LSI CORP
Form 10-Q
November 09, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 30, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File Number: 1-10317

LSI CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-2712976**
(State of Incorporation)	***(I.R.S. Employer Identification Number)***

1621 Barber Lane
Milpitas, California 95035
(Address of principal executive offices)
(Zip code)
(408) 433-8000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

As of November 2, 2007, there were 705,922,684 shares of the registrant s Common Stock, $.01 par value, outstanding.

LSI CORPORATION
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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

LSI CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2007	December 31, 2006
	(In thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	$ 749,933	$ 327,800
Short-term investments	347,992	681,137
Accounts receivable, less allowances of $10,108 and $13,871	436,021	348,638
Inventories	218,416	209,470
Assets held for sale	581,308	20,120
Prepaid expenses and other current assets	126,834	48,572
Total current assets	2,460,504	1,635,737
Property and equipment, net	236,501	86,045
Other intangible assets, net	1,241,979	59,484
Goodwill	2,459,419	932,323
Other assets	226,013	138,555
Total assets	$ 6,624,416	$ 2,852,144
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$ 236,036	$ 200,189
Accrued salaries, wages and benefits	135,675	82,292
Other accrued liabilities	350,946	155,986
Income taxes payable	24,274	88,304
Total current liabilities	746,931	526,771
Long-term debt	718,725	350,000
Pension and postretirement benefits	204,316	
Income taxes payable non-current	171,522	
Other non-current liabilities	144,514	79,400
Total long-term obligations and other liabilities	1,239,077	429,400
Commitments and contingencies (Note 12)		
Minority interest in subsidiary	245	235

Stockholders equity:		
Preferred stock, $.01 par value: 2,000 shares authorized; none outstanding		
Common stock, $.01 par value: 1,300,000 shares authorized; 709,770 and 403,680 shares outstanding	7,098	4,037
Additional paid-in capital	6,327,900	3,102,178
Accumulated deficit	(1,716,524)	(1,220,306)
Accumulated other comprehensive income	19,689	9,829
Total stockholders equity	4,638,163	1,895,738
Total liabilities and stockholders equity	$ 6,624,416	$ 2,852,144

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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LSI CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
	(In thousands, except per share amounts)			
Revenues	$ 727,415	$ 492,978	$ 1,862,769	$ 1,458,497
Cost of revenues	479,550	284,880	1,268,418	858,720
Gross profit	247,865	208,098	594,351	599,777
Research and development	182,291	102,533	488,071	305,169
Selling, general and administrative	104,518	60,276	280,931	193,790
Restructuring of operations and other items, net	101,231	2,614	119,071	(13,384)
Acquired in-process research and development			182,900	
(Loss)/income from operations	(140,175)	42,675	(476,622)	114,202
Interest expense	(9,033)	(6,556)	(21,972)	(19,314)
Interest income and other, net	11,808	13,066	33,129	32,912
(Loss)/income before income taxes	(137,400)	49,185	(465,465)	127,800
Provision for income taxes	3,200	5,575	23,156	17,175
Net (loss)/income	$ (140,600)	$ 43,610	$ (488,621)	$ 110,625
Net (loss)/income per share:				
Basic	$ (0.20)	$ 0.11	$ (0.78)	$ 0.28
Diluted	$ (0.20)	$ 0.11	$ (0.78)	$ 0.27
Shares used in computing per share amounts:				
Basic	715,733	399,613	623,692	397,408
Diluted	715,733	403,715	623,692	403,779

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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LSI CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months Ended	
	September 30, 2007	October 1, 2006
	(In thousands)	
Operating activities:		
Net (loss)/income	$ (488,621)	$ 110,625
Adjustments:		
Depreciation and amortization	216,720	65,693
Stock-based compensation expense	55,772	36,154
Non-cash restructuring and other items	88,354	(2,576)
Acquired in-process research and development	182,900	
Gain on sale of intellectual property		(15,000)
Gain on sale of Gresham manufacturing facility and associated intellectual property		(12,553)
Write-off of intangible assets acquired in a purchase business combination		3,325
Non-cash foreign exchange loss/(gain)	3,221	(472)
Loss on write-down/(gain) on sale of equity securities	2,396	(1,998)
Gain on sale of property and equipment	(9,513)	(245)
Changes in deferred tax assets and liabilities	(6,797)	24
Changes in assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Accounts receivable, net	143,998	3,063
Inventories	95,148	7,158
Prepaid expenses and other assets	35,061	(13,380)
Accounts payable	(134,621)	(1,161)
Accrued and other liabilities	658	17,104
Net cash provided by operating activities	184,676	195,761
Investing activities:		
Purchase of debt securities available-for-sale	(154,087)	(498,408)
Proceeds from maturities and sales of debt securities available-for-sale	493,029	302,407
Purchases of convertible notes/equity securities	(10,500)	(8,150)
Proceeds from sale of equity securities		6,092
Purchases of property, equipment and software	(76,986)	(44,244)
Proceeds from sale of property and equipment	13,790	89
Proceeds from sale of Consumer group	22,555	
Proceeds from sale of intellectual property		22,670
Proceeds from sale of Fort Collins facility		10,998
Proceeds from sale of Colorado Springs facility		7,029
Proceeds from sale of Gresham manufacturing facility		96,426
Proceeds from sale of intellectual property associated with the Gresham manufacturing facility		5,100
Cash acquired from acquisition of Agere, net of acquisition costs	517,712	
Acquisition of SiliconStor, net of cash acquired and transaction costs	(52,079)	

Adjustment to goodwill acquired in a prior year for resolution of a pre-acquisition income tax contingency		2,442		1,373
Net cash provided by/(used in) investing activities		755,876		(98,618)
Financing activities:				
Issuance of common stock		28,994		36,005
Purchase of common stock under repurchase programs		(549,113)		
Net cash (used in)/provided by financing activities		(520,119)		36,005
Effect of exchange rate changes on cash and cash equivalents		1,700		613
Increase in cash and cash equivalents		422,133		133,761
Cash and cash equivalents at beginning of year		327,800		264,649
Cash and cash equivalents at end of period	$	749,933	$	398,410
Non-cash information:				
Issuance of common stock in consideration for acquired assets and liabilities of Agere	$	3,647,021	$	

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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LSI CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

For financial reporting purposes, LSI Corporation (the Company or LSI) reports on a 13 or 14-week quarter with a year ending December 31. The most recent quarter ended September 30, 2007. The results of operations for the quarter ended September 30, 2007, are not necessarily indicative of the results to be expected for the full year. The first nine months of 2007 ended on September 30, 2007 and the first nine months of 2006 ended on October 1, 2006 and consisted of 39 weeks each. The third quarter in each of 2007 and 2006 consisted of 13 weeks.

On April 2, 2007, the Company acquired Agere Systems Inc. (Agere) through the merger of Agere and a subsidiary of the Company. See Note 3 to the unaudited condensed consolidated financial statements (hereafter referred to as the Notes).

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

In management s opinion, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments and restructuring and other items, net, as discussed in Note 4), necessary to state fairly the financial information included herein. While the Company believes that the disclosures are adequate to make the information not misleading, it is suggested that these financial statements be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Amortization of intangibles which was previously reported separately in operating expense has been reclassified to cost of revenues for the three and nine months ended October 1, 2006, to conform to the current period presentation.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FAS 109). FIN 48 prescribes a recognition threshold and measurement attribute for tax positions taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position in accordance with this interpretation is a two-step process. In the first step, recognition, the Company determines whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step addresses measurement of a tax position that meets the more-likely-than-not criteria. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in (a) an increase in a liability for income taxes payable or a reduction of an income tax refund receivable, (b) a reduction in a deferred tax asset or an increase in a deferred tax liability or (c) both (a) and (b). Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be de-recognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FAS 109 is not an appropriate substitute for the de-recognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on sufficiency of future taxable income is unchanged by this interpretation.

The Company adopted the provisions of FIN 48 as of January 1, 2007. The Company recognized the cumulative effect of adoption as a $3.4 million increase to the opening balance of accumulated deficit as of January 1, 2007. The amount of unrecognized tax benefit as of the date of adoption after the FIN 48 adjustment was $132.9 million. Of this amount, $103.0 million related to unrecognized tax positions that, if recognized, would affect the annual effective tax rate of the Company. The Company does not expect any uncertain tax benefits to significantly increase or decrease

within the next 12 months.

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The Company files income tax returns at the U.S. federal level and in various states and foreign jurisdictions. The Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2001. The Company s subsidiaries in Hong Kong (1997 to 2001) and Singapore (1999 to 2002) are currently under audit.

The Company recognizes interest and penalties accrued in relation to unrecognized tax benefits in tax expense. As of the date of adoption, the Company had accrued approximately $32.3 million for the payment of interest and penalties. As of September 30, 2007, we have recorded additional interest and penalties of $4.8 million.

The amount of the unrecognized tax benefit acquired from Agere on April 2, 2007 was $64.0 million. None of this amount related to unrecognized tax positions that, if recognized, would affect the annual effective tax rate of the Company. Any adjustments relating to unrecognized tax benefits for the Agere pre-acquisition period, including related interest and penalties, would be recorded to goodwill. The Company does not expect any uncertain tax benefits to significantly increase or decrease within the next 12 months.

Acquired accrued interest and penalties from Agere were approximately $10.7 million. As of September 30, 2007, the Company recorded additional interest and penalties of $2.6 million.

Since the date of adoption, there were no material changes in the liability for uncertain tax positions.

In June 2006, the FASB Emerging Issues Task Force issued EITF Issue No. 06-2 (EITF 06-02), Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43 (FAS 43), Accounting for Compensated Absences. EITF 06-02 addresses the accounting for an employee s right to a compensated absence under a sabbatical or other similar benefit arrangement which is unrestricted (that is, the employee is not required to perform any services for or on behalf of the entity during the absence) and which requires the completion of a minimum service period and in which the benefit does not increase with additional years of service. For sabbatical arrangements meeting these criteria, EITF 06-02 concludes that the accumulated criteria have been met in paragraph 6(b) of FAS 43 and that if the remaining sections of paragraph 6 are met, the sabbatical arrangement should be accrued over the requisite service period, which for the Company would be 10 years. The Company offers a sabbatical of 20 days to full-time employees upon completion of 10 years of service. The Company adopted EITF 06-02 in the first quarter of 2007, with a cumulative effect adjustment to accumulated deficit of $4.2 million.

The impact of the adoption of FIN 48 and EITF 06-02 on the opening balance of accumulated deficit as of January 1, 2007 is as follows (in thousands):

Accumulated deficit as of December 31, 2006	$ (1,220,306)
Impact of adoption of FIN 48	(3,393)
Impact of adoption of EITF 06-02	(4,204)
Accumulated deficit as of January 1, 2007	$ (1,227,903)

In September 2006, the FASB issued Statement No. 157 (FAS 157), Fair Value Measurements. FAS 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and expands on required disclosures about fair value measurement. FAS 157 is effective for fiscal years beginning after November 15, 2007, and will be applied prospectively. The Company is currently evaluating the impact that the provisions of FAS 157 will have on the Company s consolidated balance sheet and statement of operations.

In September 2006, the FASB issued Statement No. 158 (FAS 158), Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, which amends FAS No. 87, Employers Accounting for Pensions, FAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, FAS No. 106, Employers Accounting for Postretirement Benefits Other than Pensions, and FAS No. 132(R), Employers Disclosure about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88 and 106. FAS 158 requires an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status through comprehensive income in the year in which the changes occur. This Statement requires entities to measure the funded status of a plan as of the date of its year-end statement of financial position,

with limited exceptions. As a result of the Agere merger, the Company acquired Agere s pension plans and postretirement benefit plans. See Note 5.

In February 2007, the FASB issued Statement No. 159 (FAS 159), The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115. FAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. FAS 159 is effective for the Company beginning in the first quarter of 2008, although earlier adoption is permitted. The Company is currently evaluating the impact that FAS 159 will have on the Company s consolidated balance sheet and statement of operations.

NOTE 2 STOCK-BASED COMPENSATION

Stock-based compensation expense for the three and nine months ended September 30, 2007 was $21.8 million and $55.8 million, respectively, and for the three and nine months ended October 1, 2006 was $11.0 million and $36.2 million, respectively, as shown in the table below. Stock-based compensation costs capitalized to inventory and software development for the three and nine months ended September 30, 2007 and October 1, 2006 were not significant.

The estimated fair value of the Company s stock-based awards, less expected forfeitures, is amortized over the awards vesting period (the requisite service period), on a straight-line basis. The table below summarizes stock-based compensation expense, related to employee stock options, the Company s employee stock purchase plans (ESPP) and restricted stock unit awards for the three and nine months ended September 30, 2007 and October 1, 2006.

	Three Months Ended		Nine Months Ended	
Stock-Based Compensation Expense Included In:	**September 30, 2007**	**October 1, 2006**	**September 30, 2007**	**October 1, 2006**
	(In thousands)			
Cost of revenues	$ 2,824	$ 1,719	$ 7,916	$ 5,702
Research and development	8,916	3,908	22,611	13,073
Selling, general and administrative	10,035	5,398	25,245	17,379
Total stock-based compensation expense	$ 21,775	$ 11,025	$ 55,772	$ 36,154

Stock Options

The fair value of each option grant is estimated on the date of grant using a reduced form calibrated binominal lattice model (the lattice model). This model requires the use of historical data for employee exercise behavior and the use of assumptions outlined in the following table:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	**October 1, 2006**	**September 30, 2007**	**October 1, 2006**
Weighted average estimated grant date fair value	$ 2.54	$ 2.97	$ 3.31	$ 3.30
Weighted average assumptions in calculation:				
Expected life (years)	4.36	4.36	4.35	4.32
Risk-free interest rate	4%	5%	5%	5%
Volatility	49%	48%	46%	48%

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the lattice model. The expected life of employee stock options is affected by all of the underlying assumptions and calibration of the Company s model.

The Company used an equally weighted combination of historical and implied volatilities as of the grant date. The historical volatility is the standard deviation of the daily stock returns for LSI from the date of the Company s initial public offering in 1983. The Company used implied volatilities of near-the-money exchange traded call options as

stock options are call options that are granted at-the-money. The historical and implied volatilities were annualized and equally weighted to determine the volatilities as of the grant date. Management believes that the equally weighted combination of historical and implied volatilities is more representative of future stock price trends than sole use of historical or implied volatilities.

The risk-free interest rate assumption is based upon observed interest rates of constant maturity U.S. Treasury securities appropriate for the term of the Company s employee stock options.

The lattice model assumes that employees exercise behavior is a function of the option s remaining life and the extent to which the option is in-the-money. The lattice model estimates the probability of exercise as a function of these two variables based on the entire history of exercises and cancellations for all option grants made by the Company since its initial public offering in 1983.

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Because stock-based compensation expense recognized is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

A summary of the changes in stock options outstanding under the Company s equity-based compensation plans during the nine months ended September 30, 2007 is presented below:

	Number of Shares (In thousands)	Weighed Average Exercise Price Per Shares	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Options outstanding at December 31, 2006	56,750	$ 11.92		
Options assumed in Agere merger	48,884	22.41		
Options granted	10,766	9.26		
Options exercised	(2,821)	(6.10)		
Options canceled	(9,344)	(15.13)		
Options outstanding at September 30, 2007	104,235	$ 16.43	3.68	$ 41,417
Options exercisable at September 30, 2007	70,336	$ 20.47	2.75	$ 27,722

As of September 30, 2007, total unrecognized compensation expense related to nonvested stock options, net of estimated forfeitures, was approximately $110.8 million and is expected to be recognized over the next 2.7 years calculated on a weighted average basis. The total intrinsic value of options exercised during the three and nine months ended September 30, 2007 was $1.6 million and $6.5 million, respectively. Cash received from stock option exercises was $7.1 million and $17.2 million during the three and nine months ended September 30, 2007, respectively.

The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as a number of highly complex and subjective assumptions.

Employee Stock Purchase Plans

The Company also has two ESPPs, one for U.S. employees and one for employees outside the U.S., under which rights are granted to employees to purchase shares of common stock at 85% of the lesser of the fair market value of such shares at the beginning of a 12-month offering period or the end of each six-month purchase period within such an offering period. Compensation expense is calculated using the fair value of the employees purchase rights under the Black-Scholes model. A total of 1.7 million shares and 1.9 million shares related to the ESPPs were issued during the three months ended July 1, 2007 and July 2, 2006, respectively. No shares related to the ESPPs were issued during the three months ended September 30, 2007 and October 1, 2006. For disclosure purposes, the Company has included the assumptions that went into the calculation of fair value for the May 2007 and May 2006 grants as follows:

	Three Months Ended	
	July 1, 2007	July 2, 2006
Weighted average estimated grant date fair value	$ 2.37	$ 3.05
Weighted average assumptions in calculation:		

Expected life (years)	0.8	0.8
Risk-free interest rate	5%	5%
Volatility	38%	39%

Restricted Stock Awards

Under the 2003 Equity Incentive Plan (2003 Plan), the Company may grant restricted stock or restricted stock units. No participant may be granted more than a total of 0.5 million shares of restricted stock or restricted stock units in any year. The Company typically grants restricted stock units, vesting of which is subject to the employee s continuing service to the Company. The cost of these awards is determined using the fair value of the Company s common stock on the date of grant and compensation expense is recognized over the vesting period on a straight-line basis.

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A summary of the changes in restricted stock unit awards outstanding during the nine months ended September 30, 2007 is presented below.

	Number of Shares (In thousands)
Non-vested shares at December 31, 2006	1,910
Assumed in Agere merger	9,141
Granted	2,282
Vested	(1,473)
Forfeited	(544)
Non-vested shares at September 30, 2007	11,316

As of September 30, 2007, the Company had approximately $64.3 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock unit awards, which will be recognized over the weighted average period of 2.3 years. The fair value of shares vested in the three and nine months ended September 30, 2007 was $3.4 million and $12.2 million, respectively.

NOTE 3 BUSINESS COMBINATIONS

The Company actively evaluates strategic acquisitions that build upon the Company s existing library of intellectual property, human capital and engineering talent, and seeks to increase the Company s leadership position in the areas in which the Company operates.

Merger with Agere

On April 2, 2007, the Company completed the acquisition of Agere. Agere was a provider of integrated circuit solutions for a variety of computing and communications applications. Some of Agere s solutions included related software and reference designs. Agere s solutions were used in products such as hard disk drives, mobile phones, high-speed communications systems and personal computers. Agere also licensed its intellectual property to others. The purpose of the acquisition was to enable the Company to expand its comprehensive set of building block solutions including semiconductors, systems and related software for storage, networking and consumer electronics products that enable businesses and consumers to store, protect and stay connected to their information and digital content and expand its intellectual property portfolio and integrated workforce in the Semiconductor segment.

Upon completion of the merger, each share of Agere common stock outstanding at the effective time of the merger was converted into the right to receive 2.16 shares of LSI common stock. As a result, approximately 368 million shares of LSI common stock were issued to former Agere stockholders. The fair value of the common stock issued was determined using a share price of $9.905 per share, which represented the average closing price of LSI common shares for two trading days before and ending two trading days after December 4, 2006, the date by which the merger was agreed to and announced. LSI assumed stock options and restricted stock units covering a total of approximately 58 million shares of LSI common stock. The fair value of options assumed was estimated using a reduced form calibrated binomial lattice model and a share price of $9.905 per share, which represents the average closing price of LSI common shares for two trading days before and ending two trading days after December 4, 2006. The value of the options and restricted units assumed was reduced by the fair value of unvested options and restricted stock units assumed, based on the price of a share of LSI common stock on April 2, 2007. LSI also guaranteed Agere s 6.5% Convertible Subordinated Notes due December 15, 2009, the fair value of which was $370 million as of April 2, 2007.

The merger was accounted for as a purchase. Accordingly, the results of operations of Agere and estimated fair value of assets acquired and liabilities assumed were included in the Company s consolidated financial statements from April 2, 2007, the acquisition date.

The total purchase price of the acquisition was as follows (in thousands):

Fair value of LSI common shares issued	$ 3,647,021
(a) Fair value of stock awards assumed	218,713
(b) Fair value of unvested stock awards assumed	(168,555)
(a)-(b) Fair value of the vested options assumed	50,158
Direct transaction costs	22,970
Total estimated purchase price	$ 3,720,149

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Purchase Price Allocation:

The allocation of the purchase price to Agere s tangible and identifiable intangible assets acquired and liabilities assumed was based on their estimated fair values. Further adjustments may be included in the final allocation of the purchase price of Agere, if the adjustments are determined within the purchase price allocation period (up to twelve months from the closing date). The excess of the purchase price over the tangible and identifiable intangible assets acquired and liabilities assumed has been allocated to goodwill. None of the goodwill recorded is expected to be deductible for tax purposes except the tax deductible goodwill LSI inherited from Agere. The purchase price has been allocated as follows as of April 2, 2007 (in thousands):

Cash	$ 540,140
Accounts receivable	222,169
Inventory	120,848
Assets held for sale	122,756
Property and equipment	162,047
Accounts payable	(167,947)
Pension and postretirement liabilities	(214,607)
Convertible Notes	(370,249)
Other liabilities	(183,359)
Net assets acquired	231,798
Identifiable intangible assets	1,727,700
In-process research and development	176,400
Goodwill	1,584,251
Total estimated purchase price	$ 3,720,149

Note 4 contain information related to the cost of restructuring programs related to Agere. The costs were included as part of other liabilities assumed as of April 2, 2007.

The following table sets forth the components of the identifiable intangible assets, which are being amortized over their estimated useful lives, some on a straight-line basis and others on an accelerated basis:

Identifiable Intangible Assets	**Fair Value (In thousands)**	**Weighted Average Useful Life (In years)**
Current technology	$ 844,500	8.5
Customer base	513,000	10
Patent licensing	317,200	10
Order backlog	53,000	0.5
Total acquired identifiable intangible assets	$ 1,727,700	

Acquired In-Process Research and Development:

The Company recorded a charge of $176.4 million associated with acquired in-process research and development, or IPR&D, associated with the merger with Agere during the second quarter of 2007. The Company s methodology for allocating the purchase price in purchase acquisitions to IPR&D involves established valuation techniques in the high-technology industry and with the assistance of third party service providers. Each project in process was analyzed by discounting forecasted cash flows directly related to the products expected to result from the subject

research and development, net of returns on contributory assets including working capital, fixed assets, customer relationships, trade name, and assembled workforce. IPR&D was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. The fair value of technology under development is determined using the income approach, which discounts expected future cash flows to present value. A discount rate is used for the projects to account for the risks associated with the inherent uncertainties surrounding the successful development of the IPR&D, market acceptance of the technology, the useful life of the technology, the profitability level of such technology and the uncertainty of technological advances, which could impact the estimates recorded. The discount rates used in the present value calculations are typically derived from a weighted-average cost of capital analysis. These estimates did not account for any potential synergies realizable as a result of the acquisition and were in line with industry averages and growth estimates. The details of each IPR&D project measured as of April 2, 2007, the acquisition date, are summarized in the table below.

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Project	IPR&D (In millions)	Estimated cost to complete (In millions)	Discount rate	Revenue projections by project extend through
Storage read channel and preamps	$ 36.2	$ 17.8	13.8%	2016
Mobility HSPDA for 3G	$ 31.2	$ 144.2	13.8%	2016
Networking modems, Firewire, serdes, media gateway, VoIP, network processors, Ethernet, mappers and framers	$ 109.0	$ 68.0	13.8%	2021

The actual development timelines and costs were in line with original estimates as of September 30, 2007. However, development of the technology remains a substantial risk to the Company due to factors including the remaining effort to achieve technical feasibility, rapidly changing customer needs and competitive threats from other companies. Failure to bring these products to market in a timely manner could adversely affect sales and profitability of the Company in the future. Additionally, the value of other intangible assets acquired may become impaired.

Pro Forma Results:

The following pro forma summary is provided for illustrative purposes only and is not necessarily indicative of the consolidated results of operations for future periods or results that actually would have been realized had the Company and Agere been a consolidated entity during the periods presented. The summary combines the results of operations as if Agere had been acquired as of the beginning of the earliest period presented.

The summary includes the impact of certain adjustments such as amortization of intangibles, stock compensation charges and charges in interest expense because of Agere s notes that the Company guaranteed. Additionally, IPR&D associated with the Agere acquisition has been excluded from the periods presented. The $101.2 million of restructuring charges recorded in the quarter ended September 30, 2007 and referred to in Note 4 did not relate to the merger with Agere and accordingly were included.

	Three Months Ended	Nine Months Ended	
	October 1, 2006	September 30, 2007	October 1, 2006
	($ in thousands except per share amounts)		
Revenues	$849,410	$2,197,613	$2,533,113
Net loss	$ (5,599)	$ (309,374)	$ (120,648)
Basic loss per share	$ (0.01)	$ (0.41)	$ (0.16)
Diluted loss per share	$ (0.01)	$ (0.41)	$ (0.16)

Acquisition of SiliconStor, Inc.

On March 13, 2007, the Company completed the acquisition of SiliconStor, Inc. Pro forma statements of earnings information has not been presented because this acquisition was not material. The table below provides information about this acquisition (dollars in millions).

Entity Name;	Fair Value of Tangible Net

Segment Included in; Description of Acquired Business	Acquisition Date	Total Purchase Price	Type of Consideration	Assets/ (Liabilities) Acquired	Goodwill	Amortizable Intangible Assets	In-Process Research and Development
SiliconStor, Inc.; Semiconductor segment; Silicon solutions for enterprise storage based on SAS and FC-SATA	March 13, 2007	$ 56.4	$56.4 cash	$ 1.5	$ 37.8	$ 10.6	$ 6.5

There were no material acquisitions for the nine months ended October 1, 2006.

NOTE 4 RESTRUCTURING AND OTHER ITEMS

The Company recorded a charge of $101.2 million and $119.1 million in restructuring of operations and other items for the three and nine months ended September 30, 2007, respectively. A charge of $100.9 million and $114.9 million was recorded in the Semiconductor segment, and a charge of $0.3 million and $4.2 million was recorded in the Storage Systems segment for the three and nine months ended September 30, 2007, respectively. The Company recorded a charge of $2.6 million and a net credit of $13.4 million in restructuring of operations and other items during the three and nine months ended October 1, 2006, respectively. A charge of $2.7 million and a credit of $14.6 million were recorded in the Semiconductor segment, and a credit of $0.1 million and a charge of $1.2 million were recorded in the Storage Systems segment for the three and nine months ended October 1, 2006, respectively. For a complete discussion of the 2006 restructuring actions, please refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Restructuring and Impairment of Long-Lived Assets

First Quarter of 2007:

The credit of $8.1 million resulted from the following items:

$10.4 million net gain was recorded for the sale of land in Colorado, which had a net book value of $2.0 million. Total proceeds from the sale were $12.4 million. The gain was offset in part by a charge of $0.2 million associated with certain other asset write-offs;

A credit of $0.5 million was recorded for changes in sublease assumptions for previously accrued facility lease exit costs;

An expense of $0.7 million was recorded to reflect the change in time value of accruals for facility lease exit costs; and

An expense of $1.9 million was recorded for severance and termination benefits for employees.

Second Quarter of 2007:

On June 27, 2007, the Company announced the signing of a definitive agreement to sell the Consumer group to Magnum Semiconductor and a reduction in workforce of approximately 900 positions (inclusive of the Consumer group) or 13 percent of the Company s non-production workers across all business and functional areas worldwide. In connection with the restructuring actions, the Company recorded a charge of approximately $21.6 million during the quarter ended July 1, 2007, which represents future cash expenditures for termination-related benefits paid primarily in the third quarter of 2007. The sale of the Consumer group closed on July 27, 2007. The Company received approximately $22.6 million in cash on July 27, 2007. In addition, the Company received a promissory note for $18 million due in 2010 and a warrant to purchase preferred shares of Magnum Semiconductor stock. See the discussion below for the third quarter of 2007 for additional charges associated with the transaction.

On July 25, 2007, the Company announced that it had signed a definitive agreement to sell its semiconductor assembly and test operations in Thailand to STATS ChipPAC Ltd. (STATS ChipPAC) for approximately $100 million with $50 million due upon closing and a $50 million note payable over four years. The sale of the semiconductor assembly and test operations in Thailand was completed on October 2, 2007. STATS ChipPAC offered employment to substantially all of the LSI manufacturing employees associated with the facility. The Company also entered into additional agreements with STATS ChipPAC, including a multi-year wafer assembly and test agreement and a transition services agreement. The Company also announced that it would transition semiconductor and storage systems assembly and test operations performed at its facilities in Singapore and Kansas to current manufacturing partners. As part of these actions, the Company expects to eliminate approximately 2,100 production positions worldwide. In connection with the restructuring for Kansas, the Company recorded a charge of approximately $2.5 million during the quarter ended July 1, 2007, which represents future cash expenditures for termination-related benefits expected to be paid primarily by the end of the second quarter of 2008. The restructuring costs associated with the Thailand and Singapore assembly and test facilities were recorded as liabilities assumed as part of the merger with Agere on April 2, 2007. See the discussion below under Restructuring Actions Associated with the Agere

Merger . See discussion below for the third quarter of 2007 for additional charges associated with the sale of the Thailand operations.

For the quarter ended July 1, 2007, a charge of $25.9 million was recorded, resulting from the following items:

An expense of $24.1 million was recorded for severance and termination benefits for employees as a result of the actions discussed above $11.9 million was related to the Consumer restructuring action, $9.7 million related to the workforce reduction announced on June 27, 2007, and $2.5 million related to the transition of Wichita manufacturing operations to manufacturing partners;

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An expense of $0.3 million was recorded for changes in sublease assumptions for previously accrued facility lease exit costs;

An expense of $0.7 million was recorded to reflect the change in time value of accruals for facility lease exit costs; and

An expense of $0.8 million was recorded for certain asset write-offs and merger related costs.

Third Quarter of 2007:

On August 20, 2007, the Company announced that it had signed a definitive agreement to sell its Mobility Products Group (MPG) to Infineon Technologies AG (Infineon) for $450 million in cash, plus a performance-based payment of up to $50 million payable in the first quarter of 2009. MPG designs semiconductors and software for cellular telephone handsets and complete chip-level solutions for satellite digital audio radio applications. The MPG sale closed on October 24, 2007. The Company will be providing services to Infineon during a transition period and will be leasing space in its Allentown, PA facility to Infineon.

For the quarter ended September 30, 2007, a charge of $101.2 million in restructuring of operations and other items, net resulted from the following items:

A $93.6 million charge was recorded related to the sale of MPG to Infineon. The components of this charge are as follows:

- o A charge of $15.1 million for the difference between the proceeds of $450 million received at closing and the $465.1 million net book value of MPG as of September 30, 2007;
- o A charge of $27.5 million for future credits Infineon will receive from the Company on purchases of finished goods inventory;
- o A charge of $21.8 million for future inventory pricing benefits Infineon will receive for products manufactured at Silicon Manufacturing Partners Pte. Ltd. (SMP), a joint venture LSI has with Chartered Semiconductor Manufacturing Ltd. (Chartered Semiconductor). See Note 12.
- o A charge of $15.5 million for the acceleration of stock awards previously granted to MPG employees whose positions will be eliminated as part of the sale of MPG to Infineon;
- o A charge of $4.5 million for MPG-related lease termination costs not assumed by Infineon, a $4.5 million charge for estimated transaction costs, a $2.9 million charge for severance and termination benefits for employees and a charge of $1.8 million for the write-off of Mobility fixed assets not acquired by Infineon.

A charge of $3.0 million related to the sale of Thailand assets to STATS ChipPAC Ltd. to adjust the carrying value of the assets held for sale to fair market value;

A charge of $2.1 million related to the sale of the Consumer group. The components of this charge are as follows:

- o A credit of $1.3 million for the difference between the $22.6 million received and the $21.3 million net book value of the assets as of the date the transaction closed;
- o A $2.5 million charge related to facility lease termination costs not assumed by Magnum; and
- o A $0.9 million charge recorded for severance and termination benefits for employees due to a change in estimates.

A charge of $1.7 million was recorded for the change in assumptions and time value of accruals for previously recorded facility lease exit costs;

A charge of $0.8 million was recorded for severance and termination benefits for employees of which $0.3 million related to the transition of Kansas manufacturing operations to manufacturing partners and $0.5 million related to the general workforce reduction action announced June 27, 2007.

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The following table sets forth the Company s restructuring reserves as of December 31, 2006 and September 30, 2007, which are included in other accrued liabilities in the balance sheet, and the activities affecting the reserves during the nine months ended September 30, 2007:

	Balance at December 31, 2006	Restructuring Expense Q1 2007	Utilized during Q1 2007	Balance at April 1, 2007	Restructuring Expense Q2 2007	Utilized during Q2 2007	Balance at July 1, 2007	Restructuring Expense Q3 2007	Utilized during Q3 2007	Balance at September 30, 2007
					(In thousands)					
Write-down of excess assets and other liabilities (a)	$	$ (10,143)	$ 10,143	$	$ 785	$ (323)	$ 462	$ 72,646	$ (72,883)	$ 225
Lease terminations (b)	23,169	189	(2,952)	20,406	1,027	(2,082)	19,351	8,526	(2,387)	25,490
Payments to employees for severance (c)	342	1,874	(449)	1,767	24,108	(1,917)	23,958	20,059	(19,740)	24,277
Total	$ 23,511	$ (8,080)	$ 6,742	$ 22,173	$ 25,920	$ (4,322)	$ 43,771	$ 101,231	$ (95,010)	$ 49,992

(a) The credit in the first quarter of 2007 includes the gain from the sale of land in Colorado. Utilization in the third quarter of 2007 reflects the reclassification of $53.8 million to other liability accounts and $19.1 million of asset write-downs that were recorded as the reduction of assets not resulting in a liability.

(b) Amounts utilized represent cash payments. The balance remaining for real estate lease terminations is expected to be paid during the remaining terms of the leases, which extend through 2011.

(c) Amounts utilized represent cash severance payments to employees. The balance remaining for severance is expected to be paid by the end of 2008.

Assets held for sale were $581.3 million and $20.1 million as of September 30, 2007 and December 31, 2006, respectively. The $561.2 million increase in assets held for sale during the nine months ended September 30, 2007 was primarily attributable to MPG assets and Thailand and Singapore assembly and test facilities being classified as assets held for sale. Assets classified as held for sale are recorded at the lower of their carrying amount or fair value less cost to sell and not depreciated. The fair values of impaired equipment and facilities were researched and estimated by management. The Company reassesses the realizability of the carrying value of these assets at the end of each quarter until the assets are sold or otherwise disposed of, and therefore, additional adjustments may be necessary.

Restructuring Actions Associated with the Agere Merger

In connection with the Agere merger, management approved and initiated plans to restructure the operations of Agere to eliminate certain duplicative activities, reduce cost structure and better align product and operating expenses with existing general economic conditions. Agere restructuring costs were accounted for as liabilities assumed as part of the purchase business combination as of April 2, 2007 in accordance with EITF 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination.

The reserves established as of April 2, 2007 included the following:

A reserve of $50 million for severance and termination benefits for employees as a result of the restructuring actions related to the Thailand and Singapore assembly and test facilities mentioned above;

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A reserve of $14 million for facility lease exit costs, primarily in Singapore and Europe;

A reserve of $29 million for stock related compensation for employees whose positions were eliminated.

***Third Quarter of 2007*:**

For the quarter ended September 30, 2007, a credit of $1.0 million resulted from the following items:

A net credit of $1.4 million was recorded for changes in estimated payments to employees for severance previously recorded for Thailand and other restructuring actions;

A net credit of $0.5 million was recorded, which included a $1.5 million credit relating to changes in assumptions for Singapore lease termination costs offset by an expense of $0.5 million related to contract termination costs and an expense of $0.5 million which was recorded to reflect the change in time value of accruals for facility lease termination costs;

$0.9 million recorded for additional stock compensation charges for employees whose positions were eliminated.

The offsets to the changes in these liability estimates were recorded to goodwill. See Note 6.

The following table sets forth restructuring reserves related to the Agere merger as of September 30, 2007, which are included in other accrued liabilities in the balance sheet, and the activities affecting the reserves during the period from April 2, 2007 to September 30, 2007.

	Balance at April 2, 2007	Utilized during Q2 2007	Balance at July 1, 2007	Changes in estimates Q3 2007	Utilized during Q3 2007	Balance at September 30, 2007
			(in thousands)			
Lease terminations (a)	$ 14,464	$	$ 14,464	$ (533)	$ (547)	$ 13,384
Payments to employees for severance (b)	50,087	(4,070)	46,017	(1,428)	(12,252)	32,337
Stock compensation charges in accordance with FAS 123R (c)	28,841		28,841	951	(2,276)	27,516
Total	$ 93,392	$ (4,070)	$ 89,322	$ (1,010)	$ (15,075)	$ 73,237

(a) Amount utilized represents cash payments. The balance remaining for real estate lease terminations is expected to be paid during the remaining terms of these contracts, which extend through 2013.

(b) Amounts utilized represent cash severance payments to employees. The majority of the balance remaining for severance is expected to be paid by the end of 2008.

(c) Amount utilized represents stock grants exercised. Amounts accrued represent the value of stock options and restricted units LSI expects to accelerate upon termination of the holder s employment awarded to employees whose positions are to be eliminated. The balance is expected to be utilized by the end of 2009.

NOTE 5 BENEFIT OBLIGATIONS

The Company has pension plans covering substantially all former Agere U.S. employees, excluding management employees hired after June 30, 2003. Retirement benefits are offered under a defined benefit plan and are based on either an adjusted career average pay or dollar per month formula or on a cash balance plan. The cash balance plan provides for annual Company contributions based on a participant s age and compensation and interest on existing balances and covers employees of certain companies acquired by Agere since 1996 and management employees hired after January 1, 1999 and before July 1, 2003. The Company also has postretirement benefit plans that include healthcare benefits and life insurance coverage for former Agere employees. Participants in the cash balance plan and management employees hired after June 30, 2003 are not entitled to Company paid benefits under the postretirement benefit plans. The Company also has pension plans covering certain international employees.

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Net Periodic Benefit Cost

	Three months ended September 30, 2007		Nine months ended September 30, 2007	
	Pension Benefits	Postretirement Benefits	Pension Benefits	Postretirement Benefits
	(In thousands)			
Service cost	$ 1,867	$ 41	$ 3,734	$ 82
Interest cost	18,395	932	36,791	1,863
Expected return on plan assets	(21,026)	(1,235)	(41,885)	(2,429)
Amortization of prior service cost				
Recognized net actuarial loss				
Net periodic benefit cost	(764)	(262)	(1,360)	(484)
Curtailment gain				
Settlement charges				
Total benefit cost	$ (764)	$ (262)	$ (1,360)	$ (484)

Amounts recognized in the consolidated balance sheet consist of the following:

	September 30, 2007	
	Pension Benefits	Postretirement Benefits
	(In thousands)	
Accrued benefit liability	$ (196,363)	$ (1,465)
Accumulated other comprehensive loss		
Net amount realized	$ (196,363)	$ (1,465)

In connection with the Agere merger on April 2, 2007, the Agere pension and postretirement obligations were remeasured and recorded at fair value. As of September 30, 2007, the total accrued pension benefit liability was $196 million, of which $2 million was included in other current liabilities and $194 million was included as a non-current liability. The net accrued postretirement benefit liability as of September 30, 2007 was $1 million, consisting of $15 million in current liabilities and $10 million in non-current liabilities, offset by $24 million in other assets.

The actuarial assumptions for the principal pension and postretirement plans for 2007 are as follows:

	Pension Benefits	Postretirement Health Benefits	Postretirement Life Benefits
Discount rate to determine net periodic cost	6.0%	6.0%	6.0%
Discount rate to determine the benefit obligation as of April 2, 2007	6.0%	6.0%	6.0%
Rate of compensation increase	4.0%	N/A	4.0%
Expected average rate of return on plan assets	8.25% / 8.0%*	N/A	7.75%

* Rates vary by plan

The long-term rates of return on assets were based on the asset mix of the portfolios as noted below. The rates used are adjusted for any current or anticipated shifts in the investment mix of the plans. The rates also factor in the historic performance of the plans assets.

	Allocation as of April 2, 2007	
	Pension Benefits	Postretirement Benefits
Equity Securities	54%	40%
Debt Securities	46%	60%

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Benefit Payments

The following table reflects the benefit payments, which include expected future service, that the Company expects the plans to pay in the periods noted:

	Pension Benefits	Postretirement Benefits
	(In thousands)	
April 2 through December 31, 2007	$ 65,774	$ 16,335
Year ended December 31, 2008	$ 89,261	$ 17,929
Year ended December 31, 2009	$ 86,048	$ 1,355
Year ended December 31, 2010	$ 85,954	$ 1,472
Year ended December 31, 2011	$ 85,817	$ 1,591
Years ended December 31, 2012 through December 31, 2016	$ 433,612	$ 10,002

The Company does not currently plan to make contributions to its pension plans during the year ending December 31, 2007.

NOTE 6 INTANGIBLE ASSETS AND GOODWILL

Intangible Assets

	September 30, 2007	**December 31, 2006**
	(In thousands)	
Semiconductor segment	$ 1,205,149	$ 16,701
Storage Systems segment	36,830	42,783
Total intangible assets, net of accumulated amortization	$ 1,241,979	$ 59,484

On March 13, 2007, the Company acquired SiliconStor, and on April 2, 2007, the Company completed the acquisition of Agere.

Intangible assets by reportable segment are comprised of the following:

	September 30, 2007		**December 31, 2006**	
	Gross Carrying Amount	**Accumulated Amortization**	**Gross Carrying Amount**	**Accumulated Amortization**
	(In thousands)			
Semiconductor:				
Current technology	$ 833,358	$ (276,773)	$ 240,458	$ (232,716)
Trademarks	26,785	(26,255)	26,285	(25,446)
Customer base	363,488	(15,318)	8,788	(4,394)
Non-compete agreements	1,949	(1,007)	849	(625)
Existing purchase orders	200	(200)	200	(200)
Supply agreement	100	(100)		
Patent licensing	314,126	(18,259)		
Order backlog	41,300	(41,300)		
Workforce	3,567	(512)	3,567	(65)
Subtotal	1,584,873	(379,724)	280,147	(263,446)

Storage Systems:					
Current technology	164,339		(128,925)	164,339		(124,618)
Trademarks	7,150		(7,150)	7,150		(7,120)
Customer base	5,010		(5,010)	5,010		(5,010)
Non-compete agreements	1,600		(889)	1,600		(33)
Supply agreement	8,147		(8,147)	8,147		(7,472)
Trade names	800		(95)	800		(10)
Subtotal	187,046		(150,216)	187,046		(144,263)
Total intangible assets	$ 1,771,919	$	(529,940)	$ 467,193	$	(407,709)

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Amortization expense and the weighted average lives of intangible assets are as follows:

	Weighted Average Lives	Nine Months Ended September 30,	Year Ended December 31,	
		2007	2006	2005
	(In months)		(In thousands)	
Current technology	58	$ 65,392	$ 25,129	$ 53,185
Trademarks	83	&n		