

The background of the cover features a large, stylized graphic of the Tekelec logo, which is a diamond shape formed by four curved segments meeting at the center. This graphic is repeated in a grid pattern, creating a sense of depth and movement. The color palette is a deep blue and white.

T E K E L E C

A N N U A L R E P O R T

1 9 9 9

FINANCIAL HIGHLIGHTS

(in thousands, except per-share data)	Years Ended December 31,		
	1999	1998	1997
Operating Results:			
Total revenues	\$226,068	\$176,669	\$125,140
Income from operations	11,206	50,938	27,626
Net income	444	39,209	28,996
Diluted earnings per share	0.01	0.67	0.51
Pro Forma Net Income (unaudited):			
Pro forma net income ¹	\$ 26,649	\$ 34,521	\$ 20,036
Pro forma diluted earnings per share ¹	0.45	0.59	0.35

¹ Tekelec's pro forma net income and income per common share have been calculated excluding the following charges incurred in 1999 related to the acquisition of IEX Corporation: \$6,000 of purchased in-process research and development incurred; the after-tax write-off of \$541 for certain assets made redundant by the acquisition of IEX; \$22,140 attributable to the amortization of goodwill, purchased technology and other intangibles; and a tax benefit of \$3,646 for the utilization of deferred tax liabilities related to certain of these acquisition-related costs. Pro forma results also exclude one-time tax benefits of \$3,657 in 1998 and \$8,960 in 1997, a one-time after-tax gain from an insurance claim of \$1,031 in 1998, and an after-tax restructuring charge of \$1,170 in 1999.

ABOUT TEKELEC

TEKELEC IS A LEADING SUPPLIER OF SIGNALING INFRASTRUCTURE, DIAGNOSTIC SOLUTIONS AND SERVICE APPLICATIONS FOR TELECOMMUNICATIONS CARRIERS, NETWORK SERVICE PROVIDERS AND EQUIPMENT MANUFACTURERS. IN 1999, TEKELEC STRATEGICALLY BROADENED ITS PRODUCT PORTFOLIO TO INCLUDE SOLUTIONS FOR CONVERGING VOICE AND DATA NETWORKS, SOFTWARE SOLUTIONS FOR CALL CENTERS, AND A GROWING BASE OF ENHANCED SERVICE APPLICATIONS. THE COMPANY'S PREPAID SERVICES PLATFORM, WHICH PROVIDES TELECOMMUNICATIONS SERVICE PROVIDERS A SCALABLE MEANS TO TARGET THE GROWING MARKET FOR PREPAID CALLING, EXEMPLIFIES TEKELEC'S INCREASED CAPABILITIES AS A SUPPLIER OF NETWORK SOLUTIONS AND SERVICE APPLICATIONS.

CONVERGENCE: A COMMUNICATIONS REVOLUTION

V O I C E



The telecommunications industry is experiencing revolutionary changes in the way networks function. The convergence of voice networks, which require dedicated circuits for the duration of each call, and data networks that feature much more efficient “packet”-based transmissions, represents one of the most exciting technological breakthroughs in communications since Alexander Graham Bell invented the telephone. Network convergence, and the bundling of voice, data and video service offerings, are expected to have far-reaching implications for consumers and intensify competition among communications service providers.

Convergence will result in changing economic drivers for network service providers and telecom equipment suppliers. The efficiency of packet technologies inherent in

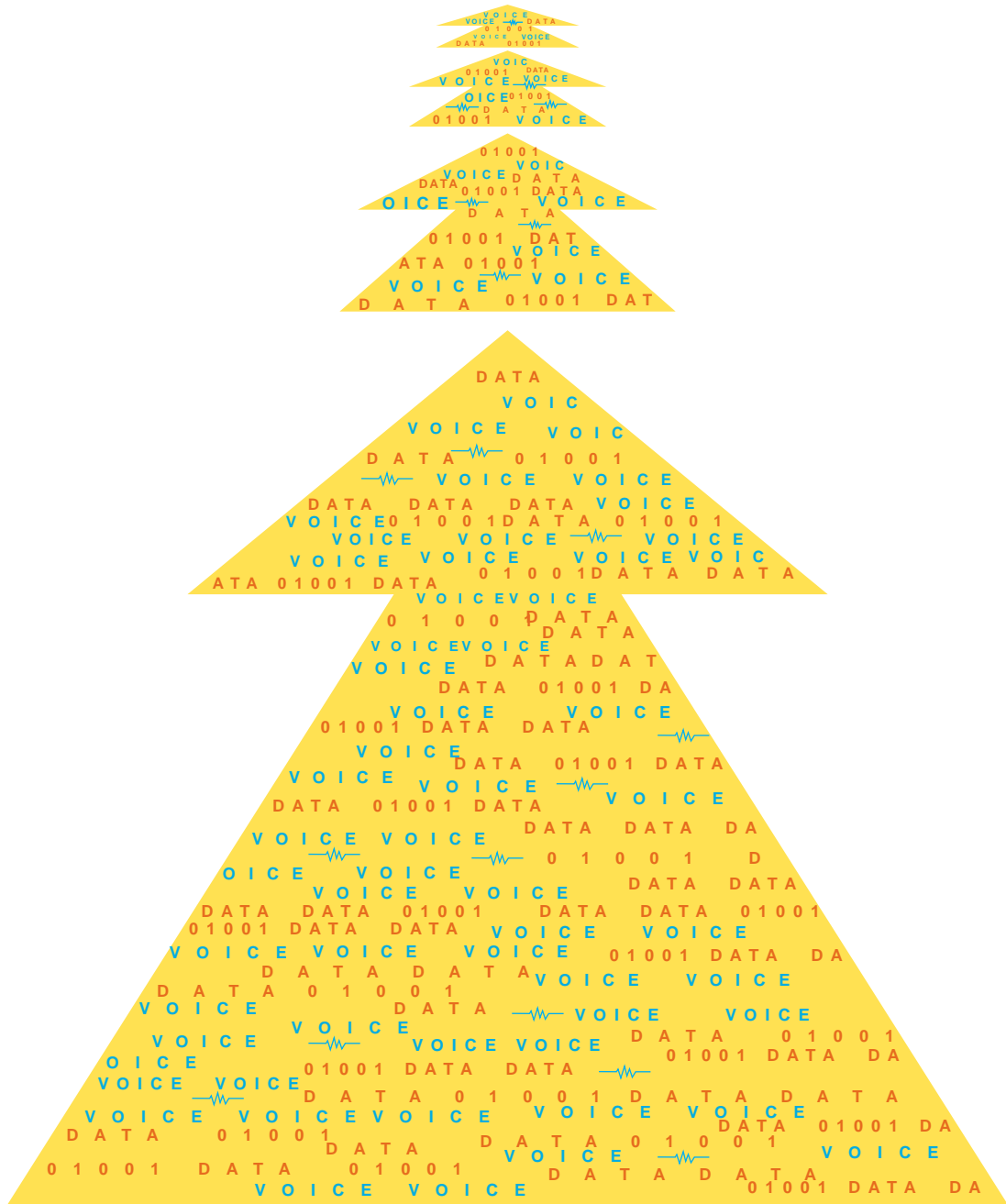
data networks will dramatically reduce basic voice transmission costs, thereby compelling service providers to turn to advanced communications services as their primary source of revenue. Importantly, the open interfaces of packet networks will allow for accelerated development of these new communications services at a lower cost than ever before.

But the promise of convergence can't occur without Signaling System #7 (SS7) and Internet Protocol (IP)-based signaling and call control solutions that bridge circuit and packet networks, preserve investments in existing network infrastructure and ensure the “always on” reliability consumers have come to expect from their telephones.

D A T A



As the recognized leader in SS7 and IP signaling technologies, Tekelec is uniquely positioned to benefit from increased demand for solutions and service applications required to enable the converged voice and data networks of the future.





MICHAEL L. MARGOLIS

Tekelec's 1999 Annual Report profiles a company that has strategically leveraged its technology leadership in Signaling System #7 (SS7) to address a much larger market opportunity relative to prior years. At the center of Tekelec's increased potential is a fast-growing market for converged solutions. This emerging market is a direct result of the convergence of telephone and data networks, which have traditionally relied on circuit switching and packet switching technologies, respectively.

The migration to packet-based technologies such as Internet Protocol (IP) has resulted in a corresponding demand for SS7/IP signaling, call control and diagnostic solutions that enable circuit and packet technologies to interoperate seamlessly, reliably and with advanced features. These requirements are ideally suited to Tekelec's core technologies, expertise and

installed customer base. I am pleased to report that, as I write this, Tekelec has established a strong foothold in this important new market, which clearly represents the largest opportunity in the company's 20-year history.

1999 Financial Results

Early recognition of the migration to packet-based networks led Tekelec in 1999 to invest substantially in the development of solutions for converging voice and data networks. We also completed a strategic acquisition that measurably extends our technological capabilities in serving converged networks, but also requires additional development spending. These investments to ensure that Tekelec emerges as a leader in the market for next-generation solutions, while essential, impacted profitability in 1999.

Total revenues increased 28% to \$226.1 million from \$176.7 million in 1998. A 60% increase in research and development spending and increased selling costs, partially attributable to the planned expansion of our salesforce, contributed to a higher expense profile in 1999. As a result, pro forma net income, excluding one-time charges and merger-related amortization charges, declined 23% to \$26.6 million, or \$0.45 per diluted share.

Breakthrough Year for Product Development

Fiscal 1999 was a breakthrough year for product development. Tekelec leveraged its expertise as the market-share leading supplier of signal transfer points (STPs) to develop its IP⁷ brand for signaling and network surveillance in next-generation networks. The IP⁷ line extends the reliability and advanced services available in traditional phone networks to converged networks that feature much more efficient packet technologies such as IP. Like the EAGLE® STP, IP⁷ offers unparalleled scalability, reliability, processing power and overall performance. In the photograph accompanying this letter, several members of our engineering team join me in celebrating the launch of the IP⁷ product line.

To provide diagnostics support for increasingly complex network architectures, in addition to introducing IP⁷ Sentinel™, our surveillance system for monitoring in-service SS7 and IP networks, we launched the *i3000™* platform to address the diagnostics requirements of other equipment manufacturers participating in the convergence revolution. *i3000* supports emerging protocols such as General Packet

TEKELEC'S NEW R&D AND OPERATIONS CENTER IN MORRISVILLE, NORTH CAROLINA





MICHAEL MARGOLIS CONGRATULATES TEKELEC TEAM MEMBERS FOR THEIR EFFORTS IN DEVELOPING THE IP⁷ PRODUCT LINE.

Radio Services (GPRS) and Wideband Code Division Multiple Access (W-CDMA) and has been selected by leading equipment manufacturers including Alcatel and NEC Corporation.

IEX Acquisition

Supplementing our internal product development, Tekelec's capabilities in serving converged networks were greatly enhanced by our second quarter acquisition of Richardson, Texas-based, IEX Corporation. In IEX, Tekelec gained the VoX™ Gateway Controller, a premiere call control solution for converged networks. VoX is an excellent complement to our IP⁷ Secure Gateway™, a best-of-breed signaling solution. Being able to offer signaling and call control capabilities adds to our attractiveness as a supplier and partner for serving next-generation networks, particularly in the market for circuit switch replacement. The merger with IEX also brought the Tekelec Service Control Point (SCP), an SS7/IP database server used for enhanced services, and a rich set of applications such as prepaid calling.

In addition, IEX extends our telecom solutions portfolio to include software-based solutions for call centers. The Call Center division's flagship product, TotalView™

Workforce Management, is an industry-leading solution that automates all administrative requirements of managing a call center. Our other new solution for call centers is TotalNet™ Call Routing, which intelligently distributes incoming calls for call centers with geographically distributed locations.

Early Leader in an Attractive Market for Convergence Solutions

Early indications suggest that our investments during 1999 were timely. Financial results in the second half of the year improved markedly as new products contributed to strong revenue growth. Our IP⁷ products for converged networks, while a modest contributor to total revenues in 1999, generated initial orders from 10 strategically important customers, including U S WEST Wireless, Level 3 and Orange PCS. In addition to sales of IP⁷ products to carriers, we also entered into OEM agreements with Tellabs and technology interoperability alliances with Cisco and Telcordia. Commitments from such industry leaders in the early stages of the migration to converged networks give me great confidence in the potential for our robust solutions for next-generation networks.

Our convergence solutions feature a broad range of applications, including signaling transport network upgrades (from traditional SS7 signaling to SS7 over IP signaling), circuit switch replacement, and Internet offload. To provide an indication of the potential market for our next-generation solutions, research suggests that the circuit switch replacement opportunity includes more than 30,000 existing switches in North America alone. Our IP⁷ Secure Gateway and VoX Gateway Controller target the signaling and call control elements of this important market opportunity for next-generation network switches to be deployed over the next several years.

Fiscal 2000 and Beyond

Admittedly, the investments of 1999 contributed to a challenging year in terms of financial performance. We genuinely appreciate the perseverance of our shareholders during this year of transition. I'd especially like to thank our 850 dedicated employee owners, who have done an outstanding job keeping Tekelec ahead of the competition during this period of rapid technological evolution.

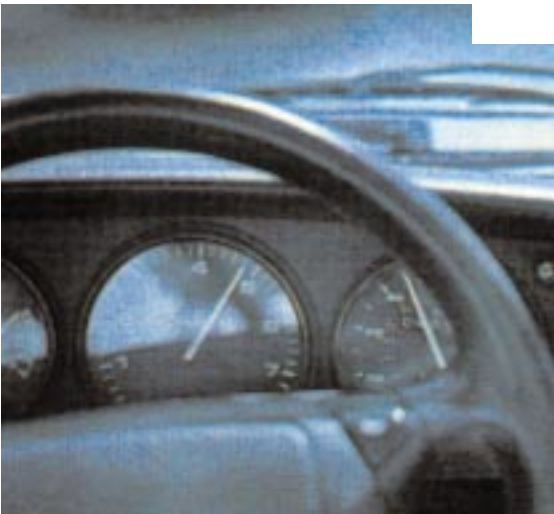
Most importantly, the strategic objectives we accomplished during 1999 greatly increase our growth potential in the next several years. While we don't expect our convergence solutions to generate substantial revenues in 2000, their availability today enables customers to commit to traditional solutions with the confidence that they can upgrade to next-generation products in the future and preserve the value of existing solutions.

In summary, I'm very excited about Tekelec's positioning as a leading supplier to the dynamic market for next-generation network solutions.

Sincerely,

Michael L. Margolis
President and Chief Executive Officer

DELIVERING ON THE PROMISE OF CONVERGENCE



C A R



H O M E

USING TEKELEC'S IP⁷ SOLUTIONS FOR IP SIGNALING, U S WEST WIRELESS ENABLES CUSTOMERS OF ITS ONE NUMBER SERVICE TO STAY IN TOUCH WHEREVER THEY GO – THE OFFICE, THE CAR, THE HOME OR VIRTUALLY ANYWHERE – WITH THE CONVENIENCE OF ONE TELEPHONE NUMBER.

Reduced voice and data transmission costs, greater flexibility to develop innovative services in less time, and improved network efficiency are among the promises of converged networks of the future. Countless telecom service providers have touted the merits of converged networks, but few have actually realized the true benefits of convergence. Of the network operators that have deployed converged network architectures to date, several have selected Tekelec's IP⁷ solutions to ensure their success.

The decision to deploy Tekelec's IP⁷ solutions by Level 3, Orange, U S WEST Wireless and Global Crossing, among other carriers, is a tribute to Tekelec's reputation as the premiere supplier of SS7/IP solutions. By choosing IP⁷, these carriers benefit from proven 99.999% reliability, unparalleled scalability, maximum throughput, and the ability to deliver SS7 over IP signaling capabilities that are many times faster than traditional

SS7 signaling. Their decisions to upgrade from standard SS7 signaling networks to Tekelec-enabled SS7 over IP networks have resulted in an increase in signaling efficiency of several orders of magnitude.

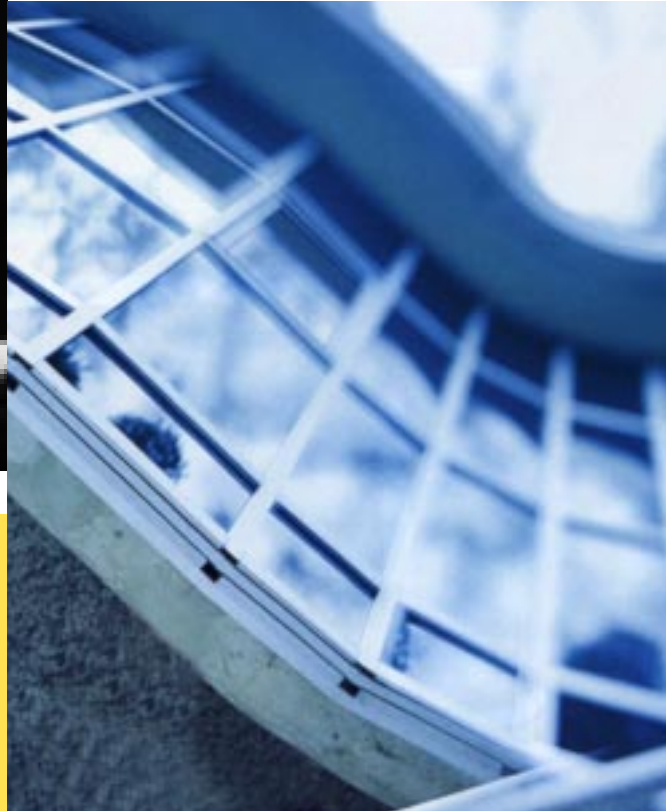
Importantly, Tekelec customers with EAGLE STPs installed in their networks can migrate to IP⁷ solutions via a simple upgrade, thereby preserving investments in their existing STPs. Tekelec's IP⁷ and VoX convergence solutions target a number of applications including:

- Signaling over IP. Tekelec's IP⁷ products utilize SS7 signaling over IP, resulting in a dramatic increase in efficiency and a reduction in latency.
- Circuit switch replacement. The IP⁷ Secure Gateway and VoX Gateway Controller target the signaling and call control elements of next-generation switches that are expected to replace existing circuit switches in the years ahead.
- Service creation. Tekelec's IP⁷ and VoX solutions enable service providers to rapidly create new services in packet networks and share communications service platforms across circuit and packet networks, eliminating the need for costly duplication.
- SS7/IP surveillance. The IP⁷ Sentinel provides real-time surveillance of in-service IP networks, enabling network service providers to efficiently monitor their entire network from a central location. IP⁷ Sentinel extends the capabilities of Sentinel, which enables service providers to ensure the reliability of products and services implemented in traditional SS7 networks.
- Internet offload. The IP⁷ Secure Gateway and VoX Gateway Controller alleviate network congestion created by the longer average duration of dial-up connections to Internet service providers (ISPs) by rerouting ISP calls from voice networks to data networks.



O F F I C E

ONE NUMBER
FOLLOW ME



"BY CHOOSING TEKELEC'S IP7 SECURE GATEWAYS FOR OUR NETWORK MIGRATION STRATEGY, WE ACHIEVED SUBSTANTIALLY FASTER CONNECTIONS AND SERVICE CONTROL THROUGH SS7 SIGNALING IN THE IP ENVIRONMENT. THE INCREASED EFFICIENCY AND REDUCTION IN LATENCY FACILITATED OUR LAUNCH OF ONE NUMBER SERVICE. WE ARE PLEASED WITH OUR DEVELOPING RELATIONSHIP WITH TEKELEC."

ANGUS DOUGHERTY

DIRECTOR OF PCS INTEGRATION, U S WEST WIRELESS

ENABLING A PROLIFERATION OF SERVICES

"THE CENTER OF GRAVITY FOR THE NETWORK WILL SHIFT FROM THE PHYSICAL TO THE LOGICAL. THAT IS, TRANSPORT AND SWITCHING TECHNOLOGY, WHILE STILL ESSENTIAL, WILL GIVE WAY TO SERVICE LAYER TECHNOLOGIES. NETWORKS WILL INCREASINGLY BE PERCEIVED AS AN ENABLER OF SERVICES, RATHER THAN A COLLECTION OF PIPES."

HAMBRECHT & QUIST

CONNECTED, VOL 2 OCTOBER 1999

For several years, Tekelec's SS7 solutions have enabled advanced communication services, including Caller ID, 800 number calling and cellular roaming as well as regulatory-driven services such as local number portability.

The merger with IEX measurably augments Tekelec's capabilities to enable a proliferation of service applications, including prepaid calling. The Yankee Group, a market research firm, estimates that U.S. carrier expenditures on prepaid systems and service capacity will grow from \$50 million in 1999 to nearly \$500 million in 2003.

Tekelec's broadened service capabilities are particularly strategic because the ability to rapidly develop and deploy innovative service is widely regarded as one of the primary drivers of network convergence. Industry analysts expect service providers to increasingly rely on revenues generated from advanced services to offset the expected decline in basic bill-by-the-minute service revenue resulting from the increased transport efficiency of next-generation networks.

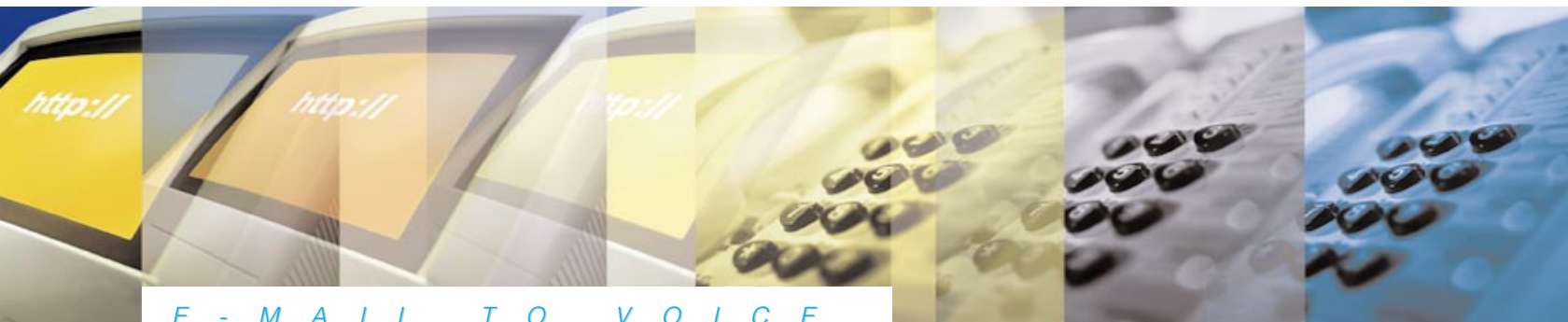
The highly flexible Tekelec Service Creation Environment, VoX Gateway Controller and Service Control Point (SCP) offer a limitless variety of services for traditional and converged networks of the future. These new solutions expand Tekelec's market potential in a burgeoning market for advanced applications. Demand for applications is being driven by the need for communications providers to differentiate their offerings in an increasingly services-driven environment. Equally important, Tekelec's service offerings preserve carriers' investments in existing solutions by enabling them to share service platforms across converged circuit and packet networks.

Call Center Services

Within the IEX Call Center division, the TotalNet Call Routing solution optimizes the management of call centers with geographically distributed locations by intelligently routing incoming calls to the call center location best able to accommodate

calls at any given moment. TotalNet's pre-answer routing capability maximizes operational efficiency and balances service levels by combining teams of agents from multiple call center locations to create a "virtual call center." TotalNet also enables the provision of customized service to preferred customers to ensure maximum customer satisfaction among specific customer segments.

PREPAID CALLING



E - M A I L T O V O I C E

C A L L F O R W A R D I N G

SERVICES

- UNIFIED MESSAGING
- ONE NUMBER SERVICE
- CALL FORWARDING
- CALLER ID
- 800 NUMBER CALLING
- CALL WAITING
- LOCAL NUMBER PORTABILITY
- CLICK TO DIAL
- CALLING NAME
- CELLULAR ROAMING

TECHNOLOGY LEADERSHIP

"WE HAVE BEEN VERY IMPRESSED BY THE SYSTEM ALREADY DEPLOYED IN THE U.S. AND THE TECHNICAL EXCELLENCE OF TEKELEC'S ARCHITECTURE. THIS SOLUTION WILL PROVIDE ORANGE WITH A STATE-OF-THE-ART, SCALABLE, AND COST-EFFECTIVE SS7 SIGNALING NETWORK WHICH WILL MEET ALL OUR DEMANDS FOR THE FORESEEABLE FUTURE."



GRAHAM BAXTER

MANAGER SWITCH SERVICES DESIGN, ORANGE PCS

Tekelec's SS7 expertise dates back to 1988 when the company introduced the Message Generator Traffic Simulator (MGTS) diagnostics tool, which has become the de-facto standard for SS7 testing by equipment suppliers. Testing capabilities for the MGTS platform have been continuously upgraded to support more than 150 protocol variants.

In early 2000, Tekelec introduced velOSity™, a revolutionary diagnostic solution based on the proven technology of MGTS. velOSity, which is hosted on the i3000 platform, uniquely enables product developers to perform converged technology testing on a single system — with complete interoperability. velOSity enables users to build and reuse test scenarios spanning multiple technologies, including SS7, GPRS, UMTS and IP.



i3000

Over the years, Tekelec has established a consistent track record of anticipating trends in SS7 requirements for a number of applications, investing in research and development, and introducing technologically superior solutions to better serve industry demands.

This is best exemplified by the success of the EAGLE STP, introduced in 1992. Recent research by Frost & Sullivan reported that EAGLE achieved a 73% market share of North American STP shipments in 1998. The achievement is particularly impressive considering Tekelec entered the STP market several years after its two primary competitors.

Leader in Convergence Technologies

More recently, the Company's early appreciation of SS7's pivotal role in the convergence of voice and data networks led Tekelec to develop a suite of converged network solutions, based on SS7 over IP technology, that leverages the superior versatility, scalability and reliability characteristics of the EAGLE platform. Tekelec's IP⁷ and VoX products target the fast-growing market for signaling, call control, service creation and network surveillance solutions for next-generation networks featuring IP or Asynchronous Transfer Mode (ATM).

Exemplifying Tekelec's market leadership, the IP⁷ Secure Gateway was the first STP-based signaling gateway in the industry to deliver SS7/IP interworking capabilities. Aside from the IP⁷ Secure Gateway's performance advantages relative to competitors' offerings, the ability to upgrade to the IP⁷ Secure Gateway platform from EAGLE STPs represents an important benefit to Tekelec's installed base of EAGLE customers by providing a direct migration path to new signaling technologies.

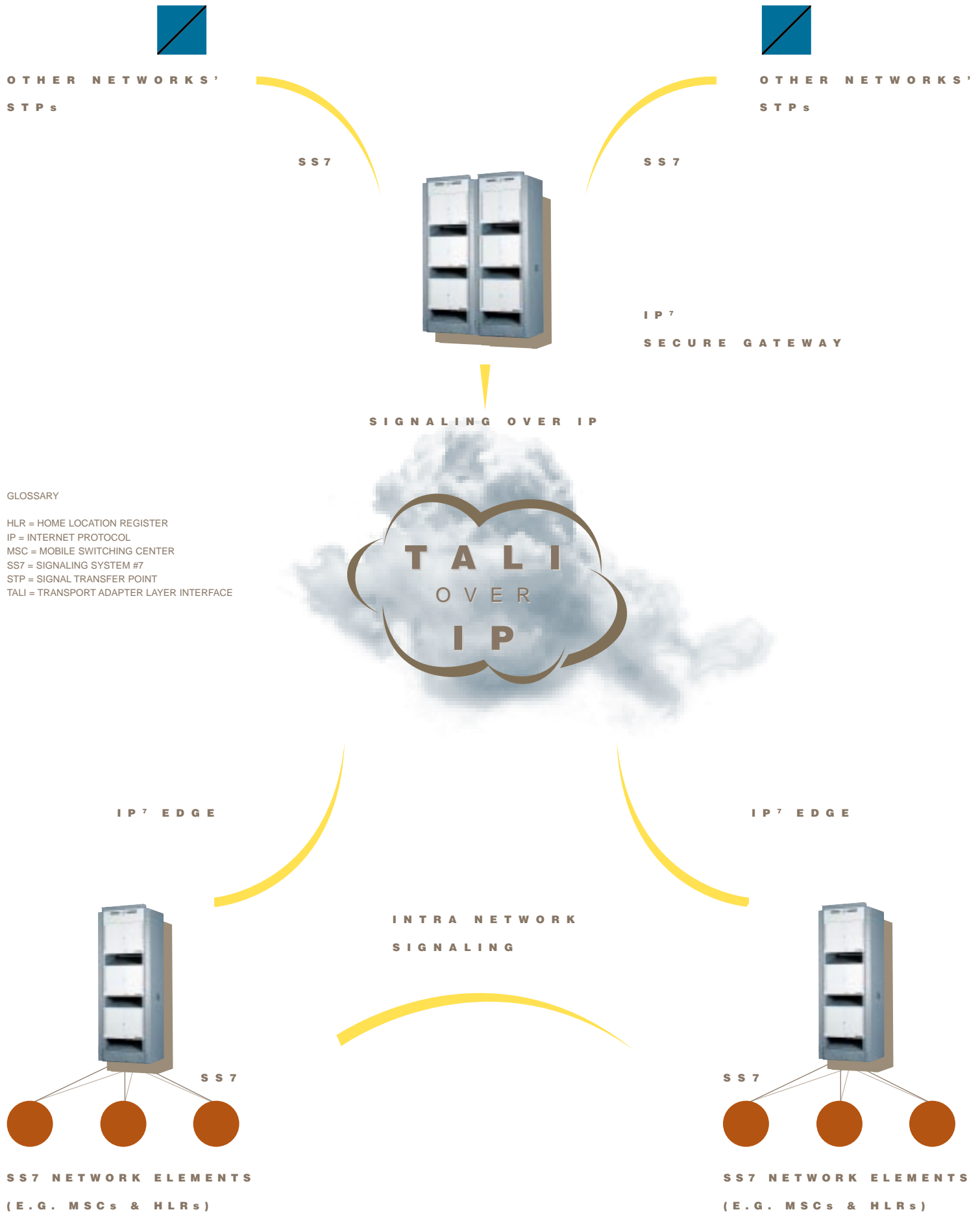
Tekelec's technology leadership extends beyond the development of solutions for customers. Demonstrating its expertise in signaling protocols, Tekelec developed the Transport Adapter Layer Interface (TALI) to fulfill an industrywide need for an open interface to ensure interoperability of convergence solutions from multiple vendors. In December 1999, Tekelec released the TALI interface source code to the telecommunications and Internet industries in an effort to promote an open network architecture for signaling over IP. With the support of Level 3, U S WEST Wireless, Lucent, Cisco, Orange PCS, and a growing list of other carriers and equipment suppliers that are currently using the interface, Tekelec has submitted TALI to the Internet Engineering Task Force (IETF) for consideration as a standard.

Call Center Solutions

During 1999, the IEX Call Center division extended the market-leading capabilities of its TotalView Workforce Management solution by incorporating skills-based scheduling into workforce forecasting. The patented Skill Scheduling module enables call center operators to effortlessly develop forecasts and schedules for multi-skilled agents and manage intraday changes in agent availability to achieve maximum efficiency.

REVOLUTIONARY NETWORK DESIGN

ORANGE PCS: SIGNALING OVER IP



GLOSSARY

- HLR = HOME LOCATION REGISTER
- IP = INTERNET PROTOCOL
- MSC = MOBILE SWITCHING CENTER
- SS7 = SIGNALING SYSTEM #7
- STP = SIGNAL TRANSFER POINT
- TALI = TRANSPORT ADAPTER LAYER INTERFACE

INDUSTRY PARTNERS AND ALLIANCES

Embarking on an important new distribution strategy for next-generation network solutions, during 1999 and early 2000 Tekelec entered into OEM agreements with Tellabs and technology interoperability agreements with Cisco and Telcordia. Because of the size and the breadth of the convergence opportunity, establishing partnerships with communications equipment vendors has become an integral part of Tekelec's strategy to maximize its growth potential in the new world of converged networks.

As the recognized leader in SS7/IP solutions, dozens of companies have expressed an interest in working with Tekelec in an effort to lower their R&D expenditures, bring products to market faster, and benefit from Tekelec's installed base of more than 120 telecom service providers. In addition, Tekelec has licensed its TALI interface for IP signaling to more than 140 companies located in 31 countries across the globe.

Tekelec's partnering strategy for converged solutions is to enter into non-exclusive agreements that enhance its distribution capabilities and maximize its ability to deliver a complete solution for next-generation networks. The Company's best-of-breed signaling and call control solutions can be deployed independently or as part of an inclusive solution, depending on requirements of each distribution partner.

Within the IEX Call Center division, in January 2000 the Company entered into an OEM and distribution agreement with Davox. Under the terms of the agreement, Davox will OEM TotalNet, IEX's award-winning intelligent call routing solution, with Davox's Ensemble customer contact suite. Similarly, IEX will distribute Ensemble to its TotalNet customers.



"WE'VE BEEN VERY PLEASED TO WORK WITH TEKELEC TO DEVELOP BEST-IN-CLASS VOICE AND DATA SERVICES FOR CARRIERS. WITH THE AN2100 GX, WE'VE CREATED A TRUE NEXT-GENERATION SWITCHING PLATFORM THAT MEETS CARRIERS' STANDARDS FOR RELIABILITY AND SCALABILITY. INCORPORATING TEKELEC'S SERVICE CONTROL POINT AND SIGNALING GATEWAY SOFTWARE GIVES TELLABS A JUMP START ON PROVIDING ENHANCED SERVICES FOR THE EMERGING VOICE-OVER-PACKET ENVIRONMENT."

BRIAN J. JACKMAN

PRESIDENT GLOBAL SYSTEMS AND TECHNOLOGY, TELLABS



STRATEGIC CUSTOMERS ACROSS THE GLOBE

One of Tekelec's primary objectives for 1999 was to expand its international presence, through its international operations and distribution relationships. Progress was achieved on both fronts, with particularly exciting developments in Europe resulting from Tekelec's U.K.-based sales office, which was established in 1998. New customers added during the year via the European sales initiative include Vodafone, Orange PCS and France Telecom. One notable highlight was the deployment of Tekelec's number portability solution by Uni2, France Telecom's subsidiary in Spain. This represents the first international order for the EAGLE number portability solution, which has achieved market share leadership in the United States. Considering the recent

European Union mandate recommending that European service providers implement number portability solutions by the beginning of 2001, Tekelec is well positioned to benefit from the investment cycle resulting from this regulatory driver.

Tekelec also strengthened its international sales resources by entering into a marketing and distribution agreement with Unisys. Under the terms of the non-exclusive agreement, Unisys will market and distribute IP7 and EAGLE products to its international base of telecom customers as well as provide comprehensive customer support. The Unisys relationship adds important sales resources to the Latin American and Asia/Pacific regions, and complements Tekelec's direct sales efforts in Europe.

UNITED KINGDOM, 12 - 99

ORANGE PCS CHOOSES TEKELEC'S IP7 SECURE GATEWAY AND IP7 EDGE TO DEPLOY AN IP SIGNALING TRANSPORT NETWORK.



ROMANIA, 6 - 99

MOBIL ROM CHOOSES EAGLE STPs FOR ITS GSM NETWORK.



FRANCE, 11 - 99

ALCATEL ORDERS TEKELEC'S i3000 DIAGNOSTIC PLATFORM FOR GPRS TESTING.



SPAIN, 1 - 00

UNI2 DEPLOYS TEKELEC'S INTERNATIONAL NUMBER PORTABILITY SOLUTION TO MEET REGULATORY REQUIREMENTS.





SPAIN

CANADA



FRANCE

AUSTRALIA



JAPAN



UNITED KINGDOM



COLORADO, 2 - 99

U S WEST DEPLOYS IP7 SECURE GATEWAYS FOR IP SIGNALING IN ITS WIRELESS NETWORK. LATER, U S WEST SELECTS IP7 SENTINEL FOR NETWORK MONITORING AND SURVEILLANCE.



COLORADO, 6 - 99

LEVEL 3 DEPLOYS TEKELEC'S IP7 SECURE GATEWAYS FOR SIGNALING IN ITS INTERNATIONAL IP NETWORK.



CALIFORNIA, 2 - 00

CISCO COLLABORATES WITH TEKELEC TO ENHANCE INTEROPERABILITY BETWEEN TEKELEC'S IP7 SECURE GATEWAY AND CISCO PRODUCTS.



OKLAHOMA, 4 - 99

WILLIAMS COMMUNICATIONS ORDERS EAGLE STPs AND TEKELEC'S LOCAL NUMBER PORTABILITY SOLUTION.



AUSTRALIA, 5 - 99

VODAFONE CHOOSES EAGLE STPs FOR ITS WIRELESS NETWORK.



ILLINOIS, 9 - 99

TELLABS ENTERS INTO OEM AGREEMENTS WITH TEKELEC TO INCORPORATE TEKELEC'S SIGNALING AND CALL CONTROL SOLUTIONS INTO TELLABS' AN2100 GX, A NEXT-GENERATION SWITCH.



NEW YORK, 5 - 99

BELL ATLANTIC AWARDS TEKELEC A MAJOR NETWORK REDESIGN PROJECT INCLUDING EAGLE STPs AND DIAGNOSTIC PRODUCTS, RESULTING IN THE LARGEST ORDER IN THE COMPANY'S HISTORY.





*SERVICE PROVIDER
CUSTOMER BASE*

(NETWORK INFRASTRUCTURE SOLUTIONS)

AT JANUARY 1,

	1998	1999	2000
	75	97	122



The IEX Call Center division strengthened its international distribution capabilities during 1999 by selecting Mitsucon Tecnologia S.A. to distribute IEX's TotalView Workforce Management solution in Brazil. The new relationship expands Tekelec's international distributor base for call center products to four spanning seven countries. Tekelec's network diagnostic products are distributed by 32 international distributors.

Attractive Trends in Overseas Markets

Growing competition in overseas markets characterized by deregulation and rapid subscriber growth has increasingly led network operators to re-evaluate their signaling and signaling services network architectures and equipment supplier relationships. These market drivers, coupled with Tekelec's increased sales resources in overseas markets, create an attractive environment for Tekelec to expand its worldwide market share.

Looking to the future, Tekelec continues to evaluate additional distribution partnerships and marketing alliances in an effort to strengthen its capabilities to serve international markets in the years ahead.

1999 FINANCIAL REVIEW

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SELECTED CONSOLIDATED FINANCIAL DATA

The statement of operations data included in the selected consolidated financial data set forth below for the years ended December 31, 1999, 1998 and 1997 and the balance sheet data set forth below at December 31, 1999 and 1998 are derived from, and are qualified in their entirety by reference to, the Company's audited consolidated financial statements and notes thereto included in this annual report. The statement of operations data set forth below for the years ended December 31, 1996 and 1995 and the balance sheet data set forth below at December 31, 1997, 1996 and 1995 are derived from audited consolidated financial statements of the Company, which are not included herein.

FIVE-YEAR SELECTED FINANCIAL DATA

(thousands, except per-share data)	For the Years Ended December 31,				
	1999	1998	1997	1996	1995
Statement of Operations Data:					
Revenues	\$226,068	\$176,669	\$125,140	\$72,126	\$75,276
Income (Loss) before provision for income taxes	10,229	55,551	29,741	(284)	8,450
Net income (loss)	444	39,209	28,996	(2,511)	6,311
Earnings (Loss) per share:					
Basic	\$ 0.01	\$ 0.73	\$ 0.58	\$ (0.05)	\$ 0.15
Diluted	0.01	0.67	0.51	(0.05)	0.13
Weighted average number of shares outstanding:					
Basic	54,931	53,518	50,408	47,100	42,116
Diluted	58,690	58,708	56,842	47,100	48,207
Balance Sheet Data (at December 31):					
Cash and investments	\$106,664	\$113,774	\$ 70,518	\$44,244	\$43,609
Working capital	127,702	108,762	86,354	44,688	56,983
Total assets	394,434	210,210	136,465	82,518	80,488
Long-term liabilities	137,552	2,252	2,839	1,061	380
Shareholders' equity	176,595	165,777	107,877	61,751	63,607

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with, and is qualified in its entirety by, the consolidated financial statements and the notes thereto included in this Annual Report. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

OVERVIEW

In May 1999, the Company acquired all of the outstanding stock of IEX Corporation ("IEX"), which develops, markets and sells solutions for intelligent networks, call centers and other telecommunications markets.

The Company's product offerings are currently organized along three distinct product lines: network systems, network diagnostics and call center.

Network Systems Products

Prior to the Company's May 1999 acquisition of IEX, the Company's network systems product line was known as the network switching product line and consisted principally of the Eagle STP and products, features and applications based on the Eagle platform, including the IP⁷ Secure Gateway and the Company's local number portability solution. As a result of the acquisition of IEX, the network systems product line has been expanded to include IEX's network products, including, among others, Network Switch, Service Node, Service Control Point, VoX Gateway Controller, Prepaid Services and other convergence products.

Network Diagnostics Products

In January 1999, the Company scaled back its data network diagnostics product line and integrated it into its intelligent network diagnostics product line. Prior to that time, the Company treated these product lines separately for organizational and financial reporting purposes. Since that time, the Company has reported these products together as the network diagnostics product line. This product line consists principally of the MGTS and i3000 families of diagnostics products and the Sentinel network surveillance system.

Call Center Products

The Company's IEX call center business develops and supplies software-based solutions for call centers, and its products include the TotalView Workforce Management and TotalNet Call Routing solutions.

IEX Acquisition

The Company accounted for the IEX acquisition under the purchase method of accounting, and the results of operations for 1999 include the results of operations of IEX following the close of the acquisition on May 7, 1999. In connection with the acquisition, the Company also recorded approximately \$133.4 million of goodwill and other intangible assets, net of related deferred income tax liabilities. During the second quarter of 1999 and in connection with the acquisition of IEX, the Company recorded a charge of \$6.0 million related to the write-off of purchased in-process research and development and an additional \$830,000 charge for the write-off of certain assets made redundant by the acquisition.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, the percentages that statement of operations items bear to total revenues:

	Percentage of Revenues For the Years Ended December 31,		
	1999	1998	1997
Revenues	100.0%	100.0%	100.0%
Cost of goods sold	34.3	33.3	33.2
Amortization of purchased technology	2.8	—	—
Gross profit	62.9	66.7	66.8
Research and development	18.7	14.9	16.8
Selling, general and administrative	28.4	22.9	27.9
Amortization of goodwill and other purchased intangibles	7.0	—	—
Acquired in-process research and development and other acquisition-related charges	3.0	—	—
Restructuring	0.8	—	—
Income from operations	5.0	28.9	22.1
Interest and other income (expense), net	(0.5)	2.6	1.7
Income before provision for income taxes	4.5	31.5	23.8
Provision for income taxes	4.3	9.3	0.6
Net income	0.2%	22.2%	23.2%

The following table sets forth, for the periods indicated, the revenues by principal product line as a percentage of total revenues:

	Percentage of Revenues For the Years Ended December 31,		
	1999	1998	1997
Network systems	61%	66%	58%
Network diagnostics	30	34	42
Call center	9	—	—
Total	100%	100%	100%

The following table sets forth, for the periods indicated, the revenues by geographic territory as a percentage of total revenues:

	Percentage of Revenues For the Years Ended December 31,		
	1999	1998	1997
North America	77%	69%	73%
Japan	10	12	13
Europe	4	4	5
Rest of World	9	15	9
Total	100%	100%	100%

Revenues

The Company's revenues increased by \$49.4 million, or 28%, during 1999 due primarily to the inclusion of post-acquisition IEX product sales following the acquisition of IEX in May 1999, and secondarily to increased Eagle STP switching and network diagnostics product sales.

Revenues from network systems products increased by \$21.5 million, or 19%, to \$137.8 million due primarily to the addition of sales of IEX's intelligent network products and higher Eagle STP products sales including increased extension and upgrade sales, as well as initial sales of the Company's IP⁷ Secure Gateway product.

Revenues from network diagnostics products increased by \$6.6 million, or 11%, to \$64.9 million due to higher sales of intelligent network diagnostics products partially offset by lower sales of data network diagnostics products.

Revenues from call center products following the acquisition of IEX in May 1999 added \$21.1 million in 1999.

Revenues in North America increased by \$52.3 million, or 43%, primarily as a result of the inclusion of post-acquisition IEX product sales and secondarily due to higher sales of Eagle STP switching and network diagnostics products. Sales in Japan were flat due to lower Chameleon and MGTS product sales, offset by higher sales of MGTS-related development services and an increase of \$2.9 million from the impact of currency translations. Revenues in Europe increased by \$2.0 million, or 26%, due to higher network systems product sales partially offset by lower network diagnostics products. Rest of world revenues decreased by \$4.9 million, or 19%, due primarily to lower network systems product sales.

The impact of exchange rate fluctuations on currency translations increased revenues by \$2.9 million, or 1%, and did not have a material effect on net income.

The Company believes that its future revenue growth depends in large part upon a number of factors, including the continued market acceptance of the Company's Eagle product and related applications and Sentinel diagnostics products, and market acceptance of the recently introduced suite of products for converged circuit and packet networks, including the IP⁷ Secure Gateway and VoX Gateway network systems products and the i3000 and IP⁷ Sentinel diagnostics products.

Gross Profit

Gross profit as a percentage of revenues decreased to 62.9% in 1999 compared with 66.7% in 1998. The decrease in gross margins was primarily due to the amortization of purchased technology acquired from IEX and a higher proportion of lower margin sales in Japan, primarily development services. Excluding the amortization of purchased technology related to the IEX acquisition, gross profit as a percentage of sales was 65.7% for 1999. Changes in the following factors, among others, may affect gross profit: product and distribution channel mix; competition; customer discounts; supply and demand conditions in the electronic components industry; internal manufacturing capabilities and efficiencies; foreign currency fluctuations; and general economic conditions.

Research and Development

Research and development expenses increased overall by \$15.9 million, or 60%, and increased as a percentage of revenues to 18.7% in 1999 from 14.9% in 1998. The dollar increase was attributable principally to the inclusion of post-acquisition IEX research and development expenses and increased expenses incurred in connection with the hiring of additional personnel for product development and enhancements for both network systems and network diagnostics products, primarily related to the Company's continued development of products to address the Internet Protocol/SS7 market. Based on present product development plans, the Company expects that research and development expenses for 2000 will increase in dollars when compared to 1999.

The Company intends to continue to make substantial investments in product and technology development and believes that its future success depends in large part upon its ability to continue to enhance existing products and to develop or acquire new products that maintain the Company's technological competitiveness.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by \$23.8 million, or 59%, and increased as a percentage of revenues to 28.4% in 1999 from 22.9% in 1998. The dollar increase was primarily due to the inclusion of post-acquisition IEX selling, general and administrative expenses and higher personnel and infrastructure-related expenses incurred to support the growing Eagle STP installed base and anticipated higher sales levels. The increase in these expenses over 1998 levels was also due to a \$1.7 million insurance settlement realized in 1998 which benefited the 1998 expenses. The Company expects that selling, general and administrative expenses for 2000 will increase in dollars when compared to 1999.

Interest and Other Income (Expense)

Interest income decreased by \$555,000, or 12%, due to lower invested cash balances primarily as a result of cash paid in connection with the acquisition of IEX. Interest expense of \$4.9 million was due to interest incurred for short-term notes issued in connection with the acquisition of IEX and convertible debt issued to refinance the short-term notes.

Income Taxes

The income tax provision for 1999 was \$9.8 million and reflected the effect of non-deductible acquisition-related costs, partially offset by a benefit of \$3.6 million from the utilization of deferred tax liabilities related to certain of these acquisition-related costs. Excluding the effect of these acquisition-related items, an estimated effective tax rate of 35% was applied and represented federal, state and foreign taxes on the Company's income, reduced primarily by research and development and foreign tax credits, compared to an effective tax rate of 36% for 1998. The decrease in the effective tax rate was due to a higher proportion of research and development expenses and corresponding tax credits. The Company expects that its effective tax rate, excluding the effect of acquisition-related items, will be 36% for 2000.

1998 COMPARED WITH 1997

Revenues

The Company's revenues increased by \$51.5 million, or 41%, during 1998 due to higher sales of both network systems products and network diagnostics products.

Revenues from network systems products increased by 62%, or \$44.3 million, to \$116.3 million due primarily to increased Eagle STP market acceptance worldwide as reflected by higher international sales, increased sales of upgrades and software enhancements to the Company's larger Eagle STP installed base and higher sales of Local Number Portability (LNP) and Local Service Management System (LSMS) features. In 1998, the Company sold 62 pairs of Eagle STPs compared with 45 pairs in 1997.

Revenues from network diagnostics products increased by 22%, or \$10.5 million, to \$58.3 million. This increase was primarily driven by higher sales of development services in Japan and the addition of sales of the Company's Sentinel product domestically, partially offset by lower sales of the Company's Chameleon products in all markets.

Revenues in North America increased by \$29.9 million, or 33%, as a result of higher network systems and MGTS product sales, partially offset by lower Chameleon product sales. Revenues in Japan increased by \$5.6 million, or 34%, due primarily to higher sales of MGTS-related development services and third-party data diagnostics products, partially offset by lower Chameleon and MGTS product sales. Revenues in Europe increased by \$1.1 million, or 16%, due to higher network systems product sales. Other international revenues increased by \$15.0 million, 141%, primarily due to higher network systems product sales including a large sale in South Africa.

The impact of exchange rate fluctuations on currency translations, which consisted primarily of the translation of Japanese yen into U.S. dollars, decreased revenues by approximately \$1.5 million, or 1%, and did not have a significant impact on net income.

Gross Profit

Gross profit as a percentage of revenues was essentially flat at 67%.

Research and Development

Although research and development expenses increased by \$5.4 million, or 25%, such expenses decreased as a percentage of revenues from 16.8% in 1997 to 14.9% in 1998. The dollar increase was attributable primarily to ongoing development expenses in the Network Switching Division with respect to development of new features for the Eagle products and consisted principally of expenses incurred in connection with the hiring of additional personnel and higher depreciation expense resulting from equipment acquisitions.

Selling, General and Administrative

Although selling, general and administrative expenses increased by \$5.5 million, or 16%, such expenses decreased as a percentage of revenues from 28.0% in 1997 to 22.9% in 1998. The increase in dollars was attributable primarily to increased infrastructure costs required to meet the needs of the growing Eagle installed base and to support higher sales levels of switching and intelligent network diagnostics products. Sales, general and administrative expenses were reduced in 1998 by the proceeds from the settlement of an insurance claim in the amount of approximately \$1.7 million, net of applicable costs.

Income Taxes

During 1998, the Company recorded tax benefits of \$3.7 million resulting from a reduction of its valuation allowance for deferred taxes, and tax benefits associated with research and development tax credits. The reduction in the valuation allowance was based on the Company's improved income trend and management's assessment of various uncertainties related to the Company's ability to utilize certain research and development tax credit carryforwards. For the year ended December 31, 1998, excluding the one-time tax benefits, the Company had a tax provision of \$20.0 million, resulting in an effective tax rate of 36%. For 1997, the Company had an effective tax rate of 33% excluding a one-time tax benefit of \$9.0 million resulting from a reduction of its valuation allowance for deferred taxes.

Interest and Other Income (Expense)

Net interest income increased by \$2.4 million primarily as a result of higher average investment balances in 1998.

LIQUIDITY AND CAPITAL RESOURCES

General

During 1999, the Company financed net working capital and capital expenditure requirements principally from operations, available cash, the proceeds from the issuance of common stock resulting from the exercise of options and warrants and the proceeds from the issuance of convertible debt. The Company's principal sources of liquidity for the next year are expected to consist of its working capital, cash generated by operations, available cash including funds available under current bank lines of credit and proceeds from the exercise of options and warrants.

During 1999, cash and cash equivalents increased by \$14.7 million to \$46.7 million, after net proceeds of \$29.1 million from the sale of short-term and long-term investments. Operating activities, including the effects of exchange rate changes on cash, provided \$32.0 million. Financing activities, which represented net proceeds from the issuance of convertible debt, the repayment of short-term notes issued in May 1999 in connection with the Company's acquisition of IEX and the issuance of common stock upon the exercise of options and warrants, provided \$21.8 million, and investing activities, excluding the net proceeds from the sale of short-term and long-term investments, used \$68.2 million primarily due to cash paid in connection with the acquisition of IEX.

Accounts receivable, including amounts due from related parties, increased by 51% during 1999 due primarily to higher sales levels. Inventory levels increased by 89%, primarily to support the higher sales levels and a broader product offering, including the added IEX products. Trade accounts payable increased by 49% during 1999, primarily due to the inclusion of IEX payables and the increased level of operating expenses incurred to support product development programs and anticipated higher sales levels. Deferred revenues increased 197% during 1999 primarily as a result of the inclusion of IEX deferred revenue and increased extended warranty service revenues which are deferred and recognized ratably over the warranty period.

Capital expenditures of \$13.9 million during 1999 represented the planned addition of equipment principally for research and development, manufacturing operations and facility expansion. Technology purchases, excluding purchased technology recorded in connection with the acquisition of IEX, amounted to \$1.6 million, and consisted primarily of software licenses purchased for use in network infrastructure and diagnostics product applications.

The Company has a \$15.0 million line of credit with a U.S. bank and lines of credit aggregating \$2.9 million available to our Japanese subsidiary from various Japan-based banks.

The Company's \$15.0 million credit facility is collateralized by substantially all of the Company's assets, bears interest at the lender's prime rate (8.5% at December 31, 1999), and expires on June 30, 2000 if not renewed. Under the terms of this facility, the Company is required to maintain certain financial ratios and meet certain net worth and indebtedness tests. In connection with the May 1999 acquisition of IEX, the Company renegotiated certain terms of this credit facility, including various financial ratios and net worth and indebtedness tests, and believes that it is in compliance with these requirements. There were no borrowings under this credit facility in 1998 or 1999.

The Company's Japanese subsidiary has collateralized yen-denominated lines of credit with Japan-based banks, primarily available for use in Japan, amounting to the equivalent of \$2.9 million with interest at the Japanese prime rate (1.375% at December 31, 1999) plus 0.125% per annum which expire between August 2000 and November 2000, if not renewed. There were no borrowings under these lines of credit in 1998 or 1999.

On November 2, 1999, the Company completed a private placement of \$135.0 million aggregate principal amount at maturity of 3.25% convertible subordinated discount notes due 2004. The notes were issued at 85.35% of their face value amount (equivalent to gross proceeds at issuance of approximately \$115.2 million before discounts and expenses). The gross proceeds at issuance before discounts and expenses included approximately \$15.2 million from the sale of notes issued upon the initial purchasers' exercise in full of their over-allotment option.

The notes are convertible at any time after January 31, 2000 into Tekelec common stock, unless the notes have been previously redeemed or otherwise purchased, at a conversion rate of 56.3393 shares per \$1,000 principal amount at maturity (approximately 7.6 million shares in total) which represents a redemption price of \$15.15 per share of common stock. The notes can be redeemed by the Company after November 2, 2002 at the redemption price together with accrued but unpaid interest.

The notes were issued with a 14.65% discount and carry a cash interest (coupon) rate of 3.25%, payable on May 2 and November 2 of each year, commencing on May 2, 2000. The payment of principal amount of the notes at maturity together with cash interest paid over the term of the notes represents a yield to maturity of 6.75% per year, computed on a semi-annual bond equivalent basis. Interest expense is computed based on the accretion of the discount, the accrual of the cash interest payment and the amortization of expenses related to the offering of these notes, and amounted to approximately \$1.4 million for the period of November 2, 1999 through December 31, 1999.

The Company believes that its existing working capital, funds generated through operations, current bank lines of credit and proceeds from the exercise of options and warrants will be sufficient to satisfy operating requirements for at least the next twelve months. Nonetheless, the Company may seek additional sources of capital as necessary or appropriate to fund acquisitions or to otherwise finance growth or operations. There can be no assurance that such funds, if needed, will be available on favorable terms, if at all.

Foreign Exchange

International operations are subject to certain opportunities and risks, including currency fluctuations. In 1999, 1998 and 1997, the percentages by which weighted average exchange rates for the Japanese yen strengthened (weakened) against the U.S. dollar were (15%), 7% and 9%, respectively.

The change in cumulative translation adjustments in 1999 was due primarily to the weakening of the Japanese yen against the U.S. dollar when comparing the exchange rate at December 31, 1999, to that of December 31, 1998. Realized exchange gains (losses) are recorded in the period when incurred, and amounted to \$79,000, \$56,000 and \$(273,000) in 1999, 1998 and 1997, respectively. Exchange gains and losses include the remeasurement of certain currencies into functional currencies and the settlement of intercompany balances.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101), which provides additional guidance in applying generally accepted accounting principles to revenue recognition in the financial statements. The Company is currently evaluating the provisions of SAB 101 and its potential impact on the Company's revenue recognition policy.

"SAFE HARBOR" STATEMENT UNDER THE
PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The statements that are not historical facts contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations and other sections of this Annual Report are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that reflect the current belief, expectations or intent of the Company's management. These statements are subject to and involve certain risks and uncertainties including, but not limited to, timing of significant orders and shipments and the resulting fluctuation of the Company's operating results; changes in customer product mix; customer acceptance of the Company's products; capital spending patterns of customers; the Company's limited product offerings; risks relating to the convergence of voice and data networks; competition and pricing; the Company's relatively limited number of customers; new product introductions by the Company or its competitors; risks related to the Company's acquisition of IEX; product liability risks; the continued growth in third party purchases of diagnostics systems; customer acceptance of the Company's products; uncertainties relating to the Company's international operations; intellectual property protection; carrier deployment of intelligent network services; the level and timing of research and development expenditures; regulatory changes; general economic conditions; and other risks described in this Annual Report and in certain of the Company's Securities and Exchange Commission filings. Many of these risks and uncertainties are outside of the Company's control and are difficult for the Company to forecast or mitigate. Actual results may differ materially from those expressed or implied in such forward-looking statements.

The Company's Common Stock is traded over the counter on The Nasdaq Stock Market under the symbol TKLC. The following table sets forth the high and low closing sales prices for the Common Stock, as reported on The Nasdaq Stock Market. As of March 1, 2000, there were 261 record holders of the Company's Common Stock based on information provided by the Company's transfer agent.

	High	Low
1998		
First Quarter	\$22.69	\$14.05
Second Quarter	25.13	19.94
Third Quarter	24.63	13.75
Fourth Quarter	22.25	10.63
1999		
First Quarter	22.25	7.09
Second Quarter	12.19	6.69
Third Quarter	17.19	9.13
Fourth Quarter	23.50	12.19

The Company has never paid a cash dividend. It is the present policy of the Company to retain earnings to finance the growth and development of its business and, therefore, the Company does not anticipate paying cash dividends on its Common Stock in the foreseeable future.

CONSOLIDATED STATEMENTS OF OPERATIONS

(thousands, except per-share data)	For the Years Ended December 31,		
	1999	1998	1997
Revenues	\$226,068	\$176,669	\$125,140
Costs and expenses:			
Cost of goods sold	77,389	58,883	41,524
Amortization of purchased technology	6,397	19	—
Research and development	42,289	26,371	21,019
Selling, general and administrative	64,294	40,458	34,971
Amortization of goodwill and other intangibles	15,863	—	—
Acquired in-process research and development and other acquisition-related charges	6,830	—	—
Restructuring	1,800	—	—
Total costs and expenses	214,862	125,731	97,514
Income from operations	11,206	50,938	27,626
Interest and other income (expense):			
Interest income	4,230	4,785	2,378
Interest expense	(4,914)	—	—
Other, net	(293)	(172)	(263)
Total other income (expense)	(977)	4,613	2,115
Income before provision for income taxes	10,229	55,551	29,741
Provision for income taxes	9,785	16,342	745
Net income	\$ 444	\$ 39,209	\$ 28,996
Earnings per share:			
Basic	\$ 0.01	\$ 0.73	\$ 0.58
Diluted	0.01	0.67	0.51
Weighted average number of shares outstanding:			
Basic	54,931	53,518	50,408
Diluted	58,690	58,708	56,842

See notes to consolidated financial statements

CONSOLIDATED BALANCE SHEETS

(thousands, except per-share data)	December 31,	
	1999	1998
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 46,671	\$ 31,932
Short-term investments, at fair value	37,997	37,704
Accounts and notes receivable, less allowances 1999 – \$1,478; 1998 – \$763	83,649	54,606
Inventories	24,310	12,872
Amounts due from related parties	1,847	1,896
Deferred income taxes, net	8,365	8,616
Prepaid expenses and other current assets	5,150	3,317
Total current assets	207,989	150,943
Long-term investments, at fair value	21,996	44,138
Property and equipment, net	21,667	12,859
Deferred income taxes	2,780	1,514
Other assets	4,296	625
Intangible assets	135,706	131
Total assets	<u>\$394,434</u>	<u>\$210,210</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	\$ 16,249	\$ 10,904
Accrued expenses	19,196	10,932
Accrued payroll and related expenses	8,937	5,660
Current portion of deferred revenues	35,330	10,480
Income taxes payable	575	4,205
Total current liabilities	80,287	42,181
Long-term convertible debt	115,786	—
Deferred income taxes	19,229	—
Long-term portion of deferred revenues	2,537	2,252
Total liabilities	<u>217,839</u>	<u>44,433</u>
Commitments and contingencies		
Shareholders' equity:		
Common stock, without par value, 200,000,000 shares authorized; issued and outstanding 1999 – 55,713,127; 1998 – 54,328,512	101,385	92,803
Retained earnings	72,528	72,084
Accumulated other comprehensive income	2,682	890
Total shareholders' equity	<u>176,595</u>	<u>165,777</u>
Total liabilities and shareholders' equity	<u>\$394,434</u>	<u>\$210,210</u>

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF CASH FLOW

(thousands)	For the Years Ended December 31,		
	1999	1998	1997
Cash flow from operating activities:			
Net income	\$ 444	\$ 39,209	\$ 28,996
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	8,519	5,776	4,790
Amortization	22,260	19	—
Write-offs of acquired in-process research and development	6,000	—	—
Non cash portion of restructuring charge	800	—	—
Convertible debt accretion	558	—	—
Deferred income taxes	(4,742)	276	(82)
Stock-based compensation	—	343	—
Changes in assets and liabilities: (excluding the effect of acquisition)			
Accounts and notes receivable	(18,506)	(24,873)	(12,537)
Inventories	(5,324)	(1,507)	(3,299)
Amounts due from related parties	49	389	93
Income taxes receivable	3,478	775	(857)
Prepaid expenses and other current assets	(1,182)	(1,548)	(266)
Trade accounts payable	3,383	5,660	(412)
Accrued expenses	5,798	4,955	(49)
Accrued payroll and related expenses	(4,442)	(1,225)	2,842
Deferred revenues	11,328	2,200	6,766
Income taxes payable	2,158	12,800	(849)
Total adjustments	30,135	4,040	(3,860)
Net cash provided by operating activities	30,579	43,249	25,136
Cash flow from investing activities:			
Purchase of available-for-sale securities	(52,737)	(107,272)	(22,737)
Proceeds from maturity of available-for-sale securities	81,842	57,200	18,000
Payments in connection with acquisition, net of cash acquired	(49,087)	—	—
Purchase of property and equipment	(13,948)	(8,702)	(6,552)
Purchase of technology	(1,561)	(150)	—
(Increase) Decrease in other assets	(3,615)	(45)	46
Net cash used in investing activities	(39,106)	(58,969)	(11,243)
Cash flow from financing activities:			
Repayments of short-term notes	(100,000)	—	—
Net proceeds from issuance of convertible debt	115,228	—	—
Proceeds from issuance of common stock	6,573	7,634	8,759
Net cash provided by financing activities	21,801	7,634	8,759
Effect of exchange rate changes on cash	1,465	1,270	(1,115)
Net increase (decrease) in cash and cash equivalents	14,739	(6,816)	21,537
Cash and cash equivalents at beginning of the year	31,932	38,748	17,211
Cash and cash equivalents at end of the year	\$ 46,671	\$ 31,932	\$ 38,748

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF CASH FLOW (Continued)

(thousands)	For the Years Ended December 31,		
	1999	1998	1997
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 3,471	\$ —	\$ —
Income taxes	8,248	2,297	2,408
Supplemental disclosure of non-cash flow activity:			
Tax benefit related to stock options	2,009	9,199	9,819
Notes payable issued in connection with acquisition	100,000	—	—
Assets and liabilities recognized in connection with acquisition:			
Account Receivable	9,957	—	—
Other current assets	13,261	—	—
Investments	7,255	—	—
Property and equipment	3,490	—	—
Other assets	169	—	—
Intangibles	61,000	—	—
Goodwill	95,274	—	—
Accounts payable	1,515	—	—
Other current liabilities	22,929	—	—
Deferred income tax liability	22,875	—	—

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(thousands)	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Number of Shares	Amount			
Balance, December 31, 1996	48,040	\$ 57,049	\$ 3,879	\$ 823	\$ 61,751
Exercise of stock options and warrants	4,212	8,759	—	—	8,759
Stock option tax benefits	—	9,819	—	—	9,819
Translation adjustment	—	—	—	(1,448)	(1,448)
Net loss	—	—	28,996	—	28,996
Balance, December 31, 1997	52,252	75,627	32,875	(625)	107,877
Exercise of stock options and warrants	2,032	7,634	—	—	7,634
Issuance of restricted stock, net of unearned compensation	45	343	—	—	343
Stock option tax benefits	—	9,199	—	—	9,199
Translation adjustment	—	—	—	1,515	1,515
Net income	—	—	39,209	—	39,209
Balance, December 31, 1998	54,329	92,803	72,084	890	165,777
Exercise of stock options and warrants	1,384	6,452	—	—	6,452
Compensation related to vesting of restricted stock	—	121	—	—	121
Stock option tax benefits	—	2,009	—	—	2,009
Translation adjustment	—	—	—	1,792	1,792
Net income	—	—	444	—	444
Balance, December 31, 1999	55,713	\$101,385	\$72,528	\$ 2,682	\$176,595

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(thousands)	For the Years Ended December 31,		
	1999	1998	1997
Net income	\$ 444	\$39,209	\$28,996
Other comprehensive income (loss):			
Foreign currency translation adjustments	1,792	1,515	(1,448)
Comprehensive income	<u>\$2,236</u>	<u>\$40,724</u>	<u>\$27,548</u>

See notes to consolidated financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

The Company designs, manufactures and markets network infrastructure products and diagnostics systems for telecommunications networks. The Company's customers include telecommunications carriers, network service providers and equipment manufacturers. The Company also develops and sells management software to operators of call centers.

Principles of Consolidation and Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions are eliminated. Certain items shown in the December 31, 1998 and 1997 financial statements have been reclassified to conform with the current period presentation.

Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Inventories

Inventories are stated at the lower of cost (first in, first out) or market.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are provided using the straight-line method. The estimated useful lives are:

Manufacturing and development equipment	3–5 years
Furniture and office equipment	5 years
Demonstration equipment	3 years
Leasehold improvements	The shorter of useful life or lease term

Software Developed for Internal Use

The Company capitalizes costs of software, consulting services, hardware and payroll-related costs incurred to purchase or develop internal-use software. The Company expenses costs incurred during preliminary project assessment, research and development, re-engineering, training and application maintenance.

Software Development Costs

The Company provides for capitalization of certain software development costs once technological feasibility is established. The costs so capitalized are amortized on a straight-line basis over the estimated

product life (generally eighteen months to three years), or on the ratio of current revenue to total projected product revenues, whichever is greater. To date, the establishment of technological feasibility of the Company's products and general release have substantially coincided. As a result, the Company has not capitalized any internal software development costs as costs qualifying for such capitalization have not been significant.

Intangible Assets

Intangible assets consist of goodwill, purchased technology and other intangible assets, all of which are generally amortized over periods ranging from three to five years. Intangible assets are stated at cost, less accumulated amortization.

Long-Term Assets

The Company identifies and records impairment on long-lived assets when events and circumstances indicate that such assets have been impaired. The Company periodically evaluates the recoverability of its long-lived assets based on expected nondiscounted cash flows, and recognizes impairment, if any, based on expected discounted cash flows.

Product Warranty Costs

The Company generally warrants its products for one year after sale and provides for estimated future warranty costs at the time revenue is recognized. At December 31, 1999 and 1998, accrued product warranty costs amounted to \$2.8 million and \$2.3 million, respectively, and are included in accrued expenses.

Revenue Recognition

Revenues from sales of network systems products, diagnostic products and call center products are recognized upon shipment to the customer's final site and satisfaction of related Company obligations, if any, provided that persuasive evidence of an arrangement exists, the fee is fixed and determinable and collectability is deemed probable. Revenues associated with multiple-element arrangements (products, upgrades, enhancements and post-contract customer support) are allocated to each element based on vendor specific objective evidence of fair value. Revenues associated with installation are recognized upon completion. Extended warranty service revenues are recognized ratably over the warranty period. Engineering service revenues are recognized on delivery or as the services are performed. Development contract revenues are recognized using the percentage-of-completion method based on the costs incurred relative to total estimated costs. Provisions for anticipated losses, if any, on development contracts are recognized in income currently.

Income Taxes

Income tax expense is the tax payable for the period and the change during the period in non-capital-related deferred tax assets and liabilities. Deferred income taxes are determined based on the difference between the financial reporting and tax bases of assets and liabilities using enacted rates in effect during the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

Advertising

Advertising costs are expensed as incurred and amounted to \$1.4 million, \$781,000 and \$669,000 for 1999, 1998 and 1997, respectively.

Stock-Based Compensation

Statement of Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), encourages but does not require companies to record compensation cost for stock-based employee compensation plans at fair value for awards granted subsequent to December 31, 1995. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" (APB 25) and related interpretations. Accordingly, no compensation expense has been recognized for the Company's stock option and purchase plans. SFAS 123 requires companies that continue to follow APB 25 to provide a pro forma disclosure of the impact of applying the fair value method of SFAS 123. See Note N.

Translation of Foreign Currencies

Translation of foreign currencies is accounted for using the local currency as the functional currency of the Company's foreign subsidiaries. All assets and liabilities are translated at exchange rates in effect on the balance sheet dates while revenues and expenses are translated at average rates in effect for the period. The resulting gains and losses are included in a separate component of shareholders' equity. Realized gains (losses) on foreign currency transactions are reflected in net income (loss) and amounted to \$79,000, \$56,000 and \$(273,000) for 1999, 1998 and 1997, respectively.

Earnings Per Share

Earning per share are computed using the weighted average number of shares outstanding and dilutive Common Stock equivalents (options and warrants), in accordance with Statement of Financial Accounting Standards (SFAS) No. 128 "Earnings per Share."

Comprehensive Income

Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders.

Segment Information

The Company uses the "management approach" in determining reportable business segments. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of the Company's reportable segments.

New Accounting Pronouncements

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (SAB 101), which provides additional guidance in applying generally accepted accounting principles to revenue recognition in the financial statements. The Company is currently evaluating the provisions of SAB 101 and its potential impact on the Company's revenue recognition policy.

NOTE B – ACQUISITION OF IEX CORPORATION

On May 7, 1999, the Company acquired all of the outstanding stock of IEX Corporation ("IEX") for \$163 million, consisting of \$63 million in cash and \$100 million in short-term notes which matured on November 7, 1999. IEX develops, markets and sells solutions for intelligent networks, call centers and other telecommunications markets.

The transaction has been accounted for under the purchase method of accounting, and resulted in net goodwill and other intangibles of approximately \$133.4 million, with an average amortization period of five years. The total purchase price, including acquisition expenses of \$2.0 million, was allocated among the assets acquired and liabilities assumed based on their estimated fair values as follows:

(thousands)	
In-process research and development	\$ 6,000
Development and existing technology	48,000
Other intangibles	13,000
Goodwill	95,274
Tangible assets acquired	50,045
Deferred income tax liabilities associated with certain intangible assets	(22,875)
Liabilities assumed	(24,444)
	<u>\$165,000</u>

Based on a third party appraisal, management determined that \$6.0 million of the purchase price represented acquired in-process research and development that had not yet reached technological feasibility and had no alternative future use. This amount was recorded as a non-recurring expense in the second quarter of 1999. Amortization expense of purchased technology and other intangible assets resulting from the acquisition amounted to \$18.5 million, net of amortization of associated deferred income tax liabilities of \$3.6 million for the year ended December 31, 1999.

The following table shows pro forma revenues, net income (loss) and diluted earnings (loss) per share of the Company giving effect to the IEX acquisition as of the beginning of 1999 and 1998, excluding the impact of the one-time non-recurring charge noted above.

(thousands, except per-share amounts)	For the Years Ended December 31,	
	1999	1998
Revenues	\$239,826	\$225,950
Net income (loss)	(6,672)	9,005
Diluted earnings (loss) per share	(0.12)	0.15

NOTE C – FAIR VALUE OF INVESTMENTS

The Company has short-term investments in corporate debt securities with original maturities of less than 90 days whose carrying amounts approximate their fair values because of their short maturities. These short-term investments are included in cash and cash equivalents, are classified as held-to-maturity securities and amounted to \$17.9 million and \$19.4 million at December 31, 1999 and December 31, 1998, respectively.

The Company also had investments classified as available-for-sale securities included in short-term and long-term investments, categorized as follows:

(thousands)	December 31,	
	1999	1998
Type of Security:		
Corporate debt securities with maturities of less than one year	\$27,853	\$25,704
State and local government securities with maturities of less than one year	8,102	—
U.S. government securities with maturities of less than one year	2,042	12,000
Total short-term investments	37,997	37,704
U.S. government securities with maturities of between one and two years	21,996	44,138
	<u>\$59,993</u>	<u>\$81,842</u>

These available-for-sale securities are accounted for at their fair value, and unrealized gains and losses on these securities are reported as a separate component of shareholders' equity. At December 31, 1999 and 1998, net unrealized gains or losses on available-for-sale securities were not significant. The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses are reported in other income and expense, and were not significant for 1999, 1998 and 1997.

NOTE D – BUSINESS AND CREDIT RISK

Financial instruments, which potentially subject the Company to concentration of credit risk, consist principally of cash, investments and trade receivables. The Company invests its excess cash in interest-bearing deposits with major banks, United States government securities, high-quality commercial paper and money market funds. At times the Company's cash balances may be in excess of the FDIC insurance limits. With respect to trade receivables, the Company sells network systems, communications diagnostic systems and call center systems worldwide primarily to telephone operating companies, equipment manufacturers and corporations that use its systems to design, install, maintain, test and operate communications equipment and networks. Credit is extended based on an evaluation of each customer's financial condition, and generally collateral is not required. Credit losses, if any, have been provided for in the financial statements and to date have been within management's expectations.

NOTE E – RELATED PARTY TRANSACTIONS

As of December 31, 1999, the Company's principal shareholder and a director and his family owned an aggregate of approximately 26% of the Company's outstanding stock.

The following is a summary of transactions and balances with a director and a foreign-affiliated company controlled by the director:

(thousands)	1999	1998	1997
Product sales	\$3,319	\$4,269	\$4,471
Purchases of inventory	—	—	212
Director's fees and expenses	66	51	104
Due from affiliates	1,847	1,896	2,286

The amounts due from affiliates are non-interest bearing.

NOTE F – RESTRUCTURING

During the first quarter of 1999, the Company announced its plan to scale down its Data Network Diagnostics Division and integrate the division into its Intelligent Network Diagnostics Division. In connection with this restructuring, the Company recorded a restructuring charge of \$1.8 million consisting of cash severance costs for 27 terminated employees in management, research and development, support and administrative functions, and non-cash charges consisting of the write-down of certain assets to their net realizable value. The costs consisted of the following:

(thousands)	
Severance pay	\$ 700
Other accrued expenses	300
Inventory	350
Fixed assets	200
Other assets	250
	<u>\$1,800</u>

At December 31, 1999, all 27 employees had been terminated, and all severance costs and other accrued expenses had been paid.

NOTE G – INCOME TAXES

The provision for income taxes consists of the following:

(thousands)	For the Years Ended December 31,		
	1999	1998	1997
Currently payable:			
Federal	\$ 9,991	\$10,736	\$ 5,394
State	2,683	3,500	1,554
Foreign	454	1,794	390
Deferred:			
Federal	(2,981)	2,134	(5,974)
State	(414)	(1,338)	(745)
Foreign	52	(484)	126
	<u>\$ 9,785</u>	<u>\$16,342</u>	<u>\$ 745</u>

The components of temporary differences that gave rise to deferred taxes at December 31, 1999 and 1998 are as follows:

(thousands)	December 31,	
	1999	1998
Deferred tax assets:		
Allowance for doubtful accounts	\$ 394	\$ 258
Inventory adjustments	953	1,708
Depreciation and amortization	309	188
Research and development credit carryforward	2,596	4,447
Accrued liabilities	5,532	2,191
Warranty accrual	1,041	885
Other	320	453
Total deferred tax asset	11,145	10,130
Current portion	8,365	8,616
Long-term portion	\$ 2,780	\$ 1,514
Deferred tax liability:		
Acquisition-related intangible assets	\$19,229	\$ —
Current portion	—	—
Long term portion	\$19,229	\$ —

The Company has not provided a valuation allowance for its deferred tax assets, based on management's assessment of the Company's ability to utilize its deferred tax assets. Realization of the deferred tax assets of \$11.1 million is dependent on the extent of the Company's income in carryback years and on the Company generating sufficient taxable income in the future. Although realization is not assured, the Company believes it is more likely than not that the deferred tax assets will be realized. The amount of the deferred tax assets considered realizable, however, could be reduced in the future if estimates of future taxable income are reduced. In connection with the acquisition of IEX, the Company recorded deferred income tax liabilities of \$22.9 million associated with certain intangible assets. These deferred income tax liabilities are amortized on a straight-line basis and amounted to \$19.2 million at December 31, 1999.

The provision for income taxes differs from the amount obtained by applying the federal statutory income tax rate to income before provision for income taxes as follows:

(thousands)	For the Years Ended December 31,		
	1999	1998	1997
Federal statutory provision (benefit)	\$ 3,580	\$19,443	\$10,112
State taxes, net of federal benefit	1,474	1,530	534
Foreign taxes	143	335	226
Reduction in valuation allowance	—	(2,248)	(8,960)
Utilization of operating loss carryforwards	—	—	(499)
Research and development credits	(1,531)	(2,111)	(723)
Nontaxable FSC income	(507)	(865)	—
Acquisition-related intangible assets, net of related deferred income tax liability	6,204	—	—
Other	422	258	55
Actual income tax provision	\$ 9,785	\$16,342	\$ 745
Effective tax rate	95.7%	29.4%	2.5%

At December 31, 1999, the Company had available state and federal research and development credit carryforwards of \$2.6 million, which will begin to expire in the year 2003.

The Company has not provided for federal income taxes on \$13.6 million of undistributed earnings of its foreign subsidiaries that have been reinvested in their operations.

NOTE H - INVENTORIES

The components of inventories are:

(thousands)	December 31,	
	1999	1998
Raw materials	\$ 7,490	\$ 3,830
Work in process	2,366	2,064
Finished goods	14,454	6,978
	\$24,310	\$12,872

NOTE I - PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

(thousands)	December 31,	
	1999	1998
Manufacturing and development equipment	\$ 31,124	\$ 23,024
Furniture and office equipment	16,007	9,677
Demonstration equipment	3,207	4,038
Leasehold improvements	4,105	1,953
	54,443	38,692
Less, accumulated depreciation and amortization	(32,776)	(25,833)
	\$ 21,667	\$ 12,859

NOTE J - INTANGIBLE ASSETS

Intangible assets consist of the following:

(thousands)	December 31,	
	1999	1998
Goodwill	\$ 95,274	\$ —
Purchased technology	49,712	150
Other	13,000	—
	157,986	150
Less, accumulated amortization	(22,280)	(19)
Intangible assets, net	\$135,706	\$ 131

NOTE K - LINES OF CREDIT AND BORROWINGS

The Company has a \$15.0 million line of credit with a U.S. bank and lines of credit aggregating \$2.9 million available to the Company's Japanese subsidiary from various Japanese based banks.

The company's \$15.0 million credit facility is collateralized by substantially all of the Company's assets, bears interest at the lender's prime rate (8.5% at December 31, 1999), and expires on June 30, 2000, if not renewed. Under the terms of this facility, the Company is required to maintain certain financial ratios and meet certain net worth and indebtedness tests. In connection with the Company's May

1999 acquisition of IEX Corporation, the Company renegotiated certain terms under this credit facility, including various financial ratios and net worth and indebtedness tests. The Company believes it is in compliance with these requirements. There have been no borrowings under this credit facility.

The Company's Japanese subsidiary has collateralized yen-denominated lines of credit with Japan-based banks, primarily available for use in Japan, amounting to the equivalent of \$2.9 million with interest at the Japanese prime rate (1.375% at December 31, 1999) plus 0.125% per annum which expire between August 2000 and November 2000, if not renewed. There have been no borrowings under these lines of credit.

NOTE L – CONVERTIBLE DEBT

On November 2, 1999, the Company completed a private placement of \$135.0 million aggregate principal amount at maturity of 3.25% convertible subordinated discount notes due 2004. The notes were issued at 85.35% of their face value amount (equivalent to gross proceeds at issuance of approximately \$115.2 million before discounts and expenses). The gross proceeds at issuance before discounts and expenses included approximately \$15.2 million from the sale of notes issued upon the initial purchasers' exercise in full of their over-allotment option.

The notes are convertible at any time after January 31, 2000, into Tekelec common stock, unless the notes have been previously redeemed or otherwise purchased, at a conversion rate of 56.3393 shares per \$1,000 principal amount at maturity (approximately 7.6 million shares in total) which represents a redemption price of \$15.15 per share of common stock. The notes can be redeemed by the Company after November 2, 2002 at the redemption price together with accrued but unpaid interest.

The notes were issued with a 14.65% discount and carry a cash interest (coupon) rate of 3.25%, payable on May 2 and November 2 of each year, commencing on May 2, 2000. The payment of principal amount of the notes at maturity together with cash interest paid over the term of the notes represents a yield to maturity of 6.75% per year, computed on a semi-annual bond equivalent basis. Interest expense is computed based on the accretion of the discount, the accrual of the cash interest payment and the amortization of expenses related to the offering of these notes and amounted to approximately \$1.4 million for the period of November 2, 1999 through December 31, 1999.

NOTE M – COMMITMENTS AND CONTINGENCIES

The Company leases its office and manufacturing facilities together with certain office equipment under operating lease agreements. Lease terms generally range from one to ten years; certain building leases contain options for renewal for additional periods and are subject to increases up to 10% every 24 months.

Total rent expense was \$4.0 million, \$2.5 million and \$2.5 million for 1999, 1998 and 1997, respectively.

Minimum annual noncancelable lease commitments at December 31, 1999 are:

For the Years Ending December 31,	(thousands)
2000	\$ 4,725
2001	4,336
2002	4,236
2003	3,528
2004	2,902
Thereafter	10,857
	<u>\$30,584</u>

NOTE N – STOCK OPTIONS AND EMPLOYEE BENEFIT PLANS

The Company has various stock option plans with maximum terms of ten years under which 34.1 million shares of the Company's Common Stock have been authorized and reserved for issuance. The terms of options granted under these option plans are determined at the time of grant, generally vest ratably over a one- to five-year period, and in any case the option price may not be less than the fair market value per share on the date of grant. Both incentive stock options and non-statutory stock options can be issued under the option plans.

The Company also has Employee Stock Purchase Plans (ESPP), with maximum terms of ten years, the latest of which expires in the year 2006, and under which 800,000 shares of the Company's Common Stock have been authorized and reserved for issuance. Eligible employees may authorize payroll deductions of up to 10% of their compensation to purchase shares of Common Stock at 85% of the lower of the market price per share at the beginning or end of each six-month offering period.

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), encourages but does not require companies to record compensation cost for stock-based employee compensation plans at fair value for awards granted subsequent to December 31, 1995. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense has been recognized for the Company's stock option and purchase plans. Had compensation costs under these plans been determined based upon the methodology prescribed under SFAS 123, the Company's net income (loss) and diluted earnings (loss) per share would approximate the following proforma amounts (in thousands except per-share data):

	As Reported	Proforma
Year Ended December 31, 1999:		
Net income (loss)	\$ 444	\$(11,864)
Earnings (Loss) per share (diluted)	0.01	(0.22)
Year Ended December 31, 1998:		
Net income	\$39,209	\$ 32,836
Earnings per share (diluted)	0.67	0.56
Year Ended December 31, 1997:		
Net income	\$28,996	\$ 26,646
Earnings per share (diluted)	0.51	0.47

The effects of applying SFAS 123 in this proforma disclosure are not indicative of future amounts, and additional awards in future years are anticipated.

A summary of the status of the Company's stock options, as of December 31, 1999, 1998 and 1997, and the changes during the year ended on those dates are presented below (shares in thousands):

	1999		1998		1997	
	Shares	Wgtd. Avg. Exercise Price	Shares	Wgtd. Avg. Exercise Price	Shares	Wgtd. Avg. Exercise Price
Outstanding at beginning of year	8,438	\$ 8.90	8,298	\$ 4.50	9,672	\$ 2.43
Granted — price equals fair value	4,932	12.07	1,959	20.25	2,722	7.27
Granted — price greater than fair value	123	16.44	340	17.71	339	10.33
Exercised	1,187	3.72	1,838	2.88	3,777	1.87
Cancelled	1,357	10.39	321	8.15	658	3.72
Outstanding at year-end	<u>10,949</u>	<u>10.79</u>	<u>8,438</u>	8.90	<u>8,298</u>	4.50
Options exercisable at year-end	4,063		2,550		2,273	
Options available for future grant	4,823		3,528		3,513	
Weighted average fair value of options granted during the year:						
Exercise price equals fair value at grant date	\$ 8.40		\$13.92		\$5.23	
Exercise price greater than fair value at grant date	10.88		11.85		6.89	

The following table summarizes information about stock options outstanding at December 31, 1999 (shares in thousands):

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/99	Wgtd. Avg. Remaining Contractual Life	Wgtd. Avg. Exercise Price	Number Outstanding at 12/31/99	Wgtd. Avg. Exercise Price
\$ 0.75 to \$ 0.99	417	3.49	\$0.87	417	\$0.87
1.00 to 4.00	2,067	5.93	3.41	1,389	3.44
4.03 to 5.55	1,226	6.99	4.77	563	4.73
7.07 to 10.63	1,347	8.84	8.40	622	7.43
10.88 to 15.94	3,540	9.23	13.07	516	13.33
16.13 to 23.69	<u>2,352</u>	8.35	20.10	<u>556</u>	20.14
0.75 to 23.69	<u>10,949</u>	7.90	10.79	<u>4,063</u>	7.51

The fair value of options granted during 1999, 1998 and 1997 is estimated as \$24.7 million, \$15.7 million and \$6.9 million, respectively, on the dates of grants using the Black-Scholes option-pricing model with the following assumptions: (i) dividend yield of 0%, (ii) expected volatility of 79%, 81% and 86%, respectively, for 1999, 1998 and 1997, (iii) weighted average risk-free interest rates of 5.3%, 5.3% and 6.4% for 1999, 1998 and 1997, respectively, (iv) weighted average expected life of 5.1 years for all three periods and (v) assumed forfeiture rate of 42%, 50% and 58%, respectively, for 1999, 1998 and 1997.

During 1999, 1998 and 1997, approximately 198,000, 103,000 and 161,000 shares, respectively, were purchased under the Company's ESPP at weighted average exercise prices of \$10.27, \$13.94 and \$5.07, respectively. At December 31, 1999, 1998 and 1997 there were approximately 229,000, 427,000 and 530,000 shares, respectively,

available for future grants. The weighted average fair values of ESPP shares granted in 1999, 1998 and 1997 were \$5.15, \$7.37 and \$2.23 per share, respectively.

In 1997, the Company granted warrants to purchase 521,000 shares of Common Stock. The grant date fair values of these warrants was \$7.44 per share. There were no warrants granted in 1998 or 1999. See Note Q.

The Company has a 401(k) tax-deferred savings plan under which eligible employees may authorize from 2% to 12% of their compensation to be invested in employee-elected investment funds managed by an independent trustee and under which the Company may contribute matching funds of up to 50% of the employees' payroll deductions. During 1999, 1998 and 1997, the Company's contributions amounted to \$1.8 million, \$654,000 and \$401,000, respectively.

NOTE O – EARNINGS PER SHARE

The following table provides a reconciliation of the numerators and denominators of the basic and diluted per-share computations for the years ended December 31, 1999, 1998 and 1997:

(thousands except per-share amount)	Net Income (Numerator)	Shares (Denominator)	Per-Share Amount
For the Year Ended December 31, 1999:			
Basic EPS	\$ 444	54,931	\$0.01
Effect of Dilutive Securities – Stock Options and Warrants	—	3,759	
Diluted EPS	<u>\$ 444</u>	<u>58,690</u>	<u>\$0.01</u>
For the Year Ended December 31, 1998:			
Basic EPS	\$39,209	53,518	\$0.73
Effect of Dilutive Securities — Stock Options and Warrants	—	5,190	
Diluted EPS	<u>\$39,209</u>	<u>58,708</u>	<u>\$0.67</u>
For the Year Ended December 31, 1997:			
Basic EPS	\$28,996	50,408	\$0.58
Effect of Dilutive Securities — Stock Options and Warrants	—	6,434	
Diluted EPS	<u>\$28,996</u>	<u>56,842</u>	<u>\$0.51</u>

The computation of diluted number of shares excludes unexercised stock options and warrants and potential shares issuable upon conversion of the Company's convertible subordinated discount notes that are anti-dilutive. The numbers of such shares excluded were 11.5 million, 1.3 million and 89,000 for the years ended December 31, 1999, 1998 and 1997, respectively.

There were no transactions subsequent to December 31, 1999, which, had they occurred prior to December 31, 1999, would have changed materially the number of shares in the basic or diluted earnings per share computations.

NOTE P – OPERATING SEGMENT INFORMATION

Information for 1999 includes the post-acquisition results of IEX (See Note B). The Network Systems operating segment develops, markets and sells the Company's Eagle STP products based on the Company's high capacity packet switching platform; IP⁷ Secure Gateway, an SS7 gateway for signaling in converged networks, and other IP⁷ convergence products; and new network systems products resulting from the Company's acquisition of IEX, including Service Control Point, an advanced database server used for the provisioning of telephony applications, VoX Gateway Controller, a media gateway controller for converged networks, and Prepaid Services, a prepaid calling platform. The Network Diagnostics operating segment develops, markets and sells diagnostic products, including MGTS, a diagnostic tool used primarily by equipment suppliers for research and development, Sentinel used for testing and surveillance within telecommunications networks and i3000, used to perform diagnostics in converged networks. The Japan Diagnostics operating segment sells the Company's and third parties' diagnostic products to customers in Japan. The Call Center operating segment develops, markets and sells software-based solutions for Call Centers, including TotalView Workforce Management and TotalNet Call Routing. Transfers between operating segments are made at prices reflecting market conditions. The allocation of revenues from external customers by geographical area is determined by the destination of the sale.

The Company's operating segments and geographical information are as follows (in thousands):

Operating Segments

(thousands)	Net Sales		
	1999	1998	1997
Network Systems	\$137,796	\$116,259	\$ 71,941
Network Diagnostics	45,424	39,335	37,751
Call Center	21,128	—	—
Japan Diagnostics	21,890	21,981	16,384
Other Products	1,771	1,881	3,706
Intercompany Eliminations	(1,941)	(2,787)	(4,642)
Total net sales	<u>\$226,068</u>	<u>\$176,669</u>	<u>\$125,140</u>
(thousands)	Operating Income		
	1999	1998	1997
Network Systems	\$ 35,305	\$47,186	\$22,591
Network Diagnostics	10,099	8,842	10,263
Call Center	8,704	—	—
Japan Diagnostics	2,352	4,342	3,450
Other Products ¹	(1,567)	(764)	(503)
Intercompany Eliminations	114	283	152
General Corporate ²	(43,801)	(8,951)	(8,327)
Total operating income	<u>\$ 11,206</u>	<u>\$50,938</u>	<u>\$27,626</u>

¹ Other Products reflects the \$1,800 restructuring charge recorded in 1999 (See Note F).

² General Corporate includes acquisition-related charges and amortization of \$28,970 for 1999, and a benefit of \$1,663 for the settlement of an insurance claim for 1998.

Enterprise Wide Disclosures

The following table sets forth, for the periods indicated, revenues from external customers by principal product line:

(thousands)	1999	1998	1997
Network Systems	\$137,796	\$116,259	\$ 71,941
Network Diagnostics	64,908	58,263	47,800
Call Center	21,128	—	—
Other Products	2,236	2,147	5,399
Total revenues from external customers	<u>\$226,068</u>	<u>\$176,669</u>	<u>\$125,140</u>

The following table sets forth, for the periods indicated, revenues from external customers by geographic territory:

(thousands)	1999	1998	1997
North America	\$173,590	\$121,288	\$ 91,404
Japan	22,034	21,981	16,384
Europe	9,717	7,738	6,687
Rest of World	20,727	25,662	10,665
Total revenues from external customers	<u>\$226,068</u>	<u>\$176,669</u>	<u>\$125,140</u>

The following table sets forth, for the periods indicated, long-lived assets by geographic area in which the Company holds assets:

(thousands)	1999	1998	1997
United States	\$160,109	\$12,348	\$ 9,370
Japan	1,175	1,216	996
Other	385	51	—
Total Assets	<u>\$161,669</u>	<u>\$13,615</u>	<u>\$10,366</u>

There were no customers accounting for 10% or more of revenues in 1999 and 1998. Sales to one customer accounted for 23% of revenues in 1997 and included sales from the Network Systems and Network Diagnostics operating segments.

NOTE Q - COMMON STOCK

Warrants:

At December 31, 1999 and 1998, the Company had warrants outstanding to purchase an aggregate of 319,000 shares of its Common Stock, as more fully discussed below.

In July 1997, the Company issued warrants to purchase a total of 360,000 shares of its Common Stock to five directors and one corporate officer at \$14.08 per share. These warrants vest and become exercisable in 12 equal quarterly installments beginning on September 30, 1997. During 1998, 36,000 of these warrants were exercised, and 319,000 were outstanding at December 31, 1998 and December 31, 1999.

In January 1997, the Company issued warrants to a director and corporate officer to purchase 161,000 shares of its Common Stock at \$4.67 per share, all of which vested in 1997. At December 31, 1997, 54,000 of these warrants were outstanding, all of which were exercised during 1998.

Restricted Stock:

In February 1998, the Company granted a restricted stock award of 30,000 shares of its Common Stock to a director and corporate officer in connection with the commencement of his employment. The restricted shares vest in five equal annual installments beginning in February 1999. This award was valued at \$607,000, which is being recognized as stock-based compensation expense over the term of the award.

In January 1998, the Company granted a restricted stock award for an aggregate of 15,000 shares of its Common Stock to its five non-employee directors. The restricted shares became fully vested in January 1999. This award was valued at \$240,000, all of which was recognized as stock-based compensation expense in 1998.

(thousands, except per-share data)	For the Years Ended December 31,			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1999				
Revenues	\$32,685	\$51,728	\$64,743	\$76,912
Gross profit	21,336	32,256	39,301	49,389
Income (loss) before provision for income taxes	768	(4,624)	4,030	10,055
Net income	492	(6,136)	920	5,168
Earnings (loss) per share:				
Basic	\$ 0.01	\$ (0.11)	\$ 0.02	\$ 0.09
Diluted	0.01	(0.11)	0.02	0.09
1998				
Revenues	\$34,908	\$42,949	\$49,658	\$49,154
Gross profit	23,503	28,818	32,998	32,448
Income before provision for income taxes	10,735	13,488	16,734	14,594
Net income	6,656	8,365	10,372	13,816
Earnings per share:				
Basic	\$ 0.13	\$ 0.16	\$ 0.19	\$ 0.26
Diluted	0.11	0.14	0.18	0.24

Tekelec typically operates with a limited backlog, and most of its revenues in each quarter result from orders received in that quarter. Further, Tekelec typically generates a significant portion of its revenues for each quarter in the last month of the quarter. Tekelec establishes its expenditure levels based on its expectations as to future revenues, and if revenue levels were to fall below expectations this would cause expenses to be disproportionately high. Therefore, a drop in near-term demand would significantly affect revenues, causing a dis-

proportionate reduction in profits or even losses in a quarter. Tekelec's quarterly operating results may fluctuate as a result of a number of factors, including general economic and political conditions (such as recessions in the U.S., Japan and Europe), capital spending patterns of Tekelec's customers, increased competition, variations in the mix of sales, fluctuation in proportion of foreign sales, and announcements of new products by Tekelec or its competitors.

REPORT OF INDEPENDENT ACCOUNTANTS



TO THE SHAREHOLDERS AND BOARD OF DIRECTORS OF TEKELEC

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, cash flow, shareholders' equity, and comprehensive income present fairly, in all material respects, the financial position of Tekelec and its subsidiaries (the "Company") at December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

A handwritten signature in cursive script that reads "PricewaterhouseCoopers" followed by a small mark.

PricewaterhouseCoopers LLP
Woodland Hills, California
February 1, 2000

CORPORATE INFORMATION

CORPORATE HEADQUARTERS

Tekelec
26580 West Agoura Road
Calabasas, CA 91302

REGIONAL OFFICES

Campbell, California
Vista, California
Englewood, Colorado
Duluth, Georgia
Lombard, Illinois
Tinton Falls, New Jersey
Morrisville, North Carolina
Irving, Texas
Richardson, Texas

SUBSIDIARIES

IEX Corporation
Richardson, Texas

Gary Crockett
President and Chief Executive Officer

Debra May
Vice President and General Manager,
Call Center Division

Tekelec Ltd.
Tokyo, Japan

Akira Ohsono
President

Tekelec Limited
Staines, United Kingdom

David Colbeck
Managing Director

INDEPENDENT ACCOUNTANTS

PricewaterhouseCoopers LLP
Woodland Hills, California

LEGAL COUNSEL

Bryan Cave LLP
Santa Monica, California

TRANSFER AGENT AND REGISTRAR

U.S. Stock Transfer Corporation
1745 Gardena Avenue
Glendale, California 91204-2991
818.502.1404

COMMON STOCK

The Company's common stock is traded over the counter on The Nasdaq Stock Market under the symbol TKLC.

REPORT ON FORM 10-K

A copy of Tekelec's Form 10-K without exhibits for the year ended December 31, 1999, as filed with the Securities and Exchange Commission, is available, without charge, upon written request to: Erik Randerson, Investor Relations Director, Tekelec, 26580 West Agoura Road, Calabasas, California 91302, via the Internet at <http://www.tekelec.com>, or by fax at 818.880.6993.

ANNUAL MEETING

Tekelec's Annual Meeting of Shareholders will be held at 9:00 a.m. on May 12, 2000, at Tekelec's offices located at 5200 Paramount Parkway, Morrisville, North Carolina.

BOARD OF DIRECTORS

Jean-Claude Asscher
Chairman of the Board,
President of Tekelec—Airtronic, S.A.

Michael L. Margolis
President and Chief Executive Officer

Robert V. Adams^{1,3}
President and Chief Executive Officer,
RV Adams Capital Management

Daniel L. Brenner^{1,2}
Senior Vice President, Law & Regulatory
Policy, National Cable Television
Association

Howard Oringer^{1,2,3}
Managing Director,
Communications Capital Group

Jon F. Rager^{1,2,3}
President, Rager Bell Daskocil &
Meyer CPAs

¹member of Audit Committee

²member of Compensation Committee

³member of Corporate Development Committee

CORPORATE OFFICERS

Michael L. Margolis
President and Chief Executive Officer

Cecil E. Boyd
Sr. Vice President and General Manager,
Network Systems Division

Danny L. Parker
Vice President and General Manager,
Network Diagnostics Division

Gary Crockett
Chief Technical Officer

Ronald W. Buckley
Vice President, General Counsel and
Corporate Secretary

Dave Frankie
Vice President, Operations and Quality

Teresa A. Pippin
Vice President, Human Resources

Lee B. Smith
Vice President, Strategy and Business
Development