
C O R P O R A T E C O M M U N I C A T I O N S

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TOLLGRADE THIRD QUARTER RESULTS WITHIN GUIDANCE

PITTSBURGH, PA – October 20, 2004 - Tollgrade Communications, Inc. (NASDAQ: TLGD) today reported third quarter revenue and earnings that are within its previous guidance. The Company said that it recorded revenue of \$13,638,297 and a loss of \$(0.02) per share, including a \$269,000 severance charge, for the third quarter ended September 25, 2004. The Company also generated \$1,936,142 in operating cash flow for the three month period ended September 25, 2004.

Revenue and earnings per share for the third quarter of 2003 were \$15,616,233 and \$0.04 per share, respectively. On a year to date basis, the Company recorded revenues of \$46,711,256 and earnings of \$0.05 per share for the nine month period ended September 25, 2004; revenues were \$47,293,203 and earnings were \$0.14 per share in the corresponding period of the prior year. Revenue and earnings per share for the third quarter of 2004 were within the Company's guidance provided in the second quarter earnings release, which ranged from \$13.0 million to \$16.0 million and a loss of \$(0.07) to earnings of \$0.02, respectively.

"We are encouraged by new DigiTest® and DigiTest EDGE™ wins among non-RBOC service providers including TDS Telecom, Matanuska Telephone Association and Talk America. We also completed successful lab trials with major telecom service providers related to DigiTest products for the growing DSL market," said Chris Allison, Chairman and CEO, Tollgrade Communications, Inc.

Allison continued, "Although our cable team in Florida was forced to evacuate our Florida facilities three times during the quarter due to hurricanes, we remain pleased with the successes of our DOCSIS® certified transponder as evidenced by a successful compliance test of the embedded product. We also received orders of approximately \$1.7 million of our Alpha external transponders; however, we did not ship this product during the quarter due to the ongoing compliance testing."

"From a financial standpoint, we completed a workforce reduction to adjust costs; however, we believe we are currently sized properly to meet customer needs. We actually plan on adding key engineering positions, and may need to add headcount to meet production needs should budget monies among our customers become available. We understand there may be such funds available in two of our RBOC customers."

Third Quarter 2004 Revenue Results

Overall sales of cable hardware and software products were \$2,438,000 in the third quarter of 2004, compared to \$3,538,000 in the third quarter of the prior year. During the current quarter we finalized the third-party certification process related to the Company's DOCSIS certified Alpha embedded transponders. Delays in the certification process impacted our ability to produce and deliver product to our customers.

Overall sales of the Company's MCU products, which extend testability into the POTS network, were \$4,667,000 in the third quarter of 2004, compared to \$6,559,000 in the corresponding prior year quarter. MCU sales to RBOCs were down 3% and OEM sales of that product were not significant.

Sales of LoopCare™ software products separate and unrelated to the Company's DigiTest system products in the third quarter of 2004 were \$321,000; no sales were recorded in the third quarter of 2003. The LoopCare software product line, which involves software license fees that are individually significant in amount, typically has long and unpredictable sales, purchase approval and acceptance cycles. As a result, revenue from this product line can fluctuate significantly on a quarter-by-quarter basis. Total software license fees and services revenue related to LoopCare were \$2,646,000 in the third quarter of 2004 compared to \$2,182,000 in the third quarter of 2003.

Gross sales of Tollgrade's DigiTest system products to new and existing customers were \$2,876,000 in the third quarter of 2004, compared to \$2,433,000 in the same period of 2003. DigiTest revenues increased in the third quarter of 2004 compared to the third quarter of 2003, primarily due to system growth in CLEC customers as well as continuing RBOC LTS modernization initiatives.

Third quarter 2004 revenue from Services, which include installation oversight and project management services provided to RBOCs and fees for software maintenance, was \$3,336,000, up slightly compared to \$3,086,000 in the third quarter of the prior year.

Third Quarter 2004 Financial and Operating Data

Gross profit for the third quarter of 2004 was \$7,627,209, a decrease of \$960,090, or 11.2%, from the third quarter of 2003, resulting primarily from reduced sales of MCU channel units and cable hardware and software products. As a percentage of sales, gross profit for the quarter was 55.9% versus 55.0% for the prior year quarter. Gross margins increased in the third quarter compared to the previous year's third quarter due to a favorable sales mix which included higher DigiTest system sales and LoopCare software products sales offset by lower absorption of manufacturing costs.

Overall operating expenses increased slightly from \$7,738,864 in the third quarter of 2003 to \$8,168,697 in the third quarter of 2004. Selling and marketing expenses in the quarter were \$2,198,125, a decrease of \$121,788, or 5.2%, from the same period in 2003. The decrease in the cost is associated with lower product consulting costs and travel costs. General and administrative expenses increased \$184,657, or 11.1%, from \$1,664,797 in the third quarter of

2003 to \$1,849,454 in the same period in 2004. The increase in the expense is primarily attributed to salaries and wages and professional services costs, offset by a decrease in bad debt expense. Research and development expenses for the third quarter of 2004 were \$3,852,481, an increase of \$98,327, or 2.6%, from the third quarter of 2003. The increase in expense is associated with higher consulting and professional service costs associated with research and development related to Cheetah™ products.

As previously discussed, we implemented a cost alignment initiative that included a total reduction of approximately 50 positions. The severance costs of \$268,637, included as a component of operating expenses, recorded in the third quarter of 2004 represents all costs that will be incurred with this reduction. All actions, including cash payments, related to this reduction were completed during the third quarter.

The effective tax rate for the third quarter of 2004 was a benefit of 36.7%, compared to a provision of 38.1% in the prior year quarter.

The Company's order backlog for firm customer purchase orders and signed software maintenance contracts was \$8,117,679 as of September 25, 2004, compared to backlog of \$15,347,000 as of December 31, 2003 and \$8,786,146 as of September 27, 2003. The decrease in the backlog from December 31, 2003 to September 25, 2004, is attributed to lower maintenance backlog, heavy MCU shipments in the first half of 2004, as well as a negotiated cancellation of certain MCU orders associated with an incentive purchase during the second quarter.

The backlog at September 25, 2004 included approximately \$3,802,000 related to software maintenance contracts, which will be earned and recognized as income on a straight-line basis during the remaining terms of the underlying agreements. Management expects that approximately 68% of the current backlog will be recognized as revenue in the fourth quarter of 2004.

Fourth Quarter Outlook

“Regarding the fourth quarter, we are beginning to see signs of some year-end budget availability which has the potential to translate to DigiTest test-head roll-outs for DSL applications among some major telecom carriers. We also have smaller telecom carriers looking for budget dollars for planned 2004 deployments. As a result, our estimates for the fourth quarter revenue range from \$13 million to \$17 million with E.P.S. of (\$0.05) to \$0.06. It should be noted that approximately \$2.6 million of product sales in the range is predicated on sufficient customer budget availability and product acceptances.”

Conference Call and Webcast

A conference call to discuss earnings results for the third quarter of 2004 will be held on Thursday, October 21, 2004 at 9:00 AM, Eastern Time. The telephone number for U.S. participants is 1-800-860-2442 (international: 412-858-4600). Please reference Tollgrade/Allison to identify the call. The conference call will also be broadcast

live over the Internet. To listen to this conference call via the Internet, simply log on to the following URL address: <http://phx.corporate-ir.net/playerlink.zhtml?c=80100&s=wm&e=950055>.

About Tollgrade

Tollgrade Communications, Inc. is a full-system provider of leading hardware and software testing solutions for the global telecommunications and cable broadband industries. Tollgrade designs, engineers, markets and supports test systems, test access and status monitoring products. The Company, which is headquartered in the Pittsburgh suburb of Cheswick, Pa., recorded 2003 revenues of \$65.1 million. The Company's web address is www.tollgrade.com.

TOLLGRADE COMMUNICATIONS, INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Operations
(In thousands, except per-share data)

	Three Months Ended		Nine Months Ended	
	<u>Sept. 25,</u> <u>2004</u>	<u>Sept. 27,</u> <u>2003</u>	<u>Sept. 25,</u> <u>2004</u>	<u>Sept. 27,</u> <u>2003</u>
Revenues:				
Products	\$ 10,358	\$ 12,529	\$ 37,080	\$ 38,015
Services	3,280	3,087	9,631	9,278
	13,638	15,616	46,711	47,293
Cost of sales:				
Products	4,556	5,529	16,836	17,055
Services	945	1,010	2,803	2,776
Amortization	510	490	1,493	1,891
	6,011	7,029	21,132	21,722
Gross profit	7,627	8,587	25,579	25,571
Operating expenses:				
Selling and marketing	2,198	2,320	7,053	6,711
General and administrative	1,849	1,665	5,445	5,230
Research and development	3,853	3,754	12,160	10,982
Severance	269	---	269	---
Total operating expenses	8,169	7,739	24,927	22,923
(Loss) income from operations	(542)	848	652	2,648
Other income	109	77	267	309
(Loss) income before income taxes	(433)	925	919	2,957
(Benefit) provision for income taxes	(159)	352	248	1,124
Net (loss) income	(274)	\$ 573	671	\$ 1,833
Diluted (loss) earnings per-share information:				
Weighted average shares of common stock and equivalents	13,148	13,346	13,263	13,330
Net (loss) income per common and common equivalent shares	\$(0.02)	\$0.04	\$0.05	\$0.14

TOLLGRADE COMMUNICATIONS, INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Balance Sheets
(In thousands)

	<u>September</u> <u>25, 2004</u>	<u>December</u> <u>31, 2003</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 30,566	\$ 31,060
Short-term investments	19,435	17,625
Accounts receivable:		
Trade	9,289	9,255
Other	119	122
Inventory	11,181	11,155
Prepaid expenses	1,394	1,534
Deferred and refundable tax assets	2,415	1,745
Total current assets	74,399	72,496
Property and equipment, net	8,310	8,292
Deferred tax assets	1,412	1,153
Capitalized software costs, net	6,366	7,713
Intangibles	45,144	44,500
Goodwill	19,340	19,340
Other assets	401	335
Total assets	\$ 155,372	\$ 153,829
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 635	\$ 1,007
Accrued warranty	2,028	2,150
Accrued expenses	734	589
Accrued salaries and wages	580	912
Accrued royalties payable	204	396
Income taxes payable	1,069	1,018
Deferred income	854	480
Total current liabilities	6,104	6,552
Deferred tax liabilities	2,433	1,448
Total liabilities	8,537	8,000
Total shareholders' equity	146,835	145,829
Total liabilities and shareholders' equity	155,372	\$ 153,829

TOLLGRADE COMMUNICATIONS, INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Cash Flows
(In thousands)

Nine Months Ended
Sept. 25, 2004 Sept. 27, 2003

Cash flows from operating activities:		
Net income	671	\$ 1,833
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,440	3,638
Tax benefit from exercise of stock options	65	55
Income taxes (paid) refundable	(41)	212
Deferred income taxes	97	631
Provisions for losses on inventory	297	302
Disposition of slow moving and obsolete inventory	(260)	(296)
Provision for allowance for doubtful accounts	(51)	517
Changes in assets and liabilities:		
Increase (decrease) in accounts receivable-trade	17	(2,665)
Decrease in accounts receivable-other	3	97
(Increase) decrease in inventory	(63)	2,953
Increase in prepaid expenses and other assets	74	601
(Decrease) increase in accounts payable	(372)	626
(Decrease) increase in accrued warranty	(122)	287
Increase in accrued expenses and deferred income	519	117
Decrease in accrued royalties payable	(192)	(50)
(Decrease) increase in accrued salaries and wages	(332)	459
Increase in income taxes payable	51	211
Net cash provided by operating activities	3,801	9,528
Cash flows from investing activities:		
Purchase of Cheetah	---	(14,898)
Purchase of short-term investments	(9,291)	(989)
Redemption/maturity of short-term investments	7,481	6,636
Capital expenditures, including capitalized software	(2,040)	(2,380)
Investments in other assets	(715)	---
Net cash used in investing activities	(4,565)	(11,631)
Cash flows from financing activities:		
Proceeds from exercise of stock options	270	201
Net cash provided by financing activities	270	201
Net decrease in cash and cash equivalents	(494)	(1,902)
Cash and cash equivalents at beginning of period	31,060	33,799
Cash and cash equivalents at end of period	30,566	\$31,897

Forward-Looking Statements

The statements contained in this release which are not historical facts are considered "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements, which may be expressed in a variety of ways, including the use of forward-looking terminology, relate to, among other things, expected revenue and earnings results for the 2004 fourth quarter, the recognition of backlog as revenue during the 2004 fourth quarter and the completion of our current cost alignment initiative and the incurrence of costs associated with such program. The Company does not undertake any obligation to publicly update any forward-looking statements.

These forward-looking statements and other forward-looking statements contained in other public disclosures of the Company are based on assumptions that involve risks and uncertainties and are subject to change based on the considerations described below. These risks, uncertainties and other factors may cause actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward looking statements. The Company wishes to caution each reader of this release to consider the following factors and certain other factors discussed herein and in past reports including, but not limited to, prior year Annual Reports and Form 10-K and Form 10-Q reports filed with the Securities and Exchange Commission ("SEC"). The factors discussed herein may not be exhaustive. Therefore, the factors discussed herein should be read together with other reports and documents that are filed by the Company with the SEC from time to time, which may supplement, modify, supersede or update the factors listed in this document.

- We recently emphasized our network assurance and testing software solutions and cable monitoring products, areas in which we have limited experience. This makes the prediction of future operating results for these portions of our business very difficult. A substantial portion of our research and development expenses is expected to relate to these products. If we fail to increase sales in these products, our future revenue and net income, as well as the prospects for these critical portions of our business, will be materially and adversely affected.
- We have derived a substantial amount of our revenues from sales of products and related services to the telecommunications industry, which has experienced significant consolidation and decreased capital spending in the past few years. We cannot be certain that consolidations in, or a slowdown in the growth of, the telecommunications industry will not harm our business.
- We base our expense levels in part on forecasts for future orders and sales, which are extremely difficult to predict. A substantial portion of our operating expenses is related to personnel, facilities and sales and marketing. The level of spending for such expenses cannot be adjusted quickly and is, therefore, relatively fixed in the short term. Accordingly, our operating results will be harmed if revenues fall below our expectations in a particular quarter.
- The sales cycle for our software products is long as they involve significant capital commitments by customers, and are dependent upon a number of different factors including business growth, spending patterns and budgetary resources of our customers. The delay or failure to complete one or more large license transactions in a quarter could cause our operating results to fall below our expectations.
- Many of the Company's products must comply with significant governmental and industry-based regulations, certifications, standards and protocols, some of which evolve as new technologies are deployed. Compliance with such regulations, certifications, standards and protocols may prove costly and time-consuming for the Company, and the Company cannot provide assurance that its products will continue to meet these standards in the future. In addition, regulatory compliance may present barriers to entry in particular markets or reduce the profitability of the Company's product offerings. Such regulations, certifications, standards and protocols may also adversely affect the industries in which we compete, limit the number of potential customers for the Company's products and services or otherwise have a material adverse effect on its business, financial condition and results of operations. Failure to comply, or delays in compliance, with such regulations, standards and protocols or delays in receipt of such certifications could delay the introduction of new products or cause the Company's existing products to become obsolete.
- In the third quarter of 2004, the Company completed a reduction in work force taken in response to the recent decrease in our revenues in our telecom business. These actions could have long term adverse effects on that portion of our business. There are several risks inherent in our efforts to bring our cost base in line with the current environment by reducing our telecom workforce. These include the risk that we will not be successful in achieving our planned cost reductions, and that even if we are successful in doing so, we will still not be able to reduce expenditures quickly enough to restore profitability in that portion of our business and may have to undertake further restructuring initiatives that would entail additional charges and create additional risks. In addition, there is the risk that cost-cutting initiatives will impair our ability to effectively develop and market products and remain competitive in the telecom business. Each of the above measures could have long-term effects on our business by reducing our pool of talent, decreasing or slowing improvements in our products, making it more difficult for us to respond to

customers, limiting our ability to increase production quickly if and when the demand for our products increases and limiting our ability to hire and retain key personnel. These circumstances could cause our earnings to be lower than they otherwise might be.

- Because our cable products generate lower margins for us than our proprietary MCU and software offerings, an increase in the percentage of our sales of cable-related products relative to our traditional products will result in lower profitability. Furthermore, as consolidations within the cable industry and the adoption of the DOCSIS standards have caused and could continue to cause pricing pressure as competitors lower product pricing, our revenues have been and may continue to be adversely affected. As a result, as our business shifts from our higher margin proprietary products to lower margin cable offerings and standardized products for which we have competition, we will need to sell greater volumes of our products to maintain profitability.
- Due to the Company's dependence upon a few major customers for a majority of our revenues, the loss of any of these customers or continued decreases in the capital budgets of these customers or cancellation, delay or reduction in purchases or products at historical levels, would significantly reduce our revenues and net income. The capital budgets of our customers, are dictated by a number of factors, most of which are beyond our control, including:
 - the conditions of the telecommunications market and the economy in general;
 - subscriber line loss and related reduced demand for telecommunications services;
 - disputes between our customers and their collective bargaining units;
 - the failure to meet established purchase forecasts and growth projections;
 - competition; and
 - reorganizations, including management changes, at one or more of our customer or potential customers.

If the financial strength of one or more of our major customers should deteriorate, or if they have difficulty acquiring investment capital due to any of these or other factors, a substantial decrease in our revenues would likely result.

- A large portion of the Company's sales are attributable to our core proprietary MCU technology, and those sales largely depend upon the rate of deployment of new, and the retrofitting of existing, Digital Loop Carrier (DLC) systems in the United States. Further, if our customers implement certain next generation network improvements that do not require the use of our MCU products, it could materially impact our MCU sales. If our major customers fail to continue to build-out their DSL networks and other projects requiring DLC deployments, or if we otherwise satisfy the domestic telecommunications market's demand for MCUs, our future results would be materially and adversely affected.
- The Company depends upon a relatively narrow range of products for the majority of our revenue. Our success in marketing our products is dependent upon their continued acceptance by our customers. In some cases, our customers require that our products meet their own proprietary requirements. If we are unable to satisfy such requirements, or forecast and adapt to changes in such requirements, our business could be materially harmed. Rapid technological change, including industry standards, could also render our products obsolete. The adoption of industry-wide standards, such as the HMS and DOCSIS cable standards, may result in the elimination of or reductions in the demand for many of our proprietary products, such as our Cheetah head-end hardware products and other Cheetah products. Furthermore, if we are unable to forecast the demand for, and to develop new products or to adapt our existing products to meet, evolving standards and other technological innovations, or if our products and services do not gain the acceptance of our customers, there could be a negative effect on our future results.
- Changes in the telecommunications or cable regulatory environment that, among other results, increase our costs of doing business, require our customers to share assets with competitors or prevent the Company or our customers from engaging in business activities they may wish to conduct, could significantly reduce the demand for our products and adversely affect our future results.
- Although we seek to protect our technology through a combination of copyrights, trade secret laws, contractual obligations and patents, these protections may not be sufficient to prevent the wrongful appropriation of our intellectual property, nor will they prevent our competitors from independently developing technologies that are substantially equivalent or superior to our proprietary technology. If we are unable to successfully assert and defend our proprietary rights in the technology utilized in our products, or if third parties are able to successfully assert that our use of technology infringes upon the proprietary rights of others, our future results could be adversely affected.
- Some of our products require technology that we must license from the manufacturers of systems with which our products must be compatible. If we are unable to obtain and retain these license agreements on favorable terms, there could be a material adverse effect on our business.
- We depend upon a limited number of third party subcontractors to manufacture certain aspects of our products and we procure components from a limited number of outside suppliers. If we were to encounter a shortage of key manufacturing components from limited sources of supply, or experience manufacturing delays caused by reduced manufacturing capacity or integration issues related to our acquisition of the Cheetah product line, the loss of key

assembly subcontractors or other factors, our ability to produce and ship our manufactured products and therefore our future results could be materially adversely affected.

- We may pursue, acquisitions of companies, product lines and technologies, which acquisitions involve numerous risks, including the disruption of our business, exposure to assumed or unknown liabilities of the acquired target, and the failure to integrate successfully the operations and products of acquired businesses. Goodwill arising from acquisitions may result in significant charges against our operating results in one or more future periods. Furthermore, we may never achieve the anticipated results or benefits of an acquisition, such as increased market share or the successful development and sales of a new product. The effects of any of these risks could materially harm our business and reduce our future results of operations.
- The carrying value of certain of our intangible assets, consisting primarily of goodwill related to our LoopCare software and Cheetah product line acquisitions from Lucent Technologies, Inc. and Acterna, LLC, respectively, could be impaired by changing market conditions. We are required under generally accepted accounting principles to review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may indicate that the carrying value of our intangible assets may not be recoverable include a decline in stock price and market capitalization and lower than anticipated cash flows produced by such intangible assets. If our stock price and market capitalization decline, or if we do not realize the expected revenues from an intangible asset, we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of that intangible asset is determined.
- Our future sales in international markets are subject to numerous risks and uncertainties, including local economic and labor conditions, political instability including terrorism and other acts of war or hostility, unexpected changes in the regulatory environment, trade protection measures, tax laws, our ability to market current or develop new products suitable for international markets, obtaining and maintaining successful distribution and resale channels and foreign currency exchange rates. Reductions in the demand for or the sales of our products in international markets could adversely affect future results.
- Any significant defect, error, failure or misuse of our products or other problems within our out of our control that may arise from the use of our products could jeopardize our relationships with our customers, resulting in substantial costs for both the Company and our customers as well as the cancellation of orders, warranty costs, product returns and legal actions that could adversely affect our future results.
- If third parties with whom we have entered into OEM and other partnerships should fail to meet their own performance objectives, customer demand for our products could be adversely affected, which would have an adverse effect on our revenues.
- There is a trend for some of our customers to place large orders near the end of a quarter or fiscal year, in part to spend remaining available capital budget funds. Seasonal fluctuations in customer demand for our products driven by budgetary and other reasons can create corresponding fluctuations in period-to-period revenues, and we therefore cannot assure you that our results in one period are necessary indicative of our results in any future period. In addition, the number and timing of large individual sales has been difficult for us to product, and large individual sales have, in some cases, occurred in quarters subsequent to those we anticipated, or have not occurred at all. The loss or deferral of one or more significant sales in a quarter could harm our operating results.
- The markets for some of our products are very competitive. Some of our competitors may have greater technological, financial, manufacturing, sales and marketing, and personnel resources than we have and may have an advantage in responding more rapidly or effectively to changes in industry standards or technologies and may better withstand the pricing pressures that increased competition may bring. If our introduction of improved products or services is not timely or well received, or if our competitors reduce their prices for products that are comparable to ours, demand for our products and services could be adversely affected
- The successful development of a secondary market for our products by a third party could negatively affect demand for our products, reducing our future revenues.
- If the Company is unable to identify and hire the personnel that we need to succeed, or if one or more of our present key employees were to cease to be associated with the Company, our future results could be adversely affected.
- We may from time to time be involved in various lawsuits and legal proceedings which arise in the ordinary course of business. An adverse resolution of these matters could negatively impact our financial position and results of operations.

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