ADTRAN INC
Form 10-Q
November 06, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

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: 000-24612

ADTRAN, Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware	63-0918200
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
901 Explorer Boulevard Huntsville, Alabama	35806-2807
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (256) 963-8000

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 12 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 has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Small reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of October 26, 2018, the registrant had 47,650,245 shares of common stock, $0.01 par value per share, outstanding.

ADTRAN, Inc.

Quarterly Report on Form 10-Q

For the Three and Nine Months Ended September 30, 2018

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FORWARD LOOKING STATEMENTS

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 other communications with our stockholders. Generally, the words, "believe", "expect", "intend", "estimate", "anticipate", "will", "may", "could" and similar expressions identify forward-looking statements. We cau you that any forward-looking statements made by us or on our behalf are subject to uncertainties and other factors that could cause such statements to be wrong. A list of factors that could materially affect our business, financial condition or operating results is included under "Factors that Could Affect Our Future Results" in "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in Item 2 of Part I of this report. They have also been discussed in Item 1A of Part I in our most recent Annual Report on Form 10-K for the year ended December 31, 2017, filed on February 23, 2018 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.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ADTRAN, INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2018	December 31, 2017
ASSETS		
Current Assets		
Cash and cash equivalents	$ 94,173	$ 86,433
Short-term investments	5,912	16,129
Accounts receivable, less allowance for doubtful accounts of $— at September 30, 2018 and December 31, 2017	101,865	144,150
Other receivables	30,084	26,578
Inventory, net	106,060	122,542
Prepaid expenses and other current assets	10,428	17,282
Total Current Assets	348,522	413,114
Property, plant and equipment, net	81,457	85,079
Deferred tax assets, net	39,595	23,428
Goodwill	3,492	3,492
Other assets	31,523	13,725
Long-term investments	144,241	130,256
Total Assets	$ 648,830	$ 669,094
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 65,032	$ 60,632
Unearned revenue	17,004	13,070
Accrued expenses	14,548	13,232
Accrued wages and benefits	12,604	15,948
Income tax payable	14,340	3,936
Total Current Liabilities	123,528	106,818
Non-current unearned revenue	3,846	4,556
Other non-current liabilities	32,255	34,209
Bonds payable	25,600	25,600
Total Liabilities	185,229	171,183
Commitments and contingencies (see Note 15)		
Stockholders' Equity		
Common stock, par value $0.01 per share; 200,000 shares authorized; 79,652 shares issued and 47,711 shares outstanding at September 30, 2018 and 79,652 shares issued and 48,485 shares outstanding at December 31, 2017	797	797

Additional paid-in capital	265,757	260,515
Accumulated other comprehensive loss	(9,564)	(3,295)
Retained earnings	900,324	922,178
Less treasury stock at cost: 31,941 and 31,167 shares at September 30, 2018 and December 31, 2017, respectively	(693,713)	(682,284)
Total Stockholders’ Equity	463,601	497,911
Total Liabilities and Stockholders’ Equity	$ 648,830	$ 669,094

See accompanying notes to consolidated financial statements.

ADTRAN, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Sales				
Products	$121,043	$145,467	$341,359	$444,607
Services	19,292	39,645	47,830	95,457
Total Sales	140,335	185,112	389,189	540,064
Cost of Sales				
Products	69,943	73,534	208,184	229,861
Services	11,944	25,087	32,828	65,377
Total Cost of Sales	81,887	98,621	241,012	295,238
Gross Profit	58,448	86,491	148,177	244,826
Selling, general and administrative expenses	30,750	34,676	96,361	104,171
Research and development expenses	29,877	33,588	93,455	99,116
Operating Income (Loss)	(2,179)	18,227	(41,639)	41,539
Interest and dividend income	825	952	2,604	2,857
Interest expense	(134)	(139)	(398)	(417)
Net investment gain	4,507	1,009	5,400	2,869
Other income (expense), net	201	(842)	(73)	(1,427)
Gain on bargain purchase of a business	—	—	11,322	—
Income (Loss) Before Provision for Income Taxes	3,220	19,207	(22,784)	45,421
(Provision) benefit for income taxes	4,369	(3,309)	11,889	(10,471)
Net Income (Loss)	$7,589	$15,898	$(10,895)	$34,950
Weighted average shares outstanding – basic	47,710	47,870	47,927	48,110
Weighted average shares outstanding – diluted	47,834	48,531	47,927	48,618
Earnings (loss) per common share – basic	$0.16	$0.33	$(0.23)	$0.73
Earnings (loss) per common share – diluted	$0.16	$0.33	$(0.23)	$0.72
Dividend per share	$0.09	$0.09	$0.27	$0.27

See accompanying notes to consolidated financial statements.

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ADTRAN, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income (Loss)	$7,589	$15,898	$(10,895)	$34,950
Other Comprehensive Income (Loss), net of tax				
Net unrealized gains (losses) on available-for-sale securities	(32)	804	(3,340)	2,512
Net unrealized gains (losses) on cash flow hedges	—	142	—	(196)
Defined benefit plan adjustments	37	73	104	214
Foreign currency translation	(451)	1,541	(3,033)	5,402
Other Comprehensive Income (Loss), net of tax	(446)	2,560	(6,269)	7,932
Comprehensive Income (Loss), net of tax	$7,143	$18,458	$(17,164)	$42,882

See accompanying notes to consolidated financial statements.

ADTRAN, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Cash flows from operating activities:		
Net income (loss)	$(10,895)	$34,950
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	11,952	12,034
Amortization of net premium on available-for-sale investments	(14)	352
Net gain on long-term investments	(5,400)	(2,869)
Net (gain) loss on disposal of property, plant and equipment	68	(10)
Gain on bargain purchase of a business	(11,322)	—
Stock-based compensation expense	5,243	5,573
Deferred income taxes	(20,368)	—
Changes in operating assets and liabilities:		
Accounts receivable, net	41,166	(6,975)
Other receivables	(1,842)	(2,924)
Inventory	16,543	(9,483)
Prepaid expenses and other assets	8,722	(9,647)
Accounts payable	5,223	(4,727)
Accrued expenses and other liabilities	156	(2,820)
Income tax payable	9,461	8,571
Net cash provided by operating activities	48,693	22,025
Cash flows from investing activities:		
Purchases of property, plant and equipment	(5,695)	(12,304)
Proceeds from disposals of property, plant and equipment	—	16
Proceeds from sales and maturities of available-for-sale investments	116,757	137,272
Purchases of available-for-sale investments	(115,271)	(79,713)
Acquisition of business	(7,806)	—
Net cash provided by (used in) investing activities	(12,015)	45,271
Cash flows from financing activities:		
Proceeds from stock option exercises	1,321	6,606
Purchases of treasury stock	(14,185)	(17,348)
Dividend payments	(12,976)	(13,031)
Net cash used in financing activities	(25,840)	(23,773)
Net increase in cash and cash equivalents	10,838	43,523
Effect of exchange rate changes	(3,098)	4,835
Cash and cash equivalents, beginning of period	86,433	79,895
Cash and cash equivalents, end of period	$94,173	$128,253

Supplemental disclosure of non-cash investing activities:		
Purchases of property, plant and equipment included in accounts payable	$355	$272

See accompanying notes to consolidated financial statements.

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, 2017 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 to fairly state these interim statements have been recorded 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, 2017, filed on February 23, 2018 with the SEC.

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. Our more significant estimates include the obsolete and excess inventory reserves, warranty reserves, customer rebates, determination of the deferred revenue components of multiple element sales agreements, estimated costs to complete obligations associated with deferred revenues, estimated income tax provision and income tax contingencies, the fair value of stock-based compensation, impairment of goodwill, valuation and estimated lives of intangible assets, estimated pension liability, fair value of investments, and the evaluation of other-than-temporary declines in the value of investments. Actual amounts could differ significantly from these estimates.

Recent Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*. ASU 2016-02 requires an entity to recognize lease assets and lease liabilities on the balance sheet and to disclose key information about the entity's leasing arrangements. In July 2018, the FASB issued ASU 2018-10, *Codification Improvements to Topic 842, Leases,* which clarified certain aspects of ASU 2016-02, as well as, ASU 2018-11, *Leases (Topic 842), Targeted Improvements,* which provides for an optional transition method that allows for the application of current legacy guidance, including its disclosure requirements, in the comparative periods presented in the year of adoption. Otherwise, *Topic 842* must be adopted by a modified retrospective method, with elective reliefs, which requires application of the new guidance for all periods presented. The Company plans to use the optional transition method when adopting the new standard. ASU 2016-02, ASU 2018-10 and ASU 2018-11 are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. We anticipate the adoption of these ASUs will have a material increase in the assets and liabilities of our consolidated balance sheets; however, we do not believe adoption will have a material effect on our results of operations. We believe the most significant effect relates to our accounting for operating leases for office space.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.* ASU 2016-13 requires the measurement and recognition of expected credit losses for financial instruments held at amortized cost. ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. We are currently evaluating the effect ASU 2016-13 will have on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. ASU 2017-04 simplifies the measurement of goodwill by eliminating step 2 of the goodwill impairment test. Under ASU 2017-04, entities will be required to compare the fair value of a reporting unit to its carrying amount and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. ASU 2017-04 is effective for annual or interim impairment tests performed in fiscal years beginning after December 15, 2019, with early adoption permitted for annual or interim impairment tests performed on testing dates after January 1, 2017. The amendments should be applied prospectively. We are currently evaluating whether to early adopt ASU 2017-04, but we do not expect it will have a material effect on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*, which shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. ASU 2017-08 is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2018 with early adoption permitted. The amendments should be applied through a modified-retrospective transition approach that requires a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. We are currently evaluating the effect of ASU 2017-08, but we do not expect it will have a material effect on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*. ASU 2017-12 expands and refines hedge accounting for both financial and non-financial risk components, aligns the recognition and presentation of the effects of hedging instruments and hedge items in the financial statements, and includes certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. ASU 2017-12 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. We are currently evaluating the effect ASU 2017-12 will have on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Comprehensive Income.* ASU 2018-02 allows for an optional reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017. ASU 2018-02 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. We are currently evaluating whether to reclassify stranded tax effects related to the Tax Cuts and Jobs Act of 2017, but we do not expect ASU 2018-02 will have a material effect on our consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820) Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement,* which changes the fair value measurement disclosure requirements of ASC 820, *Fair Value Measurement.* The amendments in this ASU are the result of a broader disclosure project called, *Concepts Statement No. 8 - Conceptual Framework for Financial Reporting — Chapter 8, Notes to Financial Statements*, which the FASB finalized on August 28, 2018. The FASB used the guidance in the Concepts Statement to improve the effectiveness of ASC 820's disclosure requirements. ASU 2018-13 provides users of financial statements with information about assets and liabilities measured at fair value in the statement of financial position or disclosed in the notes to the financial statements. More specifically ASU 2018-13 requires disclosures about the valuation techniques and inputs that are used to arrive at measures of fair value, including judgments and assumptions that are made in determining fair value. In addition, ASU 2018-13 requires disclosures regarding the uncertainty in the fair value measurements as of the reporting date and how changes in fair value measurements affect performance and cash flows. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. We are currently evaluating the effect of ASU 2018-13, but we do not expect it will have a material effect on our financial statement disclosures.

In August 2018, the FASB issued ASU 2018-14, *Compensation-Retirement Benefits-Defined Benefit Plans-General (Subtopic 715-20): Disclosure Framework-Changes to the Disclosure Requirements for Defined Benefit Plans,* which makes changes to and clarifies the disclosure requirements related to defined benefit pension and other postretirement plans. ASU 2018-14 requires additional disclosures related to the reasons for significant gains and losses affecting the benefit obligation and an explanation of any other significant changes in the benefit obligation or plan assets that are not otherwise apparent in other disclosures required by ASC 715. ASU 2018-14 also clarifies the guidance in ASC 715 to require disclosure of the projected benefit obligation (PBO) and fair value of plan assets for pension plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for pension plans with ABOs in excess of plan assets. ASU 2018-14 is effective for public business entities for fiscal years ending after December 15, 2020. We are currently evaluating the effect of ASU 2018-14, but we do not expect it will have a material effect on our financial statement disclosures.

In August 2018, the FASB issued ASU 2018-15, *Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40), Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract.* ASU 2018-15 clarifies certain aspects of ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement.* Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementations costs incurred to develop or obtain internal use software. ASU 2018-15 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. We are currently evaluating whether to early adopt, but we do not expect it will have a material effect on our consolidated financial statements.

During 2018, we adopted the following accounting standards, which had the following effects on our consolidated financial statements:

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, including most industry-specific revenue recognition guidance throughout the Industry Topics of the Codification. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. In August 2015, the FASB issued ASU 2015-14, which deferred the effective date of ASU 2014-09 to fiscal years beginning after December 31, 2017, and interim periods within those fiscal years, with early adoption permitted for reporting periods beginning after December 15, 2016. Subsequently, the FASB issued ASUs in 2016 containing implementation guidance related to ASU 2014-09, including: ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, which is intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations; ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, which is intended to clarify two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance; ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, which contains certain provisions and practical expedients in response to identified implementation issues; and ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers,* which is intended to clarify the Codification and/or to correct unintended application of guidance. ASU 2014-09 allows for either full retrospective or modified retrospective adoption. We adopted ASU 2014-09 and the related ASUs on January 1, 2018 using the modified retrospective method, which was applied to all contracts on the date of initial adoption.

These ASUs primarily affected our network implementation service revenue performance obligations and contract costs. We are using the "output method" to measure network implementation services progress, which 1) accelerates revenue recognition for certain performance obligations related to service revenue arrangements that were previously deferred until customer acceptance and 2) requires capitalization and amortization of the incremental costs of obtaining a contract as described below.

In connection with the adoption of the new revenue standard, effective January 1, 2018, we adopted ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, with respect to capitalization and amortization of incremental costs of obtaining a contract. As a result, certain costs of obtaining a contract, including sales commissions, will be capitalized, as the guidance requires the capitalization of all incremental costs incurred to obtain a contract with a customer that it would not have incurred if the contract had not been obtained, provided the costs are recoverable. The primary effect was the capitalization of certain sales commissions for our extended maintenance and support contracts in excess of one year and amortization of those costs over the period that the related revenue is recognized.

The cumulative effect of the changes made to our Consolidated Balance Sheet on January 1, 2018 for the adoption of ASU 2014-09 and the related ASUs was as follows:

(In thousands)	Balance at December 31, 2017	Adjustments due to ASU 2014-09	Balance at January 1, 2018
Other receivables	$ 26,578	$ 374	$ 26,952
Deferred tax assets, net	$ 23,428	$ (96)	$ 23,332
Retained earnings	$ 922,178	$ 278	$ 922,456

The effect of the adoption of ASU 2014-09 and the related ASUs on our financial statements was as follows:

(In thousands)	For the three months ended September 30, 2018 As Reported	Balances Without Adoption of ASC 606	Effect of Adoption of ASC 606
Sales			
Products	$121,043	$120,588	$ 455
Services	$19,292	$17,932	$ 1,360
Cost of Sales			
Products	$69,943	$69,754	$ 189
Services	$11,944	$11,046	$ 898
Income before benefit for income taxes	$3,220	$2,492	$ 728
Benefit for income taxes	$4,369	$3,382	$ 987
Net income	$7,589	$5,874	$ 1,715

(In thousands)	For the nine months ended September 30, 2018 As Reported	Balances Without Adoption of ASC 606	Effect of Adoption of ASC 606
Sales			
Products	$341,359	$341,464	$ (105)
Services	$47,830	$46,062	$ 1,768
Cost of Sales			
Products	$208,184	$208,480	$ (296)
Services	$32,828	$31,743	$ 1,085
Loss before benefit for income taxes	$(22,784)	$(23,658)	$ 874
Benefit for income taxes	$11,889	$10,938	$ 951
Net loss	$(10,895)	$(12,720)	$ 1,825

(In thousands)	As of September 30, 2018 As Reported	Balances Without Adoption of ASC	Effect of Adoption of ASC 606

		606	
Assets			
Other receivables	$30,084	$27,917	$ 2,167
Inventory	$106,060	$106,402	$ (342)
Equity			
Retained earnings	$900,324	$898,499	$ 1,825

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments — Overall: Recognition and Measurement of Financial Assets and Financial Liabilities,* which addresses certain aspects of the recognition, measurement, presentation and disclosure of financial instruments. Subsequently, the FASB issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which issued technical corrections and improvements intended to clarify certain aspects of ASU 2016-01. ASU 2016-01 was effective beginning January 1, 2018 and we now recognize any changes in the fair value of certain equity investments in net income as prescribed by the new standard rather than in other comprehensive income. We adopted ASU 2016-01 on January 1, 2018 using the modified retrospective method, which resulted in a $3.2 million reclassification of net unrealized gains from accumulated other comprehensive income to opening retained earnings. ASU 2018-03 is effective for us with the interim period beginning after June 15, 2018.

In March 2017, the FASB issued ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. ASU 2017-07 amends ASC 715, *Compensation — Retirement Benefits*, to require employers that present a measure of operating income in their statements of earnings to include only the service cost component of net periodic pension cost and net periodic postretirement benefit cost in operating expenses (together with other employee compensation costs). The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in non-operating expenses. We adopted ASU 2017-07 on January 1, 2018. We retrospectively adopted the presentation of service cost separate from other components of net periodic pension costs. As a result, \$0.1 million and \$0.3 million have been reclassified from cost of sales, selling, general and administrative expenses, and research and development expense to other income (expense), net for the three and nine months ended September 30, 2017, respectively.

2. BUSINESS COMBINATIONS

On March 19, 2018, we acquired Sumitomo Electric Lightwave Corp.'s (SEL) North American EPON business and entered into a technology license and OEM supply agreement with Sumitomo Electric Industries, Ltd. (SEI). This acquisition establishes ADTRAN as the North American market leader for EPON solutions for the cable MSO industry and it will accelerate the MSO market's adoption of our open, programmable and scalable architectures. This transaction was accounted for as a business combination. We have included the financial results of this acquisition in our consolidated financial statements since the date of acquisition. These revenues are included in the Access & Aggregation and Customer Devices categories within the Network Solutions reportable segment.

We recorded a bargain purchase gain of \$11.3 million during the first quarter of 2018, net of income taxes, which is subject to customary working capital adjustments between the parties. The bargain purchase gain of \$11.3 million represents the difference between the fair value of the net assets acquired over the cash paid. SEI, an OEM supplier based in Japan, is the global market leader in EPON. SEI's Broadband Networks Division, through its SEL subsidiary, operated a North American EPON business that included sales, marketing, support, and region-specific engineering development. The North American EPON market is primarily driven by the Tier 1 cable MSO operators and has developed more slowly than anticipated. Through the transaction, SEI divested its North American EPON assets and established a relationship with ADTRAN. The transfer of these assets to ADTRAN, which included key customer relationships and a required assumption by ADTRAN of relatively low incremental expenses, along with the value of the technology license and OEM supply agreement, resulted in the bargain purchase gain. We have assessed the recognition and measurement of the assets acquired and liabilities assumed based on historical and forecasted data for future periods and we have concluded that our valuation procedures and resulting measures were appropriate.

The preliminary allocation of the purchase price to the estimated fair value of the assets acquired and liabilities assumed at the acquisition date is as follows:

(In thousands)	
Assets	
Other receivables	$104

Inventory	510
Property, plant and equipment	392
Intangible assets	22,100
Total assets acquired	23,106
Liabilities	
Deferred income taxes	(3,978)
Total liabilities assumed	(3,978)
Total net assets	19,128
Gain on bargain purchase of a business, net of tax	(11,322)
Total purchase price	$7,806

The actual revenue and net loss included in our Consolidated Statements of Income for the three months ended September 30, 2018 and the period March 19, 2018 to September 30, 2018 are as follows:

(In thousands)	Three Months Ended September 30, 2018	March 19, 2018 to September 30, 2018
Revenue	$ 1,021	$ 2,218
Net income (loss)	$ 564	$ (322)

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The details of the acquired intangible assets are as follows:

(In thousands)	Value	Life (years)
Customer relationships	$13,400	12.0
Licensed technology	5,900	9.0
Supplier relationship	2,800	2.0
Total	$22,100	

The following unaudited supplemental pro forma information presents the financial results as if the acquisition had occurred on January 1, 2017. This unaudited supplemental pro forma information does not purport to be indicative of what would have occurred had the acquisition been completed on January 1, 2017, nor is it indicative of any future results. Aside from revising the 2017 and 2018 net income for the effect of the bargain purchase gain, there were no material, non-recurring adjustments to this unaudited pro forma information.

(In thousands)	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	2017
Pro forma revenue	$ 187,027	$390,449	$545,706
Pro forma net income (loss)	$ 14,997	$(23,431)	$43,826
Pro forma earnings per share - basic	$ 0.31	$(0.49)	$0.91
Pro forma earnings per share - diluted	$ 0.31	$(0.49)	$0.90

For the three and nine months ended September 30, 2018, we incurred acquisition and integration related expenses and amortization of acquired intangibles of $0.7 million and $1.6 million, respectively, related to this acquisition.

3. REVENUE

Revenue is measured based on the consideration we expect to receive in exchange for transferring goods or providing services to a customer and as performance obligations under the terms of the contract are satisfied. Generally, this occurs with the transfer of control of a product or service to the customer. For transactions where there are multiple performance obligations, we account for individual products and services separately if they are distinct (if a product or service is separately identifiable from other items and if a customer can benefit from it on its own or with other resources that are readily available to the customer). The consideration, including any discounts, is allocated between separate products and services based on their stand-alone selling prices. The stand-alone selling prices are determined based on the prices at which we sell the separate products and services and are allocated based on each item’s relative value to the total value of the products and services in the arrangement. For items that are not sold separately, we estimate stand-alone selling prices primarily using the “expected cost plus a margin” approach. Payment terms are typically 30 days. Shipping fees are recorded as revenue and the related cost is included in cost of sales. Sales, value-added, and other taxes collected concurrently with revenue-producing activities are excluded from revenue. Costs of obtaining a contract are capitalized and amortized over the period that the related revenue is recognized if greater than one year. We have elected to apply the practical expedient related to the incremental costs of obtaining contracts and recognize those costs as an expense when incurred if the amortization period of the assets is one year or less. These costs are included in selling, general and administrative expenses. Capitalized costs with an amortization period greater than one year were immaterial.

The following is a description of the principal activities from which we generate our revenue by reportable segment.

Network Solutions Segment

Network Solutions includes hardware products and next-generation virtualized solutions used in service provider or business networks, as well as prior generation products.

Hardware

The majority of the revenue from this segment is from hardware sales and is recognized when control is transferred to our customers, which is generally when we ship the products. Shipping terms are generally FOB shipping point. Revenue is recorded net of estimated discounts and rebates using historical trends. Customers are typically invoiced when control is transferred and revenue is recognized. Our products generally include assurance-based warranties of 90 days to five years for product defects, which are accrued at the time revenue is recognized.

In certain transactions, we are also the lessor in sales-type lease arrangements for network equipment that have terms of 18 months to five years. These arrangements typically include network equipment, network implementation services and maintenance services. Product revenue for these leases is generally recorded when we transfer control of the product to our customers. Revenue for network implementation and maintenance services is recognized as described below. Customers are typically invoiced and pay in equal installments over the lease term. In relation to these lease agreements, during the three months ended September 30, 2018 and 2017, we recognized revenue of $4.2 million and $8.4 million, respectively, and during the nine months ended September 30, 2018 and 2017 we recognized revenue of $10.5 million and $15.4 million, respectively.

Services & Support Segment

To complement our Network Solutions segment, we offer a complete portfolio of maintenance, network implementation, and solutions integration and managed services, which include hosted cloud services and subscription services.

Maintenance

Our maintenance service periods range from one month to five years. Customers are typically invoiced and pay for maintenance services at the beginning of the maintenance period. We recognize revenue for maintenance services on a straight-line basis over the maintenance period in services revenue as our customers benefit evenly throughout the contract term and deferred revenues are recorded in current and non-current unearned revenue.

Network Implementation

We recognize revenue for network implementation, which primarily consists of engineering, execution and enablement services, at a point in time when each performance obligation is complete. If we have recognized revenue, but have not billed the customer, the right to consideration is recognized as a contract asset that is included in other receivables in the Consolidated Balance Sheet. The contract asset is transferred to accounts receivable when the completed performance obligation is invoiced to the customer.

As of September 30, 2018, we did not have any significant performance obligations related to customer contracts that had an original expected duration of one year or more, other than maintenance services, which are satisfied over time.

The following table provides information about receivables, contract assets, and unearned revenue from contracts with customers:

(In thousands)

	September 30, 2018	January 1, 2018
Accounts receivable	$ 101,865	$144,150
Contract assets	$ 4,564	$374
Unearned revenue	$ 17,004	$13,070
Non-current unearned revenue	$ 3,846	$4,556

The decrease in accounts receivable is due to the collection of customer specific payment terms that became due in the first quarter of 2018. The increase in the contract asset balance for the nine months ended September 30, 2018 is primarily attributable to revenue recognized that has not yet been billed to the customer during the period. The increase in the unearned revenue balance as of nine months ended September 30, 2018 is primarily attributable to cash payments received or due in advance of satisfying our performance obligations, offset by $8.9 million of revenues recognized that were included in the unearned revenue balance as of December 31, 2017.

The following table disaggregates our revenue by major source for the three months ended September 30, 2018:

(In thousands)	Network Solutions	Services & Support	Total
Access & Aggregation	$76,046	$15,855	$91,901
Customer Devices	37,313	1,239	38,552
Traditional & Other Products	7,684	2,198	9,882
Total	$121,043	$19,292	$140,335

The following table disaggregates our revenue by major source for the nine months ended September 30, 2018:

(In thousands)	Network Solutions	Services & Support	Total
Access & Aggregation	$220,653	$37,670	$258,323
Customer Devices	99,396	3,817	103,213
Traditional & Other Products	21,310	6,343	27,653
Total	$341,359	$47,830	$389,189

4. INCOME TAXES

Our effective tax rate decreased from an expense of 23.1% in the nine months ended September 30, 2017, to a benefit of 34.9%, excluding the tax effect of the bargain purchase gain, in the nine months ended September 30, 2018. The decrease in the effective tax rate between the two periods is primarily driven by the completion of other tax projects, current year net losses in our domestic business and the effect of the U.S. Tax Cuts and Jobs Act, which was signed into law on December 22, 2017.

5. PENSION BENEFIT PLAN

We maintain a defined benefit pension plan covering employees in certain foreign countries.

The following table summarizes the components of net periodic pension cost for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2018	2017	2018	2017
Service cost	$294	$327	$905	$930
Interest cost	179	158	551	448

Expected return on plan assets	(381)	(329)	(1,174)	(935)
Amortization of actuarial losses	61	80	188	228
Net periodic pension cost	$153	$236	$470	$671

The components of net periodic pension cost other than the service cost component are included in the line item “Other income (expense), net” in the Consolidated Statements of Income.

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6. STOCK-BASED COMPENSATION

The following table summarizes the stock-based compensation expense related to stock options, performance stock units (PSUs), restricted stock units (RSUs) and restricted stock for the three and nine months ended September 30, 2018 and 2017, which was recognized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2018	2017	2018	2017
Stock-based compensation expense included in cost of sales	$101	$97	$298	$281
Selling, general and administrative expense	894	994	2,924	3,018
Research and development expense	645	743	2,021	2,274
Stock-based compensation expense included in operating expenses	1,539	1,737	4,945	5,292
Total stock-based compensation expense	1,640	1,834	5,243	5,573
Tax benefit for expense associated with non-qualified options, PSUs, RSUs and restricted stock	(292)	(402)	(1,016)	(1,215)
Total stock-based compensation expense, net of tax	$1,348	$1,432	$4,227	$4,358

Stock Options

The following table is a summary of our stock options outstanding as of December 31, 2017 and September 30, 2018 and the changes that occurred during the nine months ended September 30, 2018:

(In thousands, except per share amounts)	Number of Stock Options	Weighted Avg. Exercise Price	Weighted Avg. Remaining Contractual Life In Years	Aggregate Intrinsic Value
Stock options outstanding, December 31, 2017	5,148	$ 22.65	4.87	$ 6,109
Stock options granted	—	$ —		
Stock options exercised	(85)	$ 15.48		
Stock options forfeited	(71)	$ 16.50		
Stock options expired	(331)	$ 25.87		
Stock options outstanding, September 30, 2018	4,661	$ 22.64	4.12	$ 2,730
Stock options vested and expected to vest, September 30, 2018	4,661	$ 22.64	4.12	$ 2,730
Stock options exercisable, September 30, 2018	3,952	$ 23.75	3.63	$ 1,600

The aggregate intrinsic values in the table above represent the total pre-tax intrinsic value (the difference between the closing price of our stock on the last trading day of the quarter and the exercise price, multiplied by the number of in-the-money stock options) that would have been received by the option holders had all option holders exercised their options on September 30, 2018. The aggregate intrinsic value will change based on the fair market value of our stock.

The total pre-tax intrinsic value of options exercised during the three and nine months ended September 30, 2018 was $0.1 million and $0.2 million, respectively.

As of September 30, 2018, there was $1.2 million of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over an average remaining recognition period of 1.0 years.

The fair value of our stock options is 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.

There were no stock options granted during the three and nine months ended September 30, 2018 or 2017.

PSUs, RSUs and restricted stock

The following table is a summary of our PSUs, RSUs and restricted stock outstanding as of December 31, 2017 and the changes that occurred during the nine months ended September 30, 2018:

(In thousands, except per share amounts)	Number of Shares	Weighted Avg. Grant Date Fair Value
Unvested PSUs, RSUs and restricted stock outstanding, December 31, 2017	1,292	$ 21.33
PSUs, RSUs and restricted stock granted	22	$ 17.84
PSUs, RSUs and restricted stock vested	(14)	$ 20.19
PSUs, RSUs and restricted stock forfeited	(165)	$ 21.66
Unvested PSUs, RSUs and restricted stock outstanding, September 30, 2018	1,135	$ 21.23

The fair value of our PSUs with market conditions is calculated using a Monte Carlo simulation valuation method. The fair value of RSUs and restricted stock is equal to the closing price of our stock on the date of grant. During the first quarter of 2017, the Compensation Committee of the Board of Directors approved a PSU grant of 0.5 million shares that contain performance conditions. The fair value of these performance-based PSU awards was equal to the closing price of our stock on the date of grant.

As of September 30, 2018, there was $9.8 million of unrecognized compensation expense related to unvested market-based PSUs, RSUs and restricted stock, which is expected to be recognized over an average remaining recognition period of 2.6 years. In addition, there was $9.4 million of unrecognized compensation expense related to unvested performance-based PSUs, which will be recognized over the requisite service period of three years as the achievement of the performance objective becomes probable. For the three and nine months ended September 30, 2018, no compensation expense was recognized related to these performance-based PSU awards.

7. INVESTMENTS

Debt Securities and Other Investments

At September 30, 2018, we held the following debt securities and other investments, recorded at either fair value or cost:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Carrying Value
Corporate bonds	$ 25,758	$ 13	$ (209)	$ 25,562
Municipal fixed-rate bonds	1,451	—	(36)	1,415
Asset-backed bonds	8,384	—	(29)	8,355
Mortgage/Agency-backed bonds	5,450	—	(87)	5,363

U.S. government bonds	19,957	—	(184)	19,773
Foreign government bonds	593	2	—	595
Available-for-sale debt securities held at fair value	$ 61,593	$ 15	$ (545)	$ 61,063
Restricted investment held at cost				26,700
Other investments held at cost				