

LATTICE SEMICONDUCTOR CORP
Form 10-Q/A
April 19, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q/A

Amendment No. 1

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

For the quarterly period ended September 27, 2003

OR

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

For the transition period from to

Commission file number 000-18032

LATTICE SEMICONDUCTOR CORPORATION

(Exact name of Registrant as specified in its charter)

State of Delaware
(State or other jurisdiction
of incorporation or organization)

5555 N.E. Moore Court, Hillsboro, Oregon
(Address of principal executive offices)

93-0835214
(I.R.S. Employer
Identification No.)

97124-6421
(Zip Code)

(503) 268-8000
(Registrant's telephone number, including area code)

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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 an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

At September 27, 2003, there were 112,772,007 shares of the Registrant's common stock, \$.01 par value, outstanding.

This Quarterly Report on form 10-Q/A amends the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, as filed by the Registrant on November 12, 2003, and is being filed to reflect the restatement of the Registrant's Condensed Consolidated Financial Statements (the Restatement). The Restatement reflects adjustments to revenue, related cost of products sold, deferred income and accrued expenses pertaining to both a correction of an error and a change in estimate to deferred income and a correction to accrued expenses as of September 30, 2003. A discussion of this Restatement and a summary of the effects of the Restatement are presented in Note 15 to the Condensed Consolidated Financial Statements. Changes have been made to the disclosure in Items 1,2 and 4 of this Form 10-Q/A in connection with the Restatement.

The information contained in this Form 10-Q/A is as of November 12, 2003, except for the information related to the Restatement discussed above, which has been updated through April 19, 2004. This Form 10-Q/A should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2003.

LATTICE SEMICONDUCTOR CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LATTICE SEMICONDUCTOR CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(In thousands, except per share data)

(unaudited)

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2003	Sept. 30, 2002	Sept. 30, 2003	Sept. 30, 2002
	(Restated)		(Restated)	
Revenue	\$ 43,033	\$ 56,072	\$ 156,905	\$ 171,416
Costs and expenses:				
Cost of products sold	19,431	22,429	65,452	68,527
Research and development	21,173	21,523	64,707	63,986
Selling, general and administrative	12,114	11,712	37,211	35,790
In-process research and development		5,653		29,853
Amortization of intangible assets (1)	18,665	18,070	58,466	54,616
Total costs and expenses	71,383	79,387	225,836	252,772
Loss from operations	(28,350)	(23,315)	(68,931)	(81,356)
Other (expense) income, net	(3,611)	2,764	(3,485)	3,941
Loss before benefit for income taxes	(31,961)	(20,551)	(72,416)	(77,415)
Benefit for income taxes	(3,300)	(6,180)	(5,854)	(29,280)
Net loss	\$ (28,661)	\$ (14,371)	\$ (66,562)	\$ (48,135)
Basic net loss per share	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)
Diluted net loss per share	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)

Shares used in per share calculations:

Basic	111,840	110,232	111,615	109,855
Diluted	111,840	110,232	111,615	109,855

(1) **Includes \$820 and \$760 of amortization of deferred stock compensation expense for the three months ended September 30, 2003 and September 30, 2002, respectively, and \$4,931 and \$1,887 for the nine months ended September 30, 2003 and September 30, 2002, respectively, attributable to Research and Development activities.**

See Accompanying Notes to Condensed Consolidated Financial Statements

LATTICE SEMICONDUCTOR CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEET

(In thousands, except share and par value data)

(unaudited)

	Sept. 30, 2003	December 31, 2002
	(Restated)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 153,334	\$ 169,475
Short-term investments	125,420	107,405
Accounts receivable, net	26,941	26,374
Inventories	47,942	56,241
Other current assets	12,617	35,033
Total current assets	366,254	394,528
Property and equipment, net	56,520	62,786
Foundry investments, advances and other assets	124,670	104,507
Intangible assets, net	102,466	155,953
Goodwill	223,605	223,489
	\$ 873,515	\$ 941,263
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 34,356	\$ 33,597
Deferred income on sales to Distributors	9,766	11,983
Income taxes payable		142
Total current liabilities	44,122	45,722
4 3/4% Convertible notes due in 2006		208,061
Zero Coupon Convertible notes due in 2010	184,000	
Other long-term liabilities	22,053	26,345
Commitments and contingencies		
Stockholders equity:		

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Preferred stock, \$.01 par value, 10,000,000 shares authorized; none issued or outstanding

Common stock, \$.01 par value, 300,000,000 shares authorized, 112,772,007 and 112,358,043 shares issued and outstanding

	1,128	1,124
Paid-in capital	584,635	580,987
Deferred stock compensation	(6,320)	(11,540)
Accumulated other comprehensive income (loss)	15,264	(4,631)
Retained earnings	28,633	95,195
Total stockholders equity	623,340	661,135
	\$ 873,515	\$ 941,263

See Accompanying Notes to Condensed Consolidated Financial Statements.

LATTICE SEMICONDUCTOR CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands)

(unaudited)

	Nine Months Ended	
	September 30, 2003	September 30, 2002
	(Restated)	
Cash flows from operating activities:		
Net loss	\$ (66,562)	\$ (48,135)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	74,873	70,205
Gain on sale of equity securities	(271)	(4,017)
Loss (Gain) on retirement of convertible notes	1,381	(5,710)
In-process research and development		29,853
Tax benefit of option exercises		797
Changes in assets and liabilities (net of effect of business combination):		
Accounts receivable	(567)	(8,247)
Inventories	8,299	7,534
Foundry, investments, advances and other assets	23,447	27,337
Deferred income taxes		1,369
Accounts payable and accrued expenses	2,451	3,006
Deferred income	(2,217)	(3,701)
Income taxes payable	(142)	(22,513)
Other liabilities	(4,683)	(1,406)
Total adjustments	102,571	94,507
Net cash provided by operating activities	36,009	46,372
Cash flows from investing activities:		
Proceeds from short-term investments, net	311,307	249,048
Purchase of short-term investments	(329,323)	(103,259)
Acquisition of Agere FPGA		(254,232)
Acquisition of Cerdelix		(2,530)
Purchase of equity securities	(474)	
Proceeds from sale of equity securities	745	9,930
Capital expenditures	(8,015)	(15,314)
Net cash used by investing activities	(25,760)	(116,357)
Cash flows from financing activities:		
Extinguishment of convertible debt, net	(223,684)	(27,441)
Issuance of convertible debt, net	194,558	

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Net proceeds from issuance of common stock	2,736	1,864
Net cash used in financing activities	(26,390)	(25,577)
Net decrease in cash and cash equivalents	(16,141)	(95,562)
Beginning cash and cash equivalents	169,475	250,203
Ending cash and cash equivalents	\$ 153,334	\$ 154,641
Supplemental disclosures of cash flow information:		
Cash received for income taxes, net	\$ (28,370)	\$ (35,083)
Cash paid for interest	\$ 6,371	\$ 6,527
Supplemental disclosures of non-cash investing and financing activities:		
Unrealized gain (loss) on appreciation of foundry investments included in other comprehensive income	\$ 19,752	\$ (23,776)
Stock issued in conjunction with Cerdelinx acquisition	\$	\$ 21,643

See Accompanying Notes to Condensed Consolidated Financial Statements.

LATTICE SEMICONDUCTOR CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 - Basis of Presentation:

The accompanying consolidated financial statements are unaudited and have been prepared by Lattice Semiconductor Corporation (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission and in our opinion include all adjustments, consisting only of normal recurring adjustments, necessary for the fair statement of results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. These consolidated financial statements should be read in conjunction with our audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2002.

On August 26, 2002, we completed the stock for stock acquisition of Cerdelinx Technologies, Inc. (Cerdelinx) for 2.6 million shares valued at \$8.30 per share. This transaction was accounted for as an asset purchase, and accordingly, the results of operations for Cerdelinx and estimated fair value of assets acquired and liabilities assumed were included in our condensed consolidated financial statements beginning August 26, 2002. This acquisition is discussed further in Note 4.

On January 18, 2002, we completed the acquisition of the field-programmable gate array (FPGA) business (Agere FPGA) of Agere Systems Inc. (Agere) for \$250 million in cash. This transaction was accounted for as an asset purchase, and accordingly, the results of operations for Agere FPGA and estimated fair value of assets acquired and liabilities assumed were included in our condensed consolidated financial statements beginning January 18, 2002. This acquisition is discussed further in Note 5.

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

We report based on a 52 or 53 week year ending on the Saturday closest to December 31. For ease of presentation, we have adopted the convention of using March 31, June 30, September 30 and December 31 as period end dates for all financial statement captions.

This Quarterly Report on Form 10-Q/A contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Actual results could differ materially from those projected in the forward-looking statements as a result of the factors, set forth in the section entitled Factors Affecting Future Results and elsewhere in this report.

Note 2 - Revenue Recognition:

Revenue from sales to OEM customers is recognized upon shipment provided that persuasive evidence of an arrangement exists, the price is fixed and determinable, title has transferred, collection of resulting receivables is probable, there are no customer acceptance requirements and no remaining significant obligations. Certain of our sales are made to distributors under agreements providing price protection and right of return on unsold merchandise. Revenue and cost relating to such distributor sales are deferred until either the product is sold by the distributor or return privileges and price protection rights terminate and related estimated revenue and estimated costs are then reflected in income. Revenue from software sales was not material for the periods presented.

Note 3 Net Income Per Share:

Net income per share is computed based on the weighted average number of shares of common stock and potentially dilutive securities assumed to be outstanding during the period using the treasury stock method. Potentially dilutive securities consist of stock options, warrants to purchase common stock and convertible subordinated notes.

The most significant difference between the computation of basic and diluted net income per share is that basic net income per share does not treat potentially dilutive securities such as stock options, warrants and convertible subordinated notes as outstanding. For all periods presented, the computation of net loss per share excludes the effect of our stock options, warrants and convertible notes as they were antidilutive. A reconciliation of basic and diluted net income per share is presented below (in thousands, except for per share data):

	Three months ended		Nine months ended	
	Sept. 30, 2003	Sept. 30, 2002	Sept. 30, 2003	Sept. 30, 2002
	(Restated)		(Restated)	
Net loss	\$ (28,661)	\$ (14,371)	\$ (66,562)	\$ (48,135)
Shares used in basic net loss per share calculations	111,840	110,232	111,615	109,855
Dilutive effect of stock options, warrants and other potentially dilutive securities				
Shares used in diluted net loss per share	111,840	110,232	111,615	109,855
Basic net loss per share	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)
Diluted net loss per share	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)

Stock-Based Compensation

We account for our employee and director stock options and employee stock purchase plan in accordance with provisions of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees. Pro forma disclosures as required under Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation and as amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure, are presented below. Pursuant to FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Based Compensation an interpretation of APB Opinion No. 25, effective July 1, 2000, the in the money portion of stock options granted to employees in connection with acquisitions is accounted for as Deferred Stock Compensation in Stockholders Equity and amortized to operations as part of Amortization of Intangible Assets over the vesting periods of the options.

The fair value of our stock-based employee compensation cost for purposes of our pro forma disclosures was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Grants for			
	Three months ended		Nine months ended	
	Sept. 30, 2003	Sept. 30, 2002	Sept. 30, 2003	Sept. 30, 2002
Stock Options:				
Expected Volatility	57.5%	59.3%	58.1%	59.3%
Risk-free interest rate	2.4%	2.5%	2.1%	2.6%
Expected life from vesting date	1.6 years	1.8 years	0.5 years	1.8 years
Dividend yield	0%	0%	0%	0%

The Black-Scholes option pricing model was developed for use in estimating the fair value of freely tradable, fully transferable options without vesting restrictions. Our stock options have characteristics which differ significantly from those of freely tradable, fully transferable options. The Black-Scholes option pricing model also requires highly subjective assumptions, including expected stock price volatility and expected stock option term which greatly affect the calculated fair value of an option. Our actual stock price volatility and option term may be materially different from the assumptions used herein.

As pertaining to activity for the three and nine months ended September 30, 2003 and 2002, the resultant grant date weighted-average fair values calculated using the Black-Scholes option pricing model and the noted assumptions for stock options granted were \$3.35 and \$2.78 for the third quarter of 2003 and 2002, respectively, and \$1.24 and \$3.03 for the nine months ended September 30, 2003 and 2002, respectively. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period.

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Our pro forma information is as follows (in thousands, except per share data):

	Three months ended Sept. 30, 2003 (Restated)	Three months ended Sept. 30, 2002	Nine months ended Sept. 30, 2003 (Restated)	Nine months ended Sept. 30, 2002
Net loss, as reported	\$ (28,661)	\$ (14,371)	\$ (66,562)	\$ (48,135)
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	820	760	4,931	1,887
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effect	(5,603)	(9,970)	(19,915)	(27,165)
Pro forma net loss	\$ (33,444)	\$ (23,581)	\$ (81,546)	\$ (73,413)
Net loss per share:				
Basic-as reported	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)
Basic- pro forma	\$ (0.30)	\$ (0.21)	\$ (0.73)	\$ (0.67)
Diluted-as reported	\$ (0.26)	\$ (0.13)	\$ (0.60)	\$ (0.44)
Diluted-pro forma	\$ (0.30)	\$ (0.21)	\$ (0.73)	\$ (0.67)

Note 4 Acquisition of Cerdelinx:

On August 26, 2002, we completed the stock for stock acquisition of Cerdelinx for 2.6 million shares valued at \$8.30 per share. Cerdelinx was an early stage fabless semiconductor company focused on the design of application specific standard products targeted towards emerging high-speed communications and storage applications. Cerdelinx had a team of engineers who were developing a portfolio of low-power CMOS transceivers and backplane interfaces with embedded high-speed SERDES I/O to support 10 gigabit-per-second applications. The acquisition serves to enhance our silicon development efforts and our ability to deliver leading-edge programmable solutions within the communications and storage market segments. This acquisition principally comprises intellectual property and a work force. The core technology portion of the intellectual property is valued using a royalty savings methodology which discounts estimated royalties that would be paid on an after tax basis. The in-process technology portion of the intellectual property is valued using a discounted cash flow methodology described in detail below. Work force is valued using a replacement cost methodology which discounts costs to an after tax amount. The transaction was completed pursuant to an Agreement and Plan of Reorganization entered into on July 15, 2002, as amended on July 24, 2002, among Lattice, Cerdelinx and affiliated parties. The components of the purchase price were as follows (in millions):

Stock issued and liabilities assumed	\$	22.8
Estimated direct acquisition costs		1.1
Total	\$	23.9

In conformity with Financial Accounting Standard SFAS 142, Goodwill and Other Intangible Assets, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. As Cerdelix was not considered a business under SFAS 141, Business Combinations, no goodwill was recognized. In estimating the fair value of the assets acquired, management considered various factors, including an appraisal. The total purchase price was allocated as follows (in millions):

Core technology	\$	7.2
Deferred stock compensation		5.8
In-process research and development costs		5.7
Work force		4.7
Liabilities assumed		(1.2)
Equipment		1.1
Non compete agreement		0.3
Cash		0.3
Total	\$	23.9

There were no significant exit costs incurred or accrued in connection with this transaction. Management does not expect intangible assets acquired to be deductible for income tax purposes.

Employees who joined Lattice as a result of this acquisition held Cerdelix shares and options which were converted into 0.9 million Lattice shares and options which were either unvested or otherwise restricted from sale over terms up to four years at a grant price from \$0.41 per share to \$2.54 per share. The spread, which is the difference between grant price and market value of our common stock on the Closing Date, aggregating \$5.8 million on these shares and options, was recorded as Paid-in capital and Deferred stock compensation and is being amortized to operations equally over the vesting (or restriction lapsing) period as part of Amortization of intangible assets.

In-Process Research and Development (IPR&D)

IPR&D consists of those products obtained through acquisition that are not yet proven to be technologically feasible but have been developed to a point where there is value associated with them in relation to potential future revenue. Because technological feasibility was not yet proven and no alternative future uses are believed to exist for the in-process technologies, the assigned value was expensed immediately after the closing of the acquisition.

The fair value underlying the \$5.7 million assigned to acquired IPR&D from the Cerdelix acquisition (recognized in the third quarter of 2002) was determined by identifying research projects in areas for which technological feasibility had not been established and there were no alternative future uses. The acquired IPR&D consists of low-power CMOS transceivers and backplane

interfaces with embedded high-speed SERDES I/O. These products were approximately 60% complete and were estimated to be completed in 2003 at an estimated cost of approximately \$2 million. This project is now estimated to be complete in the first half of 2004. There has been no material change in the estimated cost of this project.

The fair value was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over six year periods were discounted at rates ranging from 15 to 17 percent in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements.

All of these projects have completion risks related to silicon functionality, architecture performance, process technology availability, packaging technology, continued availability of key technical personnel and product reliability. To the extent that estimated completion dates are not met, the risk of competitive product introduction is greater and revenue opportunity may be permanently lost.

The core technology included in the acquisition of Cerdelix has an estimated weighted average useful life of approximately six years, and the work force and non-compete agreements included in the Cerdelix acquisition have estimated useful lives of approximately four years resulting in a weighted average useful life of approximately five years.

Note 5 Acquisition of Agere FPGA:

On January 18, 2002, we completed the acquisition of Agere FPGA for \$250 million in cash. This acquisition increased our share of the PLD market, accelerated our entry into the FPGA portion of the market and provided us with additional technical employees and intellectual property. This acquisition principally comprises intellectual property, which was valued using a discounted cash flow methodology of which goodwill was a by-product. The transaction was completed pursuant to an Asset Purchase Agreement dated as of December 7, 2001 between Lattice and Agere. The components of the purchase price were as follows (in millions):

Cash	\$	250.0
Estimated direct acquisition costs		6.3
Total	\$	256.3

In accordance with SFAS 141, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. In estimating the fair value of the assets acquired, management considered various factors, including an appraisal. The total purchase price was allocated as follows (in millions):

Excess of purchase price over net assets acquired	\$	142.4
Current technology		63.4
In-process research and development		24.2
Fair value of non-compete agreement		13.8
Licensed technology		10.2
Inventory		3.5
Backlog		1.4
Property, plant and equipment		0.2
Accrued liabilities		(2.8)
Total	\$	256.3

There were no significant exit costs incurred or accrued in connection with this transaction.

Employees joining us from Agere during the first quarter of 2002 were awarded approximately 1.1 million stock options which vest equally over four years at a grant price of \$14.76 per share. The difference between grant price and market value of our common stock on the grant date, aggregating approximately \$7.0 million, was recorded as Paid-in capital and Deferred stock compensation and is being amortized to operations ratably over the vesting period as part of Amortization of intangible assets.

In-Process Research and Development (IPR&D)

IPR&D consists of those products obtained through acquisition that are not yet proven to be technologically feasible but have been developed to a point where there is value associated with them in relation to potential future revenue. Because technological feasibility was not yet proven and no alternative future uses are believed to exist for the in-process technologies, the assigned value was expensed immediately upon the closing date of the acquisition.

The fair value underlying the \$24.2 million assigned to acquired IPR&D in the Agere FPGA acquisition was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are the ORCA 4 FPGA family, the next generation FPGA family and the FPSC field-programmable system chips. The following is a brief description of these projects. The ORCA 4 FPGA family project, increasing speed and density and enhancing yields, was approximately 85% complete and estimated to be completed by 2003 at an estimated cost of \$1.5 million. This project was completed during 2002 with no material change in cost. The next generation FPGA family project, increasing speed and density while reducing die size, was approximately 50% complete and estimated to be completed by 2004 at an estimated cost of \$2 million. There has been no material change in the schedule or estimated cost of this project. The future development of FPSC field-programmable system chips (field-programmable system chips which combine embedded pre-defined logic circuits

with an FPGA platform) was approximately 25% to 90% complete, and estimated to be completed by 2004 at an estimated cost of \$2 million. There has been no material change in the schedule or estimated cost of this project. The IPR&D value of \$24.2 million was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over 5-7 year periods were discounted at rates ranging from 23 to 25 percent in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact our expected return on investment and future results. In addition, our financial condition would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to silicon functionality, architecture performance, process technology availability, packaging technology, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

The non-compete agreement from Agere and the current and licensed technology included in the acquisition of Agere FPGA have an estimated weighted average useful life of approximately 6.3 years. In accordance with SFAS 142, the excess of purchase price over net assets acquired, or Goodwill, is subject to an impairment test at least annually and is not amortized.

Pro forma results

The following pro forma results of operations information are provided for illustrative purposes only and do not purport to be indicative of the consolidated results of operations for future periods or that actually would have been realized had Lattice and Agere FPGA been a consolidated entity during the periods presented. The pro forma results combine the results of operations as if Agere FPGA had been acquired as of the beginning of the periods presented. The results include the impact of certain adjustments such as intangible asset amortization, estimated changes in interest income (expense) related to cash outlays associated with the transaction and income tax benefits related to the aforementioned adjustments. Additionally, the IPR&D charge of \$24.2 million discussed above has been excluded from the periods presented due to its non-recurring nature.

(in thousands, except per share amounts-unaudited)

	Nine months ended	
	Sept. 30, 2003	Sept. 30, 2002
	(Restated)	(Proforma)
Revenue	\$ 156,905	\$ 176,808
Net loss	\$ (66,562)	\$ (32,607)
Basic net loss per share	\$ (0.60)	\$ (0.30)
Diluted net loss per share	\$ (0.60)	\$ (0.30)

Note 6 - Acquisition of Vantis:

On June 15, 1999, we paid approximately \$500.1 million in cash to AMD for all of the outstanding capital stock of Vantis Corporation. The total purchase price of Vantis was \$583.1 million, including certain direct acquisition costs, the accrual of certain exit costs and the assumption of certain liabilities related to the Vantis business. Of this purchase price, approximately \$422.6 million was allocated to goodwill and intangible assets.

The recorded balances of goodwill and intangible assets, net of accumulated amortization, related to the Vantis acquisition approximated \$77.1 million and \$36.0 million, respectively, at September 30, 2003 and \$77.1 million and \$74.2 million, respectively, at December 31, 2002. Amortization expense related to intangible assets approximated \$38.2 million for both the first nine months of 2003 and the first nine months of 2002.

Note 7 - Inventories (in thousands):

	Sept. 30, 2003	Dec. 31, 2002
Work in progress	\$ 36,314	\$ 40,515
Finished goods	11,628	15,726
	\$ 47,942	\$ 56,241

Note 8 - Changes in Stockholders' Equity (in thousands) (Restated):

	Common Stock	Paid-in Capital	Deferred Stock Comp.	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
Balances, Dec. 31, 2002	\$ 1,124	\$ 580,987	\$ (11,540)	\$ (4,631)	\$ 95,195	\$ 661,135
Common stock issued	4	3,937				3,941
Unrealized gain on foundry investments (Note 11)				19,752		19,752
Deferred stock compensation		(289)	289			
Amortization of deferred stock compensation			4,931			4,931
Translation adjustment				143		143

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Net loss for the nine-month period						(66,562)		(66,562)				
Balances, Sept. 30, 2003	\$	1,128	\$	584,635	\$	(6,320)	\$	15,264	\$	28,633	\$	623,340

Total comprehensive loss for the first nine-month period of 2003 was approximately \$46.7 million (restated) and is substantially comprised of \$66.6 million net loss (restated) partially offset by \$19.8 million in unrealized gain related to foundry investments.

Note 9 - New Accounting Pronouncements:

In June 2001, the FASB issued SFAS 142, which supersedes APB Opinion No. 17, Intangible Assets. SFAS 142, among other things, establishes new standards for intangible assets acquired in a business combination, eliminates amortization of goodwill and sets forth requirements to periodically evaluate goodwill for impairment. We adopted this statement during the first quarter of 2002 and thus goodwill and certain intangibles with indefinite lives are no longer being amortized. To apply SFAS 142, a company is divided into separate reporting units, each representing groups of products that are separately managed. For this purpose, we have one reporting unit. To determine whether or not goodwill may be impaired, a test is required comparing the book value of the reporting unit to its trading price. Similar tests are required in the future, at least annually, and more often where there is a change in circumstances that could result in an impairment of goodwill. If the trading price of our common stock is below the book value for a sustained period, a goodwill impairment test will be performed by comparing book value to estimated market value (trading price plus a control premium). The excess of book value over estimated market value will then be subtracted from the goodwill account with a resulting charge to operations. Subsequent unrealized recoveries in market value, if any, will not be recorded. We completed an initial goodwill impairment assessment as of January 1, 2002 to determine if a transition impairment charge should be recognized under SFAS 142. Upon assessment, no transition impairment charge was recorded. We also completed our annual goodwill impairment assessment in December 2002, upon which no impairment charge was recorded. Additional goodwill impairment tests will be performed at least annually.

The following tables present details of the Company's total purchased intangible assets (in millions):

Sept. 30, 2003	Gross	Accumulated amortization	Net
Current technology	\$ 273.6	\$ (200.8)	\$ 72.8
Core technology	7.3	(1.5)	5.8
Licenses	10.2	(2.5)	7.7
Non-compete agreements	14.2	(8.0)	6.2
Workforce	4.7	(1.0)	3.7
Backlog	1.4	(1.4)	
Customer list	17.4	(14.9)	2.5
Patents and trademarks	26.8	(23.0)	3.8
Total	\$ 355.6	\$ (253.1)	\$ 102.5

December 31, 2002	Gross	Accumulated amortization	Net
Current technology	\$ 273.6	\$ (160.3)	\$ 113.3
Core technology	7.3	(.5)	6.8
Licenses	10.2	(1.4)	8.8
Non-compete agreements	14.2	(4.4)	9.8
Workforce	4.7	(.3)	4.4
Backlog	1.4	(1.4)	
Customer list	17.4	(12.3)	5.1
Patents and trademarks	26.8	(19.0)	7.8
Total	\$ 355.6	\$ (199.6)	\$ 156.0

The estimated future amortization expense of purchased intangible assets as of September 30, 2003 is as follows (in millions):

Fiscal Year:	Amount
2003 (remaining three months)	\$ 17.8
2004	43.8
2005	14.4
2006	10.8
2007	9.8
Later years	5.9
	\$ 102.5

The estimated future amortization expense of deferred stock compensation attributable to Research and Development activities as of September 30, 2003 is approximately \$0.8 million for the remainder of 2003, \$3.3 million for 2004, and \$2.2 million for 2005.

In May 2002, the FASB issued SFAS 145, Rescission of FAS Nos. 4, 44, and 64, Amendment of FAS 13, and Technical Corrections. Among other things, SFAS 145 rescinds various pronouncements regarding early extinguishment of debt and allows extraordinary accounting treatment for early extinguishment only when the provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions are met. SFAS 145 provisions regarding early extinguishment of debt are generally effective for fiscal years beginning after May 15, 2002. Management adopted this pronouncement during the second quarter of 2002. During the second through fourth quarters of 2002, we extinguished approximately \$51.9 million face value of our 4¾% convertible notes for approximately \$42.8 million in cash, including accrued interest. We recognized a gain of approximately \$9.3 million in connection with these transactions. During the first quarter of 2003, we extinguished approximately \$32.8 million of these notes for approximately \$29.9 million in cash including accrued interest and recognized a gain of approximately \$2.9 million. During the second

quarter of 2003, we extinguished \$3.0 million of these notes for approximately the same amount in cash including accrued interest, at approximately carrying cost. As specified in SFAS 145, gains recognized were recorded in Other (expense) income, net in the accompanying Consolidated Statement of Operations. During the third quarter of 2003, we extinguished our remaining 4¾% convertible notes (see Note 14). Expenses related to the call of these notes were recorded in Other (expense) income, net in the accompanying Consolidated Statement of Operations. Also during the third quarter of 2003, a \$1.4 million gain recognized in connection with the early extinguishment of a portion of our Zero Coupon Convertible Subordinated Notes issued in June 2003 (see Note 14) was recorded in accordance with SFAS 145.

In December 2002, the FASB issued SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure. This statement provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, it amends the disclosure requirements of SFAS 123 to require prominent disclosure in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reporting results. This statement is effective for fiscal years ending after December 15, 2002 and for the interim periods beginning after December 15, 2002. As we continue to report stock-based employee compensation costs using the intrinsic value method as defined by APB 25, adoption of the provisions of the new statement affects only our disclosure of these costs, which is presented in Note 3.

Note 10 - Legal Matters:

We are not currently a party to any material legal proceedings. We are exposed to certain asserted and unasserted potential claims. There can be no assurance with respect to potential claims made against us, that we could resolve such claims under terms and conditions that would not have a material adverse effect on our financial position, cash flows or results of operations.

Note 11 Foundry Investment:

In 1995, we entered into a series of agreements with United Microelectronics Corporation (UMC), a public Taiwanese company, pursuant to which we agreed to join UMC and several other companies to form a separate Taiwanese corporation, (UICC), for the purpose of building and operating an advanced semiconductor manufacturing facility in Taiwan, Republic of China. Under the terms of the agreements, we invested approximately \$49.7 million for an approximate 10% equity interest in the corporation and the right to receive a percentage of the facility's wafer production at market prices.

In 1996, we entered into an agreement with Utek Corporation (Utek), a public Taiwanese company in the wafer foundry business that became affiliated with the UMC group in 1998, pursuant to which we agreed to make a series of equity investments in Utek under specific terms. In exchange for these investments, we received the right to purchase a percentage of Utek's wafer production. Under this agreement, we invested approximately \$17.5 million. On January 3, 2000, UICC and Utek merged into UMC.

During 2002, we sold approximately 7.6 million of our UMC shares for approximately \$9.9 million in cash, resulting in a gain of \$4.0 million. In the future, we may or may not choose to liquidate additional UMC shares. As of September 30, 2003, we owned approximately 91.7 million shares of

UMC common stock of which approximately 23.3 million are restricted from sale for more than one year by the terms of our agreement with UMC. Under the terms of the UMC agreement, if we sell any of these restricted shares, our rights to guaranteed wafer capacity at UMC may be reduced on a pro-rata basis based on the number of shares that we sell. If we sell over 10.1 million of these restricted shares, we may lose all of our rights to guaranteed wafer capacity at UMC.

For financial reporting purposes, all of our UMC shares are accounted for as available for sale and marked to market in our Consolidated Balance Sheet until they are sold, at which time a gain or loss is recognized in our Consolidated Statement of Operations. Unrealized gains and losses are included in Accumulated other comprehensive income (loss) within Stockholders' Equity. An other than temporary impairment of UMC share value could result in a reduction of the Consolidated Balance Sheet carrying value and would result in a charge to our Consolidated Statement of Operations.

The carrying value of our investment in UMC was approximately \$76.2 million and \$56.3 million at September 30, 2003 and December 31, 2002, respectively, and this balance is classified as part of Foundry investments, advances and other assets. During the first nine months of 2003, we recorded unrealized gains of \$19.8 million related to the change in market value of our UMC shares. If we liquidate our UMC shares, it is likely that the amount of any future realized gain or loss will be different from the accounting gain or loss reported in prior periods.

Note 12 Segment and Geographic Information:

We operate in one industry segment comprising the design, development, manufacture and marketing of high performance programmable logic devices. Our sales by major geographic area were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2003 (Restated)	Sept. 30, 2002	Sept. 30, 2003 (Restated)	Sept. 30, 2002
United States	\$ 12,277	\$ 21,906	\$ 50,712	\$ 70,617
Export sales:				
Europe	8,786	14,825	40,749	45,272
Asia	20,347	17,133	58,078	47,247
Other	1,623	2,208	7,366	8,280
	30,756	34,166	106,193	100,799
	\$ 43,033	\$ 56,072	\$ 156,905	\$ 171,416

Resale of product through two distributors accounted for approximately 20% and 17% of revenue in the first nine months of 2003, and 23% and 19%, respectively, for the first nine months of 2002. More than 90% of our property and equipment is located in the United States. Other long-lived assets located outside the United States consist primarily of foundry investments and advances.

Note 13 - Stock Option Exchange Program:

On March 14, 2003, we completed a stock option exchange program. Under the exchange offer, eligible employees had the opportunity to tender for cancellation certain stock options in exchange for new options to be granted at least six months and one day after the cancellation of the tendered options. Each eligible participant received four new options to purchase shares of common stock for every seven options submitted for cancellation. We accepted approximately 11.2 million options for exchange at various exercise prices between \$6.30 and \$32.25 and granted approximately 6.4 million new options on September 18, 2003, the new grant date. The exercise price per share of the new options of \$8.21 was equal to the fair market value of our common stock on the new grant date.

In connection with the stock option exchange program, we accelerated the write-off of accrued deferred compensation recorded in conjunction with certain of our acquisitions, due to the cancellation of certain assumed in-the-money stock options. Such acceleration resulted in \$2.2 million of additional intangible asset amortization expense in the first quarter of 2003. However, we do not expect to record any additional compensation expense as a result of the exchange program.

Note 14- Convertible Subordinated Notes:

On June 20, 2003, we issued \$200 million in Zero Coupon Convertible Subordinated Notes due on July 1, 2010. No interest will accrue or be payable related to these notes. Holders of these notes may convert the notes into shares of our common stock at any time before the close of business on the date of their maturity, unless the notes have been previously redeemed or repurchased, if (1) the price of our common stock issuable upon conversion of a note reaches a specified threshold, (2) the notes are called for redemption, (3) specified corporate transactions occur or (4) the trading price of the notes falls below certain thresholds. The conversion price is approximately \$12.06 per share, subject to adjustment in certain circumstances. On or after July 1, 2008, we have the option to redeem all or a portion of the notes that have not been previously repurchased or converted at 100% of the principal amount of the notes. On July 1, 2008, holders have the option to require us to purchase all or a portion of their notes in cash at 100% of the principal amount of the notes. The notes are subordinated in right of payment to all of our senior indebtedness, and are subordinated by operation of law to all liabilities of our subsidiaries. At September 30, 2003, we had no senior indebtedness and our subsidiaries had approximately \$2.6 million of debt and other liabilities outstanding. Issuance costs relative to these convertible notes are included in Foundry investments, advances and other assets and aggregated approximately \$5.5 million and are being amortized to expense over the lives of the notes. Accumulated amortization of these issuance costs was approximately \$0.4 million as of September 30, 2003.

During the third quarter of 2003, we extinguished approximately \$16.0 million of these notes for approximately \$14.2 million in cash and recognized a gain of approximately \$1.4 million. In connection with this transaction, we also wrote off approximately \$0.4 million of unamortized issuance costs.

On July 21, 2003, we redeemed for cash all of our outstanding 4¾% Convertible Subordinated Notes due in 2006 plus accrued interest. Total cash paid at redemption approximated \$178.8 million, including par value of \$172.3 million, accrued interest of approximately \$1.8 million and a call premium of 2.71% of the outstanding notes, or approximately \$4.7 million. This call premium, plus unamortized issuance costs of approximately \$1.0 million as of the redemption date, was recorded as Other expense in the quarter ended September 30, 2003.

Note 15 Restatement:

In January 2004, management learned of certain incorrect accounting entries relating to our deferred income accounting for sales to distributors in the quarters ended June 30, 2003 and September 30, 2003. Pursuant to our accounting principles for revenue recognition, we defer reporting revenue from sales to distributors until the period in which the distributors resell our product to their customers. The Audit Committee of our Board of Directors undertook an investigation of this matter with the assistance of our independent auditor and outside legal counsel. That investigation is complete and the Audit Committee has recommended the adoption of certain internal control and system enhancements. We are currently implementing these Audit Committee directives. As a result of the investigation, we have determined that entries made in the second and third quarters of 2003 which reduced Accrued Expenses in the amount of \$1.3 million and \$4.2 million, respectively, were inappropriate. We also determined that our systems, procedures and controls surrounding (1) our estimation of resale by our distributors and (2) our determination of deferred revenue related to distributor inventories needed to be improved. During the investigation, we carried out additional procedures to (1) refine our estimate of the amount of distributor resale revenue and (2) refine our method for estimating deferred revenue related to distributor inventories. As a result of those additional procedures, we believe our Consolidated Balance Sheet Deferred Income account was understated at March 31, 2003, June 30, 2003 and September 30, 2003 by amounts requiring an adjustment of approximately \$1.0 million, \$1.6 million and \$8.0 million, respectively to reduce Revenues previously recognized and approximately \$0.2 million, \$0.3 million and \$1.3 million, respectively, to reduce Cost of Products Sold previously recognized. As previously noted, approximately \$1.3 million and \$4.2 million of the resulting adjustments to the Deferred Income account were incorrectly restored to the Deferred Income account in our June 30, 2003 and September 30, 2003 balance sheet, respectively, through an entry to Accrued Expenses instead of the

Consolidated Statement of Operations. The Deferred Income account balance fell below the minimum required level to support inventory on distributors shelves primarily due to (1) non recurring transactions in the September 30, 2003 quarter related to distributor price adjustments and incorrect distributor reporting of resale in previously reported quarterly financial statements, and (2) over-estimates of revenue related to resale occurring in the current fiscal year. We have already implemented certain of the internal control and systems enhancements recommended by the Audit Committee and are currently implementing other Audit Committee directives that resulted from its investigation.

Balance Sheet at September 30, 2003 (in thousands)	As Reported		As Restated	
Accounts Payable and Accrued Expenses	\$	28,846	\$	34,356
Deferred Income		6,361		9,766
Current Liabilities		35,207		44,122
Retained Earnings		37,548		28,633
Total Liabilities and Shareholders Equity		873,515		873,515

Statement of Operations for the three months and nine months ended September 30, 2003 (in thousands, except per share data)

	Three months ended Sept 30, 2003		Nine months ended Sept 30, 2003	
	As Reported	As Restated	As Reported	As Restated
Revenue	\$ 51,038	\$ 43,033	\$ 167,527	\$ 156,905
Cost of products sold	20,662	19,431	67,159	65,452
Operating expenses	51,952	51,952	160,384	160,384
Loss from operations	(21,576)	(28,350)	(60,016)	(68,931)
Net Loss	(21,887)	(28,661)	(57,647)	(66,562)
Net Loss per share				
Basic	\$ (0.20)	\$ (0.26)	\$ (0.52)	\$ (0.60)
Net Loss per share				
Diluted	\$ (0.20)	\$ (0.26)	\$ (0.52)	\$ (0.60)

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

This Quarterly Report on Form 10-Q/A contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. Any statements about our expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and may be forward-looking. We use words or phrases such as anticipates, believes, estimates, expects, intends, plans, projects, may, will, should, continue, ongoing, future, potential and similar words or phrases to identify forward-looking statements.

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Forward-looking statements involve estimates, assumptions, risks and uncertainties that could cause actual results to differ materially from those expressed in them. Among the key factors that could cause our actual results to differ materially from the forward-looking statements are delay in product or technology development, change in economic conditions of the various markets we serve, lack of market acceptance or demand for our new products, dependencies on silicon wafer suppliers and semiconductor assemblers, the impact of competitive products and pricing, opportunities or acquisitions that we pursue, the availability and terms of financing, and the other risks that are described herein and that are otherwise described from time to time in our filings with the Securities and Exchange Commission, including but not limited to the items discussed in *Factors Affecting Future Results* set forth in *Management's Discussion and Analysis of Financial Condition and Results of Operations* in Item 2 of this report. You should not unduly rely on forward-looking statements because our actual results could materially differ from those expressed in any forward-looking statements made by us. Further, any forward-looking statement applies only as of the date on which it is made. We are not required to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Lattice Semiconductor Corporation designs, develops and markets high performance programmable logic devices, or PLDs, and related software. Programmable logic devices are widely-used semiconductor components that can be configured by the end customer as specific logic circuits, and enable the end customer to shorten design cycle times and reduce development costs. Our end customers are primarily original equipment manufacturers in the communications, computing, industrial, automotive, medical, consumer and military end markets.

Restatement and Change in Accounting Estimate During 2003

We restated our Deferred Income and Accrued Expense Balance Sheet accounts, and Revenue and Cost of Products Sold accounts in the Consolidated Statement of Operations for the June and September quarters of 2003 and our Deferred Income, Revenue and Cost of Products Sold accounts for the March quarter of 2003 to correct accounting errors and to reflect a change in accounting estimate related to Deferred Income. For the 2003 year, the aforementioned restatement related to accrued expenses and the changes in accounting estimate reduced revenue by approximately \$10.6 million, reduced cost of products sold by approximately \$1.8 million, reduced gross margin by approximately \$8.9 million and increased deferred income by approximately \$8.9 million. The related circumstances and impact on the three months and nine months ended September 30, 2003 are described in more detail in Note 15.

Results of Operations

Key elements of our consolidated statement of operations, expressed as a percentage of revenues, were as follows:

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2003 (Restated)	Sept. 30, 2002	Sept. 30, 2003 (Restated)	Sept. 30, 2002
Revenue	100.0%	100.0%	100.0%	100.0%
Gross margin	54.8%	60.0%	58.3%	60.0%
Research and development expenses	49.2%	38.4%	41.2%	37.3%
Selling, general and administrative expenses	28.2%	20.9%	23.7%	20.9%
In-process research and development		10.1%		17.4%
Amortization of intangible assets	43.4%	32.2%	37.3%	31.9%
Loss from operations	(65.9)%	(41.6)%	(43.9)%	(47.5)%

Revenue:

Revenue for the third quarter of 2003 decreased by \$13.0 million (restated), or 23 percent, as compared to the third quarter of 2002, and by \$14.5 million (restated), or eight percent for the first nine months of 2003 when compared to the first nine months of 2002. The composition of our revenue by product family for the third quarter and first nine months of 2003 and 2002, respectively, was as follows:

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2003 (Restated)	Sept. 30, 2002	Sept. 30, 2003 (Restated)	Sept. 30, 2002
FPGA	21%	13%	17%	11%
CPLD	69%	69%	70%	69%
SPLD	10%	18%	13%	20%

We acquired Agere FPGA on January 18, 2002 (see Note 5). Prior to the acquisition, we had no revenue from the sale of FPGA products.

Beginning in 2001, the semiconductor and PLD markets experienced a significant downturn, which has continued into 2003. Overall revenue levels for all periods presented remain substantially depressed from earlier periods and reflect the continued downturn and resultant overall decrease in demand for our products. The steeper revenue decline in the third quarter reflects sales allowances and price protection credited to distributors during the quarter and to a lesser extent a continued softening in demand and declining average selling prices for our SPLD and certain CPLD products, which more than offset increased revenue from sales of our FPGA and new CPLD products.

As a percentage of total revenue, U.S. sales were 32% (restated) for the first nine months of 2003 as compared to 41% for the first nine months of 2002. Export sales to Asia rose as a percentage of total revenue, from 28% in the first nine months of 2002 to 37% (restated) in the first nine months of 2003. Export sales to Europe were approximately flat when comparing both nine-month fiscal periods in percentage terms.

The 23% decline in revenue for the quarter ended on September 30, 2003 (after the restatement discussed above) as compared to the comparable prior year quarter is attributable to units sold since average selling prices only declined slightly. The nine percent decline in

revenue for the nine months ended September 30, 2003 (after the restatement discussed above) as compared to comparable prior year period is attributable to units sold since there was no significant change in overall average selling prices. During the periods discussed, average selling prices declined for SPLD products generally and for certain CPLD products which were offset by changes in product mix. Although selling prices of mature products generally decline over time, this decline is at times offset by higher selling prices of new products. Our ability to achieve revenue growth is in large part dependent on the continued development, introduction and market acceptance of new products. See Factors Affecting Future Results.

Gross margin:

Gross margin as a percentage of revenue declined to 54.8% (restated) for the third quarter of 2003 as compared to 60.0% for the third quarter of 2002, and declined to 58.3% (restated) for the first nine months of 2003 as compared to 60.0% for the first nine months of 2002. With respect to the nine month period ended September 30, 2003, the gross margin percentage decline is primarily related to the third quarter of 2003 and reflects provision for an allowance for price protection and sales returns for distributors in the quarter. To a lesser extent, the decrease in gross margin for the September 2003 quarter also reflects the increased proportion of fixed manufacturing costs in the quarter as a result of lower revenue levels.

Research and development:

Research and development expenses decreased by \$0.4 million in the third quarter of 2003 as compared to the third quarter of 2002 but increased by approximately \$0.7 million for the first nine months of 2003 when compared to the same calendar period of 2002. Research and development expenses consist primarily of labor, masks, prototype wafers, third-party design automation software, assembly tooling and qualification expenses. The slight increase in research and development expense for the first nine months of 2003 when compared to the same 2002 calendar period was primarily due to increased headcount and related spending due to our acquisition of Cerdelix (see Note 4). We believe that a continued commitment to research and development is essential in order to maintain product leadership of our existing product families and to provide innovative new product offerings, and therefore we expect to continue to make significant future investments in research and development.

Selling, General and Administrative Expense:

Selling, general and administrative (SG&A) expenses increased approximately \$0.4 million in the third quarter of 2003 when compared to the third quarter of 2002, and by \$1.4 million for the first nine months of 2003 when compared to the same calendar periods of 2002. These increases were primarily due to increased selling and marketing expenses related to new products.

In-Process Research and Development:

IPR&D consists of those products obtained through acquisition that are not yet proven to be technologically feasible but have been developed to a point where there is value associated with them in relation to potential future revenue. Because technological feasibility was not yet proven and no alternative future uses are believed to exist for the in-process technologies, the assigned value was expensed immediately upon the closing

date of the acquisitions.

Cerdelinx

The fair value underlying the \$5.7 million assigned to acquired IPR&D from the Cerdelinx acquisition (recognized in the third quarter of 2002) was determined by identifying research projects in areas for which technological feasibility had not been established and there were no alternative future uses. The acquired IPR&D consists of low-power CMOS transceivers and backplane interfaces with embedded high-speed SERDES I/O. These products were approximately 60% complete and were estimated to be completed in 2003 at an estimated cost of approximately \$2 million. This project is now estimated to be complete in the first half of 2004. There has been no material change in the estimated cost of this project.

The fair value was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over six year periods were discounted at rates ranging from 15 to 17 percent in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements.

All of these projects have completion risks related to silicon functionality, architecture performance, process technology availability, packaging technology, continued availability of key technical personnel and product reliability. To the extent that estimated completion dates are not met, the risk of competitive product introduction is greater and revenue opportunity may be permanently lost.

Agere FPGA

The fair value underlying the \$24.2 million assigned to acquired IPR&D in the Agere FPGA acquisition was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are the ORCA 4 FPGA family, the next generation FPGA family and the FPSC field-programmable system chips. The following is a brief description of these projects. The ORCA 4 FPGA family project, increasing speed and density and enhancing yields, was approximately 85% complete and estimated to be completed by 2003 at an estimated cost of \$1.5 million. This project was completed during 2002 with no material change in cost. The next generation FPGA family project, increasing speed and density while reducing die size, was approximately 50% complete and estimated to be completed by 2004 at an estimated cost of \$2 million. There has been no material change in the schedule or estimated cost of this project. The future development of FPSC field-programmable system chips (field-programmable system chips which combine embedded pre-defined logic circuits with an FPGA platform) was approximately 25% to 90% complete, and estimated to be completed by 2004 at an estimated cost of \$2 million. There has been no material change in the schedule or estimated cost of this project. The IPR&D value of \$24.2 million was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over 5-7 year periods were discounted at rates ranging from 23 to 25 percent in relation to the stage of completion and the

technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact our expected return on investment and future results. In addition, our financial condition would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to silicon functionality, architecture performance, process technology availability, packaging technology, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

Amortization of Intangible Assets:

Amortization of intangible assets is related to our 2002 acquisitions of Agere FPGA and Cerdelinx, our 1999 Vantis acquisition and our 2001 acquisition of Integrated Intellectual Property, Inc. (IIP). Amortization expense was \$18.7 million and \$58.5 million in the third quarter and first nine months of 2003, an increase of \$0.6 million and \$3.9 million when compared to the same calendar periods of 2002. The most significant portion (\$2.2 million) of this increase resulted from the accelerated write-off of accrued deferred compensation recorded in the first quarter of 2003 in conjunction with certain of our acquisitions, due to the cancellation of certain assumed in-the-money stock options as part of a stock option exchange program initiated during the first quarter of 2003 (see Note 13). Nearly all of the remaining increase resulted from the amortization of intangible assets related to our acquisition of Cerdelinx.

Other (expense) income, net:

Other (expense) income, net, was (\$3.6 million) and (\$3.5 million), respectively, in the third quarter and first nine months of 2003, as compared to \$2.8 million and \$3.9 million, respectively, for the same calendar periods of 2002. During the third quarter of 2003, we redeemed for cash all of our outstanding 4³/₄% Convertible Subordinated Notes due in 2006 plus accrued interest (see Note 14). In conjunction with the call of these notes, we paid a call premium of 2.71% of the outstanding notes, or approximately \$4.7 million. This call premium, plus unamortized issuance costs of approximately \$1.0 million on the redemption date, was recorded as Other expense in the quarter ended September 30, 2003. Also during the third quarter of 2003, we extinguished approximately \$16.0 million of our newly issued Zero Coupon Convertible Subordinated Notes due in 2010 for approximately \$14.2 million in cash and recognized a gain of approximately \$1.4 million. In connection with this transaction, we also wrote off approximately \$0.4 million of issuance costs. The gain on the extinguishment, along with interest income on our invested balances, partially offset the expenses related to the call of our outstanding convertible debt.

During the second quarter of 2002, we recorded a \$4.0 million gain in connection with the sale of approximately 7.6 million unrestricted UMC shares (see Note 11). There was no such transaction in the 2003 periods. Additionally during the second quarter of 2002, we recorded a \$1.2 million gain in connection with the extinguishment of a portion of our 4³/₄% convertible notes. During the first quarter of 2003, we recorded a gain of approximately \$2.9 million in connection with the extinguishment of an

additional portion of these convertible notes. In conjunction with reducing our outstanding 4¾% convertible debt from \$260 million at the end of the first quarter of 2002 to approximately \$172 million at the end of the second quarter of 2003, quarterly interest expense was reduced from \$3.1 million to \$2.2 million, a reduction of approximately \$0.9 million per quarter, and decreased further to approximately \$0.5 million in the September 2003 quarter due to the extinguishment of these notes (see Note 14) on July 21, 2003.

Benefit for income taxes:

During the third quarter of 2003, we recorded an income tax benefit of \$3.3 million related to the release of certain tax reserves. During the second quarter of 2003, we recorded an income tax benefit of approximately \$2.6 million, related to a refund of federal income taxes of approximately \$28.1 million received in the second quarter of 2003 and resulting from the carryback of 2002 net operating losses to prior profitable periods.

The benefit for income taxes was \$6.2 million and \$29.3 million, respectively, in the third quarter and first nine months of 2002, attributable to pre-tax losses during those periods. No income taxes were provided for in the first quarter of 2003. This is the result of the following factors:

- 1) We continued to experience significant losses during the first quarter of 2003 and are currently not paying any significant income taxes;
- 2) Federal net operating loss carrybacks and credit carrybacks available in prior periods are no longer available; and,
- 3) In the fourth quarter of 2002, we recorded a \$118.6 million charge to income tax expense, representing a valuation allowance on our recorded deferred tax assets, in accordance with SFAS 109, Accounting for Income Taxes. We provided a valuation allowance equal to our net deferred tax assets due to uncertainties regarding their realization. Due to continued uncertainties regarding their realization, we continue to provide a valuation allowance equal to our net deferred tax assets.

FACTORS AFFECTING FUTURE RESULTS

A continuing downturn in the communications equipment and computing end markets has caused a reduction in demand for our products and limited our ability to maintain or increase revenue levels and operating results.

A significant portion of our revenue is derived from customers in the communications equipment and computing end markets. A downturn in the economy could lead to a contraction of capital spending on information technology. This in turn could lead to a reduction in the demand for communications or computing equipment and for our products.

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Due to a deterioration in overall economic conditions and a significant reduction in information technology capital spending, the communications and computing end markets are currently experiencing significant and prolonged downturns. At present and in the future when these or other similar conditions exist, there is likely to be an adverse effect on our operating results.

The cyclical nature of the semiconductor industry may limit our ability to maintain or increase revenue levels and operating results during current or future industry downturns.

The semiconductor industry is highly cyclical, to a greater extent than other less technology-driven industries. Our financial performance has periodically been negatively affected by downturns in the semiconductor industry. Factors that contribute to these industry downturns include:

the cyclical nature of the demand for the products of semiconductor customers;

general reductions in inventory levels by customers;

excess production capacity;

general decline in end-user demand; and

accelerated declines in average selling prices.

Beginning in 2001, the semiconductor industry experienced a significant downturn. At present and in the future when these or other similar conditions exist, there is likely to be an adverse effect on our operating results.

We may experience unexpected difficulties integrating the field programmable gate array, or FPGA, business which we recently purchased from Agere.

On January 18, 2002, we acquired the FPGA business of Agere Systems and are currently completing the integration of this business with our operations. If our integration is unsuccessful, more difficult or more time consuming than originally planned, we may incur unexpected disruptions to our ongoing business. These disruptions could harm our operating results. Further, the following specific factors may adversely affect our ability to integrate the FPGA business of Agere:

we may experience unexpected losses of key employees or customers;

we may not achieve expected levels of revenue growth;

we may not be able to coordinate our new product and process development in a way which permits us to bring future new products to the market in a timely manner; and

we may discover unexpected liabilities.

We may be unsuccessful in defining, developing or selling new products required to maintain or expand our business.

As a semiconductor company, we operate in a dynamic environment marked by rapid product obsolescence. Our future success depends on our ability to introduce new or improved silicon and software products that meet customer needs while achieving acceptable margins. If we fail to

introduce these new products in a timely manner or these products fail to achieve market acceptance, our operating results would be harmed.

The introduction of new silicon and software products in a dynamic market environment presents significant business challenges. Product development commitments and expenditures must be made well in advance of product sales. The market reception of new products depends on accurate projections of long-term customer demand, which by their nature are uncertain.

Our future revenue growth is dependent on market acceptance of our new silicon and software product families and the continued market acceptance of our current products. The success of these products is dependent on a variety of specific technical factors including:

successful product definition;

timely and efficient completion of product design;

timely and efficient implementation of wafer manufacturing and assembly processes;

product performance;

product cost; and

the quality and reliability of the product.

If, due to these or other factors, our new silicon and software products do not achieve market acceptance, our operating results would be harmed.

Our products may not be competitive if we are unsuccessful in migrating our manufacturing processes to more advanced technologies or alternative fabrication facilities.

To develop new products and maintain the competitiveness of existing products, we need to migrate to more advanced wafer manufacturing processes that use larger wafer sizes and smaller device geometries. We also may need to use additional foundries. Because we depend upon foundries to provide their facilities and support for our process technology development, we may experience delays in the availability of

advanced wafer manufacturing process technologies at existing or new wafer fabrication facilities. As a result, volume production of our advanced process technologies at the fabs of Seiko Epson, UMC, Chartered Semiconductor or future foundries may not be achieved. This could harm our operating results.

In late 2001, UMC informed us that as part of an overall capacity rationalization they were planning to close certain of their fabrication facilities. We were developing an advanced wafer manufacturing process at one of the UMC fabs that has been closed. With UMC's support, we have transferred this process to another UMC fab. However, as a result, our new product introduction schedules were delayed. This could harm our operating results.

Our marketable securities, which we hold for strategic reasons, are subject to equity price risk and their value may fluctuate.

Currently we hold substantial equity in UMC, which we acquired as part of a strategic investment to obtain certain manufacturing rights. The market price and valuation of these equity shares has fluctuated widely due to market and other conditions over which we have little control. During the year ended December 31, 2001, we recorded a \$152.8 million pre-tax impairment loss related to this investment. In the future, UMC shares may continue to experience significant price volatility. In the second quarter of 2002, we sold a portion of our UMC shares, but have otherwise not attempted to reduce or eliminate this equity price risk through hedging or similar techniques and hence substantial, sustained changes in the market price of UMC shares could impact our financial results. To the extent that the market value of our UMC shares experiences a significant decline for an extended period of time, our net income could be reduced.

Our future quarterly operating results may fluctuate and therefore may fail to meet expectations.

Our quarterly operating results have fluctuated and may continue to fluctuate. Consequently, our operating results may fail to meet the expectations of analysts and investors. As a result of industry conditions and the following specific factors, our quarterly operating results are more likely to fluctuate and are more difficult to predict than a typical non-technology company of our size and maturity:

general economic conditions in the countries where we sell our products;

conditions within the end markets into which we sell our products;

the cyclical nature of demand for our customers' products;

excessive inventory accumulation by our end customers;

the timing of our and our competitors' new product introductions;

product obsolescence;

the scheduling, rescheduling and cancellation of large orders by our customers;

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our ability to develop new process technologies and achieve volume production at the fabs of Seiko Epson, UMC, Chartered Semiconductor or at other foundries;

changes in manufacturing yields;

adverse movements in exchange rates, interest rates or tax rates; and

the availability of adequate supply commitments from our wafer foundries and assembly and test subcontractors.

As a result of these factors, our past financial results are not necessarily a good predictor of our future results.

Our stock price may continue to experience large fluctuations.

In recent years, the price of our common stock has fluctuated greatly. These price fluctuations have been rapid and severe and have left investors little time to react. The price of our common stock may continue to fluctuate greatly in the future due to a variety of company specific factors, including:

quarter-to-quarter variations in our operating results;

shortfalls in revenue or earnings from levels expected by securities analysts; and

announcements of technological innovations or new products by other companies.

Presently, our stock price is trading near our consolidated book value. A sustained decline in our stock price may result in a write-off of goodwill (see Note 9).

Our wafer supply may be interrupted or reduced, which may result in a shortage of finished products available for sale.

We do not manufacture finished silicon wafers. Currently, substantially all of our silicon wafers are manufactured by Seiko Epson in Japan, UMC in Taiwan, and Chartered Semiconductor in Singapore. If Seiko Epson, through its U.S. affiliate, Epson Electronics America, UMC or Chartered significantly interrupts or reduces our wafer supply, our operating results could be harmed.

In the past, we have experienced delays in obtaining wafers and in securing supply commitments from our foundries. At present, we anticipate that our supply commitments are adequate. However, these existing supply commitments may not be sufficient for us to satisfy customer demand in future periods. Additionally, notwithstanding our supply commitments we may still have difficulty in obtaining wafer deliveries consistent with the supply commitments. We negotiate wafer prices and supply commitments from our suppliers on at least an annual basis. If any of Seiko Epson, Epson Electronics America, UMC or Chartered Semiconductor were to reduce its supply commitment or increase its wafer prices, and we cannot find alternative sources of wafer supply, our operating results could be harmed.

Many other factors that could disrupt our wafer supply are beyond our control. Since worldwide manufacturing capacity for silicon wafers is limited and inelastic, we could be harmed by significant industry-wide increases in overall wafer demand or interruptions in wafer supply.

Additionally, a future disruption of Seiko Epson's, UMC's or Chartered Semiconductor's foundry operations as a result of a fire, earthquake or other natural disaster could disrupt our wafer supply and could harm our operating results.

If our foundry partners experience quality or yield problems, we may face a shortage of finished products available for sale.

We depend on our foundries to deliver reliable silicon wafers with acceptable yields in a timely manner. As is common in our industry, we have experienced wafer yield problems and delivery delays. If our foundries are unable for a prolonged period to produce silicon wafers that meet our specifications, with acceptable yields, our operating results could be harmed.

The majority of our revenue is derived from products based on a specialized silicon wafer manufacturing process technology called E²CMOS[®]. The reliable manufacture of high performance E²CMOS semiconductor wafers is a complicated and technically demanding process requiring:

a high degree of technical skill;

state-of-the-art equipment;

the absence of defects in the masks used to print circuits on a wafer;

the elimination of minute impurities and errors in each step of the fabrication process; and

effective cooperation between us and the wafer supplier.

As a result, our foundries may experience difficulties in achieving acceptable quality and yield levels when manufacturing our silicon wafers.

If our assembly and test contractors experience quality or yield problems, we may face a shortage of finished products available for sale.

We rely on contractors to assemble and test our devices with acceptable quality and yield levels. As is common in our industry, we have experienced quality and yield problems in the past. If we experience prolonged quality or yield problems in the future, our operating results could be harmed.

The majority of our revenue is derived from semiconductor devices assembled in advanced packages. The assembly of advanced packages is a complex process requiring:

a high degree of technical skill;

state-of-the-art equipment;

the absence of defects in lead frames used to attach semiconductor devices to the package;

the elimination of raw material impurities and errors in each step of the process; and

effective cooperation between us and the assembly contractor.

As a result, our contractors may experience difficulties in achieving acceptable quality and yield levels when assembling and testing our semiconductor devices.

Deterioration of conditions in Asia may disrupt our existing supply arrangements and result in a shortage of finished products available for sale.

All three of our major silicon wafer suppliers operate fabs located in Asia. Our finished silicon wafers are assembled and tested by independent contractors located in China, Malaysia, the Philippines, South Korea and Taiwan. A prolonged interruption in our supply from any of these contractors could harm our operating results.

Economic, financial, social and political conditions in Asia have historically been volatile. Financial difficulties, governmental actions or restrictions, prolonged work stoppages or any other difficulties experienced by our suppliers may disrupt our supply and could harm our operating results.

Our wafer purchases from Seiko Epson are denominated in Japanese yen. The value of the dollar with respect to the yen fluctuates. Substantial deterioration of dollar-yen exchange rates could harm our operating results.

Export sales account for a substantial portion of our revenues and may decline in the future due to economic and governmental uncertainties.

Our export sales are affected by unique risks frequently associated with foreign economies including:

changes in local economic conditions;

exchange rate volatility;

governmental controls and trade restrictions;

export license requirements and restrictions on the export of technology;

political instability or terrorism;

changes in tax rates, tariffs or freight rates;

interruptions in air transportation; and

difficulties in staffing and managing foreign sales offices.

For example, our export sales have historically been affected by regional economic crises. Significant changes in the economic climate in the foreign countries where we derive our export sales could harm our operating results.

We may not be able to successfully compete in the highly competitive semiconductor industry.

The semiconductor industry is intensely competitive and many of our direct and indirect competitors have substantially greater financial, technological, manufacturing, marketing and sales resources. If we are unable to compete successfully in this environment, our future results will be adversely affected.

The current level of competition in the programmable logic market is high and may increase in the future. We currently compete directly with companies that have licensed our technology or have developed similar products. We also compete indirectly with numerous semiconductor companies that offer products and solutions based on alternative technologies. These direct and indirect competitors are established multinational semiconductor companies as well as emerging companies. We also may experience significant competition from foreign companies in the future.

We may fail to retain or attract the specialized technical and management personnel required to successfully operate our business.

To a greater degree than most non-technology companies or larger technology companies, our future success depends on our ability to attract and retain highly qualified technical and management personnel. As a mid-sized company, we are particularly dependent on a relatively small group of key employees. Competition for skilled technical and management employees is intense within our industry. As a result, we may not be able to retain our existing key technical and management personnel. In addition, we may not be able to attract additional qualified employees in the future. If we are unable to retain existing key employees or are unable to hire new qualified employees, our operating results could be adversely affected.

If we are unable to adequately protect our intellectual property rights, our financial results and competitive position may suffer.

Our success depends in part on our proprietary technology. However, we may fail to adequately protect this technology. As a result, we may lose our competitive position or face significant expense to protect or enforce our intellectual property rights.

We intend to continue to protect our proprietary technology through patents, copyrights and trade secrets. Despite this intention, we may not be successful in achieving adequate protection. Claims allowed on any of our patents may not be sufficiently broad to protect our technology. Patents issued to us also may be challenged, invalidated or circumvented. Finally, our competitors may develop similar technology independently.

Companies in the semiconductor industry vigorously pursue their intellectual property rights. If we become involved in protracted intellectual property disputes or litigation we may utilize substantial financial and management resources, which could have an adverse effect on our operating results.

Our industry is characterized by frequent claims regarding patents and other intellectual property rights of others. We have been, and from time-to-time expect to be, notified of claims that we are infringing the intellectual property rights of others. If any third party makes a valid claim against us, we could face significant liability and could be required to make material changes to our products and processes.

In response to any claims of infringement, we may seek licenses under patents that we are alleged to be infringing. However, we may not be able to obtain a license on favorable terms or without our operating results being adversely affected.

New Accounting Pronouncements

In June 2001, the FASB issued SFAS 142, which supersedes APB Opinion No. 17, Intangible Assets. SFAS 142, among other things, establishes new standards for intangible assets acquired in a business combination, eliminates amortization of goodwill and sets forth requirements to periodically evaluate goodwill for impairment. We adopted this statement during the first quarter of 2002 and thus goodwill and certain intangibles with indefinite lives are no longer being amortized. To apply SFAS 142, a company is divided into separate reporting units, each representing groups of products that are separately managed. For this purpose, we have one reporting unit. To determine whether or not goodwill may be impaired, a test is required comparing the book value of the reporting unit to its trading price. Similar tests are required in the future, at least annually, and more often where there is a change in circumstances that could result in an impairment of goodwill. If the trading price of our common stock is below the book value for a sustained period, a goodwill impairment test will be performed by comparing book value to estimated market value (trading price plus a control premium). The excess of book value over estimated market value will then be subtracted from the goodwill account with a resulting charge to operations. Subsequent unrealized recoveries in market value, if any, will not be recorded. We completed an initial goodwill impairment assessment as of January 1, 2002 to determine if a transition impairment charge should be recognized under SFAS 142. Upon assessment, no transition impairment charge was recorded. Additional goodwill impairment tests will be performed at least annually.

The following tables present details of the Company's total purchased intangible assets (in millions):

Sept. 30, 2003	Gross		Accumulated amortization		Net	
Current technology	\$	273.6	\$	(200.8)	\$	72.8
Core technology		7.3		(1.5)		5.8
Licenses		10.2		(2.5)		7.7
Non-compete agreements		14.2		(8.0)		6.2
Workforce		4.7		(1.0)		3.7
Backlog		1.4		(1.4)		
Customer list		17.4		(14.9)		2.5
Patents and trademarks		26.8		(23.0)		3.8
Total	\$	355.6	\$	(253.1)	\$	102.5

December 31, 2002	Gross		Accumulated amortization		Net	
Current technology	\$	273.6	\$	(160.3)	\$	113.3
Core technology		7.3		(.5)		6.8
Licenses		10.2		(1.4)		8.8
Non-compete agreements		14.2		(4.4)		9.8
Workforce		4.7		(.3)		4.4
Backlog		1.4		(1.4)		
Customer list		17.4		(12.3)		5.1
Patents and trademarks		26.8		(19.0)		7.8
Total	\$	355.6	\$	(199.6)	\$	156.0

The estimated future amortization expense of purchased intangible assets as of September 30, 2003 is as follows (in millions):

Fiscal Year:	Amount	
2003 (remaining three months)	\$	17.8
2004		43.8
2005		14.4
2006		10.8
2007		9.8
Later years		5.9
	\$	102.5

The estimated future amortization expense of deferred stock compensation attributable to Research and Development activities as of September 30, 2003 is approximately \$0.8 million for the remainder of 2003, \$3.3 million for 2004, and \$2.2 million for 2005.

In May 2002, the FASB issued SFAS 145, Rescission of FAS Nos. 4, 44, and 64, Amendment of FAS 13, and Technical Corrections. Among other things, SFAS 145 rescinds various pronouncements regarding early extinguishment of debt and allows extraordinary accounting treatment for early extinguishment only when the provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions are met. SFAS 145 provisions regarding early extinguishment of debt are generally effective for fiscal years beginning after May 15, 2002. Management adopted this pronouncement during the second quarter of 2002. During the second through fourth quarters of 2002, we extinguished approximately \$51.9 million face value of our 4¾% convertible notes for approximately \$42.8 million in cash, including accrued interest. We recognized a gain of approximately \$9.3 million in connection with these transactions. During the first quarter of 2003, we extinguished approximately \$32.8 million of these notes for approximately \$29.9 million in cash including accrued interest and recognized a gain of approximately \$2.9 million. During the second

quarter of 2003, we extinguished \$3.0 million of these notes for approximately the same amount of cash including accrued interest, at approximately carrying cost. As specified in SFAS 145, gains recognized were recorded in Other (expense) income, net in the accompanying Consolidated Statement of Operations. During the third quarter of 2003, we extinguished our remaining 4¾% Convertible Notes (see Note 14). Expenses related to the call of these notes were recorded in Other (expense) income, net in the accompanying Consolidated Statement of Operations. Also during the third quarter of 2003, a \$1.4 million gain recognized in connection with the early extinguishment of a portion of our Zero Coupon Convertible Subordinated Notes issued in June 2003 (see Note 14) was recorded in accordance with SFAS 145.

In December 2002, the FASB issued SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure. This statement provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, it amends the disclosure requirements of SFAS 123 to require prominent disclosure in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reporting results. This statement is effective for fiscal years ending after December 15, 2002 and for the interim periods beginning after December 15, 2002. As we continue to report stock-based employee compensation costs using the intrinsic value method as defined by APB 25, adoption of the provisions of the new statement affects only our disclosure of these costs, which is presented in Note 3.

Liquidity and Capital Resources

As of September 30, 2003, our principal source of liquidity was \$278.8 million of cash and short-term investments, an increase of \$1.9 million from the balance of \$276.9 million at December 31, 2002. This balance remained relatively flat as the receipt of \$195.0 million in the second quarter of 2003 in conjunction with the issuance of \$200 million of our Zero Coupon Convertible Subordinated Notes was offset by the \$211.6 million in cash used during the first nine months of 2003 to retire our remaining 4¾% Convertible Subordinated Notes (see Note 14). Cash generated from operations, plus \$28.3 million in tax refunds received during 2003 more than offset the net of this financing activity as well as \$14.2 million in cash used during the third quarter of 2003 to extinguish a portion of our new Zero Coupon Convertible Subordinated Notes. Working capital decreased to \$322.1 million (restated) at September, 2003 from \$348.8 million at December 31, 2002. This decrease was also primarily due to the financing activity discussed above.

Inventories decreased by \$8.3 million, or 15%, as compared to the balance at December 31, 2002. This decrease was primarily due to reduced starts and receipts of wafers in response to continued lower revenue levels. Other current assets decreased by \$22.4 million, or 64%, as compared to the balance at December 31, 2002. This was primarily due to the receipt of federal income tax refunds of approximately \$28.3 million related to the carryback of 2002 net operating losses to prior profitable periods. Foundry investments, advances and other assets increased by \$20.2 million, or 19 percent. This increase was primarily due to \$19.8 million in unrealized gains recorded during the first nine months of 2003 related to our investment in UMC (see Note 11) and approximately \$5.5 million in fees and estimated issuance costs recorded in connection with the issuance of our Zero Coupon Convertible Subordinated Notes. Intangible assets, net, decreased by \$53.5 million, or 34% as compared to the balance at December 31, 2002, substantially due to amortization during the first nine months of 2003.

Deferred income on sales to distributors decreased by \$2.2 million, or 19% (restated) at September 30, 2003, as compared to the balance at December 31, 2002. This decrease was primarily due to a reduction in estimated salable and returnable inventories at distributors. The balance at September 30, 2003, reflects a \$3.4 million restatement (increase) as compared to the balance previously reported on our Form 10-Q for the quarter ended September 30, 2003 and filed on November 12, 2003 and reflects both a correction of an error and change in estimate related to this balance as further described in Note 15 to our Condensed Consolidated Financial Statements.

On June 20, 2003, we issued \$200 million in Zero Coupon Convertible Subordinated Notes due on July 1, 2010. No interest will accrue or be payable related to these notes. Holders of these notes may convert the notes into shares of our common stock at any time before the close of business on the date of their maturity, unless the notes have been previously redeemed or repurchased, if (1) the price of our common stock issuable upon conversion of a note reaches a specified threshold, (2) the notes are called for redemption, (3) specified corporate transactions occur or (4) the trading price of the notes falls below certain thresholds. The conversion price is approximately \$12.06 per share, subject to adjustment in certain circumstances. On or after July 1, 2008, we have the option to redeem all or a portion of the notes that have not been previously repurchased or converted at 100% of the principal amount of the notes. On July 1, 2008, holders have the option to require us to purchase all or a portion of their notes in cash at 100% of the principal amount of the notes. The notes are subordinated in right of payment to all of our senior indebtedness, and are subordinated by operation of law to all liabilities of our subsidiaries. At September 30, 2003, we had no senior indebtedness and our subsidiaries had approximately \$2.6 million of debt and other liabilities outstanding. Issuance costs relative to these convertible notes are included in Foundry investments, advances and other assets and aggregated approximately \$5.5 million and are being amortized to expense over the lives of the notes. Accumulated amortization of these issuance costs was approximately \$0.4 million as of September 30, 2003.

During the third quarter of 2003, we extinguished \$16.0 million of these notes for approximately \$14.2 million in cash and recognized a gain of approximately \$1.4 million. In connection with this transaction, we also wrote off approximately \$0.4 million of unamortized issuance costs.

On July 21, 2003, we redeemed for cash all of our outstanding 4¾% Convertible Subordinated Notes due in 2006 plus accrued interest. Total cash paid at redemption approximated \$178.8 million, including par value of \$172.3 million, accrued interest of approximately \$1.8 million and a call premium of 2.71% of the outstanding notes, or approximately \$4.7 million. This call premium, plus unamortized issuance costs of approximately \$1.0 million as of the redemption date, was recorded as Other expense in the quarter ended September 30, 2003.

We do not have any financial partnerships with unconsolidated entities, such as entities often referred to as structured finance or special purpose entities, which are often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Accordingly, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had such relationships.

Capital expenditures were approximately \$8.0 million for the first nine months of 2003. We expect to spend approximately \$10 million to \$12 million for the fiscal year ending December 31, 2003.

We currently own approximately 91.7 million shares of UMC common stock. Restrictions by UMC and the Taiwan government apply to approximately 23.3 million of these shares (see Note 11). During 2002, we sold approximately 7.6 million of our UMC shares for approximately \$9.9 million

in cash, resulting in a gain of \$4.0 million. In the future, we may or may not choose to liquidate additional UMC shares.

In December 2000, our Board of Directors authorized management to repurchase up to five million shares of our common stock. As of December 31, 2002, we had repurchased 1,136,000 shares (596,000 in 2001) at an aggregate cost of approximately \$20.0 million (\$10.6 million in 2001). There were no repurchases of common stock in 2002 or the first nine months of 2003.

In March 1997 and as subsequently amended in January 2002, we entered into an advance payment production agreement with Seiko Epson and Epson Electronics America, Inc. (EEA) under which we agreed to advance up to approximately \$69 million, payable upon completion of specific milestones, to Seiko Epson to finance construction of an eight-inch sub-micron semiconductor wafer manufacturing facility. Under the terms of the agreement, the advance is to be repaid with semiconductor wafers over a multi-year period. No interest income is recorded. The agreement calls for wafers to be supplied by Seiko Epson through EEA pursuant to purchase agreements with EEA. Payments of approximately \$51.3 million have been made under this agreement. Cumulatively, approximately \$14.6 million of these payments have been repaid to us in the form of semiconductor wafers. Approximately \$3.7 million of the outstanding advances are expected to be repaid with semiconductor wafers during the next twelve months and are thus reflected as part of Prepaid expenses and Other current assets in our Consolidated Balance Sheet. We do not anticipate making additional payments under this agreement.

We believe that our existing liquid resources, expected cash generated from operations and existing credit facilities combined with our ability to borrow additional funds will be adequate to meet our operating and capital requirements and obligations for the next 12 months.

We may in the future seek new or additional sources of funding. In addition, in order to secure additional wafer supply, we may from time to time consider various financial arrangements including joint ventures, equity investments, advance purchase payments, loans, or similar arrangements with independent wafer manufacturers in exchange for committed wafer capacity. To the extent that we pursue any such additional financing arrangements, additional debt or equity financing may be required. There can be no assurance that such additional financing will be available when needed or, if available, will be on favorable terms. Any future equity financing will decrease existing stockholders' equity percentage ownership and may, depending on the price at which the equity is sold, result in dilution.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of September 30, 2003 and December 31, 2002 our investment portfolio consisted of fixed income securities of \$276.3 million and \$274.4 million, respectively. As with all fixed income instruments, these securities are subject to interest rate risk and will decline in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10% from levels as of September 30, 2003 and December 31, 2002, the decline in the fair value of our portfolio would not be material. Further, we have the ability to hold our fixed income investments until maturity and, therefore, we would not expect to recognize such an adverse impact in our income or cash flows.

We have international subsidiary and branch operations. Additionally, a portion of our silicon wafer

purchases are denominated in Japanese yen. We therefore are subject to foreign currency rate exposure. To mitigate rate exposure with respect to our yen-denominated wafer purchases, we maintain a yen-denominated bank account and bill our Japanese customers in yen. If the foreign currency rates were to fluctuate by 10% from rates at either September 30, 2003 or December 31, 2002, the effect on our consolidated financial statements would not be material. However, there can be no assurance that there will not be a material impact in the future.

We are exposed to equity price risk due to our equity investment in UMC (see Note 11). Neither a 10% increase nor a 10% decrease in equity price related to this investment would have a material effect on our consolidated financial statements. We have not attempted to reduce or eliminate this equity price risk through hedging or similar techniques. As a result, sustained changes in the market price of UMC shares could impact our financial results. To the extent that the market value of our UMC shares experiences further deterioration for an extended period of time, our net income could be reduced.

Item 4. Controls and Procedures (restated)

This portion of our quarterly report is our disclosure of the conclusions of our management, including our Chief Executive Officer and Chief Financial Officer, regarding the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, based on management's evaluation of those disclosure controls and procedures. You should read this disclosure in conjunction with the certifications attached as Exhibit 31.1 and 31.2 to this quarterly report for a more complete understanding of the topics presented.

In January 2004, the Audit Committee of our Board of Directors, with the assistance of outside legal counsel and our independent auditor, commenced an internal investigation of the facts and circumstances surrounding inappropriate journal entries affecting the deferred income and accrued expense accounts. As a result of the investigation, it was determined that the unaudited consolidated condensed financial statements for each of the three month periods ended September 30, 2003, June 30, 2003 and March 31, 2003 required restatement.

After reviewing the restatement adjustments and performing an evaluation of our controls and disclosure procedures, management concurs with the Audit Committee that improvements to internal controls are needed relating to: (1) separation of duties and (2) establishment of standards for review and approval of journal entries as well as related file documentation.

We received notice from our independent auditor that, in connection with the 2003 year-end audit, the auditor has identified a material weakness relating to our internal controls and procedures. Certain of these internal control deficiencies may also constitute deficiencies in our disclosure controls. While we are in the process of implementing a more effective system of controls and procedures, we have instituted controls, procedures and other changes to ensure that information required to be disclosed in this annual report on Form 10-K has been recorded, processed, summarized and reported accurately.

The incremental steps that we have taken as a result of the aforementioned control deficiencies to ensure that all material information about our company is accurately disclosed in this report include:

1. Performed an analytical review of all journal entries processed for the year;

2. Applied additional methods and techniques to evaluate the accuracy of the deferred income account balance;
3. Instituted an additional level of approval for non recurring journal entries;
4. Strengthened segregation of duties by adding an additional level of review for authorization and review of significant transactions; and
5. Made appropriate personnel changes.

Based in part on the steps listed above, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported accurately within the time periods specified in Securities and Exchange Commission rules and forms.

In addition, in order to address further the deficiencies described above and to improve our internal disclosure and control procedures for future periods, we will:

1. Review, select and implement available improvements to information systems for distribution accounting;
2. Separate responsibilities for preparing financial statements and maintaining accounts in the company's general ledger;

3. Perform a review of internal controls and procedures in connection with Section 404 of Sarbanes Oxley legislative requirements;
4. Perform more detailed quarterly reconciliations and analyses of the company's deferred revenue accounts related to its distributors;
5. Enhance quarterly accounting review procedures requiring an independent review of material general ledger accounts;
6. Require all non recurring journal entries to be approved by an independent reviewer; and
7. Enhance staffing to provide sufficient resources to accomplish the foregoing objectives.

These steps will constitute significant changes in internal controls. We will continue to evaluate the effectiveness of our disclosure controls and internal controls and procedures on an ongoing basis, and will take further action as appropriate.

PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.

32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350,

as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

On July 21, 2003, we filed a Current Report on Form 8-K comprising our Press Release of the same date reporting our financial results for the quarter ended June 30, 2003.

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.

LATTICE SEMICONDUCTOR CORPORATION (Registrant)

Date: April 19, 2004

By: */s/ Jan Johannessen*
Jan Johannessen
Corporate Vice President and Chief Financial Officer