

ALTERA CORP  
Form 10-Q  
August 10, 2004  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 2, 2004

OR

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

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

Commission file number 0-16617

**ALTERA CORPORATION**

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of

77-0016691  
(I.R.S. Employer

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incorporation or organization)

Identification Number)

101 INNOVATION DRIVE

SAN JOSE, CALIFORNIA 95134

(Address of principal executive offices)(zip code)

408-544-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Number of shares of common stock outstanding at July 30, 2004: 371,742,658

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## PART I FINANCIAL INFORMATION

ITEM 1: Financial Statements

**ALTERA CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited, in thousands)

|  | July 2,<br>2004     | January 2,<br>2004  |
|--|---------------------|---------------------|
|  | <u>          </u>   | <u>          </u>   |
| <b>ASSETS</b>  |                     |                     |
| Current assets:  |                     |                     |
| Cash and cash equivalents                                | \$ 458,717          | \$ 258,831          |
| Short-term investments                                   | 620,325             | 773,059             |
|  | <u>          </u>   | <u>          </u>   |
| Total cash, cash equivalents, and short-term investments | 1,079,042           | 1,031,890           |
| Accounts receivable, net                                 | 132,554             | 87,204              |
| Inventories  | 50,245              | 44,583              |
| Deferred income taxes                                    | 84,047              | 79,615              |
| Other current assets                                     | 47,225              | 33,711              |
|  | <u>          </u>   | <u>          </u>   |
| Total current assets                                     | 1,393,113           | 1,277,003           |
| Long-term investments                                    |                     | 14,451              |
| Property and equipment, net                              | 157,283             | 160,924             |
| Deferred income taxes and other assets, net              | 41,157              | 42,199              |
|  | <u>          </u>   | <u>          </u>   |
|  | <u>\$ 1,591,553</u> | <u>\$ 1,494,577</u> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>               |                     |                     |
| Current liabilities:                                     |                     |                     |
| Accounts payable   | \$ 58,217           | \$ 20,992           |
| Accrued liabilities                                      | 24,860              | 22,733              |
| Accrued compensation                                     | 37,280              | 35,507              |
| Deferred income and allowances on sales to distributors  | 269,257             | 245,421             |
| Income taxes payable                                     | 68,113              | 67,520              |
|  | <u>          </u>   | <u>          </u>   |
| Total current liabilities                                | 457,727             | 392,173             |
|  | <u>          </u>   | <u>          </u>   |
| Stockholders' equity:                                    |                     |                     |
| Common stock   | 373                 | 376                 |
| Capital in excess of par value                           | 357,254             | 365,583             |
| Retained earnings  | 777,249             | 738,420             |
| Deferred stock-based compensation                        | (553)               | (2,665)             |
| Accumulated other comprehensive (loss) income            | (497)               | 690                 |

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|                            |                     |                     |
|----------------------------|---------------------|---------------------|
| Total stockholders' equity | <u>1,133,826</u>    | <u>1,102,404</u>    |
|                            | <u>\$ 1,591,553</u> | <u>\$ 1,494,577</u> |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****ALTERA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In thousands, except per share amounts)****(Unaudited)**

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2004    | July 4,<br>2003 | July 2,<br>2004  | July 4,<br>2003 |
| Net sales  | \$ 268,972         | \$ 205,259      | \$ 511,880       | \$ 400,335      |
| Costs and expenses:                                |                    |                 |                  |                 |
| Cost of sales                                      | 81,026             | 65,424          | 156,867          | 129,682         |
| Research and development expenses                  | 42,738             | 46,105          | 85,320           | 96,293          |
| Selling, general, and administrative expenses      | 52,712             | 45,594          | 102,590          | 89,797          |
| Total costs and expenses                           | 176,476            | 157,123         | 344,777          | 315,772         |
| Income from operations                             | 92,496             | 48,136          | 167,103          | 84,563          |
| Interest and other income, net                     | 3,272              | 1,314           | 7,008            | 6,150           |
| Income before income taxes                         | 95,768             | 49,450          | 174,111          | 90,713          |
| Provision for income taxes                         | (20,459)           | (13,352)        | (40,045)         | (24,493)        |
| Net income   | \$ 75,309          | \$ 36,098       | \$ 134,066       | \$ 66,220       |
| <b>Income per share:</b>                           |                    |                 |                  |                 |
| Basic  | \$ 0.20            | \$ 0.09         | \$ 0.36          | \$ 0.17         |
| Diluted  | \$ 0.20            | \$ 0.09         | \$ 0.35          | \$ 0.17         |
| <b>Shares used in computing per share amounts:</b> |                    |                 |                  |                 |
| Basic  | 373,696            | 382,725         | 374,723          | 382,698         |
| Diluted  | 382,819            | 390,902         | 384,314          | 389,594         |

See accompanying notes to condensed consolidated financial statements.

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

|   | Six Months Ended  |                   |
|---|-------------------|-------------------|
|   | July 2,<br>2004   | July 4,<br>2003   |
| <b>Cash Flows from Operating Activities:</b>                                      |                   |                   |
| Net income  | \$ 134,066        | \$ 66,220         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                   |                   |
| Depreciation and amortization   | 16,799            | 21,251            |
| Amortization of deferred stock-based compensation                                 | 2,112             | 5,395             |
| Deferred income tax (benefit) provision   | (3,720)           | 4,999             |
| Loss on securities  |                   | 3,113             |
| Tax benefit from stock plans  | 15,500            | 5,465             |
| Changes in assets and liabilities:  |                   |                   |
| Accounts receivable   | (45,350)          | (22,405)          |
| Inventories   | (5,662)           | 10,145            |
| Other assets  | (13,904)          | (664)             |
| Accounts payable and accrued liabilities  | 41,125            | 13,505            |
| Deferred income and allowances on sales to distributors                           | 23,836            | 57,095            |
| Income taxes payable  | 593               | 14,270            |
| <b>Cash provided by operating activities</b>                                      | <b>165,395</b>    | <b>178,389</b>    |
| <b>Cash Flows from Investing Activities:</b>                                      |                   |                   |
| Purchases of property and equipment   | (9,960)           | (6,713)           |
| Purchases of available-for-sale investments                                       | (70,298)          | (307,186)         |
| Proceeds from the maturity and sale of available-for-sale investments             | 188,569           | 374,505           |
| Proceeds from the maturity of held-to-maturity investments                        | 47,015            |                   |
| Purchases of intangible assets  | (1,766)           | (750)             |
| <b>Cash provided by investing activities</b>                                      | <b>153,560</b>    | <b>59,856</b>     |
| <b>Cash Flows from Financing Activities:</b>                                      |                   |                   |
| Proceeds from issuance of common stock through various stock plans                | 21,465            | 17,629            |
| Repurchases of common stock   | (140,534)         | (51,861)          |
| <b>Cash used for financing activities</b>   | <b>(119,069)</b>  | <b>(34,232)</b>   |
| Net increase in cash and cash equivalents   | 199,886           | 204,013           |
| Cash and cash equivalents at beginning of period                                  | 258,831           | 255,397           |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 458,717</b> | <b>\$ 459,410</b> |

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Cash paid (received) during the period for:

|                                   |           |            |
|-----------------------------------|-----------|------------|
| Income taxes paid (refunded), net | \$ 27,368 | \$ (4,170) |
|-----------------------------------|-----------|------------|

See accompanying notes to condensed consolidated financial statements.



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**ALTERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

Note 1 Organization and Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements of Altera Corporation and subsidiaries, referred to herein as we, us, or our, have been prepared by us in accordance with accounting principles generally accepted in the United States of America. This financial information reflects all adjustments which are, in the opinion of our management, of a normal recurring nature and necessary to present fairly the statements of financial position as of July 2, 2004, results of operations for the three and six months ended July 2, 2004 and July 4, 2003, and cash flows for the six months ended July 2, 2004 and July 4, 2003. The January 2, 2004 balance sheet was derived from our audited financial statements included in our 2003 Annual Report on Form 10-K. All significant intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, and material effects on our operating results and financial position may result.

These condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended January 2, 2004 included in our Annual Report on Form 10-K, as filed on March 15, 2004 with the Securities and Exchange Commission, or SEC. The results of operations for the three and six months ended July 2, 2004 are not necessarily indicative of the results to be expected for any future periods.

Note 2 Balance Sheet Details:

Certain reclassifications have been made to prior period balances in order to conform to the current period's presentation. None of these reclassifications had an impact on our consolidated statements of income.

Inventories at July 2, 2004 and January 2, 2004 were comprised of the following (in thousands):

|                                   | July 2,<br>2004   | January 2,<br>2004 |
|-----------------------------------|-------------------|--------------------|
|                                   | <u>          </u> | <u>          </u>  |
| Raw materials and work in process | \$ 39,107         | \$ 32,882          |

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|                   |                  |                  |
|-------------------|------------------|------------------|
| Finished goods    | 11,138           | 11,701           |
| Total inventories | <u>\$ 50,245</u> | <u>\$ 44,583</u> |

We realized gross margin benefits of \$4.4 million for the three months ended July 2, 2004 and \$8.0 million for the six months ended July 2, 2004, resulting from the sale of inventory previously written down in 2001. These benefits were \$9.2 million and \$18.3 million for the three and six months ended July 4, 2003.

As of July 2, 2004, the book value of the inventory written down in 2001 was essentially zero while the cost basis was \$17.9 million. The cost was comprised of \$13.1 million of raw materials and work in process inventory and \$4.8 million of finished goods inventory.

We have entered into business arrangements with certain distributors to advance cash to defray their working capital costs associated with servicing our end customers. These arrangements are set forth in legal agreements and these advances are unsecured, bear no interest and are due upon demand. These advances consist of two components. The first component is an advance of anticipated price discounts and is included as a component of deferred income and allowances on sales to distributors. Such advance totaled \$54.7

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million at July 2, 2004 and \$29.1 million at January 2, 2004. The second component is, in substance, an arrangement to finance distributors accounts receivable and inventory and is classified as other current assets and totaled \$29.4 million at July 2, 2004 and \$20.6 million at January 2, 2004.

Property and equipment at July 2, 2004 and January 2, 2004 were comprised of the following (in thousands):

|   | July 2,<br>2004 | January 2,<br>2004 |
|---|-----------------|--------------------|
| Land                                      | \$ 30,779       | \$ 30,779          |
| Buildings                                 | 119,889         | 119,637            |
| Equipment and software                    | 197,478         | 190,680            |
| Office furniture and fixtures             | 19,796          | 19,527             |
| Leasehold improvements                    | 5,552           | 5,098              |
| Property and equipment, at cost           | 373,494         | 365,721            |
| Accumulated depreciation and amortization | (216,211)       | (204,797)          |
| Property and equipment, net               | \$ 157,283      | \$ 160,924         |

Note 3 Comprehensive Income:

The components of comprehensive income were as follows (in thousands):

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2004    | July 4,<br>2003 | July 2,<br>2004  | July 4,<br>2003 |
| Net income   | \$ 75,309          | \$ 36,098       | \$ 134,066       | \$ 66,220       |
| Change in unrealized gains (losses) on investments | (2,504)            | 183             | (1,899)          | (358)           |
| Income tax benefit (provision)                     | 939                | (68)            | 712              | 169             |
| Comprehensive income                               | \$ 73,744          | \$ 36,213       | \$ 132,879       | \$ 66,031       |

Accumulated other comprehensive (loss) income presented in the accompanying condensed consolidated balance sheets consists of the accumulated unrealized (loss) gain on investments, net of tax.

Note 4 Income Per Share:

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In accordance with Statement of Financial Accounting Standards No. 128, or SFAS No. 128, Earnings Per Share, we compute basic income per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period (excluding the dilutive effect of stock options and restricted stock). Diluted income per share reflects the dilution of potential common shares outstanding during the period. In computing diluted income per share, we adjust share count by assuming that all in-the-money options are exercised and that we repurchase shares with the proceeds of these hypothetical exercises along with the tax benefit resulting from the hypothetical option exercises. We further assume that any unamortized deferred stock-based compensation is also used to repurchase shares. In determining the hypothetical shares repurchased, we use the average stock price for the period.

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Diluted income per share excludes out-of-the-money stock options and unvested restricted stock totaling 30.7 million shares for the three months ended July 2, 2004 and 28.2 million shares for the three months ended July 4, 2003, as their effect is anti-dilutive. Anti-dilutive stock options and unvested restricted stock totaled 30.1 million shares for the six months ended July 2, 2004 and 33.1 million for the six months ended July 4, 2003. While these options are currently anti-dilutive, they could be dilutive in the future. A reconciliation of basic and diluted income per share is presented below (in thousands, except per share amounts):

|                                     | Three Months Ended |                 | Six Months Ended |                 |
|-------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                     | July 2,<br>2004    | July 4,<br>2003 | July 2,<br>2004  | July 4,<br>2003 |
| <b>Basic:</b>                       |                    |                 |                  |                 |
| Net income                          | \$ 75,309          | \$ 36,098       | \$ 134,066       | \$ 66,220       |
| Weighted shares outstanding         | 373,696            | 382,725         | 374,723          | 382,698         |
| Net income per share                | \$ 0.20            | \$ 0.09         | \$ 0.36          | \$ 0.17         |
| <b>Diluted:</b>                     |                    |                 |                  |                 |
| Net income                          | \$ 75,309          | \$ 36,098       | \$ 134,066       | \$ 66,220       |
| Weighted shares outstanding         | 373,696            | 382,725         | 374,723          | 382,698         |
| Effect of dilutive securities:      |                    |                 |                  |                 |
| Stock options and restricted stock  | 9,123              | 8,177           | 9,591            | 6,896           |
| Diluted weighted shares outstanding | 382,819            | 390,902         | 384,314          | 389,594         |
| Net income per share                | \$ 0.20            | \$ 0.09         | \$ 0.35          | \$ 0.17         |

Note 5 Deferred Income Taxes and Other Assets, Net:

Our deferred income taxes and other assets consisted primarily of the non-current portion of deferred tax assets of \$34.1 million at July 2, 2004 and January 2, 2004, and acquired intangible assets which are amortized on a straight-line basis over their estimated useful lives. Our acquired intangible assets comprised of the following (in thousands):

|                                  | July 2, 2004 |                             |          | January 2, 2004 |                             |          |
|----------------------------------|--------------|-----------------------------|----------|-----------------|-----------------------------|----------|
|                                  | Gross        | Accumulated<br>amortization | Net      | Gross           | Accumulated<br>amortization | Net      |
| Market ready technology          | \$ 21,168    | \$ (21,102)                 | \$ 66    | \$ 21,168       | \$ (18,937)                 | \$ 2,231 |
| Other intangible assets          | 10,744       | (5,639)                     | 5,105    | 8,978           | (4,606)                     | 4,372    |
| Total acquired intangible assets | \$ 31,912    | \$ (26,741)                 | \$ 5,171 | \$ 30,146       | \$ (23,543)                 | \$ 6,603 |



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Amortization of total acquired intangible assets was \$0.6 million for the three months ended July 2, 2004 and was \$2.3 million for the same period last year. Amortization of acquired intangible assets was \$3.2 million for the six months ended July 2, 2004 and was \$3.3 million for the six months ended July 4, 2003. The estimated future amortization expense of acquired intangible assets as of July 2, 2004 was as follows (in thousands):

*Years Ending December 31,*

|                             |          |
|-----------------------------|----------|
| 2004 (remaining six months) | \$ 1,245 |
| 2005                        | 2,434    |
| 2006                        | 1,330    |
| 2007 and beyond             | 162      |
|                             | <hr/>    |
| Total                       | \$ 5,171 |
|                             | <hr/>    |

Note 6 Indemnification and Product Warranty:

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

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

The following table summarizes the activity for the six months ended July 2, 2004 related to our product warranty liability, which was included in accrued liabilities in our consolidated balance sheets. We had no activity related to our warranty liability for the six months ended July 4, 2003.

| <i>(In thousands)</i>              | Six Months Ended |       |
|------------------------------------|------------------|-------|
|                                    | July 2, 2004     |       |
|                                    |                  | <hr/> |
| Balance at beginning of the period | \$               | 2,095 |
| Provision/Recovery                 |                  | 211   |
| Payments                           |                  | (208) |
|                                    |                  | <hr/> |
| Balance at end of the period       | \$               | 2,098 |
|                                    |                  | <hr/> |

Note 7 Common Stock Repurchases:

Share repurchase activity for the second quarter of 2004 was as follows:

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2004    | July 4,<br>2003 | July 2,<br>2004  | July 4,<br>2003 |
| <i>(In millions, except per share amounts)</i> |                    |                 |                  |                 |
| Shares repurchased                             | 4.2                | 1.7             | 6.5              | 3.6             |
| Cost of shares repurchased                     | \$ 88.9            | \$ 30.2         | \$ 140.5         | \$ 51.9         |
| Average price per share                        | \$ 21.34           | \$ 18.29        | \$ 21.66         | \$ 14.57        |



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Since the inception of our repurchase program in 1996 through July 2, 2004, we have repurchased a total of 65.0 million shares of our common stock for an aggregate cost of \$1.4 billion. All shares were retired upon acquisition. At July 2, 2004, 13.0 million shares remained authorized for repurchases under the plan.

### Note 8 Stock-Based Compensation Plans:

We currently have three stock-based compensation plans, which are described below. We account for stock-based compensation using the intrinsic value method prescribed in APB No. 25, Accounting for Stock Issued to Employees as allowed under SFAS No. 123.

#### *Stock Option Plans*

Our stock option program is a broad-based, long-term retention program intended to attract, motivate, and retain talented employees as well as align stockholder and employee interests. We currently grant stock options under two plans: the 1996 Stock Option Plan, which provides for the periodic issuance of stock options to our employees, and the 1998 Director Stock Option Plan, which provides for the periodic issuance of stock options to members of our Board of Directors who are not employees. The majority of the options granted under these plans generally vest over four years. All options have a maximum term of ten years. On May 11, 2004, our stockholders approved an amendment to our 1996 Stock Option Plan to increase the number of shares reserved for issuance from 74.0 million shares to 86.0 million shares. As of July 2, 2004, 14.1 million shares were available for future grants. The 1998 Director Stock Option Plan had 680,000 shares reserved for issuance and 149,000 shares were available for future grants.

#### *Employee Stock Purchase Plan*

On May 11, 2004, our stockholders approved an amendment to our 1987 Employee Stock Purchase Plan to increase the number of shares reserved for issuance from 17.7 million shares to 18.7 million shares. As of the end of our fiscal second quarter of 2004, 3.2 million shares were available for future issuances under that plan. Sales under the Employee Stock Purchase Plan were 414,055 shares of common stock at an average price of \$16.67 for the six months ended July 2, 2004, and 567,328 shares of common stock at an average price of \$10.56 per share for the six months ended July 4, 2003.

#### *Pro Forma Net Income and Net Income Per Share*

The fair value of each option grant, as defined by SFAS No. 123, is estimated on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. However, options granted under our stock option plans are not freely tradable, or fully transferable, and have vesting restrictions. The Black-Scholes model also requires highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the fair value.

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As required by SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure, the following table illustrates the effect on our net income and net income per share if we had recorded compensation costs based on the estimated grant date fair value defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts):

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | July 2,<br>2004    | July 4,<br>2003  | July 2,<br>2004  | July 4,<br>2003  |
| Reported net income   | \$ 75,309          | \$ 36,098        | \$ 134,066       | \$ 66,220        |
| Add: Stock-based employee compensation expense included in reported net income, net of tax                            | 347                | 1,857            | 1,423            | 3,887            |
| Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of tax | (23,690)           | (23,079)         | (51,405)         | (49,507)         |
| <b>Pro forma net income</b>   | <b>\$ 51,966</b>   | <b>\$ 14,876</b> | <b>\$ 84,084</b> | <b>\$ 20,600</b> |
| Pro forma net income per share:   |                    |                  |                  |                  |
| Basic   | \$ 0.14            | \$ 0.04          | \$ 0.22          | \$ 0.05          |
| Diluted   | \$ 0.14            | \$ 0.04          | \$ 0.22          | \$ 0.05          |
| Reported net income per share:  |                    |                  |                  |                  |
| Basic   | \$ 0.20            | \$ 0.09          | \$ 0.36          | \$ 0.17          |
| Diluted   | \$ 0.20            | \$ 0.09          | \$ 0.35          | \$ 0.17          |

## Note 9 Income Taxes:

We are currently under examination by various taxing authorities. Although the outcome of any tax audit is uncertain, we believe we have adequately provided in our financial statements for additional taxes that we may be required to pay as a result of such examinations. If the payment ultimately proves to be unnecessary, the reversal of these tax reserves would result in tax benefits being recognized in the period we determine such reserves are no longer necessary. However, if an ultimate tax assessment exceeds our estimate of tax liabilities, an additional charge to expense will result.

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

*The following Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as information contained in Risk Factors below and elsewhere in this report, contains forward-looking statements, which are provided under the safe harbor protection of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally written in the future tense and/or are preceded by words such as will, may, should, could, expect, suggest, believe, anticipate, intend, plan, or other similar words. Forward-looking statements include statements regarding (1) the adequacy of our provision for adjustments as a result of tax audits; (2) the commercial success of our new products; (3) trends in future sales; and (4) our research and development efforts.*

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

*Many factors may cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this report. These factors include, but are not limited to, those risks described below under Risk Factors and those risks described under Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended January 2, 2004.*

### CRITICAL ACCOUNTING ESTIMATES

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply these judgments and estimates and the financial statements and accompanying notes fairly represent all periods presented. However, any errors in these judgments and estimates may have a material impact on our statement of operations and financial conditions. Critical accounting estimates, as defined by the Securities and Exchange Commission, are those that are most important to the portrayal of our financial condition and results of operations and require our management's most difficult and subjective judgments and estimates of matters that are inherently uncertain. Our critical accounting estimates include those regarding (1) revenue recognition; (2) valuation of inventories; and (3) taxes. For a discussion of the critical accounting estimates, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Estimates in our Annual Report on Form 10-K for the year ended January 2, 2004.

### RESULTS OF OPERATIONS

#### Sales

We design, manufacture, and market high-performance, high-density programmable logic devices, or PLDs; low-cost, masked programmed HardCopy® structured ASIC devices; pre-defined design building blocks known as intellectual property, or IP, cores; and associated development tools. Our PLDs, which consist of field-programmable gate arrays, or FPGAs, and complex programmable logic devices, or CPLDs, are semiconductor integrated circuits that are manufactured as standard chips that our customers program to perform desired logic

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functions within their electronic systems. FPGAs, which represented 69% of our sales for the three months ended July 2, 2004 and 67% for the six months ended July 2, 2004, consist of our Stratix<sup>®</sup>, Stratix GX, Stratix II, Cyclone, APEX, APEX II, FLEX<sup>®</sup>, ACEX<sup>®</sup>, Excalibur, and Mercury families, and CPLDs, which represented 23% and 24% of our total sales during the same periods, consist of our MAX<sup>®</sup>, and Classic families. Our products serve a wide range of markets, including communications, computer and storage, consumer, and industrial market segments.

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We classify our products into three categories: New, Mainstream, and Mature and Other Products. During the fourth quarter of 2003, we updated our product categories, and all prior period data have been adjusted to reflect the following compositions:

New Products include the Stratix, Stratix GX, Stratix II, Cyclone, MAX 3000A, and HardCopy families;

Mainstream Products include the APEX 20K, APEX 20KC, APEX 20KE, APEX II, FLEX 10KE, ACEX 1K, Excalibur, Mercury, MAX 7000A, and MAX 7000B families; and

Mature and Other Products include the FLEX 6000, FLEX 8000, FLEX 10K, FLEX 10KA, MAX 7000, MAX 7000S, MAX 9000, Classic, and configuration families, mask programmed logic devices and other devices, software and other tools, and IP cores.

Sales during the three months ended July 2, 2004 were \$269.0 million compared to \$205.3 million for the three months ended July 4, 2003, representing a 31% increase in sales year over year. The increase was driven primarily by the sales of New Products which increased 216% year over year predominantly due to higher sales of our Stratix and Cyclone families. FPGA sales accounted for 69% of total sales and grew 37% year over year, driven predominantly by increased sales of our Stratix, Cyclone, and ACEX 1K families. CPLD sales accounted for 23% of total sales and increased 14% compared to the same period a year ago, driven primarily by increases in sales of our MAX 3000A and MAX 7000A families. Sales during the six months ended July 2, 2004 were \$511.9 million compared to \$400.3 million for the six months ended July 4, 2003, representing a 28% increase in sales year over year. These increases for the three and six month periods were primarily due to higher unit sales in all product categories, partially offset by routine declines in average unit selling prices in our Mainstream and Mature and Other categories.

Sales increased 11% sequentially in the second quarter of 2004. New Products continue to drive growth with a 45% sequential gain driven predominantly by the Stratix and Cyclone families. Stratix was our largest selling family in the quarter and grew over 60% sequentially as a number of customer programs entered volume production and prototyping activity continued to be strong.

Sales by Product Category

Sales by product category, as a percentage of total sales, as well as year-over-year and sequential change, were as follows:

|                    | Three Months Ended |              |               | Year-Over-Year Change | Sequential Change | Six Months Ended |              | Year-Over-Year Change |
|--------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
|                    | July 2, 2004       | July 4, 2003 | April 2, 2004 |                       |                   | July 2, 2004     | July 4, 2003 |                       |
| New                | 25%                | 10%          | 19%           | 216%                  | 45%               | 22%              | 9%           | 227%                  |
| Mainstream         | 43%                | 51%          | 46%           | 12%                   | 5%                | 45%              | 51%          | 11%                   |
| Mature and Other   | 32%                | 39%          | 35%           | 6%                    | -1%               | 33%              | 40%          | 6%                    |
| <b>Total Sales</b> | <b>100%</b>        | <b>100%</b>  | <b>100%</b>   | <b>31%</b>            | <b>11%</b>        | <b>100%</b>      | <b>100%</b>  | <b>28%</b>            |

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We expect that sales of the Stratix and Cyclone families will continue to increase as customer adoption of our New Products continues to be strong, and customers ramp their programs into volume production.

### Sales by Market Segment

The following market segment data is derived from data that is provided to us by our distributors and end customers. With a broad base of customers, who in some cases manufacture end products spanning multiple market segments, the assignment of revenue to a market segment requires the use of estimates, judgment, and extrapolation. As such, actual results may differ from those reported.

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Sales by market segment, as a percentage of total sales, as well as year-over-year and sequential change, were as follows:

|                      | Three Months Ended |              |               | Year-Over-Year Change | Sequential Change | Six Months Ended |              | Year-Over-Year Change |
|----------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
|                      | July 2, 2004       | July 4, 2003 | April 2, 2004 |                       |                   | July 2, 2004     | July 4, 2003 |                       |
| Communications       | 47%                | 44%          | 42%           | 41%                   | 22%               | 45%              | 43%          | 34%                   |
| Industrial           | 29%                | 30%          | 32%           | 25%                   | 0%                | 30%              | 30%          | 26%                   |
| Consumer             | 14%                | 16%          | 15%           | 14%                   | 2%                | 14%              | 16%          | 17%                   |
| Computer and Storage | 10%                | 10%          | 11%           | 32%                   | 8%                | 11%              | 11%          | 27%                   |
| <b>Total Sales</b>   | <b>100%</b>        | <b>100%</b>  | <b>100%</b>   | <b>31%</b>            | <b>11%</b>        | <b>100%</b>      | <b>100%</b>  | <b>28%</b>            |

In absolute dollars, sales in all four market segments provided strong growth for the three and six months ended July 2, 2004 compared to the same periods a year ago as a result of better end market conditions and increased usage of PLDs. Sales in the Communications market segment had the largest growth year over year driven primarily by improving market conditions in the wireline subsegment and increased penetration in the wireless subsegment.

While we expect that Communications will remain our largest market segment, we anticipate that the Industrial and Consumer market segments will continue to significantly contribute to our future growth. For the three and six months ended July 2, 2004 and July 4, 2003, no single end customer provided more than 10% of our sales.

Sales by Geography

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

|               | Three Months Ended |              |               | Year-Over-Year Change | Sequential Change | Six Months Ended |              | Year-Over-Year Change |
|---------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
|               | July 2, 2004       | July 4, 2003 | April 2, 2004 |                       |                   | July 2, 2004     | July 4, 2003 |                       |
| North America | 27%                | 33%          | 30%           | 9%                    | 1%                | 29%              | 33%          | 10%                   |
| Europe        | 24%                | 21%          | 24%           | 48%                   | 9%                | 24%              | 24%          | 33%                   |
| Japan         | 26%                | 24%          | 25%           | 41%                   | 14%               | 25%              | 24%          | 33%                   |
| Asia Pacific  | 23%                | 22%          | 21%           | 37%                   | 22%               | 22%              | 19%          | 47%                   |

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|                     |      |      |      |     |     |      |      |     |
|---------------------|------|------|------|-----|-----|------|------|-----|
| Total International | 73%  | 67%  | 70%  | 42% | 15% | 71%  | 67%  | 37% |
| Total Sales         | 100% | 100% | 100% | 31% | 11% | 100% | 100% | 28% |

In absolute dollars, sales increased, year over year, in all geographies, but most significantly in the international geographies. The percentage of total sales represented by international locations increased year over year, due to increased sales to end customers as well as the transfer of end customers business from North America to the Asia Pacific region. We expect that sales will continue to transfer from North America.



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Gross Margin

|  | Three Months Ended |                 |                  | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|------------------|-----------------|
|  | July 2,<br>2004    | July 4,<br>2003 | April 2,<br>2004 | July 2,<br>2004  | July 4,<br>2003 |
| <i>(Dollars in millions)</i>                                     |                    |                 |                  |                  |                 |
| Gross Margin Percentage  | 69.9%              | 68.1%           | 68.8%            | 69.4%            | 67.6%           |
| <i>Included in Reported Gross Margin Percentage Above:</i>       |                    |                 |                  |                  |                 |
| Gross Margin Benefit from Sale of Inventory Written Down in 2001 | \$ 4.4             | \$ 9.2          | \$ 3.6           | \$ 8.0           | \$ 18.3         |
| Percentage of Sales  | 1.6%               | 4.5%            | 1.5%             | 1.6%             | 4.6%            |

The year-over-year increase in gross margin was primarily due to yield enhancements especially in newer products, as well as overall declines in material and subcontractor costs. Gross margin included benefits resulting from the sale of inventory previously written down in 2001.

As of July 2, 2004, the book value of the inventory written down in 2001 was essentially zero while the cost basis was \$17.9 million. The cost was comprised of \$13.1 million of raw materials and work in process inventory and \$4.8 million of finished goods inventory.

Research and Development

|                              | Three Months Ended |                 |                  | Year-Over-Year<br>Change | Sequential<br>Change | Six Months Ended |                 | Year-Over-Year<br>Change |
|------------------------------|--------------------|-----------------|------------------|--------------------------|----------------------|------------------|-----------------|--------------------------|
|                              | July 2,<br>2004    | July 4,<br>2003 | April 2,<br>2004 |                          |                      | July 2,<br>2004  | July 4,<br>2003 |                          |
| <i>(Dollars in millions)</i> |                    |                 |                  |                          |                      |                  |                 |                          |
| Research and Development     | \$ 42.7            | \$ 46.1         | \$ 42.6          | -7%                      | 0%                   | \$ 85.3          | \$ 96.3         | -11%                     |
| Percentage of Sales          | 16%                | 22%             | 18%              |                          |                      | 17%              | 24%             |                          |

Research and development expenses include expenditures for labor, masks, prototype wafers, depreciation, and the amortization of deferred stock-based compensation for employees engaged in research and development activities. These expenditures were for the design of new PLD families, and the development of process technologies, new packages, software to support new products and design environments, and IP cores.

Research and development expenses decreased 7% for the three months ended July 2, 2004 over the same period a year ago. The decrease was primarily attributable to lower spending on prototype wafers, which was partially offset by increased spending on labor and benefit costs. Historically, the level of our research and development expenses has fluctuated in part due to the timing of the purchase of masks and prototype wafers used in the development of new products. Research and development expenses decreased 11% for the six months ended July 2, 2004 over the same period a year ago. The decrease was primarily attributable to lower spending on prototype wafers, which was partially offset by increased spending on labor and benefit costs.

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We will continue to make significant investments in the development of new products and focus our efforts on the development of new programmable logic devices that utilize advanced semiconductor wafer fabrication processes, as well as related development software. We are currently investing in the development of our Stratix II, MAX II, Cyclone II, and HardCopy families, our Nios® II soft core embedded processor, our Quartus® II software, our library of IP cores, and other future products. We expect that our research and development costs will increase in absolute dollars during the third quarter of 2004.

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## Selling, General, and Administrative

| <i>(Dollars in millions)</i>         | Three Months Ended |                 |                  | Year-Over-Year<br>Change | Sequential<br>Change | Six Months Ended |                 | Year-Over-Year<br>Change |
|--------------------------------------|--------------------|-----------------|------------------|--------------------------|----------------------|------------------|-----------------|--------------------------|
|                                      | July 2,<br>2004    | July 4,<br>2003 | April 2,<br>2004 |                          |                      | July 2,<br>2004  | July 4,<br>2003 |                          |
| Selling, General, and Administrative | \$ 52.7            | \$ 45.6         | \$ 49.9          | 16%                      | 6%                   | \$ 102.6         | \$ 89.8         | 14%                      |
| Percentage of Sales                  | 20%                | 22%             | 21%              |                          |                      | 20%              | 22%             |                          |

Selling, general, and administrative expenses primarily include salary expenses related to sales, marketing, and administrative personnel, commissions and incentives, depreciation, legal, advertising, facilities, and travel expenses.

Selling, general, and administrative expenses increased \$7.1 million, or 16%, for the three months ended July 2, 2004 over the same period a year ago. The increase was primarily attributable to higher spending on labor and benefit costs, as well as higher spending on commissions and incentives. Selling, general and administrative expenses increased \$12.8 million, or 14%, for the six months ended July 2, 2004 over the same period a year ago. The increase was primarily attributable to higher spending on labor and benefit costs, commissions and incentives, and travel expenses.

## Interest and Other Income, Net

| <i>(Dollars in millions)</i>   | Three Months Ended |                 |                  | Year-Over-Year<br>Change | Sequential<br>Change | Six Months Ended |                 | Year-Over-Year<br>Change |
|--------------------------------|--------------------|-----------------|------------------|--------------------------|----------------------|------------------|-----------------|--------------------------|
|                                | July 2,<br>2004    | July 4,<br>2003 | April 2,<br>2004 |                          |                      | July 2,<br>2004  | July 4,<br>2003 |                          |
| Interest and Other Income, Net | \$ 3.3             | \$ 1.3          | \$ 3.7           | 154%                     | -12%                 | \$ 7.0           | \$ 6.2          | 13%                      |
| Percentage of Sales            | 1%                 | 1%              | 2%               |                          |                      | 1%               | 2%              |                          |

Interest and other income consists mainly of interest income generated from investments in high-quality fixed income securities. The increase in interest and other income during the three and six months ended July 2, 2004 compared to the same period a year ago was primarily due to a recognized loss of \$3.1 million in the second quarter of 2003. This was offset by a decrease in interest income due to lower investment yields.

## Provision for Income Taxes

Our effective income tax rate was 23% for the six months ended July 2, 2004 and 27% for the six months ended July 4, 2003. The second quarter effective tax rate of 21% reflects the impact of a reduction in the estimated effective tax rate for the year from 25% to 23%. The decrease in the effective tax rate primarily resulted from a favorable change in the geographic mix of income, partially offset by smaller benefits from

tax-exempt income and research and development tax credits.

We are currently under examination by various taxing authorities. Although the outcome of any tax audit is uncertain, we believe we have adequately provided in our financial statements for additional taxes that we may be required to pay as a result of such examinations. If the payment ultimately proves to be unnecessary, the reversal of these tax reserves would result in tax benefits being recognized in the period we determine such reserves are no longer necessary. However, if an ultimate tax assessment exceeds our estimate of tax liabilities, an additional charge to expense will result.

#### Financial Condition, Liquidity, and Capital Resources

We ended the second quarter of 2004 with \$1.1 billion of cash, cash equivalents, and short-term investments available to finance our operating activities and future growth. We currently use cash generated

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from operations to support our operating activities, capital expenditures, and acquisitions and investments. We also use our available cash for repurchases of our common stock under our stock repurchase program. As of July 2, 2004, there were no outstanding loans due from us.

Cash provided by operating activities was \$165.4 million for the six months ended July 2, 2004. Our positive cash flows from operating activities were primarily attributable to net income, adjusted for non-cash items. Working capital uses of cash included an increase in accounts receivable primarily due to increased shipments to our distributors, as well as an increase in cash advances to distributors. Working capital sources of cash included increases in accounts payable primarily due to timing of payments, and increases in accrued liabilities, and deferred income and allowances on sales to distributors.

Cash provided by investing activities was \$153.6 million for the six months ended July 2, 2004, and consisted primarily of proceeds from the maturity and sale of investments, net of purchases, of \$165.3 million. We also spent \$10.0 million to purchase property and equipment for the six months ended July 2, 2004.

Cash used for financing activities of \$119.1 million resulted from repurchases of our common stock of \$140.5 million, which was partially offset by net proceeds of \$21.5 million from the issuance of our common stock to employees through various stock option plans. We expect that we will continue to use a portion of our available capital to repurchase shares.

We believe our current cash and cash equivalents, investments and cash generated from operations will satisfy our working capital requirements for the foreseeable future.

### Purchase Commitments and Contractual Obligations

We depend entirely upon subcontractors to manufacture our silicon wafers and provide assembly and test services. Due to lengthy subcontractor lead times, we must order these materials and services from these subcontractors well in advance, and if the subcontractor has commenced production to satisfy our order, we are ultimately obligated to pay for the materials and services. As of July 2, 2004, we had less than \$150.0 million of outstanding purchase commitments to such subcontractors. We expect to receive and pay for these materials and services within the next four to six months.

We also lease facilities under non-cancelable lease agreements expiring at various times through 2010. There had been no significant changes to our operating lease obligations since our 2003 fiscal year end. We also enter into various non-cancelable contracts to acquire goods and services in the normal course of business.

### Impact of Currency Translation and Inflation

We purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars. As of July 2, 2004, we had no open forward contracts; however, we may enter into contracts from time to time to hedge foreign exchange exposure. We have, in the past, entered into forward contracts to hedge against currency fluctuations associated with contractual commitments denominated in

foreign currencies.

Common Stock Repurchases

Share repurchase activity for the second quarter of 2004 was as follows:

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | July 2,<br>2004    | July 4,<br>2003 | July 2,<br>2004  | July 4,<br>2003 |
| <i>(In millions, except per share amounts)</i> |                    |                 |                  |                 |
| Shares repurchased                             | 4.2                | 1.7             | 6.5              | 3.6             |
| Cost of shares repurchased                     | \$ 88.9            | \$ 30.2         | \$ 140.5         | \$ 51.9         |
| Average price per share                        | \$ 21.34           | \$ 18.29        | \$ 21.66         | \$ 14.57        |

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Since the inception of our repurchase program in 1996 through July 2, 2004, we have repurchased a total of 65.0 million shares of our common stock for an aggregate cost of \$1.4 billion. All shares were retired upon acquisition. At July 2, 2004, 13.0 million shares remained authorized for repurchases under the plan.

### Off-Balance Sheet Arrangements

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

### RISK FACTORS

*Before you decide to buy, hold, or sell our common stock, you should carefully consider the risk factors described below, in addition to the other information contained elsewhere in this report. The risk factors described below are not the only risk factors facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. Our business, financial condition, and results of operation could be seriously harmed if any of the events underlying any of these risks or uncertainties actually occurs. In that event, the market price for our common stock could decline, and you may lose all or part of your investment.*

The following risk factors have affected and, in the future, could affect our actual results of operations and could cause our actual results to differ materially from those expressed in forward-looking statements made by us:

- (1) Our financial results depend on our ability to compete successfully in the highly competitive semiconductor industry.
- (2) Our future success depends on our ability to define, develop, and sell new and enhanced products that achieve market acceptance.
- (3) We depend entirely on independent subcontractors to supply us with finished silicon wafers.
- (4) We depend on independent subcontractors, located in Asia, to assemble and test our semiconductor products.
- (5) Conditions outside the control of our independent subcontractors may impact their business operations.
- (6) Our intellectual property rights may not provide meaningful protection from our competitors.
- (7) We may face significant costs arising from intellectual property litigation.
- (8) We may incur warranty-related liabilities.

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- (9) We depend on distributors to generate sales and fulfill our customer orders.
- (10) The length of our design-in and sales cycle could impact our future sales.
- (11) We depend on international sales for a majority of our total sales.
- (12) Our business is subject to tax risks associated with being a multinational corporation.
- (13) Our gross margins are subject to fluctuations.



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- (14) Our financial results are affected by general economic conditions and the cyclical nature of the semiconductor industry.
- (15) Our quarterly operating results may fluctuate.
- (16) Our future success depends on our ability to successfully compete with other technology firms in attracting and retaining key technical and management personnel.
- (17) Our business is subject to the risks of earthquakes and other catastrophic events.
- (18) We carry only limited insurance coverages.
- (19) Our stock price may be subject to significant volatility.

For a discussion of these risk factors, see Management's Discussion and Analysis of Financial Condition and Results of Operations Risk Factors in our Annual Report on Form 10-K for the year ended January 2, 2004.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

Our investment portfolio consisted of fixed income securities of \$1.1 billion as of July 2, 2004. These securities, like all fixed income instruments, are subject to interest rate risk and will vary in value as market interest rates fluctuate. If market interest rates were to increase or decline immediately and uniformly by 10% from the levels as of July 2, 2004, the increase or decline in the fair value of the portfolio would not be material.

Although we purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars, we do have international operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has been insignificant. If foreign currency rates were to fluctuate by 10% from rates at July 2, 2004, our financial position, results of operations and cash flows would not be materially affected. However, we cannot assure you that there will not be a material impact in the future.

ITEM 4: Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of July 2, 2004. Our disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in alerting them in a timely manner to material information required to be included in our periodic SEC filings.

As required by Section 404 of the Sarbanes-Oxley act, we are conducting a thorough review of all of our internal control processes and procedures. This review has highlighted a number of processes where we have the opportunity to improve internal controls. During the quarter ended July 2, 2004 we made specific changes to our internal control processes to provide further segregation of duties in the payroll, stock

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administration and purchasing functions. We believe that these changes are significant improvements to our system of internal controls. Additionally, we intend to further strengthen access controls to sensitive financial systems and subsystems, further segregate duties in the accounts payable function and in the disbursements processes of some of our offshore locations, and strengthen our procedures and practices governing formal approval of journal entries and accounting for local sales and use tax.

Our internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of our financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and we cannot assure you that our system of controls will succeed in achieving its stated goals under all conditions.

### PART II OTHER INFORMATION

#### ITEM 1: Legal Proceedings

As previously reported in our Annual Report on Form 10-K for the year ended January 2, 2004, we are currently involved in litigation with Clear Logic Inc. There were no material developments in the case during the quarter ended July 2, 2004.

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ITEM 2: Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

(E) Issuer Purchases of Equity Securities

| Period<br><br>(in thousands, except footnotes and<br>price<br>per share amounts) | Total Number<br>of Shares<br>Purchased <sup>(1)</sup> | Average Price<br>Paid per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--|---|---------------------------------|--|---|
| 4/3/04 4/30/04   | 101   | \$ 21.45                        | 101  | 17,092  |
| 5/1/04 5/28/04   | 2,893   | \$ 20.79                        | 2,893  | 14,199  |
| 5/29/04 7/2/04   | 1,173   | \$ 22.69                        | 1,173  | 13,026  |
| <b>Total</b>   | <b>4,167</b>  | <b>\$ 21.34</b>                 | <b>4,167</b>   |   |

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

The company repurchases shares under the program announced on July 15, 1996 that has no specified expiration. As of July 2, 2004, the Board of Directors had authorized, since the inception of the program, a total of 78.0 million shares for repurchase. No existing repurchase plans or programs expired, nor has the company decided to terminate any repurchase plans or programs prior to expiration. There are no existing plans or programs under which the company does not intend to make further purchases.

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ITEM 4: Submission of Matters to a Vote of Security Holders

We held our Annual Meeting of Stockholders on May 11, 2004 at 2:00 p.m. The following matters were acted upon at the meeting:

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

| NOMINEES                 | FOR         | AUTHORITY  |
|--------------------------|-------------|------------|
|                          | VOTES       | WITHHELD   |
| John P. Daane            | 336,854,863 | 5,519,895  |
| Robert W. Reed           | 320,613,284 | 21,761,474 |
| Charles M. Clough        | 338,695,831 | 3,678,927  |
| Robert J. Finocchio, Jr. | 320,570,946 | 21,803,812 |
| Kevin McGarity           | 338,927,049 | 3,447,709  |
| Paul Newhagen            | 338,993,010 | 3,381,748  |
| William E. Terry         | 325,065,695 | 17,309,063 |
| Susan Wang               | 320,610,420 | 21,764,338 |

|  | FOR         | BROKER        |             | NON-       |
|--|-------------|---------------|-------------|------------|
|  | VOTES       | VOTES AGAINST | ABSTENTIONS | VOTES      |
| 2. Approval of an amendment to the 1996 Stock Option Plan to increase by 12,000,000 the number of shares of common stock reserved for issuance under the plan.           | 194,651,078 | 99,458,783    | 1,878,799   | 46,386,098 |
| 3. Approval of an amendment to the 1987 Employee Stock Purchase Plan to increase by 1,000,000 the number of shares of common stock reserved for issuance under the plan. | 286,366,253 | 7,798,735     | 1,823,672   | 46,386,098 |
| 4. Ratification of the appointment of PricewaterhouseCoopers LLP as our independent accountants for the fiscal year ending December 31, 2004.                            | 309,446,690 | 31,067,024    | 1,861,044   |            |

ITEM 5: Other Information

Stock Option Plans

Our stock option program is a broad-based, long-term retention program intended to attract, motivate, and retain talented employees as well as align stockholder and employee interests. We currently grant stock options under two plans: the 1996 Stock Option Plan, which provides for the periodic issuance of stock options to our employees, and the 1998 Director Stock Option Plan, which provides for the periodic issuance of stock options to members of our Board of Directors who are not employees. The majority of the options granted under these plans generally vest over four years. All options have a maximum term of ten years.

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We monitor dilution related to our option program by comparing net option grants in a given year to the number of shares outstanding. The dilution percentage is calculated as the new option grants for the year, net

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of options forfeited by employees leaving the company, divided by the total outstanding shares at the beginning of the year. The option grant dilution percentage for the six months ended July 2, 2004 was 4.4%. We also have a share repurchase program under which we regularly repurchase shares from the open market to offset dilution related to our option program.

Our named executive officers, or NEOs, did not receive stock option grants in fiscal 2003 but instead received a grant on January 5, 2004. These grants amounted to 8% of approximately 17.2 million total options granted. For comparison purposes, our NEOs for the first six months of 2004 are defined as the Chief Executive Officer and the four other most highly compensated executive officers as disclosed in our 2003 Proxy Statement filed with the SEC in April 2004. For additional information regarding options granted to our NEOs in 2003 and 2002, please refer to the Executive Compensation section of our 2003 and 2002 Proxy Statements filed with the SEC.

A summary of the distribution and dilutive effect of options granted is as follows:

|  | 2004 YTD | 2003               | 2002  |
|--|----------|--------------------|-------|
| Net grants during the period as percentage of outstanding shares           | 4.4%     | N/A <sup>(1)</sup> | 2.4%  |
| Grants to NEOs during the period as percentage of total options granted    | 7.7%     |                    | 14.0% |
| Grants to NEOs during the period as percentage of outstanding shares       | 0.4%     |                    | 0.5%  |
| Cumulative options held by NEOs as percentage of total options outstanding | 14.4%    | 16.4%              | 13.4% |

(1) Dilution percentage calculation is negative and therefore does not provide a meaningful comparison with prior periods.

A summary of activity under all of our stock option plans and related weighted average exercise prices for the first six months of 2004 is as follows (in thousands, except price per share amounts):

|                            | Shares Available for Options | Options Outstanding |                                 |
|----------------------------|------------------------------|---------------------|---------------------------------|
|                            |                              | Number of Shares    | Weighted Average Exercise Price |
| January 2, 2004            | 18,933                       | 51,209              | \$ 16.21                        |
| Additional shares reserved | 12,000                       |                     |                                 |
| Grants <sup>(1)</sup>      | (17,223)                     | 17,223              | 22.91                           |
| Exercises                  |                              | (2,510)             | 5.80                            |
| Forfeitures                | 531                          | (531)               | 22.66                           |
| July 2, 2004               | 14,241                       | 65,391              | \$ 18.32                        |

(1) Grants in the first six months of 2004 included 4.3 million shares of our common stock granted in exchange of surrendered options under the Stock Option Exchange Program. In addition, these grants included deferred focal grants of 1.8 million shares for employees who participated in this exchange program.

A summary of outstanding in-the-money and out-of-the-money options and related weighted average exercise prices as of July 2, 2004 is as follows (in thousands, except price per share amounts):

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|                                  | Exercisable   |                 | Unexercisable |                 | Total         |                 |
|----------------------------------|---------------|-----------------|---------------|-----------------|---------------|-----------------|
|                                  | Shares        | Price           | Shares        | Price           | Shares        | Price           |
| In-the-Money                     | 20,117        | \$ 9.63         | 8,366         | \$ 14.68        | 28,483        | \$ 11.11        |
| Out-of-the-Money                 | 12,167        | 24.91           | 24,741        | 23.38           | 36,908        | 23.88           |
| <b>Total Options Outstanding</b> | <b>32,284</b> | <b>\$ 15.39</b> | <b>33,107</b> | <b>\$ 21.18</b> | <b>65,391</b> | <b>\$ 18.32</b> |

In-the-money options are options with an exercise price (the amount of money the employee would have to pay to exercise the options) that is less than \$20.76 per share, which was the closing market price of our common stock as reported on the Nasdaq National Market as of July 2, 2004. We include in-the-money options in computing diluted income per share. Out-of-the-money stock options are excluded in this calculation, as their effect is anti-dilutive.

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The following table provides the specified information concerning exercises of options to purchase our common stock during the first six months of 2004 and the value of unexercised options held by our NEOs at July 2, 2004:

| Name                | Number of Shares Acquired on Exercise | Dollar Value Realized | Dollar Value of Unexercised   |               |   |               |
|---------------------|---------------------------------------|-----------------------|---|---------------|---|---------------|
|                     |                                       |                       | Number of Securities Underlying Unexercised Options at July 2, 2004 |               | In-the-Money Options at July 2, 2004 <sup>(1)</sup> |               |
|                     |                                       |                       | Exercisable   | Unexercisable | Exercisable   | Unexercisable |
| John P. Daane       |                                       | \$                    | 1,531,250   | 1,468,750     | \$ 1,284,375  | \$ 2,140,625  |
| Denis M. Berlan     | 100,000                               | 2,015,615             | 1,820,750   | 736,250       | 18,840,054  | 1,070,313     |
| Nathan M. Sarkisian | 200,000                               | 2,634,911             | 788,200   | 625,000       | 4,863,342   | 856,250       |
| Eric Cleage         |                                       |                       | 929,584   | 498,750       | 5,967,672   | 642,187       |
| Jordan S. Plofsky   |                                       |                       | 460,833   | 559,167       | 513,750   | 856,250       |

(1) Amounts reflecting gains on outstanding stock options are based on the closing market price of our common stock as reported on the Nasdaq National Market as of July 2, 2004 of \$20.76 per share.

The following table provides information regarding equity compensation plans approved and not approved by security holders as of July 2, 2004 (in thousands, except footnotes and price per share amounts):

| Plan Category  | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants, and Rights | Weighted-Average Exercise Price of Outstanding Options, Warrants, and Rights | Number of Securities   |
|--|--|--|--|
|  |  |  | Remaining Available for Future Issuance  |
|  |  |  | Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
| (a)  | (b)  | (c)  |  |
| Equity Compensation Plans Approved by Security Holders | 65,297   | \$ 18.34   | 17,428 <sup>(1)</sup>  |
| Equity Compensation Plans not Approved by Shareholders |  |  |  |
| <b>Total</b>   | <b>65,297<sup>(2)</sup></b>  | <b>\$ 18.34</b>  | <b>17,428</b>  |

(1) Consists of 14,092,510 shares available for future issuance under our 1996 Stock Option Plan, 149,167 shares available for future issuance under our 1998 Director Stock Option Plan, and 3,186,681 shares available for future issuance under our 1987 Employee Stock Purchase Plan.

(2) Does not include information for options assumed in connection with mergers and acquisitions. As of July 2, 2004, a total of 94,139 shares of our common stock with a weighted-average exercise price of \$5.11 were issuable upon exercise of such outstanding options.

ITEM 6: Exhibits and Reports on Form 8-K



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### (a) Exhibits

| Exhibit No. | Description   |
|-------------|---|
| #10.1+      | Altera Corporation 1987 Employee Stock Purchase Plan, as amended and restated May 11, 2004, and form of Subscription Agreement. |
| #10.2+      | Altera Corporation 1996 Stock Option Plan, as amended effective as of May 11, 2004.   |
| #10.3       | Consent to Assignment of TSMC Agreements, effective as of July 3, 2004.   |
| #31.1       | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.                     |

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- #31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
- #32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- #32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

(b) Reports on Form 8-K

We furnished the following Current Reports on Form 8-K during the quarter ended July 2, 2004. The information furnished under Item 9. Regulation FD Disclosure or Item 12. Results of Operations and Financial Condition is not deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934:

Current Report on Form 8-K furnished to the SEC on April 21, 2004 under Item 12. Results of Operations and Financial Condition.

Current Report on Form 8-K furnished to the SEC on April 27, 2004 under Item 5. Other Events and Item 7. Financial Statements, Pro Forma Financial Information and Exhibits.

Current Report on Form 8-K furnished to the SEC on June 2, 2004 under Item 9. Regulation FD Disclosure.

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SIGNATURES

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

ALTERA CORPORATION

/s/ Nathan Sarkisian

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Nathan Sarkisian, Senior Vice President  
(duly authorized officer) and Chief Financial Officer  
(principal financial officer)

Date: August 10, 2004

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EXHIBIT INDEX

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|-------------|--|
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