LSI LOGIC CORP
Form 10-Q
August 13, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 29, 2003

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: 0-11674

LSI LOGIC CORPORATION

(Exact name of registrant as specified in its charter)

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

1621 Barber Lane
Milpitas, California 95035
(Address of principal executive offices)
(Zip code)

(408) 433-8000
(Registrant s telephone number, including area code)

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

YES [X] NO [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) YES [X] NO [ ]

As of August 8, 2003, there were 378,750,957 shares of the registrant s Common Stock, $.01 par value, outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

LSI LOGIC CORPORATION
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2003	December 31, 2002
	(In thousands, except per-share amounts)	
Assets		
Cash and cash equivalents	$ 636,164	$ 448,847
Short-term investments	478,615	541,129
Accounts receivable, less allowances of $6,329 and $7,033	241,056	248,621
Inventories	205,365	194,466
Deferred tax assets	11,405	11,380
Prepaid expenses and other current assets	188,138	181,610
Total current assets	1,760,743	1,626,053
Property and equipment, net	497,396	746,964
Goodwill	968,583	968,464
Amortized Intangible assets, net	219,115	282,579
Deferred tax assets	137,283	137,152
Other assets	457,388	381,525
Total assets	$4,040,508	$4,142,737
Liabilities and Stockholders Equity		
Accounts payable	$ 112,232	$ 100,856
Accrued salaries, wages and benefits	61,841	71,499
Other accrued liabilities	201,090	184,837
Income tax payable	44,976	30,066
Deferred tax liabilities	10,192	10,192
Current portion of long-term obligations	173,676	361
Total current liabilities	604,007	397,811
Deferred tax liabilities	123,575	123,365
Long-term debt and capital lease obligations	1,133,177	1,241,217
Other non-current liabilities	139,475	73,483
Total long-term obligations and deferred tax liabilities	1,396,227	1,438,065
Commitments and contingencies (Note 12)		
Minority interest in subsidiary	6,799	6,506
Stockholders equity:		
Preferred shares; $.01 par value; 2,000 shares authorized, none outstanding		
Common stock; $.01 par value; 1,300,000 shares authorized; 378,507 and 375,096 shares outstanding	3,785	3,751

Additional paid-in capital	2,941,853	2,954,282
Deferred stock compensation	(31,734)	(51,161)
Accumulated deficit	(896,752)	(612,243)
Accumulated other comprehensive income	16,323	5,726
Total stockholders equity	2,033,475	2,300,355
Total liabilities and stockholders equity	$4,040,508	$4,142,737

See notes to unaudited consolidated financial statements.

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LSI LOGIC CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
	(In thousands, except per share amounts)			
Revenues	$ 407,213	$437,768	$ 779,998	$ 850,277
Costs and expenses:				
Cost of revenues	238,469	274,404	486,537	581,067
Research and development	111,326	112,833	226,453	227,176
Selling, general and administrative	56,870	57,366	114,499	115,546
Restructuring of operations and other items, net	124,527	(6,405)	160,193	58,655
Amortization of non-cash deferred stock compensation (*)	8,884	23,849	19,427	50,770
Amortization of intangibles	19,267	19,147	39,392	38,304
Total costs and expenses	559,343	481,194	1,046,501	1,071,518
Loss from operations	(152,130)	(43,426)	(266,503)	(221,241)
Interest expense	(7,314)	(15,486)	(16,145)	(31,320)
Interest income and other, net	3,360	2,621	10,139	6,267
Loss before income taxes	(156,084)	(56,291)	(272,509)	(246,294)
Provision/ (benefit) for income taxes	6,000	6,000	12,000	(12,250)
Net loss	$(162,084)	$ (62,291)	$ (284,509)	$ (234,044)
Loss per share:				
Basic	$ (0.43)	$ (0.17)	$ (0.76)	$ (0.63)
Dilutive	$ (0.43)	$ (0.17)	$ (0.76)	$ (0.63)
Shares used in computing per share amounts:				
Basic	376,619	369,672	375,745	368,769
Dilutive	376,619	369,672	375,745	368,769

(*) Amortization of non-cash deferred stock compensation recorded in connection with acquisitions, if not shown separately, would have been included in cost of revenues, research and development and selling, general and administrative expenses as shown below:

	Three months ended June 30, 2003	Three months ended June 30, 2002	Six months ended June 30, 2003	Six months ended June 30, 2002
	(In thousands)			
Cost of revenues	$ 88	$ 444	$ 270	$ 994
Research and development	7,391	18,580	15,541	38,899

Selling, general and administrative	1,405	4,825	3,616	10,877

See notes to unaudited consolidated financial statements.

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LSI LOGIC CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended June 30,	
	2003	2002
	(In thousands)	
Operating activities:		
Net loss	$ (284,509)	$ (234,044)
Adjustments:		
Depreciation and amortization	152,111	175,928
Amortization of non-cash deferred stock compensation	19,427	50,770
Non-cash restructuring and other items, net	127,323	49,598
Loss on write-down of equity securities	9,074	
Loss on repurchase of Convertible Subordinated Notes	2,029	
Gain on sale of property and equipment	(2,560)	
Changes in deferred tax assets and liabilities	37	(3,171)
Changes in assets and liabilities:		
Accounts receivable, net	8,500	(49,577)
Inventories, net	(10,040)	61,115
Prepaid expenses and other assets	52,440	(9,308)
Accounts payable	12,028	(41,398)
Accrued and other liabilities	18,205	(9,847)
Net cash provided by / (used in) operating activities	104,065	(9,934)
Investing activities:		
Purchase of debt securities available-for-sale	(1,409,529)	(937,742)
Maturities and sales of debt securities available-for-sale	1,455,927	627,823
Purchases of equity securities		(9,894)
Purchases of property and equipment, net	(19,663)	(12,148)
Proceeds from the sale-lease back of equipment	160,000	
(Increase)/decrease in non-current assets and deposits	(145,768)	236
Net cash provided by / (used in) investing activities	40,967	(331,725)
Financing activities:		
Proceeds from borrowings	350,000	
Repurchase of Convertible Subordinated Notes	(288,587)	
Cash paid for call spread options	(28,000)	
Debt issuance costs	(10,566)	
Repayment of debt obligations	(174)	(191)
Issuance of common stock, net	15,890	26,589
Net cash provided by financing activities	38,563	26,398
Effect of exchange rate changes on cash and cash equivalents	3,722	4,065
Increase / (decrease) in cash and cash equivalents	187,317	(311,196)
Cash and cash equivalents at beginning of period	448,847	757,138

Cash and cash equivalents at end of period	$ 636,164	$ 445,942

See notes to unaudited consolidated financial statements.

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LSI LOGIC CORPORATION
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

In the opinion of LSI Logic Corporation (the Company or LSI), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments, additional excess inventory and other related charges and restructuring and other items, net as discussed in Note 3 to the Unaudited Consolidated Financial Statements, hereafter referred to as the Notes), necessary to present fairly the financial information included herein. While the Company believes that the disclosures are adequate to make the information not misleading, it is suggested that these financial statements be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2002.

For financial reporting purposes, the Company reports on a 13 or 14-week quarter with a year ending December 31. The current quarter ended June 29, 2003. For presentation purposes, the consolidated financial statements refer to the quarter s calendar month end for convenience. The results of operations for the quarter ended June 30, 2003, are not necessarily indicative of the results to be expected for the full year.

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

Certain items previously reported in specific financial statement captions have been reclassified to conform to the current period presentation.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. On March 28, 2003, the Company entered into new operating leases to refinance the old leases. See Note 12 of the Notes. The Company refinanced these leases in a manner that best met our capital financing strategy and cost of capital objectives and the new leases are not subject to the consolidation provisions of FIN 46. The Company believes that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company believes that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

In April 2003, the FASB issued Statement No. 149 (SFAS No. 149), Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this statement clarifies the circumstances under which a contract with an initial net investment meets the characteristics of a derivative, clarifies when a derivative contains a financing component, amends the definition of an underlying to conform it to the language used in FIN 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and amends certain other existing pronouncements. The provisions of SFAS No. 149, which were not already applied under an Implementation Issue, are effective for contracts entered into or modified after June 30, 2003. The Company believes that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

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In May 2003, the FASB issued Statement No. 150 (SFAS No. 150), Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for classification and measurement of certain financial instruments with characteristics of both liabilities and equity. It requires financial instruments within its scope be classified as a liability (or an asset in some circumstances). Many of those financial instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. For financial instruments created before and still existing as of the issuance of this statement, a cumulative effect of change in accounting principle shall be reported upon implementation in the first interim period beginning after June 15, 2003. The Company believes that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

NOTE 2 STOCK-BASED COMPENSATION

The Company adopted the disclosure requirement of Statement of Financial Accounting Standards No. 148 (SFAS No. 148) as of December 31, 2002. These disclosure requirements include more prominent presentation, in a tabular format, of the pro forma effect of using the fair value method of accounting for stock-based employee compensation in interim and annual financial statements. The following table provides pro forma disclosures as if the Company had recorded compensation costs based on the estimated grant date fair value, as defined by SFAS No. 123, for awards granted under its stock option and stock purchase plans. The estimated weighted average grant date fair value, as defined by SFAS No. 123, was calculated using the Black-Scholes model. The Black-Scholes model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company s stock option awards. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated grant date fair value.

	Three months ended June 30,		Six months ended June 30,	
	2003	2002	2003	2002
	(In thousands, except per share amounts)			
Net loss, as reported	$ (162,084)	$ (62,291)	$ (284,509)	$ (234,044)
Add: Amortization of non-cash deferred stock compensation expense determined under the intrinsic value method as reported in net loss, net of related tax effects *	2,228	7,904	6,129	18,742
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(50,338)	(58,930)	(103,005)	(119,598)
Pro forma net loss	$ (210,194)	$ (113,317)	$ (381,385)	$ (334,900)
Loss per share:				
Basic-as reported	$ (0.43)	$ (0.17)	$ (0.76)	$ (0.63)
Basic-pro forma	$ (0.56)	$ (0.31)	$ (1.02)	$ (0.91)

* This amount excludes amortization of non-cash deferred stock compensation on restricted stock awards.

For the three and six months ended June 30, 2003, common stock equivalents of approximately 85.7 million and 73.0 million shares, respectively, were excluded from the computation of pro forma diluted loss per share as a result of their antidilutive effect. For the three and six months ended June 30, 2002, common stock equivalents of approximately 93.7 million and 97.3 million shares, respectively, were excluded from the computation of pro forma diluted loss per share as a result of their antidilutive effect.

NOTE 3 RESTRUCTURING AND OTHER ITEMS

The Company recorded a charge of $125 million and $160 million in restructuring of operations and other items for the three and six months ended June 30, 2003, respectively. The Company recorded a gain of $6 million and a charge of $59 million in restructuring of operations and other items for the three and six months ended June 30, 2002, respectively. For a complete discussion of the 2002 restructuring actions, please refer to the Company s Annual Report on Form 10-K.

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Restructuring and impairment of long-lived assets:

On January 1, 2003, the Company adopted SFAS No. 146, Accounting for Exit or Disposal Activities. SFAS No. 146 has been applied to restructuring activities initiated after December 31, 2002 and changes the timing of when restructuring charges are recorded to the date when the liabilities are incurred. The adoption of SFAS No. 146 did not affect restructuring reserves recorded prior to December 31, 2002.

In February 2003, the Company downsized operations and recorded $36 million in charges for restructuring of operations and other items. Of this charge, $21 million was associated with the Semiconductor segment and $15 million was attributable to the Storage Systems segment. The charges consisted of severance and termination benefits for approximately 210 terminated employees primarily involved in manufacturing operations, research and development and marketing and sales; costs associated with exiting certain operating leases primarily for real estate; and a write-down of certain acquired intangibles and other long-lived assets. During the six months ended June 30, 2003, payments related to the February 2003 restructuring actions have consisted of approximately $4 million for severance and termination benefits and $0.4 million for lease and contract terminations.

In April 2003, the Company announced a restructuring of our operations that includes a reduction in workforce and the consolidation of certain non-manufacturing facilities. A charge of $33 million was recorded in the Semiconductor segment consisting of severance and termination benefits for approximately 325 terminated employees involved in manufacturing operations, research and development, marketing, sales and administration; costs associated with exiting certain operating leases primarily for real estate; other exit costs; and a write-down of fixed assets due to impairment. During the six months ended June 30, 2003, payments related to the April 2003 restructuring actions have consisted of approximately $7 million for severance and termination benefits and $0.2 million for lease and contract terminations.

In June 2003, the Company announced the decision to sell the Tsukuba, Japan manufacturing facility. As a result, a charge of $73 million was recorded in the Semiconductor segment to write down fixed assets to their fair market value, which has been reclassified from property, plant and equipment to other current assets to reflect the intention to dispose of the facility within the next twelve months. In addition, approximately $2 million in restructuring charges were recorded for severance and other exit costs. During the six months ended June 30, 2003, there have been no payments related to the amounts accrued for severance and other exit costs under the June 2003 restructuring actions.

In June 2003, the Company also recorded $19 million of additional fixed asset write-downs to reflect the decrease in fair market value of the assets during the period. This write-down included a reduction in the value of the Colorado Springs fabrication facility of $16 million to reflect continued and accelerated efforts to sell the facility.

The fair value of assets determined to be impaired was the result of the use of management estimates and independent appraisals. Given that current market conditions for the sale of older fabrication facilities and related equipment may fluctuate, there can be no assurance that the Company will realize the current net carrying value for the assets. The Company reassesses the realizability of the carrying value of these assets at the end of each quarter until the assets are sold or otherwise disposed of and additional adjustments may be necessary. Assets held for sale of $60 million and $74 million were included as a component of prepaid expenses and other current assets as of June 30, 2003 and December 31, 2002, respectively. Assets classified as held for sale are not depreciated.

The following table sets forth the Company s restructuring reserves as of June 30, 2003, which are included in other accrued liabilities on the balance sheet:

	Balance at December 31, 2002	Restructuring Expense Q1 2003	Utilized during Q1 2003	Balance at March 31, 2003	Restructuring Expense Q2 2003	Utilized during Q2 2003	Balance at June 30, 2003
	(In thousands)						
Write-down of excess assets (a)	$ 6,008	$ 29,754	$ (30,021)	$ 5,741	$ 96,805	$ (97,917)	$ 4,629
Lease terminations and maintenance contracts (b)	6,757	1,396	(1,172)	6,981	18,762	(1,425)	24,318
Facility closure and other exit costs (c)	8,129		(2,520)	5,609	498	(2,040)	4,067
Payments to employees for severance (d)	1,391	4,516	(4,493)	1,414	10,637	(7,116)	4,935
Total	$ 22,285	$ 35,666	$ (38,206)	$ 19,745	$ 126,702	$ (108,498)	$ 37,949

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(a) The amounts utilized in 2003 reflect $126.6 million of non-cash write-downs of amortizable intangible and other long-lived assets in the U.S due to impairment, and $1.4 million in cash payments to decommission and sell assets. The write-downs of the intangible and other long-lived assets were accounted for as a reduction of the assets and did not result in a liability. The $4.6 million balance as of June 30, 2003, relates to machinery and equipment decommissioning costs in the U.S and estimates of selling costs for assets held for sale and is expected to be utilized during 2003.

(b) Amounts utilized represent cash payments. The balance remaining for primarily real estate lease terminations and maintenance contracts will be paid during the remaining terms of these contracts, which extend through 2010.

(c) Amounts utilized represent cash payments. The balance remaining for facility closure and other exit costs will be paid during 2003.

(d) Amounts utilized represent cash severance payments to approximately 470 employees during the six months ended June 30, 2003. The balance remaining for severance will be paid during 2003.

Other items:

A gain of approximately $2 million was recorded in restructuring and other items, net during the second quarter of 2003 associated with additional sales of intellectual property associated with the CDMA handset product line.

NOTE 4 INVESTMENTS

	June 30, 2003	December 31, 2002
	(In thousands)	
Available-for-sale debt securities		
Asset and mortgage-backed securities	$258,897	$102,083
U.S. government and agency securities	138,245	202,613
Corporate and municipal debt securities	76,129	180,843
Auction rate preferred stock	5,005	55,590
Foreign debt securities	339	
Total short-term investments	$478,615	$541,129
Long-term investment in equity securities	$ 32,970	$ 37,655

An unrealized gain on available-for-sale securities of $4 million, net of the related tax effect of $2 million, and $3 million, net of the related tax effect of $1 million, was included in accumulated other comprehensive income as of June 30, 2003 and December 31, 2002, respectively. Net realized gains/(losses) on sales of available-for-sale debt securities were $2 million and $9 million for the three and six months ended June 30, 2003, respectively. Realized gains and losses on available-for-sale debt securities were not significant for the three and six months ended June 30, 2002. The Company recorded a pre-tax loss of $2 million and $9 million, in interest income and other, net, associated with the decline in value of long-term investment in equity securities during the three and six months ended June 30, 2003, respectively. The decline in value was considered by management to be other than temporary.

NOTE 5 DERIVATIVE FINANCIAL INSTRUMENTS

Foreign currency risk

The Company enters into purchased currency option contracts that are designated as foreign currency cash-flow hedges of third-party yen revenue exposures. Changes in the fair value of currency option contracts due to changes in time value are excluded from the assessment of effectiveness and are recognized in interest income and other, net. During the second quarter of 2003, the Company terminated all outstanding purchased currency options hedging previously forecasted yen revenues because the underlying revenue

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agreements were modified to be denominated in U.S. dollars. At the time the options were terminated, there were no unrealized gains or losses in accumulated other comprehensive income. The change in option time value was approximately $1 million for both the three and six months ended June 30, 2003. For the three and six months ended June 30, 2002, the change in option time value was not significant. During the three and six months ended June 30, 2003 and 2002, amounts reclassified to revenue were not significant. The Company did not record any gains or losses due to hedge ineffectiveness for the three and six months ended June 30, 2003 and 2002. There were no option contracts outstanding as of December 31, 2002. There were no unrealized gains or losses included in accumulated other comprehensive income as of June 30, 2003 or December 31, 2002.

The Company enters into forward contracts that are designated as foreign currency cash-flow hedges of forecasted payments in euros. Changes in the fair value of the forward contracts due to changes in time value are excluded from the assessment of effectiveness and are recognized in interest income and other, net. As of June 30, 2003, the Company held forward contracts designated as foreign currency cash flow hedges of forecasted euro payment transactions that were set to expire over a six month period. There were no such hedges outstanding as of December 31, 2002. For the three and six months ended June 30, 2003, the change in time value of these forward contracts was not significant. The unrealized gains included in accumulated other comprehensive income as of June 30, 2003, which will be reclassified to interest income and other, net over the next six months, were not significant. The amounts reclassified to the income statement for the three and six months ended June 30, 2003 were not significant. The Company did not record any gains or losses due to hedge ineffectiveness for the six months ended June 30, 2003.

Forward exchange contracts and options are also used to hedge certain foreign currency-denominated assets or liabilities. These derivatives do not qualify for SFAS No. 133 hedge accounting treatment. Accordingly, changes in the fair value of these hedges are recorded immediately in earnings to offset the changes in fair value of the assets or liabilities being hedged. The related gains and losses included in interest income and other, net were not significant.

Interest rate risk

With the objective of protecting cash flows and earnings of the Company from the impact of fluctuations in interest rates, while minimizing the cost of capital, the Company may enter into or terminate interest rate swaps, such as the below mentioned transactions.

In the second quarter of 2003, the Company terminated interest rate swaps (the Swaps) with a notional amount of $740 million. The unrecognized gain of $44 million from the termination of these Swaps was included as a component of the Convertible Notes and is being amortized as an adjustment to interest expense over the remaining term of the hedged Convertible Notes (see Note 7). The Swaps had effectively converted fixed interest payments on a portion of the Company s 4% and 4.25% Convertible Subordinated Notes (Convertible Notes) to LIBOR-based floating rates. Under the terms of the Swaps, the Company provided collateral to match any mark-to-market exposure on the Swaps. The Swaps qualified for hedge accounting as fair value hedges, with changes in the fair value of the interest rate risk on the Convertible Notes being offset by changes in the fair values of the Swaps recorded as a component of interest expense. The difference between the changes in the fair values of the derivative and the hedged risk resulted in a benefit to interest expense of $2 million and $1 million for the three and six months ended June 30, 2003, respectively. For the three months ended June 30, 2002, a charge to interest expense for the difference between the changes in the fair values of the derivative and the hedged risk was not significant. Collateral of approximately $7 million included in other long-term assets as of December 31, 2002, was returned to the Company upon termination of the Swaps.

In the second quarter of 2003, the Company entered into an interest rate swap transaction to effectively convert the LIBOR-based floating rate interest payments on the equipment operating leases discussed in Note 12, with a notional amount of $395 million, to a fixed interest rate (the Lease Swap). The Lease Swap qualifies to be accounted for as a cash flow hedge of the forecasted interest payments attributable to the benchmark interest rate on the equipment operating leases through September 2006. The unrealized gains or losses included in accumulated other comprehensive income will be reclassified to cost of sales on a quarterly basis as lease payments are made. A loss of approximately $2 million, net of tax of $1 million included in accumulated other comprehensive income as of June 30, 2003, is expected to be reclassified to cost of sales within the next 12 months. The loss due to ineffectiveness recorded in interest income and other, net during the three months ended June 30, 2003 was not significant. Under the terms of the Lease Swap, the Company must provide collateral to match any mark-to-market exposure on the swap. As of June 30, 2003, collateral of approximately $8 million was included in other long-term assets.

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NOTE 6 BALANCE SHEET DETAIL

	June 30, 2003	December 31, 2002
	(In thousands)	
Cash and cash equivalents:		
Cash	$ 65,564	$ 279,620
Cash equivalents	570,600	169,227
	$ 636,164	$ 448,847
Inventories:		
Raw materials	$ 16,229	$ 18,152
Work-in-process	79,616	65,052
Finished goods	109,520	111,262
	$ 205,365	$ 194,466
Property and equipment:		
Land	$ 38,202	$ 53,013
Buildings and improvements	344,288	470,028
Equipment	730,030	1,253,061
Furniture and fixtures	36,996	46,783
Leasehold improvements	36,921	37,151
Construction in progress	13,633	18,747
	1,200,070	1,878,783
Accumulated depreciation and amortization	(702,674)	(1,131,819)
	$ 497,396	$ 746,964
Other long-term assets:		
Non-current assets and deposits	$ 341,828	$ 211,248
Investment in equity securities	32,970	37,655
Other assets	82,590	132,622
	$ 457,388	$ 381,525
Goodwill:		
Semiconductor segment	$ 887,990	$ 887,990
Storage systems segment	80,593	80,474
	$ 968,583	$ 968,464
Amortized intangible assets, net of accumulated amortization:		
Semiconductor segment	$ 188,884	$ 236,723
Storage systems segment	30,231	45,856
	$ 219,115	$ 282,579

The Company monitors the recoverability of goodwill recorded in connection with acquisitions annually, or sooner if events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment, if any, would be determined in accordance with SFAS No. 142, which uses a fair value model for determining the carrying value of goodwill. See the Company s Annual Report on Form 10-K for further discussion.

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NOTE 7 DEBT

	Maturity	Interest Rate *	Conversion Price	June 30, 2003	December 31, 2002
				(In thousands)	
2003 Convertible Subordinated Notes	2010	4%	$13.4200	$ 350,000	$
2001 Convertible Subordinated Notes	2006	4%	$26.3390	490,000	490,000
2000 Convertible Subordinated Notes	2005	4%	$70.2845	250,000	385,000
1999 Convertible Subordinated Notes	2004	4.25%	$15.6765	171,935	324,935
Change in fair value of the hedged interest rate risk on Convertible Subordinated Notes					36,724
Unamortized gain on terminated swaps				44,198	4,025
Capital lease obligations				720	894
				1,306,853	1,241,578
Current portion of long-term debt and capital lease obligations				(173,676)	(361)
Long-term debt and capital lease obligations				$1,133,177	$1,241,217

* The interest rate payable on a portion of the Convertible Subordinated Notes was converted to floating rates through interest rate swaps. Interest rate swaps with a notional amount of $740 million were terminated in the second quarter of 2003 (see Note 5). The weighted average interest rate payable on the Convertible Subordinated Notes, after adjusting for the impact of the interest rate swaps was 2.94% and 3.92% for the three months ended June 30, 2003 and 2002, respectively, and 2.54% and 3.99% for the six months ended June 30, 2003 and 2002, respectively.

On May 12, 2003, the Company issued $350 million of 4% Convertible Subordinated Notes (the 2003 Convertible Notes) due in 2010. The 2003 Convertible Notes are subordinated to all existing and future senior debt, are convertible at the holder s option, at any time prior to the maturity date of the convertible notes, into shares of the Company s common stock at a conversion price of $13.42 per share. The Company cannot elect to redeem the 2003 Convertible Notes prior to maturity; however, each holder of the 2003 Convertible Notes has the right to cause the Company to repurchase all of such holder s convertible notes at 100% of their principal amount plus accrued interest upon the occurrence of any fundamental change, which includes a transaction or event such as an exchange offer, liquidation, tender offer, consolidation, merger or combination. Interest is payable semiannually. The Company paid approximately $10.6 million in debt issuance costs that are being amortized using the interest method.

Approximately $28 million of the proceeds from issuance of the 2003 Convertible Notes were used to purchase call spread options on LSI s common stock (the Call Spread Options). The Call Spread Options, including fees and costs have been accounted for as capital transactions in accordance with Emerging Issues Task Force No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock. The Call Spread Options cover approximately 26.1 million shares of our common stock, which is the number of shares that are initially issuable upon conversion of the 2003 Convertible Notes in full. The Call Spread Options are designed to mitigate dilution from conversion of the 2003 Convertible Notes in the event that the market price per share of the Company s common stock upon exercise of the Call Spread Options is greater than $13.42 and is less than or equal to $23.875. The Call Spread Options may be settled at the Company s option in either net shares or in cash and expire in 2010. Settlement of the Call Spread Options in net shares on the expiration date would result in the Company receiving a number of shares, not to exceed 26.1 million shares, of our common stock with a value equal to the amount otherwise receivable on cash settlement. Should there be an early unwind of the Call Spread Options, the amount of cash or net shares potentially received by the Company will be dependent upon then existing overall market conditions, and on the Company s stock price, the volatility of the Company s stock and the amount of time remaining on the Call Spread Options.

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The proceeds from the 2003 Convertible Notes were used to repurchase $153 million of the 1999 Convertible Subordinated Notes and $135 million of the 2000 Convertible Subordinated Notes. A net pre-tax loss of $2 million was recognized, in interest income and other, net, on the repurchases of the 1999 and 2000 Convertible Notes. The pre-tax loss is net of the write-off of debt issuance costs and a portion of the unamortized gain on the terminated Swaps (see Note 5).

NOTE 8 COMMON STOCK

Stock option plans. In May 2003, the stockholders approved an amendment to the Amended 1995 Director Option Plan to increase the number of shares of common stock reserved for issuance thereunder by 1 million. As of June 30, 2003, 1.1 million shares were available for future grants under the Amended 1995 Director Option Plan.

In May 2003, the stockholders approved the adoption of the 2003 Equity Incentive Plan (2003 Plan) under which 11 million shares of common stock were reserved for issuance. Under the terms of the 2003 Plan, the Company may grant stock options or restricted stock awards to employees with an exercise price that is no less than the fair market value of the stock on the date of grant. No participant shall be granted options covering more than 2 million shares in any year. The term of each option is determined by the Board of Directors and is usually ten years. Options generally vest in annual increments of 25% per year commencing one year from the date of grant. Under the 2003 Plan, the Company may also grant restricted stock awards. No participant may be granted more than 0.5 million shares of restricted stock in any year. The vesting requirements for the restricted stock awards are determined by the Board of Directors. As of June 30, 2003, there were 11 million shares available for future grants under the 2003 Plan.

Stock option exchange program. On August 20, 2002, the Company filed, with the Securities Exchange Commission, an offer to exchange stock options outstanding under the 1991 Equity Incentive Plan and the 1999 Nonstatutory Stock Option Plan for new options. Under the exchange offer, eligible employees had the opportunity to exchange eligible stock options for the promise to grant new options under the 1999 Nonstatutory Stock Option Plan. Directors and executive officers of the Company were not eligible to participate in this program. The exchange offer expired September 18, 2002, and the Company accepted an aggregate of 16,546,370 options for exchange. On March 20, 2003, the Company granted a new option that covered two shares of LSI Logic common stock for every three shares covered by an option that an employee had elected to exchange. The exercise price per share of the new options was equal to the fair market value of the Company s common stock on the grant date. The Company granted 10,691,139 options at an exercise price of $5.06 per share. The exchange program did not result in the recording of any compensation expense in the statement of operations.

NOTE 9 RECONCILIATION OF BASIC AND DILUTED LOSS PER SHARE

A reconciliation of the numerators and denominators of the basic and diluted loss per share computations are as follows:

	Three Months Ended June 30,					
	2003			2002		
(In thousands except per share amounts)	Loss*	Shares+	Per-Share Amount	Loss*	Shares+	Per-Share Amount
Basic EPS:						
Net loss available to common stockholders	$(162,084)	376,619	$(0.43)	$(62,291)	369,672	$(0.17)
Effect of dilutive securities:						
Diluted EPS:						
Net loss available to common stockholders	$(162,084)	376,619	$(0.43)	$(62,291)	369,672	$(0.17)

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	Six Months Ended June 30,					
	2003			2002		
(In thousands except per share amounts)	Loss*	Shares+	Per-Share Amount	Loss*	Shares+	Per-Share Amount
Basic EPS:						
Net loss available to common stockholders	$(284,509)	375,745	$(0.76)	$(234,044)	368,769	$(0.63)
Effect of dilutive securities:						
Diluted EPS:						
Net loss available to common stockholders	$(284,509)	375,745	$(0.76)	$(234,044)	368,769	$(0.63)

* Numerator

+ Denominator

Options to purchase approximately 66,326,662 shares and 74,740,226 shares were outstanding at June 30, 2003 and 2002, respectively, and were excluded from the computation of diluted shares because of their antidilutive effect on loss per share for the three and six months then ended. The exercise price of these options ranged from $0.06 to $72.25 at June 30, 2003, and from $0.01 to $72.25 at June 30, 2002.

For the three and six months ended June 30, 2003, common equivalent shares of 54,720,989 and 49,819,986, respectively, associated with the 2003, 2001, 2000 and 1999 Convertible Notes were excluded from the calculation of diluted shares because of their antidilutive effect on loss per share. For the three and six months ended June 30, 2002, common equivalent shares of 47,720,853 associated with the 2001, 2000 and 1999 Convertible Notes were excluded from the calculation of diluted shares because of their antidilutive effect on loss per share.

NOTE 10 COMPREHENSIVE LOSS

Comprehensive loss is defined as a change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. Comprehensive loss, net of taxes for the current reporting period and comparable period in the prior year is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(In thousands)			
Net loss	$(162,084)	$(62,291)	$(284,509)	$(234,044)
Change in unrealized gain on derivative instruments designated as and qualifying as cash-flow hedges, net of tax	(16)	(2,608)	464	
Change in unrealized gain on available for sale securities, net of tax	1,454	(10,074)	1,711	(16,267)
Change in foreign currency translation adjustments	6,178	23,758	8,422	14,199
Comprehensive loss	$(154,468)	$(51,215)	$(273,912)	$(236,112)