Management's Discussion and Analysis

Introduction and Overview of Business

Tellabs designs, develops, deploys and supports telecommunications networking products around the world. Our product portfolio includes solutions for wireline and wireless transport, access networking, broadband data, optical transport and voice-quality enhancement.

We generate revenue principally through the sale of telecommunications products, both as stand-alone products and as elements of integrated systems, to many of the world's largest telecommunications service providers. In addition, we generate revenue by providing installation and professional services related primarily to our own products and systems.

In North America we derive the majority of our product revenue from transport products, principally digital cross-connect systems that manage and route network traffic and combine, consolidate and segregate signals to maximize efficiency; and access products that support the delivery of voice, data and video services to residences and businesses over copper wire and fiber-optic cable. Demand for transport products is driven by end-user demand for wireline and wireless services, bandwidth, industry capacity utilization, service provider capital expenditure budgets and competing technologies. Demand for access products is driven by consumer demand for voice, data and video services and the competition among traditional telecommunications companies and cable service operators to be the sole source provider of voice, data and video services (referred to as the "triple play"). According to industry analysts, Tellabs has a market-leading position in the U.S. transport and access markets.

Outside North America, we earn the majority of our product revenue from managed access and transport systems that control the flow of voice and data across communications networks. Demand is driven primarily by business services for voice and high-speed data, and network transport services for wireless communications. Demand for these products is driven by end-user demand for bandwidth, industry capacity utilization, service provider capital expenditure budgets and competing technologies.

Globally, we earn services revenue from network construction, support agreements and other professional services. Network construction revenue, which is more than half of services revenue, arises primarily from sales of our transport products in North America and tends to lag product sales by approximately one fiscal quarter. Revenue from support agreements arises primarily from sales of our managed access and transport systems, with approximately half coming from outside of North America. Other professional services offered by the company include network deployment, traffic management and training.

The markets for our products have undergone dynamic change over the last few years. Beginning in 2001, carrier overcapacity, a softening economy and other factors caused our customers to reduce their capital spending significantly. The impact on Tellabs was a dramatic decline in revenue for each of the years 2001 through 2003. In addition, we had manufacturing overcapacity, excess inventories and a cost structure that could not be supported by our smaller revenue base. We responded by closing manufacturing facilities, reducing global headcount, consolidating office space, exiting certain product lines and instituting cost controls across the organization. We also reviewed our product portfolio and cut back or stopped development efforts on some products. In addition, at the end of 2003, we moved to outsource the majority of our remaining manufacturing operations to third-party electronics manufacturing services providers to take advantage of their greater purchasing power and other efficiencies. These actions caused us to record material charges in 2001 through 2005 for excess and obsolete inventory and excess purchase commitments, severance costs, facilities shutdown costs, including accelerated depreciation on certain manufacturing and office buildings and equipment due to shortened useful lives, and various contractual obligations. We also recorded charges for other impaired and surplus assets.

Market stability began in 2003 and continued in 2004 and 2005 as service providers invested in their networks at levels at or above 2003. This stability enabled us to post year-over-year revenue growth in 2004 for the first time since fiscal 2000. Growing demand for wireless services, including third-generation (3G) services, drove capital investments by both wireless and wireline service providers and helped drive sales of our transport and managed access products.

Revenue growth was broad-based in 2005. We benefited from increasing wireless and data traffic by selectively enhancing our transport and managed access products with new features. In addition, we continued to address new, evolving growth opportunities with our broadband data networking and access products. Our acquisition of Advanced Fibre Communications, Inc. (AFC), was a significant part of our revenue growth in 2005 as its sales grew sequentially each quarter during the year. Additionally, through our acquisition of Vinci Systems, Inc., (Vinci) and the introduction of its optical network terminal (ONT) product, we were successful at reducing the cost of such product to close to breakeven.

For 2006, we will continue to focus on maximizing the synergies from our integration of AFC and continue to

review our spending, asset utilization and product development roadmap opportunities to optimize revenue, improve asset utilization and contain spending.

Acquisitions

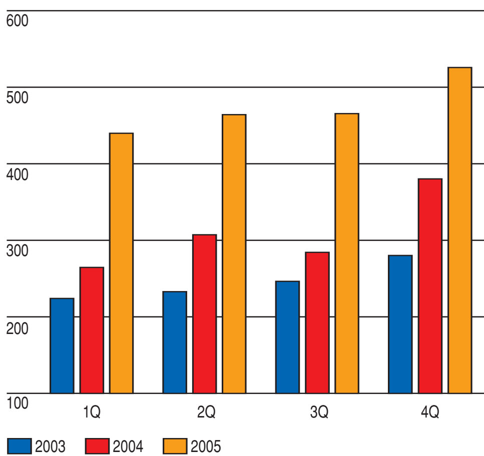
On December 30, 2004, Tellabs acquired Vinci, a privately held developer of ONTs for Fiber-to-the-Premises (FTTP) access systems, for up to $52.5 million in cash and Tellabs restricted stock. Of the $52.5 million, $34.0 million was paid through 2005, with the remainder expected to be paid in 2006. Acquiring Vinci's ONT technology enabled us to deliver a more cost-effective fiber-access solution. We accounted for this acquisition under the purchase method and recorded the final adjustments to the purchase price in 2005.

On November 30, 2004, Tellabs acquired AFC, a leading supplier of access products, for approximately $1.6 billion. Under the terms of the acquisition, AFC stockholders received 0.504 shares of Tellabs common stock and $12.00 in cash for each AFC share of common stock. We issued approximately 44.8 million shares of our common stock for the acquisition. We used our U.S.-based cash and cash equivalents to satisfy the cash portion of the purchase price. As a result of the transaction, at the acquisition date, historical Tellabs stockholders owned approximately 90% of the combined company and historical AFC stockholders owned approximately 10%. In conjunction with the acquisition, Frank Ianna, a director of AFC and retired president of AT&T Network Services, joined the Tellabs board of directors. Our results of operations for the fourth-quarter and full-year 2004 include AFC's results for the one-month period following the acquisition. We report AFC's and Vinci's products in the revenue category called access. We accounted for this acquisition under the purchase method and recorded the final adjustments to the purchase price in 2005.

As a result of our acquisition of AFC, we became party to a multiyear agreement with Verizon Services Group (Verizon) to be the primary FTTP project vendor in providing the central office and premises electronics required for the delivery of telephone, data and video services to customers' homes or business locations over fiber-optic cable. Although we expect the overall contract to be profitable, gross margins are below Tellabs' historical gross margins. One component, the ONT, had been sold substantially below current cost through the third quarter of 2005, when we introduced a new version of the ONT from Vinci with a cost close to breakeven.

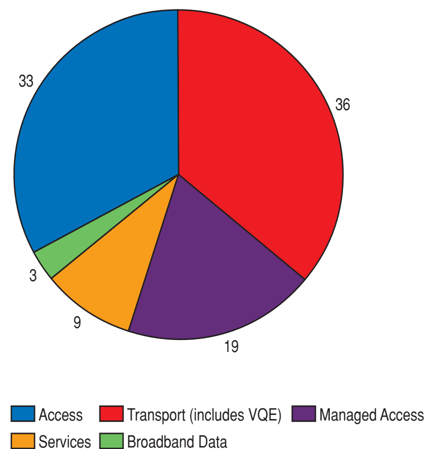
We have an ongoing program to continue to improve the profitability of the ONT. We expect product design changes, lower cost versions, component price reductions and increased production volumes to continue to improve gross margins for the ONT. We expect to continue to sell other components of the FTTP systems at a profit.

Quarterly Revenue
$ in millions



Tellabs revenue grew 53% in 2005 as the company returned to profitability.

2005 Revenue Distribution
Percent



2005 was Tellabs' first full year to include access products, which generated 33% of overall revenue.

Results of Operations

For 2005, we had net earnings of $175.8 million ($0.39 per share) compared with a net loss of $29.8 million ($0.07 per share) in 2004 and a net loss of $241.6 million ($0.58 per share) in 2003. The year-over-year improvements were driven by higher revenue and lower operating expenses as a percentage of revenues.

Revenue

In millions, except percentages	2005	2004	2003	*2005 vs. 2004*	*2004 vs. 2003*
Transport	$ 637.9	$ 597.9	$419.4	*7%*	*43%*
Access	617.0	53.3	—	*N/M*	*N/M*
Managed Access	364.8	331.0	336.1	*10%*	*(2%)*
Broadband Data	60.3	17.4	6.4	*N/M*	*172%*
Voice-Quality Enhancement	36.3	74.6	68.2	*(51%)*	*9%*
Services	167.1	157.6	150.3	*6%*	*5%*
Total	$1,883.4	$1,231.8	$980.4	*53%*	*26%*

N/M – Not meaningful.

Total revenue grew by 53% in 2005 compared with a 26% increase in 2004 (20% excluding the December 2004 revenue from AFC). Total 2005 revenue was $1,883.4 million compared with $1,231.8 million in 2004 and $980.4 million in 2003. Revenue in North America amounted to $1,419.4 million (75% of total revenue) in 2005 compared with $813.0 million (66% of total revenue) in 2004 and $597.8 million (61% of total revenue) in 2003. International revenue was $464.0 million (25% of total revenue) in 2005 compared with $418.8 million (34% of total revenue) in 2004 and $382.6 million (39% of total revenue) in 2003.

The increase in transport revenue in 2005 and 2004 came from increased spending by North American wireless service providers to meet growing capacity requirements and to build out their networks to provide 3G services. Shipments to our North American wireless customers accounted for approximately 55% of all transport revenue in 2005, compared with 50% in 2004 and 38% in 2003. Approximately 69% of 2005 revenue from wideband cross-connect products, which constitute the majority of transport revenue, came from port-card growth on our installed base, with the balance consisting of new systems, system expansions and software upgrades. This mix compares with 76% in 2004 and 69% in 2003. We shipped approximately 7.3 million T-1 equivalents in 2005 compared with 6.4 million in 2004 and 3.7 million in 2003. The transport category includes the Tellabs® 5300 and Tellabs® 5500 digital cross-connect systems, Tellabs® 5500 NGX transport switch, Tellabs® 6500 transport switch and Tellabs® 7100 optical transport system.

Fiscal 2005 was the first full year of revenue from AFC in our results. The importance of access in our 2005 growth is highlighted by the fact that access revenue increased in each quarter of the year. Approximately half this revenue was for fiber-to-the-premises and fiber-to-the-curb deployments, with most of the balance coming from copper-based access solutions. The access category includes the Tellabs® 1000 multiservice access system, Tellabs® 1100 multiservice access system and Tellabs® 1600 optical network terminal (ONT) series.

The 2005 increase in managed access revenue was due primarily to strength in sales of our managed transport systems and managed access systems driven by Ethernet-over-SDH applications and 3G wireless network build-outs. Revenue for 2004 compared with 2003 was relatively flat. The managed access category includes the Tellabs® 8100 managed access system, the Tellabs® 6300 managed transport system and the Tellabs® 2300 telephony distribution system.

Revenue from our broadband data products (which includes the Tellabs® 8800 multiservice router series and the Tellabs® 8600 managed edge system) has grown since we introduced them in the second half of 2003. We continued to add new customers in 2005, with our customer base now including wireline and wireless service providers as well as cable TV operators.

Voice-Quality Enhancement (VQE) revenue decreased from 2004 to 2005. Across the industry, VQE is migrating from a technology that is sold as stand-alone products to a technology that is integrated into transport, switching and other products. In fact, we have integrated voice-quality capability into our Tellabs® 5500 digital cross-connect system. Therefore, beginning in 2006, we will include all VQE revenue in the transport category. The increase in VQE revenue from 2003 to 2004 was attributable to increased spending by wireless service

providers. The VQE category primarily includes the Tellabs® 3000 series of VQE products.

Services revenue increased from 2004 to 2005 as a result of higher product sales. Services revenue from 2003 to 2004 was relatively flat as a larger percentage of our 2004 products in North America required less installation or were installed by our customers without assistance from Tellabs.

Gross Profit & Margin

In millions, except percentages	2005	2004	2003
Gross Profit	$855.0	$657.0	$354.0
Gross Margin	45.4%	53.3%	36.1%
Product Gross Profit	$807.5	$602.1	$317.1
Product Margin	47.0%	56.1%	38.2%
Services Gross Profit	$ 47.5	$ 54.9	$ 36.9
Services Margin	28.4%	34.8%	24.6%

Gross Margin

When we acquired AFC in the fourth quarter of 2004, its access products and related services had average gross margins that were substantially below the average for Tellabs products and services. Although the access product category had an overall margin below Tellabs average margin, one component, the Tellabs 610x ONT (optical network terminal for FTTP applications), had a cost that was substantially in excess of its selling price. However, beginning in the third quarter of 2005, a portion of our ONT revenue came from shipments of a new ONT, the Tellabs 611 ONT, which has a cost close to breakeven.

Negative margins from sales of ONTs and the inclusion of other access products were the principal drivers of the decrease in our overall gross margin in 2005 compared with 2004 (9.2 percentage points). The impact was offset partially by higher margins from products in the transport category (2.3 percentage points). During the periods presented, there were wide variances in our product and services gross margins due to a number of unusual items. In 2003 we incurred significant charges for excess and obsolete inventories and excess purchase commitments that did not recur in 2004 and 2005. Our gross margin in 2003 also was burdened by significant additional depreciation charges due to our decision to outsource our manufacturing operations and close facilities. These unusual charges were the key reasons for the differences between our consolidated gross margin of 36.1% in 2003 and the 53.3% gross margin in 2004. They likewise account for the difference in product gross margins for those periods.

Product Gross Margin

Product margins declined from 2004 to 2005 primarily due to the inclusion of the lower margin access products (10.5 percentage points), partially offset by lower manufacturing costs for our transport products (2.6 percentage points). Product gross margin improved in 2004 compared with 2003 due to the absence of significant unusual charges (11.7 percentage points), lower manufacturing-related costs (8.1 percentage points) and favorable product mix and other (0.7 percentage points). The inclusion of access product revenue and related costs for one month in 2004 reduced full-year 2004 product margins by 1.7 percentage points compared with 2003.

Services Gross Margin

The decrease in services gross margin in 2005 compared with 2004 was due to the addition of access-product related services in 2005 (8.2 percentage points) and higher material costs. Services gross margin improved in 2004 compared with 2003 due to labor efficiencies achieved as a result of reduced headcount in our services business. The inclusion of access services revenue and the related costs for one month in 2004 reduced 2004 services margin by 0.8 percentage points compared with 2003.

Gross Margin Trend

Our total gross margin will continue to be subject to variability due to product mix. Our gross margins are different for each product and services category and for each product within a category because they depend on specific system configurations sold and customer and geographic pricing differences. Under normal conditions, this variability has tended to affect our gross margin in the range of 2 to 3 percentage points up or down. In addition, since acquiring AFC near the end of 2004, our gross margin from the sale of ONTs reduced our overall gross margin. However, we have been successful in bringing the cost of our ONT to near breakeven by the end of 2005. We will continue our efforts to reduce the cost of ONTs through internal development and cost of parts savings.

Operating Expenses

In millions	Expense 2005	2004	2003	Percent of Revenue 2005	2004	2003
Research and development	$344.0	$250.3	$286.1	18.3%	20.3%	29.2%
Sales and marketing	175.5	155.1	143.5	9.3%	12.6%	14.6%
General and administrative	95.6	81.5	99.1	5.1%	6.6%	10.1%
Subtotal	615.1	486.9	528.7	32.7%	39.5%	53.9%
Intangible asset amortization	36.0	17.8	12.6			
Restructuring and other charges	12.9	14.1	77.2			
Purchased in-process R&D	2.2	102.1	—			
Asset impairment charge	—	47.2	—			
Net loss on sale of real estate	—	20.6	—			
Total Operating Expenses	$666.2	$688.7	$618.5			
Headcount at end of year	3,609	4,125[1]	3,515			

[1]Includes 1,084 employees at AFC and Vinci who joined Tellabs at the end of 2004.

The increase in research and development, sales and marketing, and general and administrative expenses from 2004 to 2005 is due primarily to the inclusion of approximately $184.0 million in operating expenses from AFC and Vinci for 2005 compared with $15.5 million of AFC operating expenses included in 2004. In 2005, we set a target to realize $30.0 million in operating expense reductions, based on the combined 2004 operating expense of Tellabs, AFC (including entities it acquired in 2004) and Vinci. By year-end, we realized more than $50.0 million in total operating expense reductions.

The total of research and development, sales and marketing, and general and administrative expenses decreased from 2003 to 2004 due to lower expenses in headcount-related areas such as benefits, travel and telecommunications as we reduced our global workforce. We also significantly reduced spending on prototypes and incurred lower facilities costs due to closing or vacating a number of owned and leased facilities over the periods. Sales and marketing expense increased in 2004 due to higher commissions and incentives on higher sales volume compared with 2003.

Intangible Asset Amortization

The increase in amortization from 2003 through 2005 is due to the amortization of developed technology acquired in our acquisitions of AFC and Vinci in late 2004. We adjusted intangible assets in 2005 for the final allocation of the purchase price of these acquisitions.

Restructuring and Other Charges

Restructuring and other charges were $12.9 million in 2005, $14.1 million in 2004 and $77.2 million in 2003. These charges continue to decrease as our previously announced restructuring and other activities wind down. The charges in 2003 relate to outsourcing of our global manufacturing operations, which resulted in a workforce reduction of approximately 500 employees, facility closures and asset disposals. Additional restructuring activities in 2003 included non-manufacturing workforce reductions and facility closures. As a result of these actions, we recorded charges for severance and related costs, asset impairments and accelerated depreciation due to a change in the useful lives of buildings and equipment because of the outsourcing of our North American manufacturing operations.

Purchased In-Process Research and Development

The charge to in-process research and development expense (IPR&D) was for the estimated fair value of IPR&D that we acquired when we purchased AFC and Vinci. IPR&D refers to the value of technology under development that does not have an alternative use outside of its value within the acquired business. Generally accepted accounting principles requires that IPR&D be expensed in whole at the time it is acquired. The value of the IPR&D at AFC was $89.0 million of the total charges and primarily was attributable to development of enhanced versions of the company's FTTP products. The remainder was attributable to development of ONTs at Vinci. We determined the estimated fair values of the IPR&D at both AFC and Vinci by using a discounted cash-flow analysis that incorporates estimates of the amounts of costs

remaining to complete the development, the amount of revenue that would result from the fully developed technology and an estimate of risk. The IPR&D amount in 2005 is due to the finalization of the purchase price allocation for these two acquisitions.

Asset Impairment Charge

In 2004, we determined that impairment indicators existed for our Tellabs® 5500 NGX switch asset group because actual and forecasted revenue for that group were lower than expected. We further determined that future undiscounted cash flows would not be sufficient to support the total carrying value of the asset group. We therefore recorded an impairment charge of $47.2 million to reduce the carrying value of those assets, principally amortizable intangibles, to their fair value. We determined the fair value of the assets by reference to the present value of the cash flows attributable to those assets over the remaining life of the intangibles, the primary asset in the asset group.

Net Loss on Sale of Real Estate

In 2004 we sold an administrative and research and development facility in Denmark, which resulted in a loss of approximately $21.1 million.

Other Income

In millions	2005	2004	2003
Interest income, net	$28.3	$26.9	$ 24.2
Other expense, net	(4.0)	(5.4)	(4.4)
Total	$24.3	$21.5	$ 19.8

Other expense, net in 2005 includes $1.8 million of losses from the sale of short-term investments, driven by the repatriation of cash in the fourth quarter; $4.0 million in income from a long-term investment purchased by a publicly traded entity; and a net $4.0 million loss from foreign currency transaction gains or losses made up of $19.3 million in gains from the impact of foreign currency transactions offset by $23.3 million in losses on forward foreign exchange contracts. *Other expense, net* also includes impairment charges to write down the carrying value of certain cost-basis equity investments in start-up technology companies and other long-term equity investments. These charges were $4.8 million in 2005, $11.2 million in 2004 and $3.3 million in 2003. *Other expense, net* in 2004 also includes a $6.6 million foreign currency gain resulting from converting a portion of our offshore cash from Euro-denominated investments to investments denominated in U.S. dollars.

Income Taxes

In millions, except percentages	2005	2004	2003
Income tax (expense) benefit	$(37.3)	$(19.6)	$3.1
Effective income tax rate	17.5%	192.2%	(1.3)%

Our tax expense increased in 2005 to $37.3 million, compared with tax expense of $19.6 million in 2004. The increase is due principally to a tax expense of $15.4 million associated with our repatriation of $600 million under the American Jobs Creation Act of 2004 (AJCA) and an increase in foreign taxes on higher foreign source income. The increase is offset by $10.1 million attributable to the reversal of reserves due to the expiration of the applicable statute of limitations to a potential claim in a foreign jurisdiction. Our tax expense increased to $19.6 million in 2004 from a benefit of $3.1 million in 2003, due to an increase in foreign taxes on higher foreign source income.

Our tax expense for 2003 and 2004 was impacted unfavorably by our inability to record a tax benefit for all or a portion of the domestic and foreign tax losses and other unused tax benefits (referred to herein as deferred tax assets). Generally, un-benefited deferred tax assets increase tax expense and decrease tax benefits in our results of operations in the year they arise or in the year we are required to accrue a valuation allowance against them.

In 2005 we re-evaluated the need to maintain a valuation allowance on our net deferred tax assets under the rules of SFAS 109. Based on this evaluation, which included a review of recent profitability and projections of future profitability, we concluded that a full valuation allowance against our net domestic deferred tax assets was no longer necessary. At December 30, 2005, we continued to maintain a valuation allowance of $14.2 million against deferred tax assets related to foreign net operating losses.

Financial Condition, Liquidity and Capital Resources

Our principal source of liquidity is our cash, cash equivalents and marketable securities. A significant portion of our cash historically has been provided by operations outside of the United States, with significant tax implications to repatriate these funds for domestic use. However, the AJCA created a one-time incentive for U.S. corporations to repatriate this foreign capital by providing an 85% dividends-received deduction with respect to qualifying dividends. In 2005, we repatriated approximately $600 million of existing foreign cash under the AJCA. Since we intend to continue to reinvest

unrepatriated foreign earnings outside the United States for the foreseeable future, we have not recognized any U.S. tax expense on those earnings.

In 2005, we generated $258.4 million of cash from operating activities and purchased $192.6 million (24.4 million shares) of our common stock under our $300.0 million stock repurchase plan, which was authorized by our Board of Directors in early 2005. In January 2006, our Board of Directors authorized the repurchase of up to $100.0 million in shares of our outstanding common stock. We intend to use cash generated by employee stock option exercises (other than those of company officers and the Board of Directors) to purchase stock under this separate plan.

We believe that the current level of working capital, particularly cash and marketable securities, is sufficient to meet our normal operating requirements for the foreseeable future. Further, we believe that sufficient resources exist to support our future growth and strategic needs. Future available sources of working capital include cash-on-hand, cash generated from future operations, short-term or long-term financing, equity offerings or any combination of these sources. Our current policy is to retain our earnings to provide funds for operating and expanding our business. We do not anticipate paying a cash dividend in the foreseeable future.

Contractual Obligations

The following table sets forth an overview of our contractual obligations as of December 30, 2005, that will affect our liquidity and cash flows in future periods:

		Payments Due by Period			
In millions	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating lease obligations	$ 86.5	$ 18.7	$30.1	$17.9	$19.8
Net operating lease obligations related to restructuring activities	29.7	5.7	12.1	9.8	2.1
Purchase commitments to contract manufacturers and suppliers	261.8	261.8	—	—	—
Cisco stock loan[1]	180.8	180.8	—	—	—
Cisco stock loan borrowing fees[2]	7.8	1.5	3.0	2.5	0.8
Total obligations	$566.6	$468.5	$45.2	$30.2	$22.7

1 Our agreement with the lender of the stock has no defined date when we must repay the loan; however, the loan is callable at the discretion of the lender.
2 For purposes of contractual obligations disclosure, we used Cisco's average share price of $17.12 for the quarter ended December 30, 2005, to determine the hypothetical value of the borrowing fees assuming the loans are settled in 2011.

We use several contract manufacturers and suppliers to provide manufacturing services for our products. During the normal course of business, to reduce manufacturing lead times and ensure adequate component supply, we enter into agreements with certain contract manufacturers and suppliers to enable them to procure inventory based upon criteria defined by us. Under these agreements, the maximum liability for purchase commitments as of December 30, 2005, was $261.8 million, of which $17.4 million was accrued on the balance sheet.

The Cisco stock loan borrowing fees that are recorded in the financial statements each period are based partially on Cisco's average share price at the end of each quarter.

Off-Balance Sheet Arrangements

None.

Critical Accounting Policies

The methods, estimates and judgments that we use in applying our accounting policies can have a significant impact on the results we report in the consolidated financial statements. Some of these estimates require difficult and subjective judgments, often as a result of the need to estimate matters that are inherently uncertain. For the reasons discussed below, we consider our critical accounting estimates to be the allowance for excess and obsolete inventory and excess purchase commitments (collectively E&O), goodwill valuation, the valuation of amortizable intangible assets, reserve requirements for lease obligations on vacated facilities, the valuation of deferred tax assets, the estimate of warranty liability and income taxes.

We have discussed the development and selection of these critical accounting policies and estimates with the Audit and Ethics Committee of our Board of Directors.

Excess & Obsolete Inventory and Excess Purchase Commitments

We determine our inventory cost using the first-in, first-out method, and we value our inventory at the lower of cost or market, with market determined by reference to current replacement cost. We determine the amount of inventory that is excess and obsolete (E&O) and purchase commitments in excess of requirements using estimates of future demand for individual components of raw materials and finished goods.

To determine E&O, we compare our existing inventory and inventory purchase commitments with estimates of future product demand and usage requirements. We consider quantities in excess of two years' expected usage to be excess and we record a full valuation allowance for that amount. For quantities that fall between one- and two-years' demand, we use management judgment to determine the appropriate E&O amount. We do not record an allowance if the quantity is less than one year's forecasted demand.

Because our visibility to future sales volume and product mix is limited and actual results can differ materially from our estimates, charges for E&O can have a material impact on our financial statements.

Goodwill

Accounting rules require that we evaluate goodwill for impairment annually. Because we report our operating results as a single segment or reporting unit, we performed the impairment test in 2005 by comparing the per-share market price of our stock with our net book value per share on our annual measurement date in the fourth quarter. Because the market price exceeded our net book value, we concluded that our goodwill was not impaired. Therefore, we did not perform additional impairment testing or record an impairment charge.

Intangible Assets

Our intangible assets consist primarily of purchased technology, which arose primarily from our acquisitions in 2004 and 2003.

We evaluate the carrying value of our intangible assets for impairment whenever indicators of impairment exist. If an impairment indicator exists, we compare the sum of the undiscounted future cash flows expected to result from the intangibles, or asset group of which the intangibles are a part, with our carrying value. If the sum of the undiscounted future cash flows is less than the carrying value, then we compare the fair value of the asset group with our carrying value to determine if an impairment charge is required. We calculate the amount of impairment by subtracting the asset's fair value from its carrying value.

We believe that the accounting estimate related to asset impairment is a critical accounting estimate because it requires us to make assumptions that are highly uncertain, including: future sales prices, sales volumes and margins for our products, including products that employ new technologies, and uncertainties around customer acceptance. The amount of any such impairment could be material to our financial statements.

Valuation Allowance for Deferred Tax Assets

Deferred tax assets arise when we record charges or expenses in our financial statements that will not be allowed as income-tax deductions until future periods. The term deferred tax asset also includes unused tax net operating losses and unused tax credits that we are allowed to carry forward to future years. Accounting rules permit us to carry deferred tax assets on the balance sheet at full value as long as it is "more likely than not" the deductions, losses or credits will be used in the future. A valuation allowance must be recorded against the deferred tax assets via a charge to income tax expense if the test cannot be met.

Through the quarter ended September 30, 2005, we maintained a valuation allowance against our domestic deferred tax assets. In the quarter ended December 30, 2005, we re-evaluated the need to maintain a valuation allowance on our net deferred tax assets under the rules of SFAS 109. Based on this evaluation, which included a review of recent profitability and projections of future profitability, we concluded that a full valuation allowance against our net U.S. deferred tax assets is no longer necessary. At December 30, 2005, we continued to maintain a valuation allowance of $14.2 million against deferred tax assets related to tax benefits from certain non-U.S. net operating losses.

Warranty Costs

We provide warranties for all of our products, with terms and conditions that vary by product. We provide a basic limited warranty, including parts and labor, for all products other than access products for periods that generally range from 90 days to 5 years. The basic limited warranty for access products covers parts and labor for periods that generally range from 2 years to 6 years. We record warranty expense in cost of revenue on the consolidated statement of operations. We estimate our warranty liability by applying historical warranty return rates and costs per claim to the number of units shipped that are still within their warranty period. In addition, when we judge that a particular warranty claim will involve costs that are out of the ordinary, we separately estimate the costs for that claim and record the amount as an additional warranty expense for the period in which we determine we have a liability. These estimates require us to make assumptions about matters that are highly uncertain, including future rates of product failure; repair costs, including availability of materials; shipping and handling; and de-installation and re-installation costs at our customers' sites, among others. Consequently, the changes in our warranty reserves could be material from period to period.

Restructuring Reserves – Leases

Our restructuring reserves consist of lease obligations that arose from facility closures. We determined the amount of the reserve for each facility by calculating our outstanding lease obligation, then reducing it by an estimate of potential sublease income. We examine real-estate market conditions in each location where we have a vacated facility. We use input from local real-estate professionals to formulate an estimate of potential sublease income. We review our estimate quarterly and adjust our reserves as necessary. We believe our estimate of restructuring lease obligations is a critical accounting estimate because it requires us to make assumptions about matters that are highly uncertain: real-estate rental market conditions, the length of time required to secure tenants, the amount of tenant incentives and the potential sublease income. Although the changes in our reserves for restructuring lease obligations have not been material in the past, it is possible that future changes in estimates could have a material impact on our financial statements.

Income Taxes

We conduct business and file income tax returns in numerous tax jurisdictions around the world. Having a global business requires us to interpret tax laws that are often vague and uncertain, and to make judgments about the application of those laws when we prepare our tax returns. When we calculate income tax expense and the related tax liabilities and assets for our consolidated financial statements, we use estimates of the amount of income, deductions and credits that we believe are allowable under local tax laws, and that should be allowed by tax authorities if our tax returns are audited. However, tax authorities may disagree on the amounts of income, deductions and credits that are allowed to be included in those tax returns. This discrepency could result in paying additional taxes or receiving a refund of previously paid taxes.

Because we are a large, multinational corporation, the United States Internal Revenue Service generally audits each of our federal income tax returns. They are currently auditing our tax returns for the years 2001 through 2003 and have not yet completed their audit. We anticipate that the IRS will submit the results of the audit to us in the first half of 2006. Although we believe any increase to our tax expense that might result from the audit would not have a material impact on our financial statements, we cannot provide assurance that a material adjustment, positive or negative, will not result.

Strategy and Outlook

We expect capital spending by our customers in 2006 to be stable internationally with growth in North America. On a global basis, wireless operators will continue to build next-generation networks to deliver new, data-oriented services. In North America, we expect the regional Bell operating companies to continue to upgrade the access portion of their networks with fiber technology to deliver broadband services to their customers. We also expect that customers will begin to upgrade the transport portion of their networks with next-generation optical technology. Globally, we expect that customers will begin to accelerate spending on broadband data infrastructure equipment. Tellabs believes that it has products either currently available or in development to address these opportunities.

In 2006, we will continue to focus on our strategies to energize our transport products, enlarge our presence in data and expand into adjacent markets, specifically fiber access. In addition, we are driving toward a business target model to achieve over time an overall gross margin of 50% of revenue, operating expenses of 30% of revenue (excluding unusual charges), operating margins at 20% of revenue, and 15% annual revenue growth. While we have achieved and even exceeded these targets in the past, we cannot say when or if we consistently will achieve them again, given today's market conditions and our product portfolio and services.

Expensing stock options will increase our cost-of-goods sold and operating expenses in 2006. For the first quarter, we expect stock-option expense to be approximately $10.0 million.

We also expect higher income tax expense in 2006. We have exhausted the financial statement benefit of the net loss carryforwards that limited our taxes on domestic operations throughout 2005. We expect that our effective tax rate for the first-quarter and the entire year 2006 will be approximately 35%.