

ALTERA CORP  
Form 10-Q  
October 24, 2006  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-16617

**ALTERA CORPORATION**

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of

77-0016691  
(I.R.S. Employer

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incorporation or organization)

Identification Number)

101 INNOVATION DRIVE SAN JOSE, CALIFORNIA  
(Address of principal executive offices)

95134  
(zip code)

408-544-7000

(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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares of common stock outstanding at September 29, 2006: 361,777,469

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## PART I FINANCIAL INFORMATION

## ITEM 1: Financial Statements

ALTERA CORPORATION  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Unaudited In thousands, except par value amount)

	June 30, 2006	December 30, 2005
		(as restated) (1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 713,571	\$ 787,707
Short-term investments	543,238	378,881
	<u>1,256,809</u>	<u>1,166,588</u>
Total cash, cash equivalents and short-term investments	1,256,809	1,166,588
Accounts receivable, net of allowance of \$5,055 for both period ends	200,604	80,509
Inventories	77,819	70,711
Deferred income taxes	69,176	66,264
Deferred compensation plan assets	63,004	61,567
Other current assets	64,096	49,562
	<u>1,731,508</u>	<u>1,495,201</u>
Total current assets	1,731,508	1,495,201
Long-term investments	203,841	115,965
Property and equipment, net	171,951	165,999
Deferred income taxes and other assets, net	53,454	50,531
	<u>\$ 2,160,754</u>	<u>\$ 1,827,696</u>
Total assets	\$ 2,160,754	\$ 1,827,696
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 76,567	\$ 29,388
Accrued liabilities	38,829	30,462
Accrued compensation	49,466	50,631
Deferred compensation plan obligations	63,004	61,567
Deferred income and allowances on sales to distributors	367,806	258,285
Income taxes payable	120,126	133,904
	<u>715,798</u>	<u>564,237</u>
Total current liabilities	715,798	564,237
Capital lease obligations	3,484	3,871
	<u>719,282</u>	<u>568,108</u>
Total liabilities	719,282	568,108
Stockholders equity:		
Common stock: \$0.001 par value; 1,000,000 shares authorized; outstanding - 361,107 shares at June 30, 2006 and 359,419 shares at December 30, 2005	361	359

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Capital in excess of par value	470,179	385,201
Retained earnings	972,886	875,164
Deferred stock-based compensation		(46)
Accumulated other comprehensive loss	(1,954)	(1,090)
	<u>          </u>	<u>          </u>
Total stockholders' equity	1,441,472	1,259,588
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 2,160,754	\$ 1,827,696
	<u>          </u>	<u>          </u>

(1) See Restatement of previously issued financial statements in Note 1.

See accompanying notes to condensed consolidated financial statements.

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**ALTERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2006	July 1, 2005	June 30, 2006	July 1, 2005
Net sales	\$ 334,100	\$ 285,477	\$ 626,930	\$ 550,299
Cost of sales (1)	113,335	90,592	210,441	174,482
Gross margin	220,765	194,885	416,489	375,817
Operating expenses: (1)				
Research and development	63,904	55,340	126,761	106,729
Selling, general, and administrative	76,749	55,895	152,998	110,229
Total operating expenses	140,653	111,235	279,759	216,958
Income from operations	80,112	83,650	136,730	158,859
Interest and other income, net	10,781	8,058	23,214	12,556
Income before income taxes	90,893	91,708	159,944	171,415
Provision for income taxes	(13,633)	(24,142)	(23,991)	(40,083)
Net income	\$ 77,260	\$ 67,566	\$ 135,953	\$ 131,332
<b>Net income per share:</b>				
Basic	\$ 0.21	\$ 0.18	\$ 0.38	\$ 0.35
Diluted	\$ 0.21	\$ 0.18	\$ 0.37	\$ 0.35
<b>Shares used in computing per share amounts:</b>				
Basic	360,501	373,040	359,990	372,961
Diluted (as restated for 2005) (2)	367,092	379,693	367,070	379,631

(1) Effective December 31, 2005, Altera adopted FAS 123(R), Share-Based Payments, and uses the modified prospective method to value its share-based payments. See Note 8 - Stock based compensation for additional information. Stock based compensation is included as follows:

Cost of sales	\$ 554	\$	\$ 1,077	\$
Research and development	\$ 7,977	\$	\$ 15,901	\$
Selling, general and administrative	\$ 10,158	\$ 69	\$ 20,624	\$ 144

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(2) See Restatement of previously issued financial statements in Note 1.

See accompanying notes to condensed consolidated financial statements.

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**ALTERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited, in thousands)

	Six Months Ended	
	June 30, 2006	July 1, 2005
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 135,953	\$ 131,332
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,325	14,697
Stock-based compensation	37,602	144
Deferred income tax credit	(5,543)	(4,251)
Tax benefit from stock plans	16,316	14,100
Gross tax benefit from stock-based compensation	(11,455)	
Changes in assets and liabilities:		
Accounts receivable, net	(120,095)	(78,730)
Inventories	(7,108)	3,866
Other assets	(15,121)	97
Accounts payable and accrued liabilities	53,708	(8,565)
Deferred income and allowances on sales to distributors	109,521	34,473
Income taxes payable	(13,778)	18,868
<b>Net cash provided by operating activities</b>	<b>195,325</b>	<b>126,031</b>
<b>Cash Flows from Investing Activities:</b>		
Purchases of property and equipment	(16,195)	(10,812)
Purchases of available-for-sale investments	(513,433)	(167,884)
Proceeds from the maturities and sales of available-for-sale investments	259,794	251,306
Proceeds from the maturities of held-to-maturity investments		14,470
<b>Net cash (used for) provided by investing activities</b>	<b>(269,834)</b>	<b>87,080</b>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from issuance of common stock through stock plans	45,945	38,070
Repurchases of common stock	(53,068)	(81,386)
Gross tax benefit from stock-based compensation	11,455	
(Decrease) increase in book overdrafts	(2,537)	(381)
Payments on capital lease obligations	(1,422)	
<b>Net cash provided by (used for) financing activities</b>	<b>373</b>	<b>(43,697)</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(74,136)</b>	<b>169,414</b>
Cash and cash equivalents at beginning of period	787,707	579,936
<b>Cash and cash equivalents at end of period</b>	<b>\$ 713,571</b>	<b>\$ 749,350</b>



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**Cash paid during the period for:**

Income taxes paid, net of refunds	\$ 26,911	\$ 13,570
Interest paid on capital lease obligations	\$ 215	\$

**Non-cash transactions:**

Assets acquired under capital leases	\$ 4,245	\$
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See accompanying notes to condensed consolidated financial statements.

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**ALTERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 Summary of Significant Accounting Policies:**

**Organization and Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of Altera Corporation and subsidiaries, collectively referred to herein as, Altera we, us, or our, have been prepared by us in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information. This financial information reflects all adjustments which are, in the opinion of our management, of a normal recurring nature and necessary for a fair statement of the results for the periods presented. The December 30, 2005 condensed consolidated balance sheet data was derived from our audited consolidated financial statements, as restated included in our 2005 Annual Report on Form 10-K/A but they do not include all disclosures required by accounting principles generally accepted in the United States of America. The condensed consolidated financial statements include our accounts as well as those of our wholly-owned subsidiaries after elimination of all significant inter-company balances and transactions.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in our condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates, and material effects on our operating results and financial position may result.

These condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements, as restated, for the year ended December 30, 2005 included in our Annual Report on Form 10-K/A, as filed on October 24, 2006 with the Securities and Exchange Commission ( SEC ). The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for any future period.

**Restatement of previously issued financial statements**

On October 24, 2006, we filed our 2005 Form 10-K/A amending our 2005 Form 10-K and restated our consolidated financial statements for the fiscal years 2005, 2004, 2003 and for each of the quarters in fiscal year 2004. The effects of this restatement on the fiscal year ended December 30, 2005 were negligible and therefore we did not restate any fiscal 2005 consolidated financial statements, except to reflect the cumulative restatement adjustments made to the consolidated balance sheet as of December 30, 2005, as well as a negligible change to fully diluted shares outstanding. We also restated the pro forma disclosures for stock-based compensation expense required under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, ( SFAS 123 ) included in notes to the consolidated financial statements. We also restated our Selected Consolidated Financial Data for the fiscal years 2005, 2004, 2003, 2002 and 2001. The decision to restate our consolidated financial statements and related disclosures was based on facts obtained by management and the results of an independent investigation into our stock option accounting that was conducted under the direction of a special committee formed by the board of directors, composed solely of independent directors. The special committee was assisted by independent legal counsel and forensic accountants. This special

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committee was established after our Chief Executive Officer and General Counsel, on their own initiative, commenced a review of our historical stock option practices. In the restatement we recorded additional non-cash, stock-based compensation expense resulting from seven stock option grants during fiscal years 1996 to 2001 that were incorrectly accounted for under generally accepted accounting principles ( GAAP ). We also recorded additional non-cash, stock-based compensation expense resulting from modifications of certain employees' stock option grant agreements made during 1996 to 2002 in connection with the termination of their employment. Although we did not believe that the effects of the restatement were material to the results of operations for years 2005, 2004, or 2003, we restated prior financial statements because the alternative method of correcting the errors, which is to record the cumulative impact of the error corrections in the quarter ended March 31, 2006, would result in a material charge to that period and such a charge would likely have a material impact on our fiscal year ended December 29, 2006.

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**Stock based compensation**

On December 31, 2005, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors including employee stock options, restricted stock units and employee stock purchases under our Employee Stock Purchase Plan ( ESPP ) based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) for periods beginning in fiscal year 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ) providing supplemental implementation guidance for SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of stock-based awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. We adopted SFAS 123(R) using the modified prospective transition method which requires the application of the accounting standard starting from December 31, 2005, the first day of our fiscal year 2006. Our Consolidated Financial Statements, as of and for the three and six months ended June 30, 2006, reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method we used in adopting SFAS 123(R), our results of operations prior to fiscal year 2006 have not been restated to reflect, and do not include, the impact of SFAS 123(R).

Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ). Under APB No. 25, compensation cost was measured as the excess, if any, of the quoted market price of our stock at the date of grant over the exercise price of the stock option granted. Under APB No. 25, compensation cost for stock options, if any, was recognized over the vesting period using the straight-line single option method.

Stock-based compensation expense recognized during a period is based on the value of the portion of stock-based awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the three and six months ended June 30, 2006, included compensation expense for stock-based awards granted prior to, but not yet vested as of December 30, 2005, based on the fair value on the grant date estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the stock-based awards granted subsequent to December 30, 2005, based on the fair value on the grant date estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), we changed our method of attributing the value of stock-based compensation expense from the accelerated multiple-option method (for the purposes of pro forma information under SFAS 123) to the straight-line single option method (straight line method). Compensation expense for all stock-based awards granted on or prior to December 30, 2005, will continue to be recognized using the accelerated multiple-option approach, while compensation expense for all stock-based awards granted subsequent to December 30, 2005, will be recognized using the straight-line single option method. As stock-based compensation expense recognized in our results is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock options and purchase rights under Employee Stock Purchase Plan ( ESPP ). The Black-Scholes model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option s expected term and the price volatility of the underlying stock. For restricted stock units, compensation expense is calculated based on the fair market value of our stock on the date of grant.

Also see Note 8 for further discussion on stock-based compensation.

### **Recent Accounting Pronouncements**

In July 2006, the FASB issued FASB Interpretation ( FIN ) No. 48 Accounting for Uncertainty in Income Taxes an interpretation of SFAS 109. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48 these will be accounted for as an adjustment to retained earnings. We are currently assessing the impact of FIN 48 on our consolidated financial position and results of operations.

On September 13, 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. ( SAB 108 ) which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The guidance is applicable for our fiscal 2007. We are not yet in a position to determine what, if any, effects SAB No. 108 will have on our consolidated financial statements.

**Table of Contents****Note 2 Balance Sheet Details:****Inventories**

Inventories at June 30, 2006 and December 30, 2005 were comprised of the following:

	June 30, 2006	December 30, 2005
<i>(in thousands)</i>		
Raw materials and work in process	\$ 58,262	\$ 50,071
Finished goods	19,557	20,640
<b>Total inventories</b>	<b>\$ 77,819</b>	<b>\$ 70,711</b>

We realized gross margin benefits of \$0.7 million for the three months ended June 30, 2006 and \$1.5 million for the six months ended June 30, 2006, resulting from the sale of inventory written down in 2001. As of June 30, 2006, the book value of the inventory written down in 2001 was zero while the cost basis was \$2.7 million which comprised of raw materials and work in process inventory only.

**Advances to Distributors**

On sales to distributors, our payment terms frequently require the distributor to settle amounts owed to us for an amount in excess of their ultimate cost. Our sales price to the distributor may be higher than the amount that the distributor will ultimately owe us because distributors often negotiate price discounts after purchasing the product from us and such discounts are often significant. It is our practice to apply these negotiated price discounts to future purchases, requiring the distributor to settle, on a current basis, generally within 30 days, for amounts originally invoiced. This practice has an adverse impact on the working capital of our distributors. As a consequence, we have entered into business arrangements with certain distributors whereby we advance cash to the distributors to minimize the distributor's working capital requirements. These advances are settled in cash on a quarterly basis and are estimated based on the amount of ending inventory at the distributor as reported at the end of the preceding quarter multiplied by a negotiated percentage. Such advances have no impact on revenue recognition or our condensed consolidated statements of income and are a component of the deferred income and allowances on sales to distributors line-item on our condensed consolidated balance sheets. We continuously process discounts taken by distributors against our deferred income and allowances on sales to distributors and true-up the advanced amounts at the end of each quarter. These advances are set forth in agreements and are unsecured, bear no interest and are due upon demand. The agreements governing these advances can be cancelled by us at any time. Such advances totaled \$86.1 million at June 30, 2006 and \$74.2 million at December 30, 2005.

We also enter into arrangements that are, in substance, an arrangement to finance distributors' accounts receivable and inventory. The amounts advanced are classified as other current assets in our condensed consolidated balance sheets and totaled \$50.0 million at June 30, 2006 and \$34.6 million at December 30, 2005.

***Long-Term Investments***

Effective July 1, 2005, we classified certain investments as long-term. These investments represent funds that are deemed to be in excess of our estimated operating requirements. The classification of these investments as long-term is based on the remaining maturities exceeding 12 months as of the balance sheet date. All of our investments, including long-term investments, are classified as available-for-sale and are therefore carried at fair value based on quoted market prices as of the balance sheet date.

**Table of Contents****Property and Equipment**

Property and equipment at June 30, 2006 and December 30, 2005 were comprised of the following:

<i>(in thousands)</i>	June 30, 2006	December 30, 2005
Land	\$ 30,779	\$ 30,779
Buildings	125,608	121,772
Equipment and software	214,553	209,244
Office furniture and fixtures	20,775	20,101
Leasehold improvements	7,184	6,739
Property and equipment, at cost	398,899	388,635
Accumulated depreciation and amortization	(226,948)	(222,636)
Property and equipment, net	\$ 171,951	\$ 165,999

We have entered into arrangements which were recorded as capital lease obligations and assets in property and equipment. Capital lease obligations recorded totaled \$9.1 million as of June 30, 2006 and \$6.2 million as of December 30, 2005. Amortization expense related to assets recorded as capital leases was \$0.9 million for the three months ended June 30, 2006 and \$2.0 million for the six months ended June 30, 2006.

**Note 3 Comprehensive Income:**

The components of comprehensive income were as follows:

<i>(in thousands)</i>	Three Months Ended		Six Months Ended	
	June 30, 2006	July 1, 2005	June 30, 2006	July 1, 2005
Net income	\$ 77,260	\$ 67,566	\$ 135,953	\$ 131,332
Change in unrealized losses on investments	(766)	900	(1,406)	564
Income tax benefit (provision)	287	(337)	542	(211)
Comprehensive income	\$ 76,781	\$ 68,129	\$ 135,089	\$ 131,685



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Accumulated other comprehensive loss presented in the accompanying condensed consolidated balance sheets consist of the accumulated unrealized loss on investments, net of tax.

### **Note 4 Income Per Share:**

In accordance with Statement of Financial Accounting Standards No. 128, or SFAS No. 128, Earnings Per Share, we compute basic income per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Our diluted income per share is calculated by including adjustments to our weighted average common shares outstanding during the period, assuming any dilutive effects of options, restricted stock units, and employee stock purchase plan shares, using the treasury stock method.

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In applying the treasury stock method, we excluded 39.6 million stock options for the three months ended June 30, 2006 and 35.9 million shares for the three months ended July 1, 2005, because their effect was anti-dilutive. Anti-dilutive stock options totaled 39.9 million shares for the six months ended June 30, 2006 and 39.0 million for the six months ended July 1, 2005. While these stock options are currently anti-dilutive, they could be dilutive in the future. All restricted stock units outstanding as of June 30, 2006 were in-the-money and included in our treasury stock calculation. A reconciliation of basic and diluted income per share is presented below:

	Three Months Ended		Six Months Ended	
	June 30, 2006	July 1, 2005	June 30, 2006	July 1, 2005
<i>(in thousands, except per share amounts)</i>				
<b>Basic:</b>				
Net income	\$ 77,260	\$ 67,566	\$ 135,953	\$ 131,332
Weighted shares outstanding	360,501	373,040	359,990	372,961
Net income per share	\$ 0.21	\$ 0.18	\$ 0.38	\$ 0.35
<b>Diluted:</b>				
Net income	\$ 77,260	\$ 67,566	\$ 135,953	\$ 131,332
Weighted shares outstanding	360,501	373,040	359,990	372,961
Effect of dilutive securities:				
Stock options, ESPP, and restricted stock unit shares	6,591	6,653	7,080	6,670
Diluted weighted shares outstanding (as restated for the 2005 periods) (1)	367,092	379,693	367,070	379,631
Net income per share	\$ 0.21	\$ 0.18	\$ 0.37	\$ 0.35

(1) See Restatement of previously issued financial statements in Note 1.

**Note 5 Deferred Income Taxes and Other Assets, Net:**

Deferred income taxes reflect the effect of temporary differences between asset and liability amounts that are recognized for financial reporting purposes and amounts that are recognized for income tax purposes. These deferred taxes are measured by applying currently enacted tax laws. Valuation allowances, if necessary, are recognized to reduce deferred tax assets to the amount that will more likely than not be realized. In assessing the likelihood of realization, we consider estimates of future taxable income.

Our deferred income taxes and other assets consisted primarily of the non-current portion of deferred tax assets of \$49.0 million at June 30, 2006 and \$45.8 million at December 30, 2005 as restated.

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Also included in our deferred income taxes and other assets, net are intangible assets. We amortize intangible assets on a straight-line basis over their estimated useful lives. Amortization of intangible assets was \$0.4 million for the three months ended June 30, 2006 and was \$0.8 million for the six months ended June 30, 2006. Amortization of intangible assets was \$0.6 million for the three months ended July 1, 2005 and was \$1.2 million for the six months ended July 1, 2005. The net balance of our intangible assets as of June 30, 2006 was \$0.7 million, compared with \$1.6 million as of December 30, 2005.

**Table of Contents****Note 6 Indemnification and Product Warranty:**

We indemnify certain customers, distributors, suppliers, and subcontractors for attorney fees and damages and costs awarded against these parties in certain circumstances in which our products are alleged to infringe third party intellectual property rights including patents, trade secret, trademarks, or copyrights. We cannot estimate the amount of potential future payments, if any, that we might be required to make as a result of these agreements. To date, we have not paid any claim or been required to defend any action related to our indemnification obligations, and accordingly, we have not accrued any amounts for such indemnification obligations. However, we may record charges in the future as a result of these indemnification obligations.

We generally warrant our products against defects in materials and workmanship and non-conformance to our specifications for varying lengths of time. If there is a material increase in customer claims compared with our historical experience, or if costs of servicing warranty claims are greater than expected, we may record a charge against cost of sales.

The following table summarizes the activity related to our product warranty liability for the six months ended June 30, 2006 and July 1, 2005, which was included in accrued liabilities in our condensed consolidated balance sheets.

	Six Months Ended	
	June 30, 2006	July 1, 2005
<i>(in thousands, except per share amounts)</i>		
Balance at beginning of period	\$ 1,454	\$ 1,822
Provision	1,260	
Payments	(172)	(290)
Balance at end of period	\$ 2,542	\$ 1,532

**Note 7 Common Stock Repurchases:**

Share repurchase activities for the three and six months ended June 30, 2006 and July 1, 2005 were as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2006	July 1, 2005	June 30, 2006	July 1, 2005
<i>(in thousands, except per share amounts)</i>				
Shares repurchased	448	1,873	2,666	4,128
Cost of shares repurchased	\$ 9,403	\$ 37,990	\$ 53,068	\$ 81,386
Average price per share	\$ 20.99	\$ 20.28	\$ 19.91	\$ 19.72

As a result of our failure to timely file our Form 10-Q for the quarter ended March 31, 2006, effective May 11, 2006 we temporarily suspended our stock repurchase program. Since the inception of our stock repurchase program in 1996 through June 30, 2006, we have repurchased a total of 89.3 million shares of our common stock for an aggregate cost of \$1.9 billion. All shares were retired upon acquisition. At June 30, 2006, 18.7 million shares remained authorized for repurchases under our stock repurchase program.

**Note 8 Stock-Based Compensation:**

***Stock-Based Compensation Plans***

**2005 Equity Incentive Plan**

Our equity incentive program is a broad-based, long-term retention program intended to attract, motivate, and retain talented employees as well as align stockholder and employee interests. On May 10, 2005, our stockholders approved Altera's 2005 Equity Incentive Plan (the 2005 Plan). The 2005 Plan replaces our 1996 Stock Option Plan and our 1998 Director Stock Option Plan (collectively Prior Plans) before their expiration and is now Altera's only plan for providing stock-based incentive compensation to both our eligible employees

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and non-employee directors. Awards that may be granted under the 2005 Plan include non-qualified and incentive stock options, restricted stock awards, restricted stock units, stock appreciation rights, and stock bonus awards. Prior to 2006, we granted only stock options under the 2005 Plan. Effective for 2006, awards granted under the 2005 Plan include stock options and restricted stock units. The majority of awards of stock options and restricted stock units granted under the 2005 Plan vest over four years. All awards granted under the 2005 Plan have a maximum term of ten years.

On May 9, 2006, the stockholders approved an amendment to the 2005 Plan to increase by 10 million the number of shares of common stock reserved for issuance under the 2005 Plan. As of June 30, 2006, the 2005 Plan had a total of 25.4 million shares reserved for future issuance, of which 19.3 million shares were available for future grants.

**Prior Stock Option Plans**

Prior to stockholder approval of the 2005 Plan on May 10, 2005, we granted stock options under the 1996 Stock Option Plan and the 1998 Director Option Plan. The 1996 Plan provided for the periodic issuance of stock options to our employees, and the 1998 Director Option Plan provided for the periodic issuance of stock options to members of our Board of Directors who were not employees. The vesting period for the options granted under these plans is four to five years. The maximum contractual term of options granted under these plans is ten years.

As of June 30, 2006, the 1996 Stock Option Plan had 53.5 million shares reserved for future issuance and the 1998 Director Option Plan had 0.4 million shares reserved for future issuance. Shares reserved for future issuance under the 1996 Stock Option Plan and the 1998 Director Option Plan are for awards previously granted that remained outstanding as of June 30, 2006. We may no longer grant awards under these plans.

Prior to the 1996 and 1998 Plans, we granted stock options under various plans. The terms for the majority of awards granted under these plans were consistent with the 1996 and 1998 Plans. As of June 30, 2006, 0.1 million shares were reserved for issuance for awards previously granted under these plans that remained outstanding as of June 30, 2006. We may no longer grant awards under these plans.

A summary of shares available for grant under our 2005 Plan is as follows:

	Shares Available For Grant
<i>(in thousands, except per share amounts)</i>	
Balance, December 30, 2005	11,659
Additional shares reserved	10,000
Stock option grants	(1,265)
Stock option exercises	
Stock option forfeitures (1)	1,921
Restricted stock units granted (2)	(3,121)
Restricted stock units forfeited (2)	60

Balance, June 30, 2006

19,254

- (1) Includes 1,730,364 shares that were subject to awards granted under the Prior Stock Option Plans that were outstanding on the effective date of the 2005 Plan, and cancelled during the six months ended June 30, 2006. Upon cancellation, these shares were returned to the pool of shares available for grant and issuance under the 2005 Plan.
- (2) During the six months ended June 30, 2006, we granted 1,387,168 restricted stock units. For purposes of determining the number of shares available for grant under the 2005 Plan against the maximum number of shares authorized, each restricted stock unit granted reduces the number of shares available for issuance by 2.25 shares and each restricted stock unit canceled increases shares available for issuance by 2.25 shares.

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A summary of activity under all of our stock option plans and related weighted average exercise prices for the six months ended June 30, 2006 is as follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (1)
<i>(In thousands, except price per share amounts and terms)</i>				
Outstanding, December 30, 2005	63,773	\$ 18.98		
Additional shares reserved				
Grants	1,265	20.04		
Exercises	(4,277)	8.83		
Forfeitures	(1,925)	22.76		
Outstanding, June 30, 2006	58,836	19.61	5.95	\$ 84,675
Exercisable, June 30, 2006	43,936	\$ 19.31	5.15	\$ 81,346

(1) Aggregate intrinsic value represents the total pre-tax value that would have been received by option holders if stock options would have been exercised on June 30, 2006 based on the closing stock price of \$17.55.

Range of Exercise Prices	Stock Options Outstanding			Stock Options Exercisable	
	Number Outstanding (in thousands)	Weighted-Average Remaining Contractual Term (in Years)	Weighted-Average Exercise Price	Number Exercisable (in thousands)	Weighted-Average Exercise Price
\$ 0.01 \$13.91	13,550	4.28	\$ 11.51	12,797	\$ 11.39
\$ 14.01 \$20.88	18,196	6.82	19.24	9,959	18.78
\$ 20.95 \$23.13	12,712	6.33	22.00	9,529	22.23
\$ 23.14 \$23.94	9,078	6.94	23.55	6,372	23.58
\$ 23.99 \$61.56	5,300	4.58	29.11	5,279	29.12
	58,836	5.95	\$ 19.61	43,936	\$ 19.31

For the six months ended June 30, 2006, 4.3 million stock option shares were exercised. The intrinsic value of stock options exercised during the six months ended June 30, 2006 was \$49.2 million. The intrinsic value represents the total pretax value received by option holders upon the exercise of stock options during the quarter.

**Employee Stock Purchase Plan**



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As implemented, our 1987 Employee Stock Purchase Plan ( ESPP ) has two consecutive, overlapping twelve-month offering periods, with a new period commencing on the first trading day on or after May 1 and November 1 of each year and terminating on the last trading day on or before April 30 and October 31. Each twelve-month offering period generally includes two six-month purchase periods. The purchase price at which shares are sold under the ESPP is 85% of the lower of the fair market value of a share of our common stock on (1) the first day of the offering period, or (2) the last trading day of the purchase period. If the fair market value at the end of any purchase period is less than the fair market value at the beginning of the offering period, each participant will be automatically withdrawn from the current offering period following the purchase of shares on the purchase date and will be automatically re-enrolled in the immediately following offering period.

On May 9, 2006, the stockholders approved an amendment to the ESPP to increase the number of shares reserved for issuance from 19.7 million to 20.7 million shares. As of June 30, 2006, 3.2 million shares were available for future issuances under this plan. Sales under the Employee Stock Purchase Plan were 579,605 shares of common stock at an average price of \$14.12 for the six months ended June 30, 2006 and 438,916 shares of common stock at an average exercise price of \$16.95 for the six months ended July 1, 2005.

**Table of Contents****Adoption of SFAS No. 123(R)**

On December 31, 2005, we adopted SFAS 123(R) using the modified prospective transition method. SFAS 123(R) requires the measurement and recognition of compensation expense for all stock-based awards made to our employees and directors including employee stock options, and other stock-based awards based on estimated fair values. The following table summarizes the impact of the adoption of SFAS 123(R) on stock-based compensation costs for employees on our condensed consolidated statements of income for the three and six months ended June 30, 2006:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
<i>(in thousands, except per share amounts)</i>		
Cost of sales	\$ 554	\$ 1,077
Research and development	7,977	15,901
Selling, general, and administrative	10,158	20,624
<b>Pre-tax incremental stock-based compensation expense</b>	<b>18,689</b>	<b>37,602</b>
Less: income tax benefit	(4,996)	(9,584)
<b>Net stock-based compensation expense</b>	<b>\$ 13,693</b>	<b>\$ 28,018</b>
<b>Effect on net income per share:</b>		
Basic	\$ 0.04	\$ 0.08
Diluted	\$ 0.04	\$ 0.08

At June 30, 2006, unamortized compensation expense related to outstanding unvested stock options, restricted stock units, and ESPP Shares that are expected to vest was approximately \$90 million. This unamortized compensation expense is expected to be recognized over a weighted average period of approximately 2 1/2 years. In addition to the expense for outstanding unvested stock options, restricted stock units and ESPP Shares, we will incur significant additional expense during fiscal 2006 related to new awards granted during 2006. During the three months ended March 31, 2006, stock-based compensation expense was not capitalized to inventory or property and equipment.

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Under the modified prospective recognition method, prior period financial statements are not restated. Prior to the adoption of SFAS 123(R), as required by SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure, we disclosed the following pro forma information to illustrate the effect on our net income and net income per share as if we had recorded compensation costs for the three and six months ended July 1, 2005 under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation:

	Three Months Ended July 1, 2005	Six Months Ended July 1, 2005
<i>(in thousands, except per share amounts)</i>		
Reported net income	\$ 67,566	\$ 131,332
Add: Stock-based employee compensation expense included in reported net income, net of tax	46	96
Deduct: Stock-based employee compensation expense determined under the fair value method, net of tax (as restated) (1)	(17,332)	(37,602)
<b>Pro forma net income</b>	<b>\$ 50,280</b>	<b>\$ 93,826</b>
<b>Pro forma net income per share:</b>		
Basic	\$ 0.13	\$ 0.25
Diluted	\$ 0.13	\$ 0.25
<b>Reported net income per share:</b>		
Basic	\$ 0.18	\$ 0.35
Diluted	\$ 0.18	\$ 0.35

(1) See Restatement of previously issued financial statements in Note 1.

**Valuation of Stock-Based Compensation****Stock Options and ESPP Shares**

We estimate the fair value of stock options and purchase rights under the ESPP ( ESPP Shares ) on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. However, options granted under our stock option plans are not freely tradable, or transferable, and have vesting restrictions.

The Black-Scholes model requires our estimate of highly subjective assumptions, which greatly affect the fair value of each stock option and ESPP Share. The assumptions used to estimate the fair value of stock options granted during the three and six months ended June 30, 2006 and July 1, 2005 were as follows:

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	Three Months Ended		Six Months Ended	
	June 30, 2006	July 1, 2005	June 30, 2006	July 1, 2005
<b>Stock option plan:</b>				
Expected term (in years)	4.8	3.9	4.7	3.9
Expected stock price volatility	42.9%	46.4%	42.2%	48.2%
Risk-free interest rate	5.0%	4.0%	4.4%	3.4%
Weighted-average estimated fair value	\$ 8.95	\$ 8.26	\$ 8.45	\$ 8.11
<b>Stock purchase plan:</b>				
Expected term (in years)	0.8	0.8	0.8	0.8
Expected stock price volatility	30.1%	39.1%	30.1%	39.1%
Risk-free interest rate	5.0%	3.3%	5.0%	3.3%
Weighted-average estimated fair value	\$ 5.62	\$ 6.05	\$ 5.62	\$ 6.05

For stock options, our expected term estimate represents the weighted average term for stock options that have completed the full contractual term based on the period from the date of grant to exercise, cancellation, or expiration. For ESPP Shares, the expected term represents the average term from grant date to purchase date.

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Our expected stock price volatility assumption for both stock options and ESPP Shares is estimated using a combination of implied volatility for publicly traded options on our stock with a term of one year and our historical stock price volatility.

The interest rate used to value stock options and ESPP Shares approximates the risk-free interest rate of a zero-coupon Treasury bond on the date of grant. Our calculation of fair value per share for stock options and ESPP Shares assumes no expected dividends.

We monitor the assumptions used to compute the fair value of our stock-based awards and revise our methodology as appropriate.

**Restricted Stock Units**

For restricted stock units, compensation expense is calculated based on the fair market value of our stock on the date of grant, multiplied by the number of restricted stock units granted. The grant-date value of restricted stock units, less estimated pre-vest forfeitures, is recorded on a straight-line basis, over the vesting period. The vesting period for restricted stock units is generally four years.

A summary of our restricted stock activity for the six months ended June 30, 2006 is as follows:

	Number of Shares	Weighted-Average Grant-Date Fair Value
<i>(In thousands, except price per share amounts)</i>		
Outstanding, December 30, 2005		\$
Grants	1,387	19.30
Exercises		
Forfeitures	(26)	19.29
Outstanding, June 30, 2006	1,361	\$ 19.30

**Note 9 Income Taxes:**

Our effective tax rate reflects the impact of a significant amount of our earnings being taxed in foreign jurisdictions at rates below the US statutory tax rate. Our effective tax rate for the three and six months ended June 30, 2006 was 15%, compared with 26% and 23% for the three and six months ended July 1, 2005 respectively. The decrease in our effective tax rate was primarily due to the impact associated with expensing predominantly U.S. related stock-based compensation in accordance with SFAS 123(R), a favorable change in the geographical mix of income, and an increase in tax-exempt income. These decreases were partially offset by the expiration of the federal Research and Development tax credit.

We maintain within our income taxes payable account reserves for tax contingencies. These reserves involve considerable judgment and estimation and are monitored by management based on the best information available including changes in tax regulations, the outcome of relevant court cases and other information. We are currently under examination by various taxing authorities. Although the outcome of any tax audit is uncertain, we believe we have adequately provided in our consolidated financial statements for any additional taxes that we may be required to pay as a result of such examinations. If the payment ultimately proves to be unnecessary, the reversal of these tax liabilities would result in tax benefits being recognized in the period we determine such liabilities are no longer necessary. However, if an ultimate tax assessment exceeds our estimate of tax liabilities, an additional tax provision will be recorded. The impact of such adjustments in our tax accounts could have a material impact on our results of operations in future periods.

**Note 10 Nonqualified Deferred Compensation Plan:**

We allow our U.S.-based officers, director-level employees, and members of our Board of Directors to defer a portion of their compensation under the Altera Corporation Nonqualified Deferred Compensation Plan ( the NQDC Plan ). Our Retirement Plans Committee administers the NQDC Plan. At June 30, 2006, there were approximately 140 participants in the NQDC Plan who self-direct their investments in the NQDC Plan. In the event we become insolvent, NQDC Plan assets are subject to the claims of our general creditors. Since the inception of the NQDC Plan, we have not made any contributions to the NQDC Plan and we have no commitments to do so in the future. There are no NQDC Plan provisions that provide for any guarantees or

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minimum return on investments. NQDC Plan participants are prohibited from investing in Altera stock. At June 30, 2006, NQDC Plan assets and obligations were \$63.0 million. At December 30, 2005, NQDC Plan assets and obligations were \$61.6 million.

We account for investment income earned by the NQDC Plan as interest and other income, net. The investment income also represents an increase in the future payout to employees and is treated as current period compensation expense. During the three months ended June 30, 2006, the NQDC Plan experienced a net investment loss of \$1.0 million. This loss resulted in a \$1.0 million unfavorable impact to other income and a favorable impact to operating expenses, decreasing selling, general and administrative expenses by \$0.6 million and decreasing research and development expenses by \$0.4 million. During the six months ended June 30, 2006, the NQDC Plan experienced a net investment gain of \$1.3 million. This gain resulted in a \$1.3 million favorable impact to other income and an unfavorable impact to operating expenses, increasing compensation expense by \$1.3 million. Income earned by the NQDC Plan does not, nor has it ever, impacted our income before income taxes, net income, or cash balances.

**Note 11 - Legal Proceedings:**

In May and July 2006, we were notified that three shareholder derivative lawsuits had been filed in the Superior Court of the State of California, County of Santa Clara, by persons identifying themselves as Altera shareholders and purporting to act on behalf of Altera, naming Altera Corporation as a nominal defendant and naming some of our current and former officers and directors as defendants. On July 12, 2006, one of these derivative actions was voluntarily dismissed by the plaintiff shareholder. The remaining two derivative lawsuits pending in Santa Clara Superior Court were consolidated into a single action on September 5, 2006. The consolidated action names as defendant Altera Corporation (nominal defendant) and the following current and former Altera officers and directors: John P. Daane, Nathan M. Sarkisian, Denis M. Berlan, Scott Wylie, Robert W. Reed, Robert J. Finocchio, Jr., Kevin McGarity, Paul Newhagen, William E. Terry, Susan Wang, Charles M. Clough, Rodney Smith, Erik Cleage, Michael B. Jacobs and Katherine E. Schuelke.

In the consolidated action, the plaintiffs assert claims against these individual defendants for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, violations of California Corporation Code sections 25402 and 25403, breach of fiduciary duty for insider selling and misappropriation of information, rescission, constructive trust, and an accounting. Plaintiffs' claims concern the granting of stock options by Altera between 1996 and December 2000 and the alleged filing of false and misleading financial statements between 1996 and 2006. All of these claims are asserted derivatively on behalf of Altera. Plaintiffs seek, among other relief, an indeterminate amount of damages from the individual defendants and a judgment directing Altera to reform its corporate governance.

During the months of May, June, and July 2006, four other derivative lawsuits were filed by purported Altera shareholders, on behalf of Altera, in the United States District Court for the Northern District of California. On August 8, 2006, these actions were consolidated. The plaintiffs have not yet filed a consolidated complaint. The initial complaints filed by the four shareholders included claims for violations of Sections 10(b), 14(a), 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934, unjust enrichment, breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, breach of contract, an accounting, constructive fraud, rescission, and violations of California Corporations Code section 25402. Plaintiffs' claims concern the granting of stock options by Altera between 1995 and December 2000 and the alleged filing of false and misleading financial statements between 1996 and 2005. Among the defendants named in these derivative actions are Altera Corporation as a nominal defendant and the following current and former officers and directors of Altera: John P. Daane, Robert W. Reed, Denis M. Berlan, Nathan M. Sarkisian, Katherine E. Schuelke, Robert J. Finocchio, Jr., Kevin McGarity, Paul Newhagen, William E. Terry, Susan Wang, Rodney Smith, Erik Cleage, and Michael Jacobs.





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**Note 12 - Subsequent Events:**

***Stock Option Investigation and Regulatory Proceedings***

On August 10, 2006, we received from the SEC an informal request for the production of documents relating to its informal inquiry into our stock option accounting practices. We continue to cooperate with both the SEC and the Department of Justice with respect to their investigations of our stock option accounting practices. If we are subject to adverse findings resulting from the above investigations, we could be required to pay significant damages or penalties or have other remedies imposed upon us.

On October 16, 2006, we issued a press release announcing that we had completed our review of our historical stock option practices and related accounting. We reported that the expected restatement adjustments would total \$47.6 million (pre-tax) and related primarily to (1) stock option grant measurement date errors from December 1996 through February 2001 (\$17.8 million), (2) stock option grant agreement modifications from 1996 to 2002 in connection with the termination of certain employees employment (\$24.3 million), and (3) other adjustments (\$5.5 million), principally related to the accounting for our service award program. We reported that we anticipated a \$12.5 million tax benefit arising from the cumulative restatement adjustments resulting in a net income restatement impact of \$35.1 million. Further, we reported that restatement will not be material to the results of operations for fiscal year 2005 or affect any historical revenues.

As of September 29, 2006, the Company had incurred direct costs of approximately \$9 million associated with the special committee's investigation and additional related professional services and consulting fees associated with the restatement effort and litigation. We expect to incur up to several million dollars of additional expense in the fourth quarter of 2006 associated with the investigation, litigation defense, and financial restatement.

***NASDAQ Delisting***

We have received two NASDAQ Staff Determinations stating that we are not in compliance with Marketplace Rule 4310(c)(14) because we have not timely filed our Forms 10-Q for the quarters ended March 31, 2006 and June 30, 2006 and therefore, that our securities are subject to delisting from the NASDAQ Global Market.

On June 22, 2006, we attended a NASDAQ hearing, at which we sought an exception to the filing requirement. On August 1, 2006, we announced that a NASDAQ Listing Qualifications Panel (the Panel) had granted our request for continued listing of our securities on the NASDAQ Global Market subject to the following conditions: (1) on or before September 14, 2006, we had to file with the SEC our Form 10-Q for the period ended March 31, 2006, as well as any necessary restatements; (2) on or before September 28, 2006, we had to file with the SEC our Form 10-Q for the period ended June 30, 2006; and (3) we were required to submit additional information regarding our internal review of our historical stock option practices and related accounting.

On September 5, 2006, we filed a revised plan of compliance with the Panel, pursuant to which we requested an extension of time through October 26, 2006 in which to complete and file the aforementioned periodic reports. On September 13, 2006, the Panel granted our request for the extension of time.

On October 16, 2006, we announced that we expect to file with the SEC a Form 10-K/A for 2005 and Form 10-Q s for the first and second quarters of 2006 by October 26, 2006, the deadline established by a NASDAQ Listing Panel.

***Departure of Chief Financial Officer; Appointment of Acting Chief Financial Officer***

On October 16, 2006, we issued a press release announcing that Nathan Sarkisian, our Chief Financial Officer, had retired from the Company and that James W. Callas has assumed the roles of Principal Financial and Accounting Officer and acting Chief Financial Officer. We also announced that a search for Mr. Sarkisian s permanent replacement is ongoing.

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**ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as information contained in the risk factors described in Item 1A of this report and elsewhere in this report, contains forward-looking statements, which are provided under the safe harbor protection of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally written in the future tense and/or are preceded by words such as will, may, should, could, expect, suggest, believe, anticipate, intend, plan, or other similar words. Forward-looking statements include statements regarding (1) our gross margins and factors that affect gross margins; (2) the commercial success of our new products; (3) the growth prospects of the semiconductor industry and PLD market, including the FPGA and CPLD product sub-segments; (4) trends in our future sales, including our opportunities for growth by displacing ASICs, ASSPs and other semiconductor alternatives and the geographic mix of our sales and (5) our tax liabilities.*

*Forward-looking statements are not guarantees of future performance and involve risks and uncertainties. The forward-looking statements contained in this report are based on information that is currently available to us and expectations and assumptions that we deem reasonable at the time the statements were made. We do not undertake any obligation to update any forward-looking statements in this report or in any of our other communications, except as required by law. All such forward-looking statements should be read as of the time the statements were made and with the recognition that these forward-looking statements may not be complete or accurate at a later date.*

*Many factors may cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this report. These factors include, but are not limited to, those risks described in Part II Item 1A of this report and those risks described under Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K/A for the year ended December 30, 2005.*

**RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS**

On October 24, 2006, we filed our 2005 Form 10-K/A amending our 2005 Form 10-K and restated our consolidated financial statements for the fiscal years 2005, 2004, 2003 and for each of the quarters in fiscal year 2004. The effects of this restatement on the fiscal year ended December 30, 2005 were negligible and therefore we did not restate any fiscal 2005 consolidated financial statements, except to reflect the cumulative restatement adjustments made to the consolidated balance sheet as of December 30, 2005, as well as a negligible change to fully diluted shares outstanding. We also restated the pro forma disclosures for stock-based compensation expense required under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) included in notes to the consolidated financial statements. We also restated our Selected Consolidated Financial Data for the fiscal years 2005, 2004, 2003, 2002 and 2001. The decision to restate our consolidated financial statements and related disclosures was based on facts obtained by management and the results of an independent investigation into our stock option accounting that was conducted under the direction of a special committee formed by the board of directors, composed solely of independent directors. The special committee was assisted by independent legal counsel and forensic accountants. This special committee was established after our Chief Executive Officer and General Counsel, on their own initiative, commenced a review of our historical stock option practices. In the restatement we recorded additional non-cash, stock-based compensation expense resulting from seven stock option grants during fiscal years 1996 to 2001 that were incorrectly accounted for under generally accepted accounting principles (GAAP). We also recorded additional non-cash, stock-based compensation expense resulting from modifications of certain employees' stock option grant agreements made during 1996 to 2002 in connection with the termination of their employment. Although we did not believe that the effects of the restatement were material to the results of operations for years 2005, 2004, or 2003, we restated prior financial statements because the alternative method of correcting the errors, which is to record the cumulative impact of the error corrections in the quarter ended March 31, 2006, would result in a material charge to that period and such a charge would likely have a material impact on our fiscal year ended December 29, 2006.



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**CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply these judgments and estimates and the financial statements and accompanying notes fairly represent all periods presented. However, any differences between these judgments and estimates and actual results could have a material impact on our statement of income and financial conditions. Critical accounting estimates, as defined by the Securities and Exchange Commission (SEC), are those that are most important to the portrayal of our financial condition and results of operations and require our management's most difficult and subjective judgments and estimates of matters that are inherently uncertain. Our critical accounting estimates include those regarding (1) revenue recognition, (2) valuation of inventories, (3) income taxes, and (4) stock-based compensation. We describe our critical accounting estimate regarding stock-based compensation below. For a discussion of the remaining critical accounting estimates, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Estimates in our Annual Report on Form 10-K/A for the year ended December 30, 2005.

**Stock-Based Compensation**

On December 31, 2005, the first day of our 2006 fiscal year, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for share-based payment awards. We estimate the fair value of employee stock options and employee stock purchase rights under our 1987 Employee Stock Purchase Plan ( ESPP Shares ) on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model requires our estimate of highly subjective assumptions, including the expected term of the award, stock price volatility, dividend rate, risk free interest rate, and a pre-vest forfeiture rate, which greatly affect the fair value of each employee stock option and ESPP Share. Our expected stock price volatility assumption for both stock options and ESPP Shares is estimated using a combination of implied volatility for publicly traded options on our stock with a term of one year and our historical stock price volatility. We monitor the assumptions used to compute the fair value of our stock-based awards and we will revise our assumptions as appropriate. In the event that assumptions used to compute the fair value of our stock-based awards are later determined to be inaccurate or if we change our assumptions significantly in future periods, stock-based compensation expense and our results of operations could be materially impacted. For restricted stock units, compensation expense is calculated based on the fair market value of our stock on the date of grant.

**RESULTS OF OPERATIONS**

**Sales Overview**

We design, manufacture, and market high-performance, high-density programmable logic devices, or PLDs; HardCopy® structured ASIC devices; pre-defined software design building blocks known as intellectual property, or IP, cores; and associated development tools.

We classify our products into three categories: New, Mainstream, and Mature and Other Products as follows:

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New Products include the Stratix® II, Stratix II GX, Cyclone II, MAX II, HardCopy and HardCopy II devices;

Mainstream Products include the Stratix, Stratix GX, Cyclone, MAX 3000A; and

Mature and Other Products include the Classic , MAX 7000, MAX 7000A, MAX 7000B, MAX 7000S, MAX 9000, FLEX 6000, FLEX 8000, FLEX 10K, FLEX 10KA, FLEX 10KE, APEX 20K, APEX 20KC, APEX 20KE, APEX II, ACE 1K, Mercury , Excalibur , configuration and other devices, intellectual property cores, and software and other tools.

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Sales were \$334.1 million during the three months ended June 30, 2006, compared to \$285.5 million for the three months ended July 1, 2005, representing a 17% increase in sales year-over-year. The year-over-year increase in sales was due to growth in sales of our New Products, led by higher sales of our Stratix II, Cyclone II and Max II families, and growth in sales of Mainstream Products, led by higher sales of our Stratix, Stratix GX and Cyclone families. The year-over-year sales increase reflects higher unit sales of all product categories, partially offset by declines in average unit selling prices.

Sales during the six months ended June 30, 2006 were \$626.9 million compared to \$550.3 million during the six months ended July 1, 2005, representing a 14% increase in sales year over year. The year over year sales increase was attributable to higher sales of our new products and mainstream products, partially offset by routine declines in average selling prices. The increase in sales of new products was driven by sales of our Stratix II, Stratix II GX, Cyclone II, MAX II families and mainstream products increased year over year primarily as a result of our Stratix, Cyclone II, and Max 3000 A families. .

Sales increased 14% sequentially to \$334.1 million in the second quarter of 2006 from \$292.8 million in the first quarter of 2006. The increase resulted from higher sales of all product categories.

**Sales by Product Category**

Sales by product category, as a percentage of total sales, as well as year-over-year and sequential growth or decline for the periods indicated, were as follows:

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
New	17%	8%	13%	138%	49%	15%	7%	151%
Mainstream	36%	32%	36%	32%	15%	36%	30%	34%
Mature and Other	47%	60%	51%	-8%	5%	49%	63%	-11%
<b>Total Sales</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>17%</b>	<b>14%</b>	<b>100%</b>	<b>100%</b>	<b>14%</b>

Effective January 2006, our product classification (New, Mainstream and Mature and Other) has changed. All prior period data has been adjusted to conform to the current classification.

**Sales by Market Segment**

The following market segment data is derived from data that is provided to us by our distributors and end customers. With a broad base of customers, who in some cases manufacture end products spanning multiple market segments, the assignment of revenue

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to a market segment requires the use of estimates, judgment, and extrapolation. As such, actual results may differ from those reported.



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Sales by market segment, as a percentage of total sales, as well as year-over-year and sequential growth or decline for the periods indicated, were as follows:

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
Communications	44%	43%	44%	19%	13%	44%	42%	18%
Industrial	34%	31%	33%	27%	16%	34%	31%	24%
Consumer	13%	16%	13%	-2%	19%	13%	17%	-9%
Computer and Storage	9%	10%	10%	8%	9%	9%	10%	3%
<b>Total Sales</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>17%</b>	<b>14%</b>	<b>100%</b>	<b>100%</b>	<b>14%</b>

**Sales of FPGAs and CPLDs**

Our PLDs consist of field-programmable gate arrays, or FPGAs, and complex programmable logic devices, or CPLDs. FPGAs consist of our Stratix, Stratix GX, Stratix II, Stratix II GX, Cyclone, Cyclone II, APEX, APEX II, FLEX, ACEX, Excalibur, and Mercury families, and CPLDs consist of our MAX, MAX II, and Classic families. Our other products consist of HardCopy, HardCopy II and other masked programmed logic devices, configuration devices, software and other tools and IP cores. Our sales of FPGAs and CPLDs, as a percentage of total sales, as well as year-over-year and sequential growth or decline for the periods indicated, were as follows:

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
FPGA	70%	69%	71%	18%	12%	70%	69%	16%
CPLD	21%	20%	19%	25%	27%	20%	21%	13%
Other	9%	11%	10%	-3%	4%	10%	10%	2%
<b>Total Sales</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>17%</b>	<b>14%</b>	<b>100%</b>	<b>100%</b>	<b>14%</b>

**Table of Contents****Sales by Geography**

The following table is based on the geographic location of the original equipment manufacturers or the distributors who purchased our products. The geographic location of distributors may be different from the geographic locations of the ultimate end users. Sales by geography, as a percentage of total sales, as well as year-over-year and sequential growth or decline for the periods indicated, were as follows:

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
North America	25%	24%	26%	26%	12%	26%	24%	22%
Europe	24%	25%	25%	13%	9%	25%	26%	9%
Japan	24%	25%	25%	10%	8%	24%	25%	10%
Asia Pacific	27%	26%	24%	20%	29%	25%	25%	16%
Total International	75%	76%	74%	14%	15%	74%	76%	11%
Total Sales	100%	100%	100%	17%	14%	100%	100%	14%

**Gross Margin**

	Three Months Ended			Six Months Ended	
	June 30, 2006	July 1, 2005	March 31, 2006	June 30, 2006	July 1, 2005
<i>(Dollars in millions)</i>					
Gross Margin Percentage	66.1%	68.3%	66.8%	66.4%	68.3%
<i>Included in Reported Gross Margin Percentage Above:</i>					
Gross Margin Benefit from Sale of Inventory Written Down in 2001	\$ 0.7	\$ 3.4	\$ 0.8	\$ 1.5	\$ 7.0
Percentage of Net Sales	0.2%	1.2%	0.3%	0.2%	1.3%

The decrease in gross margin for the three and six months ended June 30, 2006 compared to same periods a year ago were primarily as a result of a reduction in the benefit due to the sale of inventory previously written down in 2001. The gross margin benefit resulting from the sale of inventory previously written down decreased during the quarter ended June 30, 2006, and is expected to continue to decrease. As of June 30, 2006, the book value of the inventory written down in 2001 was zero while the cost basis was \$2.7 million which was comprised of raw materials and work in process inventory only.

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On December 31, 2005, the first day of our 2006 fiscal year, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which requires us to recognize compensation expense for all stock-based compensation. Compensation expense recognized during the three and six months ended June 30, 2006 had an immaterial impact on our gross margin.

### Research and Development

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
<i>(Dollars in millions)</i>								
Research and development	\$ 63.9	\$ 55.3	\$ 62.9	16%	2%	\$ 126.8	\$ 106.7	19%
Percentage of Net Sales	19%	19%	21%			20%	19%	

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Research and development expenses include expenditures for labor and benefits, stock-based compensation expense, masks, prototype wafers, depreciation, and the impact on compensation costs of the net investment gain or loss on our Nonqualified Deferred Compensation Plan. These expenditures were for the design of new PLD families, and the development of process technologies, new packages and design tools, and IP cores.

Research and development expenses increased 16% for the three months ended June 30, 2006 and increased 19% for the six months ended June 30, 2006 compared to the same periods a year ago primarily due to increased stock-based compensation expense resulting from our adoption of SFAS 123(R) during the three and six months ended June 30, 2006. The stock-based compensation expense classified as research and development expense was \$8.0 million for three month periods ended June 30, 2006 and March 31, 2006, compared to zero for the three months ended July 1, 2005 and April 1, 2005, respectively. Research and development expenses also increased year-over-year due to higher labor costs, partially offset by lower spending on masks and prototype wafers.

We will continue to make significant investments in the development of new products and focus our efforts on the development of new programmable logic devices that use advanced semiconductor wafer fabrication processes, as well as related development software. We are currently investing in the development of our Stratix II, Stratix II GX, MAX II, Cyclone II, and HardCopy II devices, our Nios® II soft core embedded processor, our Quartus® II software, our library of IP cores, and other future products.

**Table of Contents****Selling, General, and Administrative**

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
<i>(Dollars in millions)</i>								
Selling, General, and Administrative	\$ 76.7	\$ 55.9	\$ 76.2	37%	1%	\$ 153.0	\$ 110.2	39%
Percentage of Net Sales	23%	20%	26%			24%	20%	

Selling, general, and administrative expenses primarily include labor and benefit expenses related to sales, marketing, and administrative personnel, stock-based compensation expense, commissions and incentives, depreciation, legal, advertising, facilities, and travel expenses.

Selling, general, and administrative expenses increased 37% for the three months ended June 30, 2006 and increased 39% for the six months ended June 30, 2006 compared to the same periods a year ago. The increases were primarily due to an increase in stock-based compensation expense resulting from our adoption of SFAS 123(R) during the three and six months ended June 30, 2006. The stock-based compensation expense classified as selling, general, and administrative expense was \$10.2 million and \$10.5 million respectively for the three months ended June 30, 2006 and March 31, 2006, compared to \$0.07 million and \$0.07 million respectively for the three months ended July 1, 2005 and April 1, 2005. The year-over-year increase also resulted from higher labor and benefit costs as we added sales and marketing personnel to drive our revenue growth, increased consulting expenses relating to the implementation of a new enterprise resource planning system, and increased support costs associated with the stock option investigation.

**Interest and Other Income, Net**

	Three Months Ended			Year-Over-Year Change	Sequential Change	Six Months Ended		Year-Over-Year Change
	June 30, 2006	July 1, 2005	March 31, 2006			June 30, 2006	July 1, 2005	
<i>(Dollars in millions)</i>								
Interest and Other Income, Net	\$ 10.8	\$ 8.1	\$ 12.4	33%	-13%	\$ 23.2	\$ 12.6	84%
Percentage of Net Sales	3%	3%	4%			4%	2%	

Interest and other income, net consists mainly of interest income generated from investments in high-quality fixed income securities, as well as the mark-to-market impact of our Nonqualified Deferred Compensation Plan ( NQDC Plan ). The year-over-year increases in interest and other income, net for the three and six months ended June 30, 2006 were driven primarily by increases in interest income as a result of higher investment yields.

During the three months ended June 30, 2006, the NQDC Plan experienced a net investment loss of \$1.0 million. This loss resulted in a \$1.0 million unfavorable impact to other income and a favorable impact to operating expenses, decreasing selling, general and administrative expenses by \$0.6 million and decreasing research and development expenses by \$0.4 million. During the six months

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ended June 30, 2006, the Plan experienced a net investment gain \$1.3 million. This gain resulted in a \$1.3 million favorable impact to other income and an unfavorable impact to operating expenses, increasing compensation expense by \$1.3 million. There was no impact to income before income taxes, net income or cash balances. See Note 10 Nonqualified Deferred Compensation Plan in the accompanying notes to condensed consolidated financial statements for background information regarding the Plan.

### **Provision for Income Taxes**

Our effective tax rate for the three and six months ended June 30, 2006 was 15%, compared with 26% and 23% for the three months and six months ended July 1, 2005. The decrease in our effective tax rate was

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primarily due to the impact associated with expensing predominantly U.S. related stock-based compensation in accordance with SFAS 123(R), a favorable change in the geographical mix of income, and an increase in tax-exempt income. This decrease was partially offset due to the expiration of the Research and Development Tax Credit. Our effective tax rate reflects the impact of significant amounts of our earnings being taxed in foreign jurisdictions at rates below the U.S. statutory rate.

Our adoption of SFAS 123(R) in the quarter ended June 30, 2006 has had a favorable impact on our 2006 effective tax rate of approximately two percentage points. SFAS 123(R) may have a favorable or unfavorable impact on our effective tax rate in the future.

**Stock-Based Compensation**

On December 31, 2005, the first day of our 2006 fiscal year, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which requires the measurement and recognition of compensation expense for share-based payment awards. We have elected to adopt SFAS 123(R) using the modified prospective recognition method. The modified prospective recognition method requires us to recognize compensation cost for new and unvested stock options, restricted stock, restricted stock units, and employee stock purchase plan shares ( ESPP Shares ). Under the modified prospective recognition method, prior period financial statements are not restated.

Prior to the adoption of SFAS 123(R) on December 31, 2005, we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, or APB No. 25, Accounting for Stock Issued to Employees. Under APB No. 25, compensation cost was measured as the excess, if any, of the quoted market price of our stock at the date of grant over the exercise price of the stock option granted. Under APB No. 25, compensation cost for stock options, if any, was recognized over the vesting period using the straight-line single option method.

During the three months ended June 30, 2006, we recorded total stock-based compensation of \$18.7 million, compared with \$0.1 million for the three months ended July 1, 2005. During the six months ended June 30, 2006, the stock-based compensation was \$37.6 million, compared with \$0.1 million for the six months ended July 1, 2005.

At June 30, 2006, unamortized compensation expense related to outstanding unvested stock options, restricted stock units and ESPP shares that are expected to vest was approximately \$90 million. This unamortized compensation expense is expected to be recognized over a weighted average period of 2 1/2 years. In addition to the expense for outstanding unvested stock options, restricted stock units and ESPP shares, we will incur significant additional expense during fiscal 2006 related to new awards granted during 2006.

**Financial Condition, Liquidity, and Capital Resources**

<i>(in thousands)</i>	June 30,	Dec. 30,
	2006	2005

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Cash and cash equivalents	\$ 713,571	\$ 787,707
Short-term investments	543,238	378,881
Long-term investments	203,841	115,965
<b>Total cash, cash equivalents, and investments</b>	<b>\$ 1,460,650</b>	<b>\$ 1,282,553</b>

	Six Months Ended	
	June 30	July 1,
	2006	2005
<i>(in thousands)</i>		
Net cash provided by operating activities	\$ 195,325	\$ 126,031
Net cash (used for) provided by investing activities	(269,834)	87,080
Net cash used for financing activities	373	(43,697)
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>\$ (74,136)</b>	<b>\$ 169,414</b>



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### **Liquidity**

We derive our liquidity and capital resources primarily from our cash flows from operations. We continue to generate positive operating cash flows and remain debt-free. We currently use cash generated from operations for capital expenditures, investments and repurchases of our common stock. Based on past performance and current expectations, we believe our current available sources of funds including cash, cash equivalents, and investments, plus the anticipated cash generated from operations, will be adequate to finance our operations and capital expenditures for at least the next year.

During the six months ended June 30, 2006, we spent \$53.1 million to repurchase shares of our common stock, compared to \$81.4 million for the six months ended July 1, 2005. The decrease was due to suspension of our stock repurchase program in May 2006. We also spent \$16.2 million on capital expenditures during the six ended June 30, 2006, compared to \$10.8 million in the six months ended July 1, 2005. We expect that capital expenditures will increase in 2006 as we launch a program to replace our enterprise resource planning ( ERP ) system. Total planned expenditures for the ERP system are estimated to be approximately \$35 million and we expect to install and have the system operational in 2007. When our stock repurchase program is resumed, we also plan to use a portion of our available capital to repurchase shares of our common stock. As of September 29, 2006, we have incurred direct costs of approximately \$9 million associated with the special committee s investigation and additional related professional services and consulting fees associated with the restatement effort and litigation. We expect to incur up to several million dollars of additional expense in the fourth quarter of 2006 associated with the conclusion of the investigation, litigation defense, and financial restatement.

### **Cash Flows**

Our positive cash flows from operating activities for the six months ended June 30, 2006 was primarily attributable to net income of \$136.0 million, adjusted for non-cash items including stock-based compensation expense of \$37.6 million and depreciation and amortization of \$15.3 million, and cash inflows of \$7.1 million from changes in our working capital excluding cash. Non-cash working capital, changes included \$109.5 million increase in deferred income and allowances on sales to distributors as a result of increased shipments into the channel, \$53.7 million increase in accounts payables and accrued liabilities offset by \$120.1 million increase in accounts receivable, \$22.2 million increase in inventory and other assets and \$13.8 million decrease in income taxes payable.

Cash used for investing activities for the six months ended June 30, 2006 primarily consist of purchases of available-for-sale investments of \$513.4 million, partially offset by proceeds from the maturities and sales of investments of \$259.8 million.

Cash used for financing activities for the six months ended June 30, 2006 primarily consisted of repurchases of our common stock of \$53.1 million, partially offset by proceeds of \$45.9 million from the issuance of common stock to employees through our stock option and employee stock purchase plans.

### **Purchase Commitments and Contractual Obligations**

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We depend entirely upon subcontractors to manufacture our silicon wafers and provide assembly and test services. Due to lengthy subcontractor lead times, we must order these materials and services from these subcontractors well in advance, and we are obligated to pay for the materials and services once they are completed. As of June 30, 2006, we had \$132 million of outstanding purchase commitments to such subcontractors. We expect to receive and pay for these materials and services within the next four to six months. The impact of any adverse purchase commitments was immaterial as of June 30, 2006.

We also lease facilities under non-cancelable lease agreements expiring at various times through 2011. There have been no significant changes to our operating lease obligations since our 2005 fiscal year end. Capital lease obligations recorded totaled \$9.1 million as of June 30, 2006. Amortization expense for the three months ended June 30, 2006 related to assets recorded as capital leases was \$0.9 million and for the six months ended June 30, 2006 was \$2.0 million. We also enter into various non-cancelable contracts to acquire goods and services, as well as corporate guarantees and commitments, in the normal course of business.

**Table of Contents****Impact of Currency Translation and Inflation**

Although we purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars, we do have international operations and are, therefore, subject to foreign currency rate exposure. For non-U.S. subsidiaries and branches that have assets and liabilities in local currencies, the impact of the remeasurement of these local currencies into U.S. dollars for the three months ended June 30, 2006 and July 1, 2005 was immaterial. As of June 30, 2006, we had no open forward contracts; however, we may enter into contracts from time to time to hedge foreign exchange exposure. We have, in the past, entered into forward contracts to hedge against currency fluctuations associated with contractual commitments denominated in foreign currencies.

**Common Stock Repurchases**

Since the inception of our share repurchase program on July 15, 1996 until the temporary suspension of our share repurchase program in May 2006, we have repurchased a total of 89.3 million shares of our common stock for an aggregate cost of \$1.9 billion. All shares were retired upon acquisition. At June 30, 2006, 18.7 million shares remained authorized for repurchase under our stock repurchase program.

Share repurchase activities for the three and six months ended June 30, 2006 and July 1, 2005 were as follows:

	Three Months Ended		Six Months Ended	
	June 30 2006	July 1, 2005	June 30 2006	July 1, 2005
Shares repurchased	448	1,873	2,666	4,128
Cost of shares repurchased	\$ 9,403	\$ 37,990	\$ 53,068	\$ 81,386
Average price per share	\$ 20.99	\$ 20.28	\$ 19.90	\$ 19.72

As a result of our failure to timely file our Form 10-Q for the quarter ended March 31, 2006, effective May 11, 2006 we temporarily suspended our stock repurchase program.

**Off-Balance Sheet Arrangements**

We do not have any financial partnerships with unconsolidated entities, such as entities often referred to as structured finance or special purpose entities.

**Recent Accounting Pronouncements**

In July 2006, the FASB issued FASB Interpretation ( FIN ) No. 48 Accounting for Uncertainty in Income Taxes an interpretation of SFAS 109. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48 these will be accounted for as an adjustment to retained earnings. We are currently assessing the impact of FIN 48 on our consolidated financial position and results of operations.

On September 13, 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. ( SAB 108 ) which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The guidance is applicable for our fiscal 2007. We are not yet in a position to determine what, if any, effects SAB No. 108 will have on our consolidated financial statements.

**ITEM 3: Quantitative and Qualitative Disclosures About Market Risk**

Our investment portfolio consisted of fixed income securities of various durations depending on the nature of the investments totaling \$1.4 billion as of June 30, 2006. These securities are subject to interest

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rate risk and will vary in value as market interest rates fluctuate. If market interest rates were to increase or decline immediately and uniformly by 10% from the levels as of June 30, 2006, the increase or decline in the fair value of the portfolio would not be material.

Although we purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars, we do have international operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has been insignificant. If foreign currency rates were to fluctuate by 10% from rates at June 30, 2006, our financial position, results of operations and cash flows would not be materially affected. However, we cannot assure you that there will not be a material impact in the future.

### **ITEM 4: Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures.**

Under the supervision and with the participation of our management, including our Chief Executive Officer and acting Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as amended, as of the end of the period covered by this Quarterly Report on Form 10-Q (the Evaluation Date ).

The purpose of this evaluation is to determine if, as of the Evaluation Date, our disclosure controls and procedures were designed and operating effectively to provide reasonable assurance that the information relating to Altera, required to be disclosed in our Exchange Act filings (i) was recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) was accumulated and communicated to our management, including our Chief Executive Officer and acting Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As more fully described in our 2005 Form 10-K/A, during fiscal 2005, the Company did not maintain effective internal control over financial reporting regarding the accounting and reporting of modifications to certain employees' stock option grant agreements primarily in connection with the termination of their employment. Consequently, management concluded that as of December 30, 2005, we had a material weakness in our internal control over financial reporting.

Because of the material weakness in our internal control over financial reporting related to modifications of stock option agreements, our Chief Executive Officer and acting Chief Financial Officer have concluded that we did not maintain effective disclosure controls and procedures as of the Evaluation Date. Our management undertook and completed additional reviews and procedures to confirm that this Quarterly Report is prepared in accordance U.S. Generally Accepted Accounting Principals ( GAAP ) and fairly present, in all material respects, our financial position, results of operations and cash flows for each of the periods presented herein.

As of the date of this filing, in response to the identification of the material weakness described above, management has initiated the following corrective actions:

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We are in the process of searching for a new Chief Financial Officer with substantial accounting and financial expertise and intend to add additional experienced management level personnel in the finance, accounting, and human resource functions.

Additional training for our finance, human resource, stock administration, and legal personnel covering the equity grant process and the accounting and financial reporting for equity awards and modifications of such awards.

Better coordination and communication among the finance, human resource, and legal functions to identify in advance accounting issues relating to proposed actions and to make sure that transactions are properly accounted for under generally accepted accounting principles.

Review by our CEO, acting CFO, and General Counsel as well as our finance and human resources personnel of non-standard agreements relating to termination of employment.

Validation of critical stock administration data fields including employee termination dates and stock option cancellation dates.

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Additionally, management is investing in ongoing efforts to continuously improve the Company's internal control over financial reporting and has committed considerable resources to the improvement of the design, implementation, documentation, testing and monitoring of our internal controls. As of the date of this filing, we believe that we have made substantial progress in the implementation of the corrective actions, noted above, toward remediation of the material weakness.

We believe that these corrective actions, taken as a whole, when fully implemented, will mitigate the control deficiencies identified above. However, we will continue to monitor the effectiveness of these actions and will make any changes that management deems appropriate. As of the Evaluation Date, the design and testing of the effectiveness of our remediation efforts has not been completed.

## **Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f) under the Exchange Act) that occurred during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **Limitation on Effectiveness of Controls**

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. The design of any control system is based, in part, upon the benefits of the control system relative to its costs. Control systems can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. In addition, over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies and procedures may deteriorate. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

## **PART II OTHER INFORMATION**

### **ITEM 1: Legal Proceedings**

In May and July 2006, we were notified that three shareholder derivative lawsuits had been filed in the Superior Court of the State of California, County of Santa Clara, by persons identifying themselves as Altera shareholders and purporting to act on behalf of Altera, naming Altera Corporation as a nominal defendant and naming some of our current and former officers and directors as defendants. On July 12, 2006, one of these derivative actions was voluntarily dismissed by the plaintiff shareholder. The remaining two derivative lawsuits pending in Santa Clara Superior Court were consolidated into a single action on September 5, 2006. The consolidated action names as defendant Altera Corporation (nominal defendant) and the following current and former Altera officers and directors: John P. Daane, Nathan M. Sarkisian, Denis M. Berlan, Scott Wylie, Robert W. Reed, Robert J. Finocchio, Jr., Kevin McGarity, Paul Newhagen, William E. Terry, Susan Wang, Charles M. Clough, Rodney Smith, Erik Cleage, Michael B. Jacobs and Katherine E. Schuelke.

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In the consolidated action, the plaintiffs assert claims against these individual defendants for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, violations of California Corporation Code sections 25402 and 25403, breach of fiduciary duty for insider selling and misappropriation of information, rescission, constructive trust, and an accounting. Plaintiffs' claims concern the granting of stock options by Altera between 1996 and December 2000 and the alleged filing of false and misleading financial statements between 1996 and 2006. All of these claims are asserted derivatively on behalf of Altera. Plaintiffs seek, among other relief, an indeterminate amount of damages from the individual defendants and a judgment directing Altera to reform its corporate governance.

During the months of May, June, and July 2006, four other derivative lawsuits were filed by purported Altera shareholders, on behalf of Altera, in the United States District Court for the Northern District of California. On August 8, 2006, these actions were consolidated. The plaintiffs have not yet filed a consolidated complaint. The initial complaints filed by the four shareholders included claims for violations of Sections 10(b), 14(a), 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934, unjust enrichment, breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, breach of contract, an accounting, constructive fraud, rescission, and violations of California



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Corporations Code section 25402. Plaintiffs' claims concern the granting of stock options by Altera between 1995 and December 2000 and the alleged filing of false and misleading financial statements between 1996 and 2005. Among the defendants named in these derivative actions are Altera Corporation as a nominal defendant and the following current and former officers and directors of Altera: John P. Daane, Robert W. Reed, Denis M. Berlan, Nathan M. Sarkisian, Katherine E. Schuelke, Robert J. Finocchio, Jr., Kevin McGarity, Paul Newhagen, William E. Terry, Susan Wang, Rodney Smith, Erik Cleage, and Michael Jacobs.

**ITEM 1A: Risk Factors**

There have been no material changes from the risk factors previously described under Item 1A of our Annual Report on Form 10-K/A for the year ended December 30, 2005. For additional information regarding risk factors, please refer to the description of the risk factors associated with our business previously disclosed in Item 1A of our Annual Report on Form 10-K/A for the year ended December 30, 2005 incorporated herein by reference.

*Before you decide to buy, hold, or sell our common stock, you should carefully consider the risks described in Item 1A of our Annual Report on Form 10K/A for the year ended December 30, 2005 and the other information contained elsewhere in this report. These risks are not the only risks facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. Our business, financial condition, and results of operation could be seriously harmed if any of the events underlying any of these risks or uncertainties actually occurs. In that event, the market price for our common stock could decline, and you may lose all or part of your investment.*

**Table of Contents****ITEM 2: Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

During the second quarter of 2006, we repurchased shares of our common stock as follows:

Period	Total		Publicly Announced Plans or Programs	Additional Shares Authorized for Repurchase	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
	Number of Shares Purchased as Part of	Number of Shares			
	Number of Shares Purchased <sup>(1)</sup>	Average Price Paid Per Share			
<i>(in thousands except footnotes and price per share amounts)</i>					
4/1/06 - 4/28/06	338	\$ 20.71	338		18,801
4/29/06 - 5/26/06	110	21.84	110		18,691
5/27/06 - 6/30/06					18,691
	<u>448</u>		<u>448</u>		

(1) No shares were purchased outside of publicly announced plans or programs.

We repurchase shares under the program announced on July 15, 1996 that has no specified expiration. As of June 30, 2006, the Board of Directors has authorized, since the inception of the program, a total of 108 million shares for repurchase. No existing repurchase plans or programs expired, nor have we decided to terminate any repurchase plans or programs prior to expiration. There are no existing plans or programs under which we do not intend to make further purchases. As a result of our failure to timely file our 10-Q for the quarter ended March 31, 2006, effective May 11, 2006 we temporarily suspended our stock repurchase program.

**Table of Contents****ITEM 4: Submission of Matters to a Vote of Security Holders**

We held our Annual Meeting of Stockholders on May 9, 2006 at 4:00 p.m. The following matters were acted upon at the meeting:

1. Election of Directors to serve until the next annual meeting of stockholders or until their successors are elected.

NOMINEES	FOR AUTHORITY		BROKER	NON-
	VOTES	WITHHELD		
John P. Daane	317,901,784	6,358,528		
Robert W. Reed	318,036,648	6,223,664		
Robert J. Finocchio, Jr.	319,853,945	4,406,367		
Kevin McGarity	318,730,265	5,530,047		
Paul Newhagen	318,057,165	6,203,147		
William E. Terry	316,039,108	8,221,204		
Susan Wang	319,915,572	4,344,740		
	FOR	VOTES	ABSTENTIONS	NON-
	VOTES	AGAINST		VOTES
2. Approval of an amendment to the 2005 Equity Incentive Plan to increase by 10,000,000 the number of shares of common stock reserved for issuance under the plan.	204,684,314	79,966,533	1,792,690	37,816,775
3. Approval of an amendment to the 1987 Employee Stock Purchase Plan to increase by 1,000,000 the number of shares of common stock reserved for issuance under the plan.	256,558,402	28,103,508	1,781,627	37,816,775
4. Ratification of the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending December 29, 2006.	319,456,632	2,950,603	1,853,077	

**ITEM 5: Other Information****2005 Equity Incentive Plan and 1987 Employee Stock Purchase Plan**

At our 2006 Annual Meeting of Stockholders, held on May 9, 2006 (the Annual Meeting), our stockholders approved an amendment to our 2005 Equity Incentive Plan to increase by 10 million the number of shares reserved for issuance to a total of 25,991,502. In addition, at our Annual Meeting, our stockholders approved an amendment to our 1987 Employee Stock Purchase Plan to increase the number of shares reserved for issuance by 1 million thereby increasing the total number of shares issuable under the plan from 19,700,000 to 20,700,000.

The foregoing summary of 2005 Equity Incentive Plan and 1987 Employee Stock Purchase Plan is not intended to be complete, and is qualified in its entirety by reference to the amended 2005 Equity Incentive Plan and 1987 Employee Stock Purchase Plan, which are filed as Exhibits 10.1 and 10.2, respectively, to this Report.



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**ITEM 6: Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
3.2	By-laws of the Registrant, as currently in effect. <sup>(1)</sup>
#10.1+	2005 Equity Incentive Plan, as amended May 9, 2006.
#10.2+	1987 Employee Stock Purchase Plan, as amended May 9, 2006.
#31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
#31.2	Certification of acting Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
#32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
#32.2	Certification of acting Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to the Registrant's report on Form 8-K filed on March 16, 2006.

# Filed herewith.

+ Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Report on Form 10-Q pursuant to Item 6 thereof.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ALTERA CORPORATION

/s/ James Callas

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James Callas, Vice President  
(duly authorized officer) and acting Chief Financial  
Officer (principal financial and accounting officer)

Date: October 23, 2006

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EXHIBIT INDEX

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