended June 30, 2006 to 16.0% in the three months ended June 30, 2007 and from 16.1% in the six months ended June 30, 2006 to 15.7% in the six months ended June 30, 2007.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

At June 30, 2007, our cash and cash equivalents of \$22.1 million and short-term investments of \$152.5 million placed our short-term liquidity at \$174.6 million. At December 31, 2006, our cash and cash equivalents of \$40.1 million and short-term investments of \$99.7 million placed our short-term liquidity in at \$139.8 million.

Operating Activities

Our working capital, which consists of current assets less current liabilities, increased from \$219.6 million as of December 31, 2006 to \$250.6 million as of June 30, 2007. The quick ratio, defined as cash, cash equivalents, short-term investments, and net accounts receivable, divided by current liabilities, increased from 3.97 as of December 31, 2006 to 5.11 as of June 30, 2007. The current ratio, defined as current assets divided by current liabilities, increased from 5.43 as of December 31, 2006 to 6.31 as of June 30, 2007. These liquidity ratios will fluctuate with business growth and as our inventory, accounts payable and income tax position change.

As of December 31, 2006, we had a net income tax receivable of \$1.4 million, primarily related to overpayment of estimated taxes as a result of retroactive federal research and development tax credits that were enacted late in 2006. As of June 30, 2007, we had a net income tax payable of \$0.1 million, primarily related to current year taxable income.

Net accounts receivable increased 17.0% from December 31, 2006 to June 30, 2007, primarily due to the volume and timing of sales near the end of the current quarter as compared to the fourth quarter of 2006. Our allowance for doubtful accounts remained relatively stable at \$0.3 million at June 30, 2007 and \$0.2 million at December 31, 2006. Quarterly accounts receivable days sales outstanding (DSO) increased 2 days from 47 days as of December 31, 2006 to 49 days as of June 30, 2007. A steady level of shipments and good collection performance throughout a quarter will result in reduced DSO, compared with higher levels of shipments toward the end of the quarter, which results in a shorter amount of time to collect the related accounts receivable and increased DSO.

Quarterly inventory turnover increased from 3.60 turns as of December 31, 2006 to 4.4 turns as of June 30, 2007. Inventory levels at June 30, 2007 decreased 19.4% from December 31, 2006 as production levels were adjusted to correspond with our customers' product requirements over the first two quarters. Inventory levels will fluctuate as we attempt to maintain sufficient inventory levels to ensure competitive lead times while guarding against the risk of inventory obsolescence that may occur due to rapidly changing technology and customer demand.

Accounts payable decreased 10.2% from December 31, 2006 to June 30, 2007 and accrued expenses increased 20.5% from December 31, 2006 to June 30, 2007. These changes are primarily related to the variations in the timing of payments and increased payroll tax liabilities.

Investing Activities

At June 30, 2007, our long-term investments decreased by 17.3% to \$156.8 million from \$189.8 million at December 31, 2006. This decrease is primarily attributable to repositioning maturing long-term fixed income investments into short-term fixed income investments.

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Restricted investment balances at June 30, 2007 included \$49.5 million in a restricted certificate of deposit and \$2.8 million in deferred compensation plan assets. Restricted investment balances at December 31, 2006 included \$49.5 million invested in a restricted certificate of deposit and \$2.6 million of deferred compensation plan assets.

Capital expenditures totaled approximately \$3.8 million and \$3.5 million for the six months ended June 30, 2007 and 2006, respectively. These expenditures were primarily used for the purchase of computer hardware and software and manufacturing and test equipment.

Financing Activities

In July 2003, our board of directors elected to begin declaring quarterly dividends on our common stock, and anticipates that it will declare a regular quarterly dividend so long as the present tax treatment of dividends exists and adequate levels of liquidity are maintained. During the six months ended June 30, 2007, ADTRAN paid dividends totaling \$12.5 million.

Debt

We have amounts outstanding under loans made pursuant to an Alabama State Industrial Development Authority revenue bond (the Bond) which totaled \$49.5 million at June 30, 2007 and December 31, 2006. Included in long-term investments are restricted funds in the amount of \$49.5 million at June 30, 2007 and December 31, 2006, which is a collateral deposit against the principal amount of the Bond. The Bond matures on January 1, 2020, and bears interest at the rate of 5% per annum. In conjunction with this program, we are eligible to receive certain economic incentives from the state of Alabama that reduce the amount of payroll withholdings we are required to remit to the state for those employment positions that qualify under this program.

We are required to make payments in the amounts necessary to pay the principal and interest on the amounts currently outstanding. Due to continued positive cash flow from operating activities, we made a business decision to begin an early partial redemption of the Bond, as evidenced by a \$0.5 million principal payment in the third quarter of 2006. It is our intent to make annual principal payments of between \$0.5 million and \$5.0 million per year in addition to the interest amounts that are due. In connection with this decision, \$0.7 million of the Bond debt has been reclassified to a current liability in the Consolidated Balance Sheet.

Off-Balance Sheet Arrangements and Contractual Obligations

We do not have off-balance sheet financing arrangements and have not engaged in any related party transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect liquidity or the availability of or requirements for capital resources. During the six months ended June 30, 2007, there have been no material changes in contractual obligations and commercial commitments from those discussed in our most recent Form 10-K filed on February 28, 2007. We have committed to invest up to an aggregate of \$7.9 million in two private equity funds, of which \$6.8 million has been invested to date. The duration of each of these commitments is ten years with \$0.3 million expiring in 2010 and \$0.8 million expiring in 2012.

Stock Repurchase Program

During the six months ended June 30, 2007, we repurchased 2.1 million shares at an average price of \$24.72 per share under the repurchase plan approved by our Board of Directors on July 17, 2006. We have the authority to purchase an additional 0.2 million shares under this plan. During 2006, we repurchased 7.4 million shares at an average price of \$22.96 per share.

On July 16, 2007, ADTRAN announced that its board of directors had authorized the repurchase of an additional 5.0 million shares of our common stock to commence upon completion of the repurchase plan announced on July 17, 2006. Upon completion of the current plan, under which ADTRAN has the remaining authority to purchase 0.2 million shares, the new plan to repurchase 5.0 million shares will be implemented through open market or private purchases from time to time as conditions warrant.

We issued 1.0 million shares of treasury stock for \$12.9 million during the six months ended June 30, 2007 to accommodate employee stock option exercises. During 2006, we issued 0.4 million shares of treasury stock for \$4.4 million to accommodate employee stock option exercises.

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We intend to finance our operations with cash flows from operations. We have used, and expect to continue to use, the cash generated from operations for working capital, dividend payments, and other general corporate purposes, including (i) product development activities to enhance our existing products and develop new products and (ii) expansion of sales and marketing activities. We believe our cash and cash equivalents, investments and cash generated from operations to be adequate to meet our operating and capital needs for the foreseeable future.

FACTORS THAT COULD AFFECT OUR FUTURE RESULTS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our success depends on attracting and retaining key personnel.

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

The foregoing list of risks is not exclusive. For a more detailed description of the risk factors associated with our business, see Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2006.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

ITEM 4. CONTROLS AND PROCEDURES

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

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

PART II. OTHER INFORMATION**ITEM 1A. RISK FACTORS**

A list of factors that could materially affect our business, financial condition or operating results is included under *Factors That Could Affect Our Future Results* in *Management's Discussion and Analysis of Financial Condition and Results of Operations* contained in Item 2 of Part I of this report. There have been no material changes to the risk factors as disclosed in Item 1A of Part I of our most recent Annual Report on Form 10-K filed on February 28, 2007.

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

The following table sets forth ADTRAN's repurchases or deemed repurchases (swaps) of its common stock for the months indicated.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of | Maximum Number |
|--------------------------------|--|------------------------------------|---|--|
| | | | Shares Purchased as Part of Publicly Announced Plans or Programs (1) | of Shares that May Yet Be Purchased Under the Plans or Programs |
| April 1, 2007 - April 30, 2007 | 270,000 | \$ 25.74 | 270,000 | 1,340,356 |
| May 1, 2007 - May 31, 2007 | 1,167,030 | \$ 25.84 | 1,167,030 | 173,326 |
| June 1, 2007 - June 30, 2007 | 1,363(2) | \$ 26.06 (2) | | 173,326 |
| Total | 1,438,393 | | 1,437,030 | |

(1) On July 17, 2006, ADTRAN's Board of Directors approved the repurchase of up to 5,000,000 shares of its common stock. This plan is being implemented through open market purchases from time to time as conditions warrant.

(2) 1,363 shares delivered to ADTRAN as payment of the exercise price for employee stock options. None of the transactions with respect to these shares were made in the open market. The average price paid per share with respect to these transactions is based on the closing price of the common stock on the NASDAQ Global Market on the date of the transaction.

Table of Contents**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The 2007 Annual Meeting of Stockholders of ADTRAN was held on May 8, 2007. Proxies with regard to the matters voted upon at the Annual Meeting were solicited under Regulation 14A of the Securities Exchange Act of 1934, as amended. Set forth below is a brief description of each matter voted upon at the Annual Meeting and the results of voting on each such matter.

- (a) Election of each director named below to serve until the next Annual Meeting of Stockholders. There was no solicitation in opposition to any of the nominees listed in the proxy statement, and all of the nominees were elected.

| Nominees | Votes | |
|-------------------|------------|-----------|
| | For | Withheld |
| Thomas R. Stanton | 63,065,952 | 1,114,039 |
| James E. Matthews | 61,709,203 | 2,470,788 |
| H. Fenwick Huss | 63,963,947 | 216,044 |
| William L. Marks | 63,390,635 | 789,356 |
| Balan Nair | 63,957,943 | 222,048 |
| Roy J. Nichols | 63,392,038 | 787,953 |

- (a) Ratification of the appointment of PricewaterhouseCoopers LLP as ADTRAN's independent registered public accounting firm for 2007.

| | For | Votes Against | Abstain |
|--|------------|------------------|---------|
| | 63,526,305 | 643,829 | 9,856 |

ITEM 6. EXHIBITS

Exhibits.

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

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SIGNATURE

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

ADTRAN, INC.

(Registrant)

Date: August 1, 2007

/s/ James E. Matthews
James E. Matthews
Senior Vice President Finance,
Chief Financial Officer, Treasurer,
and Secretary

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EXHIBIT INDEX

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