

CYPRESS SEMICONDUCTOR CORP /DE/  
Form 10-Q  
August 11, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended July 2, 2006

OR

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

Commission file number 1-10079

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**CYPRESS SEMICONDUCTOR CORPORATION**

(Exact name of registrant as specified in its charter)

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

**198 Champion Court, San Jose, California 95134**

(Address of principal executive offices and zip code)

**(408) 943-2600**

**94-2885898**  
*(I.R.S. Employer*

*Identification No.)*

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(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The total number of outstanding shares of the registrant's common stock as of August 1, 2006 was 141,136,603.

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**Table of Contents**

**INDEX**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
<u>Forward-Looking Statements</u>	3
Item 1. <u>Financial Statements</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	45
Item 4. <u>Controls and Procedures</u>	46
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	46
Item 1A. <u>Risk Factors</u>	47
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	55
Item 3. <u>Defaults Upon Senior Securities</u>	56
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	56
Item 5. <u>Other Information</u>	56
Item 6. <u>Exhibits</u>	56
<u>Signatures</u>	57

**Table of Contents**

**PART I FINANCIAL INFORMATION**

**Forward-Looking Statements**

The discussion in this Quarterly Report on Form 10-Q contains statements that are not historical in nature, but are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties, including, but not limited to, statements as to our ability to develop and bring to market new products; our intent to hold or distribute our SunPower s shares; the rate of customer acceptance of our products and our resulting market share; the general economy and its impact on the markets we serve; the changing environment and/or cycles of the semiconductor and solar power industries; the successful integration and achievement of the objectives of acquired businesses; competitive pricing; our ability to utilize and manage the wafer capacity in our manufacturing facilities; cost goals emanating from manufacturing efficiencies; the availability of raw materials, such as polysilicon, used in the manufacture of SunPower s products; the financial and operational performance of our subsidiaries; the adequacy of cash and working capital; risks related to investing in development stage companies; our management of the risk related to our outstanding employee loans; our ability to manage our interest rate and exchange rate exposure; and other liquidity risks. We use words such as anticipates, believes, expects, future, intends and similar expressions to identify forward-looking statements. Such forward-looking statements are made as of the date hereof and are based on our current expectations, beliefs and intentions regarding future events or our financial performance and the information available to management as of the date hereof. Except as required by law, we assume no responsibility to update any such forward-looking statements. Our actual results could differ materially from those expected, discussed or projected in the forward-looking statements contained in this Quarterly Report on Form 10-Q for any number of reasons, including, but not limited to, the materialization of one or more of the risks set forth above or in the Risk Factors section in this Quarterly Report on Form 10-Q.

**Table of Contents****ITEM 1. FINANCIAL STATEMENTS**

**CYPRESS SEMICONDUCTOR CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited)

	July 2, 2006 (In thousands, except per-share amounts)	January 1, 2006 (In thousands, except per-share amounts)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 493,851	\$ 221,206
Short-term investments	123,488	109,102
Total cash, cash equivalents and short-term investments	617,339	330,308
Accounts receivable, net	177,830	151,213
Inventories	95,871	73,573
Other current assets	116,507	91,513
Total current assets	1,007,547	646,607
Property, plant and equipment, net	474,142	464,656
Goodwill	363,190	407,260
Intangible assets, net	42,843	52,236
Other assets	126,462	127,115
Total assets	\$ 2,014,184	\$ 1,697,874
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 81,981	\$ 72,125
Accrued compensation and employee benefits	41,432	31,402
Other current liabilities	70,515	75,886
Deferred income on sales to distributors	54,938	29,404
Income taxes payable	2,483	2,680
Total current liabilities	251,349	211,497
Convertible subordinated notes	598,997	599,997
Deferred income taxes and other tax liabilities	55,058	56,910
Other long-term liabilities	41,259	34,031
Total liabilities	946,663	902,435
Commitments and contingencies (Note 9)		
Minority interest	113,270	38,304
Stockholders' equity:		
Preferred stock, \$.01 par value, 5,000 shares authorized; none issued and outstanding		

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Common stock, \$.01 par value, 650,000 and 650,000 shares authorized; 142,498 and 142,444 shares issued; 140,941 and 137,036 shares outstanding at July 2, 2006 and January 1, 2006, respectively	1,425	1,424
Additional paid-in-capital	1,419,358	1,268,704
Deferred stock-based compensation		(391)
Accumulated other comprehensive income (loss)	(1,640)	764
Accumulated deficit	(447,864)	(455,565)
	971,279	814,936
Less: shares of common stock held in treasury, at cost; 1,557 and 5,408 shares at July 2, 2006 and January 1, 2006, respectively	(17,028)	(57,801)
Total stockholders' equity	954,251	757,135
Total liabilities and stockholders' equity	\$ 2,014,184	\$ 1,697,874

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****CYPRESS SEMICONDUCTOR CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>July 2, 2006</b>	<b>July 3, 2005</b>	<b>July 2, 2006</b>	<b>July 3, 2005</b>
	<b>(In thousands, except per-share amounts)</b>			
Revenues	\$ 265,236	\$ 220,506	\$ 514,373	\$ 420,810
Costs and expenses:				
Cost of revenues	151,343	129,556	297,068	256,205
Research and development	61,598	57,043	124,264	115,083
Selling, general and administrative	43,563	36,791	88,483	75,200
Amortization of acquisition-related intangibles	3,937	7,113	8,387	15,513
Restructuring costs (credits)	(113)	4,986	489	27,695
In-process research and development charge				12,300
Gain on sale of NSE assets			(5,998)	
Total costs and expenses	260,328	235,489	512,693	501,996
Operating income (loss)	4,908	(14,983)	1,680	(81,186)
Interest income	7,184	2,499	12,237	5,049
Interest expense	(2,391)	(2,094)	(4,615)	(4,267)
Other income (expense), net	(1,596)	(1,197)	7,584	(3,856)
Income (loss) before income tax and minority interest	8,105	(15,775)	16,886	(84,260)
Income tax (provision) benefit	(1,119)	521	(2,782)	210
Minority interest, net of tax	(1,139)		(1,176)	
Net income (loss)	\$ 5,847	\$ (15,254)	\$ 12,928	\$ (84,050)
Net income (loss) per share:				
Basic	\$ 0.04	\$ (0.12)	\$ 0.09	\$ (0.64)
Diluted	\$ 0.04	\$ (0.12)	\$ 0.09	\$ (0.64)
Shares used in per-share calculation:				
Basic	139,989	132,081	139,160	131,293
Diluted	145,306	132,081	145,110	131,293

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****CYPRESS SEMICONDUCTOR CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>Six Months Ended</b>	
	<b>July 2,</b>	<b>July 3,</b>
	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
<b>Cash flow from operating activities:</b>		
Net income (loss)	\$ 12,928	\$ (84,050)
<b>Adjustments to reconcile net income (loss) to net cash generated from operating activities:</b>		
Depreciation and amortization	64,603	76,010
Stock-based compensation expense	22,694	5,389
Gain on sale of NSE assets	(5,998)	
Gain related to investments	(10,027)	
Impairment of investments	883	821
In-process research and development charge		12,300
Loss on sale/write-down of property and equipment, net	460	762
Employee stock purchase assistance plan ( SPAP ) interest	(1,153)	(827)
Non-cash restructuring charges	489	12,425
Deferred income taxes and other tax liabilities	944	14
Minority interest	1,176	
<b>Changes in assets and liabilities, net of effects of acquisitions:</b>		
Accounts receivable, net	(26,617)	(19,956)
Inventories, net	(23,491)	17,971
Other assets	(26,446)	1,336
Accounts payable and other liabilities	26,684	(13,462)
Deferred income on sales to distributors	25,534	(3,912)
Income taxes payable	(197)	(1,528)
<b>Net cash flow generated from operating activities</b>	<b>62,466</b>	<b>3,293</b>
<b>Cash flow from investing activities:</b>		
Purchase of available-for-sale investments	(61,825)	(48,640)
Proceeds from sale or maturities of available-for-sale investments	58,793	114,046
Proceeds from sale of common shares related to NetLogic Microsystems, Inc. ( NetLogic )	58,852	
Cash paid for other investments	(5,247)	(4,000)
Acquisition of property and equipment	(66,411)	(50,775)
Cash used for acquisitions, net		(39,606)
Issuance of SunPower note receivable	(10,000)	
Proceeds from collection of SPAP loans	5,603	
Proceeds from sale of property and equipment	1,501	
<b>Net cash flow used in investing activities</b>	<b>(18,734)</b>	<b>(28,975)</b>
<b>Cash flow from financing activities:</b>		
Repayment of borrowings	(6,259)	(8,152)
Conversion of convertible subordinated notes	(300)	(1)
Issuance of common shares	37,443	30,567
Proceeds from SunPower's follow-on public offering, net	197,431	
Structured purchase of options	598	

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Net cash flow generated from financing activities	228,913	22,414
Net increase (decrease) in cash and cash equivalents	272,645	(3,268)
Cash and cash equivalents, beginning period	221,206	66,619
Cash and cash equivalents, end of period	\$ 493,851	\$ 63,351
Supplemental disclosure of non-cash information:		
Common shares of Cypress issued for acquisitions	\$	\$ 3,723
Common shares of NetLogic received from sale of NSE assets	\$ 58,531	\$
Conversion of convertible subordinated notes to common shares of Cypress	\$ 700	\$

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents**

**CYPRESS SEMICONDUCTOR CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Fiscal Years**

Cypress Semiconductor Corporation ( Cypress or the Company ) reports on a fiscal-year basis and ends its quarters on the Sunday closest to the end of the applicable calendar quarter, except in a 53-week fiscal year, in which case the additional week falls into the fourth quarter of that fiscal year. Both fiscal 2006 and 2005 consist of 52 weeks. The second quarter of fiscal 2006 ended on July 2, 2006 and the second quarter of fiscal 2005 ended on July 3, 2005.

**Basis of Presentation**

In the opinion of the management of the Company, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting solely of normal recurring adjustments) necessary to state fairly the financial information included therein. The Company believes that the disclosures are adequate to make the information not misleading. However, this financial data should be read in conjunction with the audited consolidated financial statements and related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended January 1, 2006.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

The condensed consolidated financial statements include the amounts of the Company and all of its subsidiaries, including SunPower Corporation ( SunPower ). Inter-company transactions and balances have been eliminated in consolidation.

The consolidated results of operations for the three and six months ended July 2, 2006 are not necessarily indicative of the results to be expected for the full fiscal year.

**Recent Accounting Pronouncement**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes. This Interpretation prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return (including a decision whether to file or not to file a return in a particular jurisdiction). Under the Interpretation, the financial statements will reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts. The Interpretation also revises disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of the unrecognized tax benefits. This Interpretation is effective for fiscal years beginning after December 15, 2006. The Company will adopt this provision in the first quarter of fiscal 2007 and is currently evaluating the impact of this provision on its consolidated results of operations and financial condition.

**NOTE 2. SUNPOWER**

During the second quarter of fiscal 2006, SunPower, a majority-owned subsidiary of Cypress specializing in solar power products, completed a follow-on public offering of 7.0 million shares of its class A common stock at a per-share price of \$29.50 and received total proceeds, net of commission fees and transaction costs, of approximately \$197.4 million. As a majority shareholder of SunPower, the Company recognized a change of interest gain of \$126.4 million in connection with this transaction, which was recorded in Additional paid-in capital in the accompanying Condensed Consolidated Balance Sheet.

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Currently, SunPower has two classes of authorized common stock: class A common stock and class B common stock. As of July 2, 2006, the Company held 52.0 million shares of SunPower's class B common stock. Only the Company, its successors in interest and its subsidiaries may hold shares of SunPower's class B common stock unless the Company

**Table of Contents**

distributes the shares to its stockholders in a tax-free distribution. The Company has agreed not to sell or distribute any of its shares of SunPower's class B common stock without the prior consent of Credit Suisse and Lehman Brothers, lead underwriters of SunPower's follow-on public offering, until August 29, 2006. The Company is continuing to explore ways in which to more fully realize the value of its equity interest in SunPower for the benefit of the Company's stockholders.

The rights of the holders of class A and class B common stock are substantially similar, except with respect to voting, conversion and other protective provisions. The holders of class B common stock are entitled to eight votes per share and the holders of class A common stock are entitled to one vote per share. Each share of class B common stock is convertible into one share of class A common stock at any time and will so convert automatically on any transfer unless the Company distributes its shares of class B common stock to its stockholders in a tax-free distribution. In the event that the Company, its successors in interest and its subsidiaries collectively own less than 40% of the shares of all classes of SunPower's common stock then outstanding and the Company has not effected a tax-free distribution of SunPower's class B common stock to its stockholders prior to that time, each outstanding share of class B common stock will automatically convert into one share of class A common stock.

As of July 2, 2006, the fair value of the Company's equity interest in SunPower was approximately \$1.5 billion, based on the closing stock price of SunPower of \$28.02 on June 30, 2006. As the Company's financial statements were presented on a consolidated basis, the fair value of the Company's equity interest in SunPower was not recorded as an asset in the accompanying Condensed Consolidated Balance Sheets.

The following table summarizes the Company's percentage of ownership in SunPower as of July 2, 2006:

As a percentage of SunPower's total outstanding shares of capital stock	75.6 %
As a percentage of SunPower's total outstanding shares of capital stock on a fully diluted basis after taking into account its outstanding stock options	69.7 %
As a percentage of the total voting power of SunPower's outstanding shares of capital stock	96.1 %

**NOTE 3. SALE OF NETWORK SEARCH ENGINE ( NSE ) ASSETS****Transaction Summary**

During the first quarter of fiscal 2006, the Company completed the sale of the assets and intellectual property associated with certain products in the Company's NSE product line to NetLogic Microsystems, Inc. ( NetLogic ) pursuant to the Agreement for the Purchase and Sale of Assets, dated January 25, 2006 and amended February 15, 2006 (the Agreement ). The assets sold to NetLogic included the Ayama 20000, Ayama 20000, and NSE70000 Network Search Engine product families as well as the Sahasra 50000 Algorithmic Search Engine product family (the NSE Assets ). The Company retained the right to sell and continues to support the custom TCAM1 and TCAM2 products in its NSE product line. The NSE product line is a business unit of the Company's Data Communications Division.

Pursuant to the Agreement, NetLogic issued to the Company approximately 1.7 million shares of its common stock. In addition, if certain revenue milestones associated with the NSE Assets are achieved in the twelve-month period after the close of the transaction, NetLogic will pay the Company up to an additional \$10.0 million in cash and up to an additional 0.3 million shares in NetLogic's common stock.

**Gain on Sale of NSE Assets**

The Company recorded a gain of \$6.0 million in connection with the disposal of the NSE Assets during the first quarter of fiscal 2006. The following table summarizes the components:

<b>(In thousands)</b>	
Value of shares of NetLogic's common stock received	\$ 58,531
Net book value of assets sold to NetLogic	(4,021)
Goodwill related to assets sold	(44,070)
Severance and other benefits	(2,799)
Transaction costs	(1,643)

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Gain on disposal of NSE Assets

\$ 5,998

The value of the shares of NetLogic's common stock received was determined using the closing price of NetLogic's common stock of \$35.40 on February 15, 2006, the effective date of the completion of the transaction.

**Table of Contents**

Assets sold to NetLogic included the following:

<b>(In thousands)</b>	
Inventories, net	\$ 2,716
Prepaid expense	201
Property and equipment, net	67
Intangible assets, net	1,037
<b>Total assets sold to NetLogic</b>	<b>\$ 4,021</b>

Intangible assets sold to NetLogic included certain purchased technology and trademarks which had previously been acquired by the Company in conjunction with business combinations.

The NSE product line also included goodwill which had previously been acquired by the Company in conjunction with business combinations. However, NetLogic did not acquire any goodwill from the NSE product line pursuant to the Agreement. In accordance with SFAS No. 142,

Goodwill and Other Intangible Assets, the Company included a portion of the goodwill in the carrying amount of the NSE Assets in determining the gain on disposal. The amount was based on the relative fair values of the NSE Assets disposed of and the remaining portion of the NSE products that was retained by the Company.

In conjunction with the sale, the Company paid severance and other benefits to 54 employees in the NSE business unit (35 in research and development and 19 in selling, general and administrative functions) who were either terminated or transferred to NetLogic as a direct result of this transaction.

**Investment in NetLogic**

Subsequent to the completion of the transaction, the Company sold approximately 1.5 million shares of NetLogic's common stock and recognized a gain of \$6.2 million in Other income (expense), net in the Condensed Consolidated Statement of Operations in the first quarter of fiscal 2006. As of July 2, 2006, the Company held approximately 0.2 million shares of NetLogic's common stock with a fair value of \$5.3 million.

**NOTE 4. GOODWILL AND INTANGIBLE ASSETS****Goodwill**

The following table presents the changes in the carrying amount of goodwill under the Company's reportable business segments (see Note 16):

<b>(In thousands)</b>	<b>CCD</b>	<b>DCD</b>	<b>MID</b>	<b>SunPower</b>	<b>Total</b>
Balance at January 1, 2006	\$ 132,580	\$ 187,878	\$ 83,919	\$ 2,883	\$ 407,260
Goodwill adjustment		(44,070)			(44,070)
<b>Balance at July 2, 2006</b>	<b>\$ 132,580</b>	<b>\$ 143,808</b>	<b>\$ 83,919</b>	<b>\$ 2,883</b>	<b>\$ 363,190</b>

During the first quarter of fiscal 2006, the Company completed the sale of the NSE Assets, which were a component of the Company's DCD segment. In accordance with SFAS No. 142, a portion of the goodwill related to DCD, totaling \$44.1 million, was allocated to the NSE Assets and included in the computation of the gain on the disposal of the NSE Assets (see Note 3).

**Table of Contents****Intangible Assets**

The following table presents details of the Company's intangible assets:

	Accumulated		
As of July 2, 2006 (in thousands)	Gross	Amortization	Net
Purchased technology	\$ 233,880	\$ (210,993)	\$ 22,887
Non-compete agreements	19,415	(19,196)	219
Patents, customer contracts, licenses and trademarks	30,534	(14,589)	15,945
Other acquisition-related intangible assets	6,666	(5,281)	1,385
Non-acquisition related intangible assets	3,100	(693)	2,407
Total intangible assets	\$ 293,595	\$ (250,752)	\$ 42,843

	Accumulated		
As of January 1, 2006 (in thousands)	Gross	Amortization	Net
Purchased technology	\$ 246,527	\$ (217,974)	\$ 28,553
Non-compete agreements	19,415	(19,021)	394
Patents, customer contracts, licenses and trademarks	32,784	(13,540)	19,244
Other acquisition-related intangible assets	6,666	(4,996)	1,670
Non-acquisition related intangible assets	2,600	(225)	2,375
Total intangible assets	\$ 307,992	\$ (255,756)	\$ 52,236

During the first quarter of fiscal 2006, the Company sold purchased technology (with a net book value of \$0.9 million) and trademarks (with a net book value of \$0.2 million) to NetLogic in connection with the sale of the NSE Assets (see Note 3).

The estimated future amortization expense of intangible assets as of July 2, 2006 was as follows:

(In thousands)	
2006 (remaining six months)	\$ 7,990
2007	15,064
2008	10,953
2009	6,182
2010	1,354
Thereafter	1,300
Total amortization expense	\$ 42,843

**NOTE 5. RESTRUCTURING****Overview**

The Company initiated a restructuring plan in the first quarter of fiscal 2005 ( Fiscal 2005 Restructuring Plan ) and a restructuring plan in the fourth quarter of fiscal 2002 ( Fiscal 2002 Restructuring Plan ). During the second quarter of fiscal 2006, the Company completed all obligations related to the Fiscal 2002 Restructuring Plan. As of July 2, 2006, the Fiscal 2005 Restructuring Plan has been substantially completed with remaining reserves consisting of lease payments for restructured facilities. For a detailed discussion on these two restructuring plans and the

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restructuring activities prior to fiscal 2006, refer to the Annual Report on Form 10-K for the fiscal year ended January 1, 2006.

As discussed further below, the Company recorded total restructuring charges of \$0.6 million in the first quarter of fiscal 2006 and restructuring credits of \$0.1 million in the second quarter of fiscal 2006.

**Table of Contents****Fiscal 2005 Restructuring Plan**

Activities related to the restructuring reserves during fiscal 2006 are summarized as follows:

(In thousands)	Leased		Total
	Facilities	Personnel	
Balance at January 1, 2006	\$ 774	\$ 21	\$ 795
Benefit		(21)	(21)
Cash payments	(127)		(127)
Balance at April 2, 2006	647		647
Cash payments	(106)		(106)
Balance at July 2, 2006	\$ 541	\$	\$ 541

**Leased Facilities:**

Amounts related to the lease expense will be paid over the respective lease terms through fiscal 2007.

**Personnel:**

As of April 2 2006, the Company had completed the obligations relating to severance and benefits owed to the terminated employees.

**Property and Equipment (not included in the restructuring reserve activity table above):**

During the first quarter of fiscal 2006, the Company recorded an additional restructuring charge of \$0.5 million as the proceeds received from the sale of the restructured assets were lower than the original estimated values. During the second quarter of fiscal 2006, the Company completed the disposal of all restructured assets.

**Fiscal 2002 Restructuring Plan**

Activities related to the restructuring reserves during fiscal 2006 are summarized as follows:

(In thousands)	Leased
	Facilities
Balance at January 1, 2006	\$ 877
Provision	67
Cash payments	(26)
Balance at April 2, 2006	918
Benefit	(88)
Cash payments	(830)
Balance at July 2, 2006	\$

During the first quarter of fiscal 2006, the Company recorded an additional provision, as the Company revised the estimated lease obligations. During the second quarter of fiscal 2006, the Company terminated the lease and released the unused reserve.

As of July 2, 2006, the Company completed all obligations related to the Fiscal 2002 Restructuring Plan.

**Table of Contents****Reconciliation**

The following table reconciles the restructuring charges (credits) recorded in the Condensed Consolidated Statements of Operations:

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
<b>Fiscal 2005 Restructuring Plan:</b>				
Amounts included in the restructuring reserve activity table:				
Provision (benefit)	\$	\$ 4,878	\$ (21)	\$ 18,756
Amounts not included in the restructuring reserve activity table:				
Provision (benefit)	(25)	108	531	8,939
<b>Fiscal 2002 Restructuring Plan:</b>				
Amounts included in the restructuring reserve activity table:				
Benefit	(88)		(21)	
<b>Total</b>	<b>\$ (113)</b>	<b>\$ 4,986</b>	<b>\$ 489</b>	<b>\$ 27,695</b>

**NOTE 6. BALANCE SHEET COMPONENTS****Accounts Receivable, Net**

(In thousands)	July 2, 2006	As of January 1, 2006
Accounts receivable, gross	\$ 183,543	\$ 154,865
Allowance for doubtful accounts receivable and customer returns	(5,713)	(3,652)
<b>Total accounts receivable, net</b>	<b>\$ 177,830</b>	<b>\$ 151,213</b>

**Inventories**

(In thousands)	July 2, 2006	As of January 1, 2006
Raw materials	\$ 13,677	\$ 10,868
Work-in-process	51,209	43,702
Finished goods	30,985	19,003
<b>Total inventories</b>	<b>\$ 95,871</b>	<b>\$ 73,573</b>

As of July 2, 2006, total inventories included approximately \$1.5 million of capitalized stock-based compensation costs recorded under SFAS No. 123(R), Share-Based Payments (see Note 8).

**Other Current Assets**

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	July 2,	As of January 1,
(In thousands)	2006	2006
Employee stock purchase assistance plan ( SPAP ), net	\$ 39,780	\$ 45,783
Deferred tax assets	18,264	19,471
Prepaid expenses	35,345	11,660
Other	23,118	14,599
<b>Total other current assets</b>	<b>\$ 116,507</b>	<b>\$ 91,513</b>

**Table of Contents****Other Assets**

	July 2,	As of January 1,
(In thousands)	2006	2006
Restricted cash	\$ 63,395	\$ 63,480
Key employee deferred compensation plan	20,421	23,201
Other	42,646	40,434
<b>Total other assets</b>	<b>\$ 126,462</b>	<b>\$ 127,115</b>

**Other Current Liabilities**

	July 2,	As of January 1,
(In thousands)	2006	2006
Collateralized debt instruments - current portion	\$ 4,839	\$ 4,839
SunPower customer advances - current portion	11,504	8,962
Sales representative commissions	4,470	4,495
Accrued royalties	1,345	2,301
Key employee deferred compensation plan	23,871	27,766
Other	29,325	27,523
<b>Total other current liabilities</b>	<b>\$ 70,515</b>	<b>\$ 75,886</b>

**Other Long-Term Liabilities**

	July 2,	As of January 1,
(In thousands)	2006	2006
Collateralized debt instruments	\$ 1,250	\$ 1,250
SunPower customer advances	30,609	28,438
Synthetic lease liabilities	4,842	4,042
Other long-term liabilities	5,808	301
<b>Total other long-term liabilities</b>	<b>\$ 41,259</b>	<b>\$ 34,031</b>

**Deferred Income Taxes and Other Tax Liabilities**

	July 2,	As of January 1,
(In thousands)	2006	2006
Deferred income taxes	\$ 20,965	\$ 22,850

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Non-current tax liabilities	34,093	34,060
<b>Total deferred income taxes and other tax liabilities</b>	<b>\$ 55,058</b>	<b>\$ 56,910</b>

**NOTE 7. INVESTMENTS**

**Available-For-Sale Securities**

The Company's available-for-sale securities included the following:

<b>As of July 2, 2006 (in thousands)</b>	<b>Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Market Value</b>
<b>Cash equivalents:</b>				
Commercial paper	\$ 170,932	\$	\$ (49)	\$ 170,883
Money market funds	287,168			287,168
<b>Total cash equivalents</b>	<b>\$ 458,100</b>	<b>\$</b>	<b>\$ (49)</b>	<b>\$ 458,051</b>
<b>Short-term investments:</b>				
Federal agency notes	\$ 32,469	\$	\$ (306)	\$ 32,163
Corporate notes / bonds	55,582	4	(420)	55,166
Auction rate securities	30,776			30,776
Certificate of deposits	51			51
Equity securities	5,853		(521)	5,332
<b>Total short-term investments</b>	<b>\$ 124,731</b>	<b>\$ 4</b>	<b>\$ (1,247)</b>	<b>\$ 123,488</b>
Long-term equity securities (1)	\$ 7,619	\$ 2,452	\$ (1,981)	\$ 8,090
<b>Total available-for-sale securities</b>	<b>\$ 590,450</b>	<b>\$ 2,456</b>	<b>\$ (3,277)</b>	<b>\$ 589,629</b>

(1) Long-term equity securities are recorded in Other assets in the Condensed Consolidated Balance Sheets.

**Table of Contents**

As of January 1, 2006 (in thousands)	Cost	Gross Unrealized		Fair Market Value
		Gains	Losses	
<b>Cash equivalents:</b>				
Federal agency notes	\$ 1,599	\$	\$	\$ 1,599
Money market funds	149,685			149,685
Corporate notes / bonds	48,541			48,541
<b>Total cash equivalents</b>	<b>\$ 199,825</b>	<b>\$</b>	<b>\$</b>	<b>\$ 199,825</b>
<b>Short-term investments:</b>				
Federal agency notes	\$ 39,687	\$ 5	\$ (261)	\$ 39,431
Corporate notes / bonds	60,801	2	(548)	60,255
Auction rate securities	9,365			9,365
Certificate of deposits	51			51
<b>Total short-term investments</b>	<b>\$ 109,904</b>	<b>\$ 7</b>	<b>\$ (809)</b>	<b>\$ 109,102</b>
Long-term equity securities	\$ 1,955	\$	\$	\$ 1,955
<b>Total available-for-sale securities</b>	<b>\$ 311,684</b>	<b>\$ 7</b>	<b>\$ (809)</b>	<b>\$ 310,882</b>

The Company classifies all available-for-sale securities that are intended to be available for use in current operations as either cash equivalents or short-term investments.

As of July 2, 2006, contractual maturities of the Company's short-term debt investments were as follows:

(In thousands)	Cost	Estimated Fair Value
Maturing within one year	\$ 75,099	\$ 74,732
Maturing in two to three years	32,903	32,548
Maturing in more than three years	10,876	10,876
<b>Total</b>	<b>\$ 118,878</b>	<b>\$ 118,156</b>

Proceeds from sales and maturities of available-for-sale debt investments were \$58.8 million and \$114.0 million for the six months ended July 2, 2006 and July 3, 2005, respectively. Realized losses were \$0.1 million and \$0.3 million for the three and six months ended July 3, 2005, respectively. No realized gains or losses were recorded for the three and six months ended July 2, 2006.

**Equity Securities****Publicly-Traded Companies:**

The Company holds equity securities in certain publicly-traded companies. These equity securities are classified as available-for-sale investments and are being carried at fair value with the resulting unrealized gains or losses recorded in Accumulated other comprehensive income (income) in the Condensed Consolidated Balance Sheets. As of July 2, 2006 and January 1, 2006, the fair value of the investments was \$13.4 million and \$2.0 million, respectively.

**Table of Contents**

In addition, the Company holds warrants to purchase shares of a publicly-traded company's common stock that are classified as derivatives. They are being marked to market at the end of each reporting period with the resulting gains or losses recognized in Other income (expense), net in the Condensed Consolidated Statements of Operations. As of July 2, 2006 and January 1, 2006, the fair value of the warrants was \$1.3 million and \$1.3 million, respectively.

**Privately-Held Companies:**

The Company holds equity investments in several privately-held companies, many of which can be considered in the startup or development stages. As of July 2, 2006 and January 1, 2006, the carrying value of these investments was \$3.7 million and \$8.4 million, respectively, and was included in Other assets in the Condensed Consolidated Balance Sheets. As the Company's equity investments do not permit the Company to exert significant influence or control over the investees, these amounts represent the cost of the investments, less any adjustments the Company makes when it determines that an investment's net realizable value is less than its carrying cost and the decline in value is determined to be other-than-temporary. The Company recorded impairment charges of zero and \$0.9 million for the three and six months ended July 2, 2006, respectively, and zero and \$0.4 million for the three and six months ended July 3, 2005, respectively.

**Sale of Investments:**

During the first quarter of fiscal 2006, the Company completed the sale of its equity interests in two publicly-traded companies and realized total gains of \$7.1 million, of which \$6.2 million was related to the sale of NetLogic's common stock (see Note 3) and \$0.9 million was related to another investee.

In addition, during the first quarter of fiscal 2006, one of the privately-held companies merged with a publicly-traded company, resulting in the Company receiving shares in the publicly-traded company. As a result of the transaction, the Company recognized a gain of \$2.9 million.

**NOTE 8. STOCK-BASED COMPENSATION****Adoption of SFAS No. 123(R)**

Effective January 2, 2006, the Company (including both Cypress and SunPower) adopted the provisions of SFAS No. 123(R), Share-Based Payment, which requires the Company to measure the stock-based compensation costs of share-based compensation arrangements based on the grant-date fair value and recognize the costs in the financial statements over the employee requisite service period. As permitted by SFAS No. 123(R), the Company elected to use the modified prospective application transition method and has not restated its financial results for prior periods. Under this transition method, stock-based compensation expense for the second quarter and first half of fiscal 2006 included compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 2, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Stock based compensation expense for all stock-based compensation awards granted after January 2, 2006 was based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R).

The following table summarizes the stock-based compensation costs by line item in the Condensed Consolidated Statement of Operations and the impact on net income per share:

(In thousands, except per-share amounts)	Three Months Ended			Six Months Ended		
	July 2, 2006			July 2, 2006		
	Cypress	SunPower	Consolidated	Cypress	SunPower	Consolidated
Cost of revenues	\$ 2,644	\$ 243	\$ 2,887	\$ 3,367	\$ 436	\$ 3,803
Research and development	4,090	264	4,354	8,387	684	9,071
Selling, general and administrative	4,118	630	4,748	8,391	1,429	9,820
Total stock-based compensation expense before income taxes	10,852	1,137	11,989	20,145	2,549	22,694
Tax effect on stock-based compensation expense						
Total stock-based compensation expense after income taxes	\$ 10,852	\$ 1,137	\$ 11,989	\$ 20,145	\$ 2,549	\$ 22,694

Effect on net income per share:			
Basic		\$ 0.09	\$ 0.16
Diluted		\$ 0.07	\$ 0.13

**Table of Contents**

As stock-based compensation expense recognized in the Condensed Consolidated Statements of Operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

As of July 2, 2006, stock-based compensation capitalized in inventories totaled \$1.5 million.

The following table summarizes the stock-based compensation costs by type of awards:

(In thousands)	Three Months Ended			Six Months Ended		
	July 2, 2006			July 2, 2006		
	Cypress	SunPower	Consolidated	Cypress	SunPower	Consolidated
Stock options	\$ 9,972	\$ 1,029	\$ 11,001	\$ 18,745	\$ 2,406	\$ 21,151
Employee stock purchase plan ( ESPP )	823		823	1,343		1,343
Restricted stock	57	108	165	57	143	200
Total stock-based compensation expense	\$ 10,852	\$ 1,137	\$ 11,989	\$ 20,145	\$ 2,549	\$ 22,694

Consolidated net cash proceeds from option exercises and issuance of shares under the ESPP were \$37.4 million for the six months ended July 2, 2006 and \$30.6 million for the six months ended July 3, 2005. No income tax benefit was realized from stock option exercises during the six months ended July 2, 2006 and July 3, 2005. As required, the Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

The following table summarizes the unrecognized stock-based compensation costs by type of awards:

(In thousands, except years)	As of July 2, 2006			Weighted-Average
	Cypress	SunPower	Consolidated	Amortization
				Period
Stock options	\$ 60,082	\$ 5,327	\$ 65,409	1.9 years
ESPP	207		207	1.0 year
Restricted stock	2,411	2,488	4,899	2.9 years
Total unrecognized stock-based compensation balance	\$ 62,700	\$ 7,815	\$ 70,515	

**Prior to the Adoption of SFAS No. 123(R)**

Prior to the adoption of SFAS No. 123(R), the Company applied SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which allowed companies to apply the accounting rules under APB No. 25, Accounting for Stock Issued to Employees, and related interpretations. The following table illustrates the effect on net loss after tax and net loss per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation:

(In thousands, except per-share amounts)	Three Months	Six Months
	Ended	Ended
	July 3, 2005	
Net loss - as reported	\$ (15,254)	\$ (84,050)
Add: Total stock-based compensation expense reported in net loss, net of related tax effects	3,613	5,389

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Deduct: Total stock-based compensation expense determined under fair value based method, net of tax effects	(19,072)	(29,628)
Net loss - pro forma	\$ (30,713)	\$ (108,289)
Net loss per share:		
Basic and diluted - as reported	\$ (0.12)	\$ (0.64)
Basic and diluted - pro forma	\$ (0.23)	\$ (0.83)

**Table of Contents****Valuation Assumptions**

The Company estimates the fair value of the stock-based awards using the Black-Scholes valuation model. Assumptions used in the Black-Scholes valuation model were as follows:

Cypress:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
	2006	2005	2006	2005
<b>Stock Option Plans:</b>				
Expected life	3.0 - 8.1 years	2.0 - 7.0 years	3.0 - 8.1 years	2.0 - 7.0 years
Volatility	43.0% - 50.3%	52.0% - 74.0%	42.0% - 50.3%	52.0% - 84.5%
Risk-free interest rate	5.0% - 5.3%	3.6% - 3.8%	4.8% - 5.3%	3.6% - 4.4%
Dividend yield	0.0%	0.0%	0.0%	0.0%
<b>ESPP:</b>				
Expected life	0.5 - 1.5 years	0.5 - 1.5 years	0.5 - 1.5 years	0.5 - 1.5 years
Volatility	46.0% - 53.4%	51.3% - 105.0%	46.0% - 53.4%	51.3% - 105.0%
Risk-free interest rate	2.3% - 4.3%	0.7% - 2.8%	2.3% - 4.3%	0.7% - 2.8%
Dividend yield	0.0%	0.0%	0.0%	0.0%

*Expected life:* Expected life was based on historical exercise patterns, giving consideration to the contractual terms of the awards and vesting schedules. In addition, employees who display similar historical exercise behavior are grouped separately into two classes (executive officers and other) in determining the expected life.

*Volatility:* Prior to January 1, 2006, Cypress's expected volatility was based on the historical volatility. As a result of adopting SFAS No. 123(R), Cypress determined that implied volatility of publicly-traded call options in its common stock and quotes from option traders is expected to be more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility. Therefore, Cypress revised the volatility factor to be based on a blend of historical volatility of its common stock and implied volatility of call options and quotes from option traders.

*Risk-free interest rate:* The risk-free interest rate is based on the U.S. Treasury curve in effect at the time of grant.

*Dividend yield:* Cypress has not issued any dividends and has no present plans to do so.

SunPower:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
	2006	2005	2006	2005
<b>Stock Option Plans:</b>				
Expected life	6.5 years	4.0 years	6.5 years	4.0 years
Volatility	91.0%	74.0%	92.0%	74.0%
Risk-free interest rate	5.1%	3.6%	5.0%	3.6%
Dividend yield	0.0%	0.0%	0.0%	0.0%

*Expected life:* Prior to January 1, 2006, SunPower estimated the expected life based on an assumed exercise of vested tranches at the earlier of one year after their vesting date or one year after an assumed public offering. Upon the adoption of SFAS No. 123(R), SunPower utilizes the simplified method under the provisions of SAB No. 107 for estimated expected term, instead of its historical exercise data. SunPower elected not to base the expected term on historical data because of the significant difference in its status before and after the adoption of SFAS No. 123(R). SunPower was a privately-held company until its initial public offering in November 2005, and the only available liquidation event for options holders was Cypress's buy-out of minority interests in November 2004. At all other times, optionees could not cash out their vested options. Even during its limited history as a public company since November 2005, optionees could not exercise vested options because of the lock-up

requirements until the second quarter of fiscal 2006.

*Volatility:* As SunPower was a privately-held company until November 2005, it has a limited history of its stock price returns. Therefore, SunPower does not believe that its historical volatility would be representative of the expected volatility for its equity awards. Prior to the fourth quarter of fiscal 2005, volatility was based on Cypress's volatility. Beginning in the fourth quarter of fiscal 2005, SunPower has chosen to use the historical volatility rates for a publicly-traded U.S.-based direct competitor to calculate the volatility for its granted options.

**Table of Contents**

*Risk-free interest rate:* The interest rate is based on the U.S. Treasury yield in effect at the time of grant.

*Dividend yield:* SunPower has not issued any dividends and has no present plans to do so.

**Equity Incentive Program Related to Cypress's Common Stock**

Cypress has the following two stock option plans:

**1999 Stock Option Plan ( 1999 Plan ):**

In fiscal 1999, Cypress adopted the 1999 Plan. Under the terms of the 1999 Plan, which is a non-shareholder approved plan, options may be granted to qualified employees, including those of acquired companies and consultants of Cypress or its subsidiaries, but options may not be granted to executive officers or directors. Options become exercisable over a vesting period as determined by the Board of Directors, generally over 60 months ratably, and expire over terms not exceeding ten years from the date of grant. As of July 2, 2006, approximately 4.6 million shares were available for grant under the 1999 Plan. The 1999 Plan will expire in March 2009.

**1994 Stock Option Plan ( 1994 Plan ):**

In fiscal 1994, the Company adopted the 1994 Plan, which is a shareholder-approved plan. The 1994 Plan replaced the Company's 1985 Incentive Stock Option Plan and the 1988 Directors Stock Option Plan with respect to future option and restricted stock grants. Under the terms of the 1994 Plan, options and restricted stock may be granted to qualified employees, consultants, officers and directors of the Company or its subsidiaries. Options become exercisable over a vesting period as determined by the Board of Directors, generally over 60 months ratably, and expire over terms not exceeding ten years. Restricted stock generally vests over one to four years from the date of grant. As of July 2, 2006, approximately 17.5 million shares were available for grant under the 1994 Plan. The 1994 Plan will expire in April 2014.

The following table summarizes Cypress's stock option activities:

	<b>Weighted-</b>
	<b>Average</b>
	<b>Exercise</b>
	<b>Price Per</b>
	<b>Share</b>
<b>(In thousands, except per-share amounts)</b>	
Options outstanding as of January 1, 2006	39,615 \$ 14.68
Granted	788 16.87
Exercised	(2,143) 9.16
Forfeited or expired	(2,288) 17.57
Options outstanding as of April 2, 2006	35,972 14.89
Granted	1,165 15.73
Exercised	(945) 9.11
Forfeited or expired	(938) 16.21
Options outstanding as of July 2, 2006	35,254 15.04
Options exercisable as of July 2, 2006	21,524 15.60

The weighted-average grant-date fair value was \$7.72 and \$7.56 per share for options granted during the three and six months ended July 2, 2006, respectively, and \$7.15 and \$8.42 per share for options granted during the three and six months ended July 3, 2005, respectively.

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The total intrinsic value of options exercised was \$6.3 million and \$22.3 million for the three and six months ended July 2, 2006, respectively, and \$5.7 million and \$10.1 million for options exercised for the three and six months ended July 3, 2005, respectively.

Total fair value of options vested was \$9.4 million and \$19.2 million for the three and six months ended July 2, 2006, respectively, and \$16.3 million and \$32.5 million for the three and six months ended July 3, 2005, respectively.

**Table of Contents**

Information regarding stock options outstanding as of July 2, 2006 was as follows:

Range of Exercise Price	Options Outstanding Weighted-						Options Exercisable Weighted-					
	Average						Average					
	Remaining		Weighted-	Aggregate			Remaining		Weighted-	Aggregate		
	Contractual	Average		Intrinsic			Contractual	Average		Intrinsic		
		Life	Exercise Price		Value			Life	Exercise Price		Value	
		Shares	(in years)	per Share	(in thousands)	Shares	(in years)	per Share	(in thousands)			
\$0.50 \$7.37	4,903	6.31	\$ 6.41	\$ 39,855	3,007	6.18	\$ 6.30	\$ 24,791				
7.38 10.30	4,213	4.36	8.99	23,362	3,176	3.24	8.82	18,171				
10.35 13.68	3,841	6.09	11.80	10,510	2,257	4.56	11.44	6,991				
13.72 14.55	5,010	8.85	14.43	600	1,012	8.65	14.43	125				
14.58 16.84	6,153	6.38	16.40		4,417	5.31	16.71					
16.85 19.60	3,972	7.69	18.91		1,382	6.76	19.29					
20.15 22.81	3,621	5.06	21.49		2,865	4.45	21.51					
22.90 45.69	3,530	4.78	25.19		3,397	4.78	25.25					
48.62 54.19	11	3.81	49.67		11	3.81	49.67					
	35,254	6.30	15.04	\$ 74,327	21,524	5.10	15.60	\$ 50,078				

The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, based on Cypress's closing stock price of \$14.54 at June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable was 9.5 million as of July 2, 2006.

As of July 2, 2006, stock options vested and expected to vest totaled approximately 33.8 million shares, with weighted-average remaining contractual life of 6.17 years and weighted-average exercise price of \$15.07 per share. The aggregate intrinsic value was approximately \$72.4 million.

The following table summarizes Cypress's non-vested restricted stock activities:

(In thousands, except per-share amounts)	Shares	Weighted-
		Average
		Grant Date Fair Value
Non-vested as of January 1, 2006		\$
Granted	5	17.38
Non-vested as of April 2, 2006	5	17.38
Granted	176	15.17
Non-vested as of July 2, 2006	181	15.23

ESPP:

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The ESPP allows eligible employees of Cypress to purchase shares of Cypress's common stock through payroll deductions. The term of the ESPP contains consecutive 18-month offering periods composed of three six-month exercise periods. The shares can be purchased at the lower of 85% of the fair market value of the common stock at the date of commencement of the offering period or at the last day of each six-month exercise period. Purchases are limited to 10% of an employee's eligible compensation, subject to a maximum annual employee contribution limit of \$25,000. During fiscal 2005, Cypress issued 2.9 million shares with a weighted-average price of \$7.52 per share and a grant-date fair value of \$5.68 per share. During the first half of fiscal 2006, Cypress issued 0.7 million shares with a weighted-average price of \$10.09 per share and a grant-date fair value of \$4.83 per share. The ESPP provided for an annual increase in shares available for issuance equal to 1.5% of the number of outstanding common stock on the last day of the preceding fiscal year. As of July 2, 2006, approximately 1.6 million shares were available for future issuance under the ESPP.

On May 1, 2006, Cypress's stockholders approved an amendment to the ESPP that: (i) extends the term of the ESPP by ten years, and (ii) reduces the percentage for the annual increase in shares available for issuance from 1.5% to 1.0% of the number of outstanding common stock on the last day of the preceding fiscal year. Effective upon such stockholder approval, Cypress further agreed to: (i) reduce the number of shares outstanding under the plan from 4.3 million to 2.3 million, (ii) only extend the term of the plan by seven years, and (iii) further reduce the percentage for the annual increase in the shares available for issuance from 1.0% to 0.75% of the number of outstanding common stock on the last day of the preceding fiscal year.

**Table of Contents****Equity Incentive Program Related to SunPower's Common Stock**Stock Option Plans:

SunPower has three stock option plans: the 1988 Incentive Stock Plan ( 1988 Plan ), the 1996 Incentive Stock Plan ( 1996 Plan ), and the 2005 Incentive Stock Plan ( 2005 Plan ). Under the terms of the plans, SunPower may issue incentive or non-statutory stock options or stock purchase rights to employees and consultants to purchase common stock. The 2005 Plan was adopted by SunPower's board of directors in August 2005, and was approved by stockholders in November 2005. The 2005 Plan replaced the 1988 Plan and 1996 Plan and allows not only for the grant of options, but also for the grant of stock appreciation rights, restricted stock grants, restricted stock units, and other equity rights. In May 2006, SunPower's stockholders approved an increase of the number of shares available for future issuance by 0.3 million shares under the 2005 Plan. As of July 2, 2006, approximately 0.3 million shares were available for grant under the 2005 Plan.

Incentive stock options may be granted at no less than the fair value of the common stock on the date of grant. Nonqualified stock options and stock purchase rights may be granted at no less than 85% of the fair value of the common stock at the date of grant. The options and rights become exercisable when and as determined by the SunPower's board of directors, although these terms are generally not to exceed ten years for stock options and six months for stock purchase rights. The options typically vest over five years with a one-year cliff and monthly vesting thereafter.

The following table summarizes SunPower's stock option activities:

		Weighted- Average Exercise
(In thousands, except per-share amounts)	Shares	Price Per Share
Options outstanding as of January 1, 2006	6,572	\$ 3.41
Granted	17	38.40
Exercised	(183)	2.22
Forfeited or expired	(73)	3.04
Options outstanding as of April 2, 2006	6,333	3.54
Granted	9	39.74
Exercised	(512)	2.69
Forfeited or expired	(28)	6.71
Options outstanding as of July 2, 2006	5,802	3.66
Options exercisable as of July 2, 2006	1,911	2.46

The weighted-average grant-date fair value was \$31.58 and \$30.84 per share for options granted during the three and six months ended July 2, 2006, respectively, and \$3.40 and \$3.36 per share for options granted during the three and six months ended July 3, 2005, respectively.

The total intrinsic value of options exercised was \$14.8 million and \$21.7 million for the three and six months ended July 2, 2006, respectively, and zero and \$0.1 million for options exercised for the three and six months ended July 3, 2005, respectively.

Total fair value of options vested was \$1.0 million and \$2.1 million for the three and six months ended July 2, 2006, respectively, and \$1.3 million and \$2.2 million for the three and six months ended July 3, 2005, respectively.

**Table of Contents**

Information regarding stock options outstanding as of July 2, 2006 was as follows:

Range of Exercise Price	Options Outstanding				Options Exercisable				
	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Aggregate Intrinsic Value
	Shares	Life	Price per Share	Value	Shares	Life	Exercise Price	Value	
	(in thousands)	(in years)	Share	(in thousands)	(in thousands)	(in years)	per Share	(in thousands)	
\$0.30 - \$0.66	1,054	6.69	\$ 0.51	\$ 28,995	604	6.70	\$ 0.52	\$ 16,618	
2.00 - 3.30	4,035	8.37	3.28	99,819	1,277	8.35	3.27	31,592	
4.30 - 9.50	520	9.06	7.05	10,905	27	9.05	6.03	602	
10.80 - 17.00	119	9.39	11.40	1,981	3	0.64	17.0	28	
29.02 - 38.40	74	9.50	32.47						
	5,802	8.16	3.66	\$ 141,700	1,911	7.77	2.46	\$ 48,840	

The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, based on SunPower's closing stock price of \$28.02 at June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable was 1.9 million as of July 2, 2006.

As of July 2, 2006, stock options vested and expected to vest totaled approximately 5.6 million shares, with weighted-average remaining contractual life of 8.2 years and weighted-average exercise price of \$3.68 per share. The aggregate intrinsic value was approximately \$136.4 million.

The following table summarizes SunPower's non-vested restricted stock activities:

	Weighted-Average	Grant Date
(In thousands, except per-share amounts)	Shares	Fair Value
Non-vested as of January 1, 2006	15	\$ 30.04
Granted	11	39.75
Non-vested as of April 2, 2006	26	34.09
Granted	51	33.84
Forfeited	(1)	44.07
Non-vested as of July 2, 2006	76	33.15

**Stock Unit Plan:**

In September 2005, SunPower adopted its 2005 Stock Unit Plan in which all of SunPower's employees except its executive officers and directors are eligible to participate, although SunPower currently intends to limit participation to those of its non-US employees who are not senior managers. Under the 2005 Stock Unit Plan, SunPower's board of directors awards participants the right to receive cash payments from SunPower in an amount equal to the appreciation in SunPower's common stock between the award date and the date the employee redeems the award. The right to redeem the award typically vests in the same manner as options vest under the 2005 Plan. As of July 2, 2006, SunPower has granted approximately 95,000 units to 900 employees in the Philippines at an average unit price of \$23.18. A maximum of 100,000 stock units may be subject to stock unit awards granted under the 2005 Stock Unit Plan. For the three and six months ended July 2, 2006, total compensation expense was zero and \$0.2 million, respectively.

**Equity Incentive Programs Related to Other Subsidiaries - Common Stock**

Silicon Light Machines ( SLM ):

SLM, a privately-held subsidiary of Cypress, has a stock option plan. SLM made available for grant 11.0 million shares under the terms of its plan. The plans allow the subsidiaries to grant options to qualified employees and consultants. Options become exercisable over a five-year period and expire over terms not exceeding ten years from the date of grant. As of July 2, 2006, approximately 2.0 million shares were available for grant under the SLM stock option plan. For the three and six months ended July 2, 2006, stock-based compensation expense was immaterial to the Company's consolidated results of operations.

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## **Table of Contents**

### **Silicon Magnetic Systems ( SMS ):**

SMS ceased operations during fiscal 2005. No new options may be granted under its stock option plan. As of July 2, 2006, outstanding options totaled approximately 2.7 million shares, which were held by former SMS employees who had transferred to other functions within the Company. For the three and six months ended July 2, 2006, stock-based compensation expense was immaterial to the Company's consolidated results of operations.

## **NOTE 9. COMMITMENTS AND CONTINGENCIES**

### **Guarantees and Product Warranties**

The Company applies the provisions of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others, to its agreements that contain guarantee or indemnification clauses. These provisions expand those required by SFAS No. 5, Accounting for Contingencies, by requiring that guarantors disclose, and in certain cases record the fair value of, certain types of guarantees, even if the likelihood of requiring the guarantor's performance is remote.

#### **Indemnification Obligations:**

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts entered into by the Company, under which the Company customarily agrees to hold the other party harmless against losses arising from a breach of representations and covenants related to such matters as title to assets sold, certain intellectual property rights, specified environmental matters and certain income taxes. In these circumstances, payment by the Company is customarily conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third parties for certain payments made by it under these agreements.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on its business, financial condition or results of operations. The Company believes that if it were to incur a loss in any of these matters, such loss would not have a material effect on its business, financial condition, cash flows or results of operations, although there can be no assurance of this.

In connection with the sale of the NSE Assets to NetLogic (see Note 3), the Company has agreed to indemnify NetLogic with respect to certain matters. Specifically, the Company has agreed to indemnify NetLogic, for up to \$16.6 million, for claims arising from the representations and warranties made by the Company under the Agreement. The term of the Company's indemnification obligation is 18 months for all such representations and warranties, except our representation regarding the intellectual property included in the NSE Assets, which survives for a period of three years from the closing. Included in the NSE Assets were shares of capital stock acquired by the Company in a previous acquisition. The Company's indemnification obligation with respect to such shares is uncapped. The Company's indemnification obligation with respect to any other liability under the Agreement is capped at the purchase price paid by NetLogic for the NSE Assets.

#### **Product Warranties:**

The Company estimates its warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products under warranty. The estimated future warranty obligations related to product sales are recorded in the period in which the related revenue is recognized. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligations based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual warranty claim experience differs from estimates.

The Company typically warrants its non-SunPower products against defects in materials and workmanship for a period of one year and that product warranty is generally limited to a refund of the original purchase price of the product or a replacement part. SunPower warrants the performance of its solar panels at certain levels of conversion efficiency for extended periods, often as long as 25 years. It also warrants or guarantees the functionality of solar cells and imaging detectors for at least one year.



**Table of Contents**

The following table presents the Company's warranty reserve activities:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
(In thousands)	2006	2005	2006	2005
Beginning balance	\$ 3,537	\$ 3,181	\$ 2,869	\$ 2,717
Settlements	(1,453)	(918)	(2,773)	(3,059)
Provisions	2,817	657	4,805	3,262
Ending balance	\$ 4,901	\$ 2,920	\$ 4,901	\$ 2,920

The table above includes amounts related to SunPower's warranty reserve. The following table presents warranty reserve activities related to SunPower:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
(In thousands)	2006	2005	2006	2005
Beginning balance	\$ 642	\$ 225	\$ 574	\$
Settlements			(163)	
Provisions	1,346	85	1,577	310
Ending balance	\$ 1,988	\$ 310	\$ 1,988	\$ 310

During the second quarter of fiscal 2006, SunPower increased its estimated warranty provision rate which increased its warranty reserve by approximately \$1.0 million. This change in estimate was based on results of recent testing that simulates adverse environmental conditions and potential failure rates SunPower's solar panels could experience during their 25-year warranty period.

**Acquisition-Related Contingent Compensation**

The following table summarizes the acquisition-related contingent compensation charges recorded in the Condensed Consolidated Statements of Operations:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
(In thousands)	2006	2005	2006	2005
Cost of revenues	\$ 17	\$ 11	\$ 36	\$ 11
Research and development	1,343	1,150	2,818	2,082
Selling, general and administrative	325	64	633	64
Total	\$ 1,685	\$ 1,225	\$ 3,487	\$ 2,157

**CMS:**

During fiscal 2005, the Company completed the acquisition of CMS's minority interest. In connection with the acquisition, all vested stock options and immature shares of CMS's capital stock were exchanged for \$0.65 in cash per share, resulting in a charge of \$1.0 million in fiscal 2005.

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In addition, unvested shares and options were exchanged for a right to receive \$0.65 in cash per share in the future for a total contingent consideration of \$3.1 million. The value of the consideration will be amortized ratably on a straight-line basis over the employment service period. To date, the Company recorded total charges of \$0.8 million, of which \$0.4 million and \$0.7 million were recorded in the second quarter and first half of fiscal 2006, respectively.

### SMaL Camera Technologies, Inc. ( SMaL ):

During fiscal 2005, the Company completed the acquisition of SMaL. The terms of the acquisition include contingent consideration of up to approximately \$22.5 million in cash through fiscal 2006. Of this amount, \$1.7 million is based on employment and the achievement of certain individual performance milestones and \$20.8 million is based on the

**Table of Contents**

achievement of certain sales milestones and employment. When the contingency is based on milestone achievements and employment conditions, no charge is recognized until it is probable that the milestone conditions will be reached at which point any contingent consideration will be recognized over the employment service period. Such payments will be accounted for as compensation and expensed in the appropriate periods. As of July 2, 2006, all of the \$20.8 million contingent compensation based on achievement of sales milestones and employment has been forfeited as the sales targets have not been met.

To date, the Company recorded total charges of \$1.3 million related to the contingent compensation based on employment and the achievement of individual performance milestones. Of this amount, \$0.3 million and \$0.7 million were recorded in the second quarter and first half of fiscal 2006, respectively.

**Cascade Semiconductor Corporation ( Cascade ):**

During fiscal 2004, the Company completed the acquisition of Cascade. The terms of the acquisition include contingent consideration of approximately \$9.4 million payable to employees based on either revenue milestone achievement and employment conditions, or employment conditions alone, through January 2007. When the contingency is based on milestone achievements and employment conditions, no charge is recognized until it is probable that the milestone conditions will be reached at which point any contingent consideration will be recognized over the employment service period. Employment-only contingent consideration is recognized over the employment service period.

To date, the Company recorded total charges of \$8.9 million related to the contingent consideration, of which \$1.0 million and \$2.1 million were recorded in the second quarter and first half of fiscal 2006.

**Synthetic Lease**

On June 27, 2003, the Company entered into an operating lease agreement, commonly known as a synthetic lease, for manufacturing and office facilities located in Minnesota and California. A synthetic lease obligation of \$62.7 million with restricted cash collateral was established as of the second quarter of fiscal 2003. The synthetic lease requires the Company to purchase the properties or to arrange for the properties to be acquired by a third party at lease expiration, which is June 2008. In addition, the Company may extend the lease if the lessor allows. If the Company had exercised its right to purchase all the properties subject to the synthetic lease at July 2, 2006, the Company would have been required to make a payment totaling \$62.7 million (the Termination Value ). If the Company exercises its option to sell the properties to a third party, the proceeds from such a sale could be less than the properties Termination Value, and the Company would be required to pay the difference up to the guaranteed residual value of \$54.5 million (the Guaranteed Residual Value ).

The Company determined that the fair value associated with the Guaranteed Residual Value embedded in the synthetic lease was \$2.0 million. The amount was recorded in Other assets and Other long-term liabilities in the Condensed Consolidated Balance Sheets and is being amortized over the term of the lease. As of July 2, 2006, the unamortized balance was \$0.8 million.

The Company is required to evaluate periodically the expected fair value of the properties at the end of the lease term. In the event the Company determines that it is estimable and probable that the expected fair value of the properties at the end of the lease term will be less than the Termination Value, the Company will ratably accrue the loss over the remaining lease term. The Company has performed an analysis and determined a loss contingency accrual is required. As of July 2, 2006, the loss contingency accrual was \$4.0 million, representing the total amounts recognized through the end of the second quarter of fiscal 2006. The fair value analysis on the properties was performed by management with the assistance of an independent appraisal firm.

The Company is required to maintain restricted cash or investments to serve as collateral for this lease. As of July 2, 2006, the balance of restricted cash and accrued interest was \$63.4 million and was classified in Other assets in the Condensed Consolidated Balance Sheets.

In addition, the Company is also required to comply with certain financial covenants associated with the synthetic lease. As of July 2, 2006, the Company was in compliance with such financial covenants.

**Litigation and Asserted Claims**

In January 1998, an attorney representing the estate of Mr. Jerome Lemelson contacted the Company and charged that the Company infringed certain patents owned by Mr. Lemelson and/or a partnership controlled by Mr. Lemelson's estate. On



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## **Table of Contents**

February 26, 1999, the Lemelson Partnership sued the Company and 87 other companies in the United States District Court for the District of Arizona for infringement of 16 patents. In May 2000, the Court stayed litigation on 14 of the 16 patents in view of concurrent litigation in the United States District Court, District of Nevada, on the same 14 patents. On January 23, 2004, the Nevada Court held, in favor of plaintiffs, that all asserted claims of the 14 patents are unenforceable, invalid, and not infringed. On March 1, 2006, the Arizona Court ordered that all claims and counterclaims related to these 14 patents were dismissed with prejudice. In October 2001, the Lemelson Partnership amended its Arizona complaint to add allegations that two more patents were infringed. Therefore, there are currently four patents that are still at issue in this litigation. The case is in the claim construction (i.e., patent claim interpretation) phase on the four remaining patents. The claim construction hearing concluded on December 10, 2004, and the Company is awaiting the Judge's order. The Company has reviewed and investigated the allegations in both Lemelson's original and amended complaints. The Company believes that it has meritorious defenses to these allegations and will vigorously defend itself in this matter. However, because of the nature and inherent uncertainties of litigation, should the outcome of this action be unfavorable, the Company's business, financial condition, results of operations or cash flows could be materially and adversely affected.

The Company is currently a party to various other legal proceedings, claims, disputes and litigation arising in the ordinary course of business, including those noted above. The Company currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position, results of operation or cash flows. However, because of the nature and inherent uncertainties of litigation, should the outcome of these actions be unfavorable, the Company's business, financial condition, results of operations or cash flows could be materially and adversely affected.

### **NOTE 10. DEBT AND EQUITY TRANSACTIONS**

#### **Collateralized Debt Instruments**

The Company's collateralized debt instruments consisted of long-term loan agreements with two lenders with an original aggregate principal amount equal to \$24.8 million. These agreements were collateralized by specific equipment located at the Company's U.S. manufacturing facilities. Principal amounts were repaid in monthly installments inclusive of accrued interest, over a three to four-year period. The applicable interest rates were variable based on changes to LIBOR rates. As of July 2, 2006, the loans have been paid in full.

#### **Equity Option Contracts**

As of July 2, 2006, the Company had outstanding a series of equity options on its common stock with an initial cost of \$26.0 million that were originally entered into in fiscal 2001. These options were included in Stockholders' equity in the Condensed Consolidated Balance Sheets. The contracts require physical settlement and will expire in August 2006. Upon expiration of the options, if the Company's stock price is above the threshold price of \$21 per share, the Company will receive a settlement value totaling \$30.3 million in cash. If the Company's stock price is below the threshold price of \$21 per share, the Company will receive 1.4 million shares of its common stock. Alternatively, the contracts may be renewed and extended.

For the three and six months ended July 2, 2006, the Company received total premiums of zero and \$0.6 million, respectively, upon extensions of the contracts. The amounts were recorded in Additional paid-in capital in the Condensed Consolidated Balance Sheets. No premiums were received for the three and six months ended July 3, 2005.

**Table of Contents****NOTE 11. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) AND COMPREHENSIVE INCOME (LOSS)**

The components of accumulated other comprehensive income (loss), net of tax, were as follows:

(In thousands)	July 2,	As of January 1,
	2006	2006
Accumulated net unrealized losses on available-for-sale investments	\$ (493)	\$ (481)
Accumulated net unrealized gains (losses) on derivatives	(1,147)	1,245
<b>Total accumulated other comprehensive income (loss)</b>	<b>\$ (1,640)</b>	<b>\$ 764</b>

The components of comprehensive income (loss), net of tax, were as follows:

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Net income (loss)	\$ 5,847	\$ (15,254)	\$ 12,928	\$ (84,050)
Net unrealized gains (losses) on available-for-sale investments	(327)	347	(12)	180
Net unrealized gains (losses) on derivatives	(1,464)	1,226	(2,392)	2,442
<b>Total comprehensive income (loss)</b>	<b>\$ 4,056</b>	<b>\$ (13,681)</b>	<b>\$ 10,524</b>	<b>\$ (81,428)</b>

**NOTE 12. FOREIGN CURRENCY DERIVATIVES**

The Company operates and sells products in various global markets and purchases capital equipment using foreign currencies. As a result, the Company is exposed to risks associated with changes in foreign currency exchange rates. The Company may use various hedge instruments from time to time to manage the exposures associated with purchases of foreign sourced equipment, net asset or liability positions of its subsidiaries and forecasted revenues and expenses. The Company does not enter into foreign currency derivative financial instruments for speculative or trading purposes.

As of July 2, 2006, the Company's hedge instruments consisted primarily of foreign exchange forward contracts. The Company calculates the fair value of its forward contracts based on spot rates and interest differentials from published sources.

**Cash Flow Hedges**

Hedges of forecasted foreign currency denominated revenues using foreign exchange forward contracts are designated as cash flow hedges and changes in fair value of the effective portion of hedge contracts are recorded in accumulated other comprehensive income (loss) in Stockholders equity in the Condensed Consolidated Balance Sheets. Amounts deferred in accumulated other comprehensive income (loss) are reclassified into the Condensed Consolidated Statements of Operations in the periods in which the related revenue is recognized. The effective portion of unrealized gains (losses) recorded in accumulated other comprehensive income (loss), net of tax, was \$(1.1) million and \$1.2 million as of July 2, 2006 and January 1, 2006, respectively. As of July 2, 2006 and January 1, 2006, the Company had outstanding forward contracts with an aggregate notional value of \$55.5 million and \$31.2 million, respectively. All outstanding contracts will mature by April 2007.

**Fair Value Hedges**

On occasion, the Company commits to purchase equipment in foreign currency, predominantly the Euro. When these purchases are hedged using foreign exchange forward contracts that qualify as firm commitments, they are designated as fair value hedges and changes in fair value of the derivative contracts are recognized in the Condensed Consolidated Statements of Operations. Under the fair value hedge treatment, the changes in the firm commitment on a spot-to-spot basis are recorded in Property, plant and equipment, net in the Condensed Consolidated

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Balance Sheets and in Other income (expense), net in the Condensed Consolidated Statements of Operations. As of July 2, 2006 and January 1, 2006, the Company had outstanding forward contracts with an aggregate notional value of \$16.5 million and \$3.1 million, respectively. All outstanding contracts will mature by October 2006.

Both cash flow hedges and fair value hedges are tested for effectiveness each period on a spot-to-spot basis using the dollar-offset method and both the excluded time value and any ineffectiveness are recorded in Other income (expense), net in the Condensed Consolidated Statements of Operations. The changes in excluded time value were immaterial for all periods presented. No ineffectiveness was recorded for any periods presented.

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**Table of Contents**

In addition, the Company records its hedges of foreign currency denominated monetary assets and liabilities at fair value with the related gains or losses recorded in Other income (expense), net in the Condensed Consolidated Statements of Operations. The gains or losses on these contracts are substantially offset by transaction gains or losses on the underlying balances. As of July 2, 2006 and January 1, 2006, the Company had outstanding forward contracts with an aggregate notional value of \$2.0 million and \$26.6 million, respectively, to offset the risks associated with foreign currency denominated assets and liabilities. All outstanding contracts will mature by July 2006.

**NOTE 13. INCOME TAXES**

The Company's effective rate of income tax expense was 13.8% and 16.5% for the three and six months ended July 2, 2006, respectively, and the Company's effective rate of income tax benefit was 3.3% and 0.2% for the three and six months ended July 3, 2005, respectively. The tax provision for the second quarter and first half of fiscal 2006 was attributable to income earned in certain countries that is not offset by current-year net operating losses in other countries, partially offset by amortization of a deferred tax liability associated with purchased intangible assets. The tax benefit for second quarter and first half of fiscal 2005 was attributable to amortization of the deferred tax liability associated with purchased intangible assets, partially offset by income earned in certain countries that is not offset by current-year net operating losses in other countries.

The tax returns of the Company and its subsidiaries could be subject to examination by various tax authorities in countries in which the Company operates. In November 2005, the Internal Revenue Service ( IRS ) commenced an audit of the Company's federal income tax return for fiscal 2003. As of July 2, 2006, no adjustments have been proposed by the IRS. In July 2006, the IRS commenced an audit of the Company's federal income tax return for fiscal 2004.

**Tax Sharing Agreement with SunPower**

Cypress has entered into a tax sharing agreement with SunPower providing for each of the party's obligations concerning various tax liabilities. The tax sharing agreement is structured such that Cypress will pay all federal, state, local and foreign taxes that are calculated on a consolidated or combined basis (while being a member of Cypress's consolidated or combined group pursuant to federal, state, local and foreign tax law). SunPower's portion of such tax liability or benefit will be determined based upon its separate return tax liability as defined under the tax sharing agreement. Such liability or benefit will be based on a pro forma calculation as if SunPower were filing a separate income tax return in each jurisdiction, rather than on a combined or consolidated basis with Cypress subject to adjustments as set forth in the tax sharing agreement.

After the date SunPower ceases to be a member of Cypress's consolidated, combined or unitary group for federal income tax purposes or state income tax purposes, as and to the extent that SunPower becomes entitled to utilize on its separate tax returns portions of those credit or loss carryforwards existing as of such date, SunPower will distribute to Cypress the tax effect, estimated to be 34% for federal income tax purposes, of the amount of such tax loss carryforwards so utilized, and the amount of any credit carryforwards so utilized. SunPower will distribute these amounts to Cypress in cash or in SunPower's shares, at SunPower's option.

As a result of its follow-on public offering of common stock in the second quarter of fiscal 2006 (see Note 2), SunPower is no longer considered to be a member of Cypress's consolidated group for federal income tax purposes. Accordingly, SunPower will be subject to the obligations payable to Cypress for any federal income tax credit or loss carryforwards utilized in its federal tax returns in subsequent periods.

SunPower will continue to be jointly and severally liable for any tax liability as governed under federal, state and local law during all periods in which it is deemed to be a member of the Cypress's consolidated or combined group. Accordingly, although the tax sharing agreement allocates tax liabilities between Cypress and all its consolidated subsidiaries, for any period in which SunPower is included in Cypress's consolidated group, SunPower could be liable in the event that any federal tax liability was incurred, but not discharged, by any other member of the group.

**NOTE 14. SPAP**

On May 3, 2001, the Company's stockholders approved the adoption of the SPAP. The SPAP will terminate on the earlier of May 3, 2011, or such time as determined by the Board of Directors. The SPAP allowed for loans to employees to purchase shares of the Company's common stock on the open market. Employees of the Company and its subsidiaries, including executive officers but excluding the chief executive officer and the Board of Directors, were allowed to participate in the SPAP. The loans were granted to certain executive officers prior to Section 402 of the Sarbanes-Oxley Act of 2002, effective July 30, 2002, which prohibits loans to executive officers of public corporations. Each loan was evidenced by a full



**Table of Contents**

recourse promissory note executed by the employee in favor of the Company and was collateralized by a pledge of the shares of the Company's common stock purchased with the proceeds of the loan. If a participant sells the shares of the Company's common stock purchased with the proceeds from the loan, the proceeds of the sale must first be used to repay the interest and then the principal on the loan before being received by the participant. As of July 2, 2006, the loans bore interest rates ranging from 4.77% to 7.75% per annum, except for outstanding loans to one executive officer, whose loans bore an interest rate of 5.0% per annum. As certain loans are at interest rates below the estimated market rate, the Company records compensation expense to reflect the difference between the rate charged and the estimated market rate for each loan outstanding. Compensation expense related to these loans was \$0.4 million and \$1.0 million for the three and six months ended July 2, 2006, respectively, and \$0.4 million and \$1.0 million for the three and six months ended July 3, 2005, respectively.

The following table summarizes the components of the outstanding loan balance:

(In thousands)	As of	
	July 2, 2006	January 1, 2006
<b>Principal:</b>		
Active employees	\$ 26,249	\$ 29,946
Former employees	13,911	15,748
<b>Total principal</b>	<b>40,160</b>	<b>45,694</b>
<b>Accrued interest:</b>		
Active employees	5,153	5,512
Former employees	2,936	3,046
<b>Total accrued interest</b>	<b>8,089</b>	<b>8,558</b>
<b>Total outstanding loan balance - principal and accrued interest</b>	<b>48,249</b>	<b>54,252</b>
Less: allowance for uncollectible loans	(8,469)	(8,469)
<b>Total outstanding loan balance, net</b>	<b>\$ 39,780</b>	<b>\$ 45,783</b>

The outstanding loan balance, net of allowance for uncollectible loans, is classified as a current asset in the Condensed Consolidated Balance Sheets.

Changes in the allowance for uncollectible loans are recognized in Selling, general and administrative in the Condensed Consolidated Statements of Operations. In determining the allowance for uncollectible loans, management considered various factors, including a review of borrower demographics (including geographic location and job grade), loan quality and a fair value analysis of the loans and the underlying collateral. The allowance was determined by management with the assistance of an analysis performed by an independent appraisal firm. To date, write-offs have totaled less than \$10,000.

During the second quarter of fiscal 2006, the Company implemented certain new measures for the SPAP program in an effort to minimize risks and collect the outstanding accrued interest and principal balances. These changes to the SPAP program include, but are not limited to, requirement to make periodic interest payment, collateral requirement, changes of interest rates charged on outstanding loan balances, and the requirement to use proceeds from the sale of stock options or shares under the ESPP to pay down the outstanding balances in certain circumstances.

**NOTE 15. NET INCOME (LOSS) PER SHARE**

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share is computed using the weighted-average number of common shares outstanding for the period. Diluted net income per share is calculated by using the weighted-average number of common shares outstanding during the period and includes any potentially dilutive securities, except when their effect is anti-dilutive.

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The dilutive effect of outstanding options is reflected in diluted net income per share by the application of the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options and ESPP stock purchases, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital, if any, when the awards becomes deductible are assumed to be used to repurchase shares.

**Table of Contents**

The following table sets forth the computation of basic and diluted net income (loss) per share:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>July 2,</b>	<b>July 3,</b>	<b>July 2,</b>	<b>July 3,</b>
<b>(In thousands, except per-share amounts)</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Basic:</b>				
Net income (loss)	\$ 5,847	\$ (15,254)	\$ 12,928	\$ (84,050)
Weighted-average common shares	139,989	132,081	139,160	131,293
Basic net income (loss) per share	\$ 0.04	\$ (0.12)	\$ 0.09	\$ (0.64)
<b>Dilutive:</b>				
Net income (loss)	\$ 5,847	\$ (15,254)	\$ 12,928	\$ (84,050)
Impact of SunPower	(206)		(225)	
Other	(134)		(212)	
Net income (loss) for diluted computation	\$ 5,507	\$ (15,254)	\$ 12,491	\$ (84,050)
Weighted -average common shares	139,989	132,081	139,160	131,293
Effect of dilutive securities:				
Stock options	5,121		5,749	
Other	196		201	
Adjusted weighted-average common shares and assumed conversions	145,306	132,081	145,110	131,293
Diluted net income (loss) per share	\$ 0.04	\$ (0.12)	\$ 0.09	\$ (0.64)

**Impact of SunPower:**

Net income used in the diluted computation for the three and six months ended July 2, 2006 has been adjusted to account for the impact of SunPower's dilutive securities.

**1.25% Convertible Subordinated Notes ( 1.25% Notes ):**

For the three and six months ended July 2, 2006, approximately 33.0 million shares of common stock issuable upon the assumed conversion of the 1.25% Notes were excluded from the calculation of diluted net income per share as the impact was anti-dilutive.

For the three and six months ended July 3, 2005, approximately 33.1 million shares of common stock issuable upon the assumed conversion of the 1.25% Notes were excluded from the calculation of diluted net loss per share as the Company was in a net loss position and therefore, their inclusion would have been anti-dilutive.

**Stock Options:**

For the three and six months ended July 2, 2006, approximately 23.0 million and 21.4 million shares of stock options, respectively, were excluded from the calculation of diluted net income per share because the exercise prices of the stock options were greater than or equal to the average share price for the period, and therefore, their inclusion would have been anti-dilutive.

For the three and six months ended July 3, 2005, all outstanding options of approximately 44.2 million shares were excluded from the calculation of diluted net loss per share as the Company was in a net loss position, and therefore, their inclusion would have been anti-dilutive.

Other:

The Company maintains a key employee deferred compensation plan. For the second quarter and first half of fiscal 2006, net income for diluted computation was adjusted for the compensation credit recorded under the deferred compensation plan, and the weighted-average common shares for diluted computation included the effect of the shares that would be issuable upon settlement of the deferred compensation plan. For the second quarter and first half of fiscal 2005, no adjustments related to the deferred compensation plan were included as their inclusion was anti-dilutive.

**Table of Contents****NOTE 16. SEGMENT, GEOGRAPHICAL AND CUSTOMER INFORMATION**

The Company designs, develops, manufactures and markets a broad range of solutions for various markets including consumer, computation, data communications, automotive, industrial and solar power. The Company evaluates its reportable business segments in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. During fiscal 2005, in conjunction with the Fiscal 2005 Restructuring Plan, the Company redefined its internal organizational structure and identified five reportable business segments. The five reportable business segments are as follows:

Reportable Segments	Description
Computation and Consumer Division ( CCD ):	a product division focusing on the timing solutions, universal serial bus and programmable system-on-chip products
Data Communications Division ( DCD ):	a product division focusing on data communication devices for wireless handset and professional / personal video systems
Memory and Imaging Division ( MID ):	a product division focusing on the static random access memories ( SRAM ), pseudo-SRAM and image sensor products
SunPower:	a majority-owned subsidiary of Cypress specializing in solar power products
Other:	includes Silicon Light Machines, a majority-owned subsidiary of Cypress specializing in optical components, Silicon Valley Technology Center, a division of Cypress, certain foundry-related services performed by the Company on behalf of others, and certain corporate expenses

The Company generally does not allocate gain on sale of assets, restructuring, acquisition-related costs, stock-based compensation expense, interest and other income and expense, income taxes and minority interest to its segments. In addition, the Company does not allocate assets and liabilities to the segments as the Company does not manage its business this way.

The following tables set forth information relating to the reportable business segments:

**Revenues:**

	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
<b>(In thousands)</b>				
CCD	\$ 75,420	\$ 65,357	\$ 164,628	\$ 131,346
DCD	35,823	44,127	67,846	85,546
MID	88,460	85,193	164,660	159,198
SunPower	54,695	16,400	96,653	27,492
Other	10,838	9,429	20,586	17,228
Total revenues	\$ 265,236	\$ 220,506	\$ 514,373	\$ 420,810

**Table of Contents****Income (Loss) Before Income Taxes and Minority Interest:**

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
CCD	\$ 2,583	\$ 5,424	\$ 10,778	\$ 6,156
DCD	8,869	5,222	12,652	4,909
MID	5,350	(8,362)	2,287	(25,826)
SunPower	6,186	(3,387)	8,088	(7,679)
Other	(2,267)	(1,213)	(6,553)	(4,574)
Unallocated items:				
Restructuring credits (costs) (1)	113	(1,941)	(489)	(20,970)
Gain on sale of NSE Assets			5,998	
Acquisition-related costs	(3,937)	(7,113)	(8,387)	(27,813)
Stock-based compensation	(11,989)	(3,613)	(22,694)	(5,389)
Interest and other income (expense), net	3,197	(792)	15,206	(3,074)
Income (loss) before income taxes and minority interest	\$ 8,105	\$ (15,775)	\$ 16,886	\$ (84,260)

- (1) For the three and six months ended July 3, 2005, \$3.0 million and \$6.7 million, respectively, of restructuring costs was allocated to Stock-based compensation as the charges were related to the modifications of stock option agreements for certain terminated employees under the Fiscal 2005 Restructuring Plan.

**Geographical Information:**

International revenues accounted for approximately 72% and 62% of total revenues for the three months ended July 2, 2006 and July 3, 2005, respectively, and approximately 73% and 65% of total revenues for the six months ended July 2, 2006 and July 3, 2005, respectively.

The following table presents the Company's total revenues by geographical locations:

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
United States	\$ 74,904	\$ 83,740	\$ 141,328	\$ 146,061
Europe	62,312	32,994	111,259	62,041
Japan	25,437	20,696	51,400	40,264
Asia-Pacific	102,583	83,076	210,386	172,444
Total revenues	\$ 265,236	\$ 220,506	\$ 514,373	\$ 420,810

**Customer Information:**

Sales to distributors accounted for approximately 56% and 47% of total revenues for the three months ended July 2, 2006 and July 3, 2005, respectively, and approximately 57% and 49% of total revenues for the six months ended July 2, 2006 and July 3, 2005, respectively.

The following table presents certain information on the Company's significant customers who accounted for 10% or greater of total revenues:

	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005

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	End Customers	Distributors						
Number of significant customers	0	1	0	1	0	0	1	1
Percentage of total revenues		11%		10%			11%	12%

**Table of Contents**

**NOTE 17. SUBSEQUENT EVENT**

**SunPower Transaction**

In July 2006, SunPower signed a multi-year polysilicon supply agreement with a leading chemical company located in Korea with expertise in producing gases used in polysilicon manufacturing. Starting in 2008, the agreement calls for SunPower to purchase approximately \$250 million of polysilicon over a four-year period from the supplier's new facility, which is expected to manufacture 3,000 metric tons of polysilicon per year. In connection with this agreement, SunPower is required to make a series of advance payments totaling \$60 million with the final installment due on July 1, 2007. The advance payments will be applied to SunPower's future polysilicon purchases.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties, which are discussed in the Forward-Looking Statements section under Part I of this Quarterly Report on Form 10-Q.

**Executive Summary****General:**

We design, develop, manufacture and market a broad range of silicon-based products and solutions for various markets including consumer, computation, data communications, automotive, industrial and solar power. Leveraging a strong commitment to customer service and performance-based process and manufacturing expertise, our product portfolio includes a selection of wired and wireless universal serial bus ( USB ) devices, complementary metal oxide semiconductor ( CMOS ) image sensors, timing solutions, specialty memories, high-bandwidth synchronous and micropower memory products, optical solutions, reconfigurable mixed-signal arrays and, through our majority-owned subsidiary SunPower Corporation ( SunPower ), solar power products.

**SunPower:**

During the second quarter of fiscal 2006, SunPower completed a follow-on public offering of 7.0 million shares of its class A common stock at a per-share price of \$29.50 and received total proceeds, net of commission fees and transaction costs, of approximately \$197.4 million. As of July 2, 2006, we owned approximately 52.0 million shares of SunPower's class B common stock. Our ownership in SunPower as of July 2, 2006 was as follows:

As a percentage of SunPower's total outstanding shares of capital stock	75.6 %
As a percentage of SunPower's total outstanding shares of capital stock on a fully diluted basis after taking into account its outstanding stock options	69.7 %
As a percentage of the total voting power of SunPower's outstanding shares of capital stock	96.1 %

Only we, our successors in interest and our subsidiaries may hold shares of SunPower's class B common stock unless we distribute the shares to our stockholders in a tax-free distribution. We have agreed not to sell or distribute any of our shares of SunPower's class B common stock without the prior consent of Credit Suisse and Lehman Brothers, lead underwriters of SunPower's recent follow-on public offering, until August 29, 2006. We are continuing to explore ways in which to more fully realize the value of our equity interest in SunPower for the benefit of our stockholders.

**Sale of Network Search Engine ( NSE ) Assets:**

During the first quarter of fiscal 2006, we completed the sale of the assets and intellectual property associated with certain products in our NSE product line to NetLogic Microsystems, Inc. ( NetLogic ). Pursuant to the agreement, NetLogic issued to us approximately 1.7 million shares of its common stock. In addition, if certain revenue milestones associated with the NSE assets sold to NetLogic are achieved in the twelve-month period after the close of the transaction, NetLogic will pay us up to an additional \$10.0 million in cash and up to an additional 0.3 million shares in NetLogic's common stock.

**Highlight of Results of Operations:**

Revenues for the three months ended July 2, 2006 were \$265.2 million, an increase of \$44.7 million, or 20%, compared to the three months ended July 3, 2005. Growth in SunPower, coupled with demand for our programmable system-on-chip ( PSoC ) family of mixed signal arrays in consumer applications and overall strength in our CCD segment, drove the increase in revenues and offset weaknesses in our DCD segment. Gross margin increased approximately 1.7% during the second quarter of fiscal 2006 compared with the same prior-year period.

For the three months ended July 2, 2006, total research and development and selling, general and administrative expenses increased \$11.3 million compared to the same prior-year period. The increase was primarily due to the stock-based compensation charges recorded under Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based



## **Table of Contents**

Payment, coupled with increases in other employee-related compensation charges. As discussed further below, we adopted SFAS No. 123(R) in the first quarter of fiscal 2006 and recorded total stock-based compensation charges of approximately \$12.0 million in the second quarter of fiscal 2006.

On a comparison of sequential quarters, revenues for the three months ended July 2, 2006 increased \$16.1 million, or 6%, compared to the three months ended April 2, 2006. Growth in SunPower, coupled with higher demand of our static random access memory ( SRAM ) products in the MID division, contributed to the increase of revenues. However, the increase in revenues was partially offset by a decrease in revenues from our CCD segment primarily due to an inventory correction at several customers. Gross margin increased approximately 1.4% during the second quarter of fiscal 2006 compared with the first quarter of fiscal 2006.

## **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our Condensed Consolidated Financial Statements, which we have prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes that other than the adoption of SFAS No. 123(R), there have been no significant changes during the three and six months ended July 2, 2006 to the items that we had disclosed as our critical accounting policies and estimates in 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 1, 2006.

### **Stock-Based Compensation:**

Effective January 2, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), using the modified prospective application transition method, and therefore have not restated prior periods' results. Under the fair value recognition provisions of SFAS 123(R), we recognize stock-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest over the requisite service period of the awards. Prior to the adoption of SFAS No. 123(R), we accounted for share-based payments under Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees and generally recognized compensation expense only when we granted options with a discounted exercise price.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of highly subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 8 to the Condensed Consolidated Financial Statements for further discussion on stock-based compensation.

**Table of Contents****Results of Operations****Revenues**

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
CCD	\$ 75,420	\$ 65,357	\$ 164,628	\$ 131,346
DCD	35,823	44,127	67,846	85,546
MID	88,460	85,193	164,660	159,198
SunPower	54,695	16,400	96,653	27,492
Other	10,838	9,429	20,586	17,228
Total revenues	\$ 265,236	\$ 220,506	\$ 514,373	\$ 420,810

**CCD:**

For the three months ended July 2, 2006, revenues from the sales of CCD products increased \$10.1 million, or 15%, compared to the same prior-year period. The increase was primarily attributable to an increase of approximately \$7.9 million in sales of our PSoC products, driven by a ramp in consumer applications, including MP3 players, set-top boxes and gaming. In addition, continued market strength of our USB products contributed an increase of approximately \$1.3 million in revenues.

For the six months ended July 2, 2006, revenues from the sales of CCD products increased \$33.3 million, or 25%, compared to the same prior-year period. The increase was primarily attributable to an increase of approximately \$25.9 million in sales of our PSoC products and an increase of approximately \$6.8 million in USB revenues.

**DCD:**

For the three months ended July 2, 2006, revenues from the sales of DCD products decreased \$8.3 million, or 19%, compared to the same prior-year period. The decrease in revenues was primarily attributable to a decline of approximately \$4.2 million in revenues due to softness in demand for our specialty memory products. In addition, the decrease in revenues was caused by the decline of approximately \$2.9 million in sales of our NSE products. During the first quarter of fiscal 2006, we sold a portion of our NSE product line to NetLogic.

For the six months ended July 2, 2006, revenues from the sales of DCD products decreased \$17.7 million, or 21%, compared to the same prior-year period. The decrease in revenues was primarily attributable to the decline of approximately \$7.0 million in sales of our NSE products and approximately \$6.1 million in sales of our specialty memory products. In addition, the decrease in revenues was attributable to a decline of approximately \$1.6 million in sales of certain of our programmable logic device products as they are at the end-of-life cycle.

**MID:**

For the three months ended July 2, 2006, revenues from the sales of MID products increased \$3.3 million, or 4%, compared to the same prior-year period. The increase was primarily driven by an increase of approximately \$6.6 million in sales of our SRAM business for networking and communications applications as we benefited from the continued consolidation in the SRAM market. This increase was offset by a decrease of approximately \$3.3 million in sales of our image sensor products.

For the six months ended July 2, 2006, revenues from the sales of MID products increased \$5.5 million, or 3%, compared to the same prior-year period. The increase was primarily driven by an increase of approximately \$8.5 million in sales of our SRAM business, offset by a decrease of approximately \$3.0 million in sales of our image sensor products.

**SunPower:**

For the three months ended July 2, 2006, revenues from the sales of SunPower products increased \$38.3 million, or 234%, compared to the same prior-year period. For the six months ended July 2, 2006, revenues increased \$69.2 million, or 252%, compared to the same prior-year period.

The increase in revenues for both the current three and six-month periods was a result of continued increases in unit production and unit shipments of both solar cells and solar modules as SunPower continued to expand its solar manufacturing capacity to meet strong global demand. During the first half of 2005, SunPower had one solar cell manufacturing line in operation with an approximate annual production capacity of 25

**Table of Contents**

megawatts. Since then, SunPower has added a second 25 megawatt line during the fourth quarter of 2005 and a third production line capable of producing approximately 25 megawatts per year, which began production during the first quarter of 2006.

**Other:**

For the three months ended July 2, 2006, revenues increased \$1.4 million, or 15%, compared to the same prior-year period. The increase was primarily attributable to an increase of revenues generated by Silicon Valley Technology Center ( SVTC ), which offers start-up and established companies the opportunities to develop silicon-based technologies.

For the six months ended July 2, 2006, revenues increased \$3.4 million, or 19%, compared to the same prior-year period. The increase was primarily attributable to an increase of revenues generated by SVTC and Silicon Light Machines, a subsidiary of Cypress specializing in optical products.

**Cost of Revenues**

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Cost of revenues	\$ 151,343	\$ 129,556	\$ 297,068	\$ 256,205
Gross margin	42.9%	41.2%	42.2%	39.1%

For the three months ended July 2, 2006, gross margin benefited from a 20% increase in sales volumes compared to the three months ended July 3, 2005, an improved gross margin achieved by SunPower, stabilization of average selling price and reduced cost structures in our memory products, a favorable shift in product mix towards proprietary programmable products, and increased efficiencies in our wafer fab utilization. For the three months ended July 2, 2006, gross margin was negatively impacted by approximately \$2.9 million of stock-based compensation expense as we implemented SFAS No. 123(R) in fiscal 2006.

For the six months ended July 2, 2006, gross margin benefited from a 22% increase in sales volumes compared to the six months ended July 3, 2005, an improved gross margin achieved by SunPower and our memory products, a favorable shift in product mix towards proprietary programmable products, and increased efficiencies in our wafer fab utilization. Gross margin was negatively impacted by approximately \$3.8 million of stock-based compensation expense.

Our gross margin has been impacted by the timing of inventory adjustments related to inventory write-downs and the subsequent sale of these written-down inventories caused by changes in demand condition from the cyclical nature of our business. The net impact of the inventory adjustments was a charge of \$5.9 million and \$3.3 million for the three months ended July 2, 2006 and July 3, 2005, respectively, and \$8.3 million and \$7.2 million for the six months ended July 2, 2006 and July 3, 2005, respectively. The inventory reserve balance was \$26.4 million and \$30.5 million as of July 2, 2006 and January 1, 2006, respectively.

We record inventory write-downs as a result of our normal analysis of demand forecasts and the aging profile of the inventory. We record charges to cost of revenues to write down the carrying values of our inventories when their estimated market values are less than their carrying values. The inventory write-downs reflect estimates of future market pricing relative to the costs of production and inventory carrying values and projected timing of product sales. The semiconductor industry has historically been highly cyclical and volatile. In recent years, a combination of global economic conditions and a slowing growth rate in the demand for semiconductors, coupled with worldwide increases in semiconductor production capacity, caused significant declines in demand and average selling prices for semiconductor components. These trends could continue in the future and could cause us to re-evaluate our inventory costs, which could result in additional inventory reserves.

In reviewing our inventory reserves, we follow methodologies that are consistent with those used by other companies within the semiconductor industry. At the time of an inventory write-down, we make a determination, based on demand forecasts and the aging profile of the inventory, that there is a very high probability that the inventory that was reserved would not be sold. Once the inventory is written down, a new cost basis is established; however, for tracking purposes, the write-down is recorded as a reserve on the balance sheets. The contra asset account is released at the time the inventory is either sold or scrapped. At July 2, 2006, the remaining inventory reserve represented excess and obsolete inventories that have not been scrapped or sold.



**Table of Contents****Research and Development ( R&D ) Expenses**

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
R&D	\$ 61,598	\$ 57,043	\$ 124,264	\$ 115,083
As a percentage of revenues	23.2%	25.9%	24.2%	27.3%

For the three months ended July 2, 2006, R&D expenses increased \$4.6 million compared to the same prior-year period. The increase in R&D expenditures was primarily due to:

stock-based compensation expense of \$4.4 million related to employee stock options and employee stock purchases as we implemented SFAS No. 123(R) during fiscal 2006; and

other compensation expense of \$1.0 million primarily related to charges recorded for two employee-related bonus plans implemented in the first quarter of fiscal 2006, additional hiring of new employees and higher earn-out payments related to our acquisitions. These increases in R&D expenditures were partially offset by a \$0.5 million reduction in depreciation expense and a \$0.7 million reduction in spending on R&D supplies and materials.

For the six months ended July 2, 2006, R&D expenses increased \$9.2 million compared to the same prior-year period. The increase in R&D expenditures was primarily due to:

stock-based compensation expense of \$9.1 million related to employee stock options and employee stock purchases as we implemented SFAS No. 123(R) during fiscal 2006; and

other compensation expense of \$6.7 million primarily related to charges recorded for two employee-related bonus plans implemented in the first quarter of fiscal 2006, additional hiring of new employees and higher earn-out payments related to our acquisitions. These increases in R&D expenditures were partially offset by a \$1.7 million reduction in depreciation expense and a \$4.8 million reduction in spending on R&D supplies and materials.

**Selling, General and Administrative ( SG&A ) Expenses**

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
SG&A	\$ 43,563	\$ 36,791	\$ 88,483	\$ 75,200
As a percentage of revenues	16.4%	16.7%	17.2%	17.9%

For the three months ended July 2, 2006, SG&A expenses increased \$6.8 million compared to the same prior-year period. The increase in SG&A expenditures was primarily due to:

stock-based compensation expense of \$4.8 million related to employee stock options and employee stock purchases as we implemented SFAS No. 123(R) during fiscal 2006;

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other compensation expense of 1.9 million primarily related to charges recorded for two employee-related bonus plans implemented in the first quarter of fiscal 2006, additional hiring of new employees and higher earn-out payments related to our acquisitions; and

an increase of \$2.1 million related to SunPower a result of higher spending to support the growth of its business. These increases in SG&A expenses were partially offset by a \$1.2 million reduction in sales commissions primarily because we implemented a new plan in fiscal 2006 to reduce commission rates.

## **Table of Contents**

For the six months ended July 2, 2006, SG&A expenses increased \$13.3 million compared to the same prior-year period. The increase in SG&A expenditures was primarily due to:

stock-based compensation expense of \$9.8 million related to employee stock options and employee stock purchases as we implemented SFAS No. 123(R) during fiscal 2006;

other compensation expense of \$4.8 million primarily related to charges recorded for two employee-related bonus plans implemented in the first quarter of fiscal 2006, additional hiring of new employees and higher earn-out payments related to our acquisitions; and

an increase of \$3.9 million related to SunPower a result of higher spending to support the growth of its business.

These increases in SG&A expenses were partially offset by a \$1.6 million reduction in sales commissions and a \$1.2 million reduction in purchases of supplies and other discretionary spending.

## **Restructuring**

We recorded total restructuring credits of \$0.1 million and restructuring charges of \$5.0 million for the three months ended July 2, 2006 and July 3, 2005, respectively, and restructuring charges of \$0.5 million and \$15.5 million for the six months ended July 2, 2006 and July 3, 2005, respectively, primarily related to our restructuring plan implemented in the first quarter of fiscal 2005 ( Fiscal 2005 Restructuring Plan ). For additional information on the Fiscal 2005 Restructuring Plan, refer to Note 5 of Notes to Condensed Consolidated Financial Statements. For additional information regarding our planned cost savings and actual results related to the Fiscal 2005 Restructuring Plan, refer to the Annual Report on Form 10-K for the year ended January 1, 2006.

## **Amortization of Acquisition-Related Intangible Assets**

Acquisition-related intangible assets with finite lives are amortized on a straight-line basis over their estimated useful lives.

For the three months ended July 2, 2006, amortization was \$3.9 million compared with \$7.1 million during the corresponding fiscal 2005 period. The decrease was primarily attributable to a \$3.0 million decrease in amortization of certain purchased technology intangible assets as they had been fully amortized during fiscal 2005 and the first half of fiscal 2006.

For the six months ended July 2, 2006, amortization was \$8.4 million compared with \$15.5 million during the corresponding fiscal 2005 period. The decrease was primarily attributable to a \$6.4 million decrease in amortization of certain purchased technology intangible assets as they had been fully amortized during fiscal 2005 and the first half of fiscal 2006.

## **In-Process Research and Development Charge**

For the six months ended July 3, 2005, we recorded \$12.3 million of in-process research and development expense relating to our acquisition of SMaL Camera Technologies, Inc. ( SMaL ). No in-process research and development expense was recorded in other periods presented. For a detailed discussion on the in-process research and development expense related to SMaL, refer to the Annual Report on Form 10-K for the year ended January 1, 2006.

## **Status of In-Process Research and Development Projects:**

To date, there have been no significant differences between the actual and estimated results of the in-process research and development projects. As of July 2, 2006, we have incurred total post-acquisition costs of approximately \$15.4 million related to the in-process research and development projects and estimate that an additional investment of approximately \$0.2 million will be required to complete the projects. We expect to complete the projects by August 2006, which represents a delay of one quarter when compared to our original estimate.

## **Gain on Sale of NSE Assets**

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During the first quarter of fiscal 2006, we completed the sale of the assets and intellectual property associated with certain products in our NSE product line to NetLogic pursuant to the Agreement for the Purchase and Sale of Assets, dated January 25, 2006 and amended February 15, 2006 (the Agreement ). Pursuant to the Agreement, NetLogic issued to us

**Table of Contents**

approximately 1.7 million shares of its common stock. In addition, if certain revenue milestones associated with the NSE Assets are achieved in the twelve-month period after the close of the transaction, NetLogic will pay us up to an additional \$10.0 million in cash and up to an additional 0.3 million shares in NetLogic's common stock.

We recorded a gain of \$6.0 million in connection with the disposal of the NSE Assets during the first quarter of fiscal 2006. The following table summarizes the components:

<b>(In thousands)</b>	
Value of shares of NetLogic's common stock received	\$ 58,531
Net book value of assets sold to NetLogic	(4,021)
Goodwill related to assets sold	(44,070)
Severance and other benefits	(2,799)
Transaction costs	(1,643)
Gain on disposal of NSE Assets	 \$ 5,998

The value of the shares of NetLogic's common stock received was determined using the closing price of NetLogic's common stock of \$35.40 on February 15, 2006, the effective date of the completion of the transaction.

Assets sold to NetLogic included the following:

<b>(In thousands)</b>	
Inventories, net	\$ 2,716
Prepaid expense	201
Property and equipment, net	67
Intangible assets, net	1,037
Total assets sold to NetLogic	 \$ 4,021

Intangible assets sold to NetLogic included certain purchased technology and trademarks which had previously been acquired by us in conjunction with business combinations.

The NSE product line also included goodwill which had previously been acquired by us in conjunction with business combinations. However, NetLogic did not acquire any goodwill from the NSE product line pursuant to the Agreement. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," we included a portion of the goodwill in the carrying amount of the NSE Assets in determining the gain on disposal. The amount was based on the relative fair values of the NSE Assets disposed of and the remaining portion of the NSE products that was retained by us.

In conjunction with the sale, the Company paid severance and other benefits to 54 employees in the NSE business unit (35 in research and development and 19 in selling, general and administrative functions) who were either terminated or transferred to NetLogic as a direct result of this transaction.

**Interest Income**

Interest income consists primarily of interest earned on cash equivalents, short-term investments and restricted cash. In addition, interest income includes interest earned on our loans to employees under the employee stock purchase assistance plan.

For the three months ended July 2, 2006, interest income was \$7.2 million compared with \$2.5 million for the same prior-year period. The increase in interest income was primarily attributable to an increase of \$4.6 million in interest earned on our cash and investments as a result of higher average cash and investment balances coupled with higher interest rates.

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For the six months ended July 2, 2006, interest income was \$12.2 million compared with \$5.0 million for the same prior-year period. The increase in interest income was primarily attributable to an increase of \$6.9 million in interest earned on our cash and investments as a result of higher average cash and investment balances coupled with higher interest rates.

**Table of Contents****Interest Expense**

Interest expense is primarily associated with our convertible subordinated notes, collateralized debt instruments and SunPower's interest payment related to customer advances.

For the three months ended July 2, 2006, interest expense was \$2.4 million compared with \$2.1 million during the same prior-year period. The increase in interest expense was driven by an increase of approximately \$0.5 million of interest expense paid by SunPower, partially offset by a decrease of \$0.2 million in interest expense associated with our collateralized debt instruments as they were paid in full during the first quarter of fiscal 2006. We recorded approximately \$1.9 million of interest expense related to our convertible subordinated notes in both periods.

For the six months ended July 2, 2006, interest expense was \$4.6 million compared with \$4.3 million during the same prior-year period. The increase in interest expense was driven by an increase of approximately \$0.9 million of interest expense paid by SunPower, partially offset by a decrease of \$0.4 million in interest expense associated with our collateralized debt instruments. We recorded approximately \$3.7 million of interest expense related to our convertible subordinated notes in both periods.

**Other Income (Expense), Net**

The following table summarizes the components of other income (expense):

(In thousands)	Three Months Ended		Six Months Ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Amortization of bond issuance costs	\$ (930)	\$ (930)	\$ (1,860)	\$ (1,860)
Investment impairment charges		(400)	(883)	(821)
Gain on sale of publicly-traded securities			7,093	
Gain on other investments			2,934	
Changes in fair value of warrants to purchase common stock	(20)	120	20	120
Foreign exchange gain (loss)	(104)	(187)	42	(631)
Changes in fair value of investments held in trust for deferred compensation plan	(500)	(61)	383	(917)
Other	(42)	261	(145)	253
<b>Total other income (expense)</b>	<b>\$ (1,596)</b>	<b>\$ (1,197)</b>	<b>\$ 7,584</b>	<b>\$ (3,856)</b>

**Gain on Sale of Publicly-Traded Securities:**

In connection with the sale of the NSE Assets to NetLogic, we received approximately 1.7 million shares of NetLogic's common stock (see "Gain on Sale of NSE Assets" discussion above). Subsequent to the completion of the transaction, we sold approximately 1.5 million shares of NetLogic's common stock and recognized a gain of \$6.2 million in the first half of fiscal 2006.

In addition, during the first half of fiscal 2006, we completed the sale of our equity interests in another publicly-traded company and recognized a gain of \$0.9 million.

**Gain on Other Investments:**

We hold investments in certain privately-held companies. During the first half of fiscal 2006, one of the privately-held companies merged with a publicly-traded company, resulting in us receiving shares in the publicly-traded company. As a result of the transaction, we recognized a gain of \$2.9 million.

**Deferred Compensation Plan:**

In fiscal 1995, we adopted a deferred compensation plan, which provides certain key employees with the option to defer the receipt of compensation in order to accumulate funds for retirement. We do not match the contributions made by the employees or guarantee returns on their investments. As of July 2, 2006 and January 1, 2006, deferred compensation plan assets of \$20.4 million and \$23.2 million, respectively,

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were recorded in Other assets, and liabilities of \$23.9 million and \$27.8 million, respectively, were recorded in Other current liabilities in the Condensed Consolidated Balance Sheets.

**Table of Contents**

We account for the deferred compensation plan in accordance with Emerging Issues Task Force ( EITF ) No. 97-14, Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested. In accordance with EITF No. 97-14, the liabilities are being marked to market with the offset being recorded as an operating expense or credit. The assets (excluding the amounts invested in our common stock) are marked to market with the offset being recorded in Other income (expense), net. No entries are recorded for the amounts invested in our common stock because the amounts are accounted for as treasury stock.

All non-cash charges recorded under the deferred compensation plan were included in the following line items in the Condensed Consolidated Statements of Operations:

	Three Months Ended		Six Months Ended	
	July 2,	July 3,	July 2,	July 3,
(In thousands)	2006	2005	2006	2005
Changes in fair value of assets recorded in:				
Other income (expense), net	\$ (500)	\$ (61)	\$ 383	\$ (917)
Changes in fair value of liabilities recorded in:				
Cost of revenues	97	(3)	(229)	206
Research and development	112	(3)	(264)	238
Selling, general and administrative	86	(3)	(201)	181
Total expense	\$ (205)	\$ (70)	\$ (311)	\$ (292)

**Income Tax (Provision) Benefit**

Our effective rate of income tax expense was 13.8% and 16.5% for the three and six months ended July 2, 2006, respectively, and our effective rate of income tax benefit was 3.3% and 0.2% for the three and six months ended July 3, 2005, respectively. The tax provision for the second quarter and first half of fiscal 2006 was attributable to income earned in certain countries that is not offset by current-year net operating losses in other countries, partially offset by amortization of a deferred tax liability associated with purchased intangible assets. The tax benefit for second quarter and first half of fiscal 2005 was attributable to amortization of the deferred tax liability associated with purchased intangible assets, partially offset by income earned in certain countries that is not offset by current-year net operating losses in other countries.

**Liquidity and Capital Resources**

The following table summarizes information regarding our cash and investments, working capital and long-term debt:

	As of	
	July 2,	January 1,
(In thousands)	2006	2006
Cash, cash equivalents and short-term investments	\$ 617,339	\$ 330,308
Working capital	\$ 750,648	\$ 435,110
Long-term debt (excluding current portion)	\$ 599,101	\$ 601,538

Cash, cash equivalents and short-term investments included \$297.4 million and \$143.6 million related to SunPower as of July 2, 2006 and January 1, 2006, respectively.

**Key Components of Cash Flows:**

(In thousands) Six Months Ended

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	July 2, 2006	July 3, 2005
Net cash flow generated from operating activities	\$ 62,466	\$ 3,293
Net cash flow used in investing activities	(18,734)	(28,975)
Net cash flow generated from financing activities	228,913	22,414
Net increase (decrease) in cash and cash equivalents	\$ 272,645	\$ (3,268)

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**Table of Contents**

During the six months ended July 2, 2006, net cash generated from operations increased \$59.2 million compared with the six months ended July 3, 2005. The increase was primarily due to net income generated during the current six-month period compared with a net loss incurred in the same prior-year period, adjusted for certain non-cash items including gains on investments, gain on sale of assets, stock-based compensation expenses, and changes in operating assets and liabilities. Accounts receivable increased primarily due to increase in sales. Increase in inventories was primarily due to the growth at SunPower, as well as the build-up of our die bank inventories in our core semiconductor business.

During the six months ended July 2, 2006, net cash used in investing activities decreased \$10.2 million compared with the six months ended July 3, 2005. During the six months ended July 2, 2006, we spent \$66.4 million on the acquisitions of property and equipment (which included \$33.4 million use of cash for SunPower's purchases). These uses of cash were partially offset by proceeds of \$50.6 million from sales and maturities of investments, net of purchases, and proceeds of \$5.6 million from the collection of loans from employees related to the employee stock purchase assistance plan. During the six months ended July 3, 2005, we spent \$50.8 million on the acquisitions of property and equipment (which included \$23.3 million use of cash for SunPower's purchases) and \$39.6 million related to our acquisition of SMaL Technologies, net of cash received. Our uses of cash were partially offset by proceeds of \$61.4 million from sales and maturities of investments, net of purchases.

During the six months ended July 2, 2006, net cash generated from financing activities increased \$206.5 million compared with the six months ended July 3, 2005. The increase was primarily attributable to the net proceeds of \$197.4 million from SunPower's follow-on public offering of 7.0 million shares of its common stock. During the six months ended July 2, 2006, cash generated from financing activities also included proceeds of approximately \$37.4 million from the issuance of common shares under our employee stock plans, partially offset by \$6.3 million for the repayment of debt. During the six months ended July 3, 2005, cash generated from financing activities included proceeds of approximately \$30.6 million from the issuance of common shares under our employee stock plans, partially offset by \$8.2 million for the repayment of debt.

**Liquidity:**

Our Board of Directors has approved a program authorizing the repurchase of our common stock in the open market or in privately negotiated transactions. The maximum amount that can be repurchased is limited to \$15.0 million. To date, we have not repurchased any shares under this plan.

We have \$599.0 million of aggregate principal amount in the outstanding 1.25% Notes that are due in June 2008. We have the ability to call for redemption of all or a portion of the 1.25% Notes any time after June 20, 2006. The 1.25% Notes are subject to compliance with certain covenants that do not contain financial ratios. As of July 2, 2006, we were in compliance with these covenants. If we failed to be in compliance with these covenants beyond any applicable grace period, the trustee of the 1.25% Notes, or the holders of a specific percentage thereof, would have the ability to demand immediate payment of all amounts outstanding.

On June 27, 2003, we entered into a synthetic lease agreement for U.S. manufacturing and office facilities. The lease agreement requires us to purchase the properties or to arrange for the properties to be acquired by a third party at lease expiration. If we had exercised our right to purchase all the properties subject to this lease at July 2, 2006, we would have been required to make a payment and record assets totaling \$62.7 million. We are required to maintain restricted cash or investments to serve as collateral for this lease. As of July 2, 2006, the amount of restricted cash and accrued interest was \$63.4 million, which was classified as a non-current asset in the Condensed Consolidated Balance Sheets.

In September 2003, we entered into a \$50.0 million, 24-month revolving line of credit with a major financial institution. In December 2004, this line of credit was extended to December 2006 and the total amount was increased to \$70.0 million. As of July 2, 2006, no amount was outstanding. Loans made under the line of credit bear interest based upon the Wall Street Journal Prime Rate or LIBOR plus a spread at our election. The line of credit agreement includes a variety of covenants including restrictions on the incurrence of indebtedness, incurrence of loans, the payment of dividends or distribution on our capital stock, and transfers of assets and financial covenants with respect to tangible net worth and a quick ratio. As of July 2, 2006, we were in compliance with all of the covenants. Our obligations under the line of credit are guaranteed and collateralized by the common stock of certain of our business entities other than SunPower. We intend to use the line of credit on an as-needed basis to fund working capital and capital expenditures.

In December 2005, SunPower entered into a \$25.0 million, three-year revolving credit facility with certain financial institutions. The credit facility is secured by substantially all assets, including the stock of SunPower's foreign subsidiaries.

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**Table of Contents**

Borrowings under the credit facility are subject to customary conditions as well as (1) with respect to the first \$10.0 million drawn on the credit facility, maintenance of cash collateral to the extent of amounts borrowed (excluding amounts borrowed), and (2) with respect to the remaining \$15.0 million of the credit facility, satisfaction of a coverage test which is based on a ratio of cash flow to capital expenditures. The credit facility contains customary covenants and defaults including limitations on dividends, incurrence of indebtedness and liens, and mergers and acquisitions. Borrowings outstanding under the credit facility bear interest at a rate of the greater of the prime rate or the federal funds rate for U.S. dollar draws, or LIBOR plus 1% for Euro dollar draws on the first \$10.0 million of borrowings and the greater of the prime rate plus 2% or federal funds rate plus 2% for U.S. dollar draws, or LIBOR plus 3% for Euro dollar draws on any borrowings over \$10.0 million. As of July 2, 2006, no borrowings were outstanding under this credit facility.

During fiscal 2003, we entered into certain long-term loan agreements with two lenders with an original aggregate principal amount equal to \$24.8 million. These agreements were collateralized by specific equipment located at our U.S. manufacturing facilities. Principal amounts were repaid in monthly installments inclusive of accrued interest, over a three to four-year period. The applicable interest rates were variable based on changes to LIBOR rates. As of July 2, 2006, the loans were paid in full.

Several of our acquisitions obligate us to pay certain contingent compensation in cash based on continued employment and meeting certain milestones. As of July 2, 2006, total outstanding contingent compensation that could be paid in cash under our agreements, assuming all contingencies are met, was \$7.6 million.

**Capital Resources and Financial Condition:**

Our long-term strategy is to maintain a minimum amount of cash and cash equivalents for operational purposes and to invest the remaining amount of our cash in interest-bearing and highly liquid cash equivalents and debt securities. Accordingly, at the end of the second quarter of fiscal 2006, in addition to \$493.9 million in cash and cash equivalents, we had \$123.4 million invested in short-term investments that are available for current operating, financing and investing activities, for a total liquid cash and investment position of \$617.3 million. We had an additional \$63.4 million of restricted cash related to our synthetic lease. As of July 2, 2006, we had outstanding \$599.0 million in principal amount of our 1.25% Notes.

As of July 2, 2006, our cash, cash equivalents and investment balances included approximately \$297.4 million of SunPower's cash and investments. During the second quarter of fiscal 2006, SunPower completed a follow-on public offering of 7.0 million shares of its class A common stock and received total proceeds, net of commission fees and transaction costs, of approximately \$197.4 million. SunPower intends to use the net proceeds of this offering for general corporate purposes, including working capital and capital expenditures, and potentially for further expansion of its Philippines manufacturing facilities. SunPower may also use approximately \$10 million of the proceeds to purchase its Philippines manufacturing facility from Cypress, which SunPower has the option to do under the lease agreement. In addition, SunPower may use proceeds of this offering for the acquisition of, or investment in, complementary businesses, technologies or other assets, and to invest in joint ventures. SunPower may undertake such transactions in furtherance of its strategy to broaden its supply-chain opportunities, increase the efficiency of the downstream channel and reduce the cost of its products delivered to end customers. SunPower may also use a portion of the proceeds for prepayments to vendors of polysilicon, ingots and wafers.

We believe that liquidity provided by existing cash, cash equivalents and investments and our borrowing arrangements will provide sufficient capital to meet our requirements for at least the next twelve months. However, should prevailing economic conditions and/or financial, business and other factors beyond our control adversely affect our estimates of our future cash requirements (including our debt obligations), we would be required to fund our cash requirements by alternative financing. There can be no assurance that additional financing, if needed, would be available on terms acceptable to us or at all.

We may choose at any time to raise additional capital or debt to strengthen our financial position, facilitate growth, and provide us with additional flexibility to take advantage of business opportunities that arise.

**Off-Balance Sheet Arrangements:**

*Synthetic Lease:*

On June 27, 2003, we entered into an operating lease agreement, commonly known as a synthetic lease, for manufacturing and office facilities located in Minnesota and California. A synthetic lease obligation of \$62.7 million with restricted cash collateral was established as of the second quarter of fiscal 2003. The synthetic lease requires us to purchase



**Table of Contents**

the properties or to arrange for the properties to be acquired by a third party at lease expiration, which is June 2008. In addition, we may extend the lease if the lessor allows. If we had exercised our right to purchase all the properties subject to the synthetic lease at July 2, 2006, we would have been required to make a payment totaling \$62.7 million (the Termination Value ). If we exercise our option to sell the properties to a third party, the proceeds from such a sale could be less than the properties Termination Value, and we would be required to pay the difference up to the guaranteed residual value of \$54.5 million (the Guaranteed Residual Value ).

We determined that the fair value associated with the Guaranteed Residual Value embedded in the synthetic operating lease was \$2.0 million. The amount was recorded in Other assets and Other long-term liabilities in the Condensed Consolidated Balance Sheets and is being amortized over the term of the lease. As of July 2, 2006, the unamortized balance was \$0.8 million.

We are required to evaluate periodically the expected fair value of the properties at the end of the lease term. In the event we determine that it is estimable and probable that the expected fair value of the properties at the end of the lease term will be less than the Termination Value, we will ratably accrue the loss over the remaining lease term. We have performed an analysis and determined a loss contingency accrual is required. As of July 2, 2006, the accrued loss contingency totaled \$4.0 million, representing the amounts recognized through the end of the second quarter of fiscal 2006. The fair value analysis on the properties was performed by management with the assistance of an independent appraisal firm.

We are required to maintain restricted cash or investments to serve as collateral for this lease. As of July 2, 2006, the balance of restricted cash and accrued interest was \$63.4 million and was classified in Other assets in the Condensed Consolidated Balance Sheets.

In addition, we are required to comply with certain financial covenants associated with the synthetic lease. As of July 2, 2006, we were in compliance with such financial covenants.

*Equity Option Contracts:*

As of July 2, 2006, we had outstanding a series of equity options on our common stock with an initial cost of \$26.0 million that were originally entered into in fiscal 2001. These options were included in Stockholders equity in the Condensed Consolidated Balance Sheets. We entered into the equity option contracts as part of our 2001 stock repurchase program. The contracts require physical settlement and will expire in August 2006. Upon expiration of the options, if our stock price is above the threshold price of \$21 per share, we will receive a settlement value totaling \$30.3 million in cash. If our stock price is below the threshold price of \$21 per share, we will receive 1.4 million shares of our common stock. Alternatively, the contracts may be renewed and extended.

For the three and six months ended July 2, 2006, we received total premiums of zero and \$0.6 million, respectively, upon extensions of the contracts. The amounts were recorded in Additional paid-in capital in the Condensed Consolidated Balance Sheets. No premiums were received for the three and six months ended July 3, 2005.

**Recent Accounting Pronouncement**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes. This Interpretation prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return (including a decision whether to file or not to file a return in a particular jurisdiction). Under the Interpretation, the financial statements will reflect expected future tax consequences of such positions presuming the taxing authorities full knowledge of the position and all relevant facts. The Interpretation also revises disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of the unrecognized tax benefits. This Interpretation is effective for fiscal years beginning after December 15, 2006. We will adopt this provision in the first quarter of fiscal 2007 and are currently evaluating the impact of this provision on our consolidated results of operations and financial condition.

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**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK****Interest and Foreign Currency Exchange Rates**

We are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. To mitigate these risks, we utilize derivative financial instruments. We do not use derivative financial instruments for speculative or trading purposes.

The fair value of our investment portfolio would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investment portfolio.

The fair market value of our 1.25% convertible subordinated notes ( 1.25% Notes ) is subject to interest rate risk and market risk due to the convertible feature. The fair market value of the 1.25% Notes will increase as interest rates fall and decrease as interest rates rise. In addition, the fair market value of the 1.25% Notes will increase as the market price of our common stock increases and decrease as the market price falls. The interest and market value changes affect the fair market value of the 1.25% Notes but do not impact our financial position, cash flows or results of operations due to the fixed nature of the debt obligations. As of July 2, 2006, the estimated fair value of the 1.25% Notes was approximately \$656.8 million based on quoted market prices. A 10% increase in quoted market prices would increase the estimated fair value of the 1.25% Notes to approximately \$722.5 million, and a 10% decrease in the quoted market prices would decrease the estimated fair value of the 1.25% Notes to \$591.2 million.

The majority of our revenues, expenses and capital spending is transacted in U.S. dollars. However, we do enter into transactions in other currencies, primarily the Euro. To protect against reductions in value and the volatility of future cash flows caused by changes in foreign exchange rates, we have established cash flow and fair value hedging programs. Our hedging programs reduce, but do not always eliminate, the impact of foreign currency exchange rate movements. We have entered into a series of Euro forward contracts to hedge forecasted foreign denominated revenues at one of our subsidiaries. The total notional amount of these contracts was \$55.5 million as of July 2, 2006. If the forecasted cash flow fails to materialize, we will have to close out the contracts at the then prevailing market rates, resulting in gains or losses. A 10% unfavorable currency movement would result in a loss of approximately \$7.1 million on these contracts.

**Investments in Publicly-Traded and Privately-Held Companies**

Other than SunPower, we hold equity securities, including common stock and warrants, in certain publicly-traded companies. The equity securities are classified as available-for-sale investments and are recorded in the Condensed Consolidated Balance Sheets at fair value with unrealized gains or losses reported as a component in Accumulated other comprehensive income (loss). In addition, we hold other warrants that are classified as derivatives and are being marked to market at the end of each reporting period, with the resulting gains or losses recognized in the Condensed Consolidated Statements of Operations.

The values of the equity securities are subject to market price volatility. As of July 2, 2006, the fair value of our available-for-sale equity investments was \$13.4 million. A 10% increase in the stock prices of our investees would increase the fair value of our investments by approximately \$1.4 million, and a 10% decrease in the stock prices would decrease the fair value of our investments by approximately \$1.4 million. As of July 2, 2006, the fair value of our warrants classified as derivatives was \$1.3 million. A 10% increase in the stock price of the investee would increase the value of our warrants by approximately \$0.1 million, and a 10% decrease in the stock price would decrease the value of our warrants by approximately \$0.1 million.

We have invested in several privately-held companies, many of which can be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire investment in these companies. As our equity investments generally do not permit us to exert significant influence or control over the companies in which we are investing, these amounts generally represent our cost of the investments, less any adjustments we make when we determine that an investment's net realizable value is less than its carrying cost. As of July 2, 2006, the carrying value of our investments in privately-held companies was \$3.7 million.

**Stock Purchase Assistance Plan ( SPAP )**

At the end of the second quarter of fiscal 2006, we had \$48.2 million of principal and cumulative accrued interest relating to loans made to employees and former employees under the shareholder-approved SPAP. We made the loans to employees for the purpose of purchasing our common stock. Each loan is evidenced by a full recourse promissory note executed by the employee in favor of Cypress and is secured by a pledge of the shares of our common stock purchased with the proceeds of the loan. In accordance with the plan, the Chief Executive Officer and the Board of Directors do not participate in this program. To date, write-offs have been negligible. As of July 2, 2006, we had an allowance for



## **Table of Contents**

uncollectible loans against these loans of \$8.5 million. In determining the allowance for uncollectible loans, management considered various factors, including a review of borrower demographics (including geographic location and job grade), loan quality and an independent fair value analysis of the loans and the underlying collateral.

As of July 2, 2006, the carrying value of the loans exceeded the underlying common stock collateral by \$21.1 million. The carrying value of the loans would exceed the underlying common stock collateral by \$18.4 million if our stock price increased 10%, and by \$23.8 million if our stock price decreased 10%.

During the second quarter of fiscal 2006, we implemented certain new measures for the SPAP program in an effort to minimize risks and collect the outstanding accrued interest and principal balances. These changes to the SPAP program include, but are not limited to, payment requirement on interest accrued after the first quarter of fiscal 2006, collateral requirement, changes of interest rates charged on outstanding loan balances, and the requirement to use proceeds from the sale of stock options or shares under the ESPP to pay down the outstanding balances in certain circumstances.

### **Equity Option Contracts**

At July 2, 2006, we had outstanding a series of equity options on our common stock with an initial cost of \$26.0 million which is classified in Stockholders' equity in the Condensed Consolidated Balance Sheets. The contracts require physical settlement and will expire in August 2006. Upon expiration of the options, if our stock price is above the threshold price of \$21 per share, we will receive a settlement value totaling \$30.3 million. If our stock price is below the threshold price of \$21 per share, we will receive 1.4 million shares of our common stock. Alternatively, the contracts may be renewed and extended.

## **ITEM 4. CONTROLS AND PROCEDURES**

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

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the fiscal quarter covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective.

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

There was no change in our internal control over financial reporting that occurred during the second quarter of fiscal 2006 covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

The information required by this item is included in Note 9 of Notes to Condensed Consolidated Financial Statements under Item 1, Part 1 of this Quarterly Report on Form 10-Q and is incorporated herein by reference.



## **Table of Contents**

### **ITEM 1A. RISK FACTORS**

There are no material changes to the risk factors set forth below, other than certain enhanced disclosure regarding SunPower contained in the risk factors related to (1) the complexity of our manufacturing processes, (2) SunPower's reliance on a limited number of suppliers, and (3) SunPower's dependence on a limited number of customers for a majority of its sales.

*We face significant volatility in supply and demand conditions for our products and this volatility, as well as any failure by us to accurately forecast future supply and demand conditions, could materially and negatively impact our business.*

The semiconductor industry has historically been characterized by wide fluctuations in the demand for, and supply of, semiconductors. Demand for our products depends in large part on the continued growth of various electronics industries that use our products, including:

wireless telecommunications equipment;

computers and computer-related peripherals;

memory and image sensor;

networking equipment;

consumer electronics, automotive electronics and industrial controls; and

solar power products.

In addition, certain of our products, including USB micro-controllers and high-frequency clocks, are incorporated into computer and computer-related products, which have historically experienced, and may in the future experience, significant fluctuations in demand. Any downturn or reduction in the growth of these industries could seriously harm our business, financial condition and results of operations.

We order materials and build our products based primarily on our internal forecasts and secondarily on existing orders, which may be cancelled under many circumstances. Because our markets are volatile and subject to rapid technological and price changes, our forecasts may be wrong causing us to make too many or too few of certain products. Also, our customers frequently place orders requesting product delivery almost immediately after the order is made, which makes forecasting customer demand even more difficult, particularly when supply is abundant. In addition, we have in the past spent, and will continue to spend, significant amounts of money to upgrade and increase our wafer fabrication, assembly and test manufacturing capability and capacity. If we experience inadequate demand or a significant shift in the mix of product orders that makes our existing capacity and capability inadequate, our fixed costs per semiconductor produced will increase, which will harm our financial condition and results of operations. Alternatively, if we should experience a sudden increase in demand, we will need to quickly ramp our inventory and/or manufacturing capacity to adequately respond to our customers. If we are unable to ramp our inventory or manufacturing capacity in a timely manner or at all, we risk losing our customer's business, which could have a negative impact on our financial performance and reputation.

*Our business, financial condition and results of operations will be seriously harmed if we fail to compete successfully in our highly competitive industry and markets.*

The semiconductor industry is intensely competitive. This intense competition results in a difficult operating environment that is marked by erosion of average selling prices over the lives of each product and rapid technological change resulting in limited product life cycles. In order to offset selling price decreases, we attempt to decrease the manufacturing costs of our products and to introduce new, higher priced products that incorporate advanced features. If these efforts are not successful or do not occur in a timely manner, or if our newly introduced products do not gain market acceptance, our business, financial condition and results of operations could be seriously harmed. Furthermore, we expect our

competitors to invest in new manufacturing capacity and achieve significant manufacturing yield improvements in the future. These developments could dramatically increase the worldwide supply of competitive products and result in further downward pressure on prices.

A primary cause of this highly competitive environment is the strength of our competitors. The industry consists of major domestic and international semiconductor companies, many of which have substantially greater financial, technical, marketing, distribution and other resources than we do. We face competition from other domestic and foreign high-performance integrated circuit manufacturers, many of which have advanced technological capabilities and have increased

## **Table of Contents**

their participation in markets that are important to us. We believe that there is a variety of competing technologies under development by other companies that could result in lower manufacturing costs than those expected for our products. Our development efforts may be rendered obsolete by the technological advances of others, and other technologies may prove more advantageous for the commercialization of solar power products and semiconductors generally.

Our ability to compete successfully in the rapidly evolving semiconductor technology industry depends on many factors, including:

our success in developing new products and manufacturing technologies;

the quality and price of our products;

the diversity of our product line;

the cost effectiveness of our design, development, manufacturing and marketing efforts;

our customer service;

our customer satisfaction;

the pace at which customers incorporate our products into their systems;

the number and nature of our competitors and general economic conditions; and

our access to and the availability of capital.

Although we believe we currently compete effectively in the above areas to the extent they are within our control, given the pace of change in the industry, our current abilities are not a guarantee of future success. If we are unable to compete successfully in this environment, our business, financial condition and results of operations will be seriously harmed.

***Our financial results could be adversely impacted if we fail to develop, introduce and sell new products or fail to develop and implement new technologies.***

Like many semiconductor companies, which frequently operate in a highly competitive, quickly changing environment marked by rapid obsolescence of existing products, our future success depends on our ability to develop and introduce new products that customers choose to buy. We introduce significant numbers of products each year, which are important sources of revenue for us. If we fail to introduce new product designs in a timely manner or are unable to manufacture products according to the requirements of these designs, or if our customers do not successfully introduce new systems or products incorporating our products, or market demand for our new products does not exist as anticipated, our business, financial condition and results of operations could be seriously harmed.

For us and many other semiconductor companies, introduction of new products is a major manufacturing challenge. The new products the market requires tend to be increasingly complex, incorporating more functions and operating at faster speeds than prior products. Increasing complexity generally requires smaller features on a chip. This makes manufacturing new generations of products substantially more difficult than prior generations. Ultimately, whether we can successfully introduce these and other new products depends on our ability to develop and implement new ways of manufacturing semiconductors. If we are unable to design, develop, manufacture, market and sell new products

successfully, our business, financial condition and results of operations would be seriously harmed.

***The complex nature of our manufacturing activities makes us highly susceptible to manufacturing problems and these problems can have a substantial negative impact on us when they occur.***

Making semiconductors is a highly complex and precise process, requiring production in a tightly controlled, clean environment. Even very small impurities in our manufacturing materials, difficulties in the wafer fabrication process, defects in the masks used to print circuits on a wafer or other factors can cause a substantial percentage of wafers to be rejected or numerous chips on each wafer to be non-functional. We may experience problems in achieving an acceptable success rate in the manufacture of wafers and the likelihood of facing such difficulties is higher in connection with the transition to new manufacturing methods. For example, we believe that certain manufacturing limitations on our PSoC, USB and clock businesses negatively affected our performance in fiscal 2005. The interruption of wafer fabrication or the failure to achieve acceptable manufacturing yields at any of our facilities would seriously harm our business, financial condition and results of operations. We may also experience manufacturing problems in our assembly and test operations and in the introduction of new packaging materials.

In addition, the manufacturing of SunPower's solar cells is a highly complex process. Minor deviations in the manufacturing process can cause substantial decreases in yield and in some cases, cause production to be suspended or yield no output. SunPower has from time to time experienced lower than anticipated manufacturing yields. This often occurs during the production of new products or the installation and start-up of new process technologies or equipment. For example, SunPower recently acquired equipment for a fourth cell production line and purchased a building to house its second solar cell manufacturing facility. As SunPower expands its manufacturing capacity and brings additional lines or facilities into production, it may experience lower yields initially as is typical with any new equipment or process. SunPower

## **Table of Contents**

also expects to experience lower yields initially as it migrates its manufacturing processes to thinner wafers. If SunPower does not achieve planned yields, its product costs could increase, and product availability would decrease resulting in lower revenues than expected.

***Problems in the performance or availability of other companies we hire to perform certain manufacturing and transport tasks can seriously harm our financial performance.***

A high percentage of our products are currently fabricated in our manufacturing facilities located in Texas, Minnesota and the Philippines. However, we also rely on independent contractors to manufacture some of our products. If market demand for our products exceeds our internal manufacturing capacity and available capacity from our foundry partners, we may seek additional foundry manufacturing arrangements. A shortage in foundry manufacturing capacity, which is more likely to occur at times of increasing demand, could hinder our ability to meet demand for our products and therefore adversely affect our operating results. We cannot guarantee that any foundries that supply our wafers will not experience manufacturing problems, including delays in the realization of advanced manufacturing process technologies. In addition, greater demand for wafers produced by any such foundries without an offsetting increase in foundry capacity raises the likelihood of potential wafer price increases.

While a high percentage of our products are assembled, packaged and tested at our manufacturing facility located in the Philippines, we rely on independent subcontractors to assemble, package and test the balance of our products. We cannot be certain that these subcontractors will continue to assemble, package and test products for us on acceptable economic and quality terms or at all and it might be difficult for us to find alternatives if they do not do so.

We also rely on independent carriers and freight haulers to move our products between manufacturing plants and our customers. Transport or delivery problems due to their error or because of unforeseen interruptions in their business due to factors such as strikes, political instability, terrorism, natural disasters or accidents could seriously harm our business, financial condition and results of operations and ultimately impact our relationship with our customers.

***SunPower is currently facing an industry-wide shortage of polysilicon. The prices that SunPower pays for polysilicon have increased recently and SunPower expects these price increases to continue, which may constrain SunPower's revenue growth and decrease its gross margins and profitability.***

Polysilicon is an essential raw material in SunPower's production of photovoltaic, or solar, cells. There is currently an industry-wide shortage of polysilicon, which has resulted in significant price increases. Based on its experience, SunPower believes that the average price of polysilicon has continued to increase. Increases in polysilicon prices have in the past increased SunPower's manufacturing costs and may impact its manufacturing costs and operating results in the future. As demand for solar cells has increased, many of SunPower's principal competitors have announced plans to add additional manufacturing capacity. As this manufacturing capacity becomes operational, it will increase the demand for polysilicon and further exacerbate the current shortage. Polysilicon is also used in the semiconductor industry generally and any increase in demand from that sector will compound the shortage. The production of polysilicon is capital intensive and adding additional capacity requires significant lead time. While SunPower is aware that several new facilities for the manufacture of polysilicon are under construction, it does not believe that the supply imbalance will be remedied in the near term. SunPower expects that polysilicon demand will continue to outstrip supply in the foreseeable future.

There are a limited number of polysilicon suppliers. Since SunPower has only been purchasing polysilicon in bulk for slightly more than one year, its competitors may have longer and perhaps stronger relationships with the suppliers than SunPower does. Some of SunPower's competitors also have inter-locking board members with their polysilicon suppliers. In addition, since some of the arrangements are with suppliers who do not themselves manufacture polysilicon but instead purchase their requirements from other vendors, it is possible that these suppliers will not be able to obtain sufficient polysilicon to satisfy their contractual obligations to SunPower.

Although SunPower has purchase orders and contracts for what it believes will be an adequate supply of silicon ingots through 2006 and approximately 80% of the expected requirements for 2007, its estimates regarding the supply needs may not be correct, its purchase orders may be cancelled, or the volume or pricing terms may be changed by the suppliers. Based on market conditions, SunPower's purchase orders are generally non-binding in nature.

The inability to obtain sufficient polysilicon at commercially reasonable prices or at all would adversely affect SunPower's ability to meet customer demand for its products, which could cause SunPower to lose customers, market share and revenue, thereby seriously harming SunPower's and our business, financial condition and results of operations.



**Table of Contents**

***SunPower's dependence on a limited number of third-party suppliers for key components for its solar power products could prevent SunPower from delivering its products to customers within required timeframes, which could result in order cancellations and loss of market share.***

SunPower manufactures all of its solar power products using materials and components procured from a limited number of third-party suppliers. For example, SunPower currently purchases a majority of its polysilicon from one supplier and aluminum frames and plastic back-sheet materials which SunPower uses in its products from a limited number of suppliers. If SunPower fails to develop or maintain its relationships with these or other suppliers, it may be unable to manufacture its products or its products may be available only at a higher cost or after a long delay, which could prevent SunPower from delivering its products to customers within required timeframes and SunPower may experience order cancellation and loss of market share. To the extent the processes that SunPower's suppliers use to manufacture components are proprietary, SunPower may be unable to obtain comparable components from alternative suppliers. The failure of a supplier to supply components in a timely manner, or to supply components that meet SunPower's quality, quantity and cost requirements, could impair SunPower's ability to manufacture its products or decrease costs, particularly if SunPower is unable to obtain substitute sources of these components on a timely basis or on terms acceptable to SunPower.

***SunPower currently depends on four customers for a high percentage of its total revenues and the loss of, or a significant reduction in orders from, any of these customers, if not immediately replaced, would significantly reduce its revenues and harm its operating results.***

SunPower currently sells to a relatively small number of customers, and it expects its operating results will likely continue to depend on sales to a relatively small number of customers for the foreseeable future, as well as the ability of these customers to sell solar power products that incorporate our solar cells. SunPower's customer relationships have been developed over a short period of time and are generally in their preliminary stages. SunPower cannot be certain that these customers will generate significant revenue in the future or if these customer relationships will continue to develop. If SunPower's relationships with its other customers do not continue to develop, it may not be able to expand its customer base or maintain or increase its revenues. The loss of sales to any of these customers would have a significant negative impact on SunPower's and our business.

***If the market for solar power products takes longer to develop than SunPower anticipates or does not develop at all, or if SunPower fails to compete successfully in the solar power market, its revenue and profitability could be adversely affected.***

The market for solar power products manufactured by SunPower is emerging and rapidly evolving. If solar power technology proves unsuitable for widespread commercial deployment or if demand for SunPower's products or solar power products generally fails to develop sufficiently or at all, SunPower's revenues and profitability could be affected adversely. In addition, demand for solar power products in the markets and geographic regions SunPower targets may develop more slowly than it anticipates or not at all. Many factors will influence the adoption of solar power technology as well as SunPower's ability to compete in the solar power products market, including:

cost effectiveness of solar power technologies as compared with conventional and non-solar alternative energy technologies;

performance and reliability of solar power products as compared with conventional and non-solar alternative energy products;

success in developing new products and manufacturing technologies;

ability to continue to ramp SunPower's manufacturing capacities;

the quality and price of SunPower's products;

the availability of the raw materials, including polysilicon, used in the production of solar cell products;

the number and nature of SunPower's competitors and general economic conditions;

access to and the availability of capital;

success of alternative power generation technologies;

fluctuations in economic and market conditions which impact the viability of conventional and non-solar alternative energy sources, such as increases or decreases in the prices of oil and other fossil fuels;

the possibility of future product failures and the warranty implications thereof;

availability of, and dependence on, subsidies and other incentives provided by various governmental agencies; and

existing or future regulations and policies that may present additional technical, economic or regulatory barriers.

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## **Table of Contents**

***Because two of SunPower's largest customers purchase SunPower's products on a fixed price basis, its financial results, including gross margin, may suffer if its manufacturing costs were to increase or purchase orders were changed or cancelled.***

SunPower's agreements with SOLON and PowerLight provide that they will purchase SunPower's products on a fixed-price basis. SunPower's agreement with SOLON, which expires in 2010, provides for a fixed-price basis through 2006. SunPower's agreement with PowerLight provides for a fixed-price basis through 2009. SunPower's manufacturing costs, including the cost of polysilicon, are variable. If SunPower's manufacturing costs increase, SunPower would be unable to raise its prices to these customers, which in turn would negatively impact its margins and profits.

SunPower does not have a long-term agreements with other customers but instead operate on a purchase order basis. Although SunPower believes that cancellations to date have been insignificant, its customers may cancel or reschedule purchase orders with SunPower on relatively short notice. Cancellations or rescheduling of customer orders could result in the delay or loss of anticipated sales without allowing SunPower sufficient time to reduce, or delay the incurrence of, its corresponding inventory and operating expenses. In addition, changes in forecasts or the timing of orders from these or other customers expose SunPower to the risks of inventory shortages or excess inventory. This in turn could cause SunPower operating results to fluctuate.

***Our ability to meet our cash requirements depends on a number of factors, many of which are beyond our control.***

Our outstanding debt obligations primarily include \$599.0 million of aggregate principal amount of the 1.25% convertible subordinated notes ( 1.25% Notes ) that are due in June 2008. As of July 2, 2006, our total cash, cash equivalents and short-term investments, excluding restricted cash and SunPower's cash, cash equivalents and investments, were \$256.6 million, which was less than our outstanding indebtedness if it were currently due.

Each holder of our 1.25% Notes is permitted at any time prior to maturity to convert his or her 1.25% Notes into 55.172 shares of our common stock plus a cash payment of \$300. If all of the holders of our 1.25% Notes were to elect to convert their 1.25% Notes to shares of our common stock and cash, we would be required to issue approximately 33.0 million additional shares of common stock, which could have a dilutive impact on any future earnings per share, as well as to make cash payments of approximately \$180 million.

Our ability to meet our cash requirements (including our debt service obligations) is dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control. We cannot guarantee that our business will generate sufficient cash flows from operations to fund our cash requirements or to meet our debt service obligations. If we are unable to meet our cash requirements from operations, we would be required to fund these cash requirements by alternative financing. The degree to which we may be leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes, could make us more vulnerable to industry downturns and competitive pressures or could limit our flexibility in planning for, or reacting to, changes and opportunities in our industry, which may place us at a competitive disadvantage. There can be no assurance that we would be able to obtain alternative financing, that any such financing would be on acceptable terms or that we will be permitted to do so under the terms of our existing financing arrangements. In the absence of such financing, our ability to respond to changing business and economic conditions, make future acquisitions, react to adverse operating results, meet our debt service obligations, or fund required capital expenditures may be adversely affected.

***Any guidance that we may provide about our business or expected future results may prove to differ from actual results.***

From time to time we have shared our views in press releases or SEC filings, on public conference calls and in other contexts about current business conditions and our expectations as to potential future results. Identifying correctly the key factors affecting business conditions and predicting future events is inherently an uncertain process. Our analyses and forecasts have in the past and, given the complexity and volatility of our business, will likely in the future, prove to be incorrect. We offer no assurance that such predictions or analysis will ultimately be accurate, and investors should treat any such predictions or analyses with appropriate caution.

In addition, because we recognize revenues from sales to certain distributors only when these distributors make a sale to customers, we are highly dependent on the accuracy of their resale estimates. The occurrence of inaccurate estimates also contributes to the difficulty in predicting our quarterly revenue and results of operations and we can fail to meet expectations if we are not accurate in our estimates.

We consolidate SunPower's financial results in the results of operation we report to the public in press releases and our SEC filings. SunPower's financial performance may be affected by a number of factors, including, but not limited to:

the average selling price of its solar cells and modules;

**Table of Contents**

the availability and pricing of raw materials, particularly polysilicon;

the rate and cost at which it is able to expand its manufacturing capacity to meet customer demand;

timing, availability and changes in government incentive programs;

unplanned additional expenses such as manufacturing failures, defects or downtime;

the loss of one or more key customers or the significant reduction or postponement of orders from these customers;

foreign currency fluctuations, particularly in the Euro or Philippine peso;

currency fluctuations and the effect of its currency hedging activities;

changes in the relative sales mix of its solar cells, solar panels and imaging detectors;

the availability, pricing and timeliness of delivery of other products, such as inverters, necessary for its solar power products to function;

decreases in the overall average selling prices of its solar power products and imaging detectors;

increases or decreases in electric rates due to fossil fuel prices; and

shipping delays.

Any analysis or forecast that we make which ultimately proves to be inaccurate may adversely affect our stock price.

***We may be unable to protect our intellectual property rights adequately and may face significant expenses as a result of ongoing or future litigation.***

Protection of our intellectual property rights is essential to keeping others from copying the innovations that are central to our existing and future products. Consequently, we may become involved in litigation to enforce our patents or other intellectual property rights, to protect our trade secrets and know-how, to determine the validity or scope of the proprietary rights of others or to defend against claims of invalidity. We are also from time to time involved in litigation relating to alleged infringement by us of others' patents or other intellectual property rights.

Intellectual property litigation is frequently expensive to both the winning party and the losing party and could take up significant amounts of management's time and attention. In addition, if we lose such a lawsuit, a court could find that our intellectual property rights are invalid, enabling our competitors to use our technology, or require us to pay substantial damages and/or royalties or prohibit us from using essential technologies. For these and other reasons, this type of litigation could seriously harm our business, financial condition and results of operations. Also, although in certain instances we may seek to obtain a license under a third party's intellectual property rights in order to bring an end to certain claims or actions asserted against us, we may not be able to obtain such a license on reasonable terms or at all.

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For a variety of reasons, we have entered into technology license agreements with third parties that give those parties the right to use patents and other technology developed by us and/or give us the right to use patents and other technology developed by them. Historically, these arrangements have not been a material source of revenue to the Company. We anticipate that we will continue to enter into these kinds of licensing arrangements in the future. It is possible, however, that licenses we want will not be available to us on commercially reasonable terms or at all. If we lose existing licenses to key technology, or are unable to enter into new licenses that we deem important, our business, financial condition and results of operations could be seriously harmed.

It is critical to our success that we are able to prevent competitors from copying our innovations. Therefore, we intend to continue to seek intellectual property protection for our technologies. The process of seeking patent protection can be long and expensive and we cannot be certain that any currently pending or future applications will actually result in issued patents, or that, even if patents are issued, they will be of sufficient scope or strength to provide meaningful protection or any commercial advantage to us. Furthermore, others may develop technologies that are similar or superior to our technology or design around the patents we own.

We also rely on trade secret protection for our technology, in part through confidentiality agreements with our employees, consultants and third parties. However, these parties may breach these agreements and we may not have adequate remedies for any breach. Also, others may come to know about or determine our trade secrets through a variety of methods. In addition, the laws of certain countries in which we develop, manufacture or sell our products may not protect our intellectual property rights to the same extent as the laws of the United States.

*We are subject to many different environmental regulations and compliance with them may be costly.*

We are subject to many different governmental regulations related to the storage, use, discharge and disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing process. Compliance with these regulations can be costly. In addition, over the last several years, the public has paid a great deal of attention to the potentially negative environmental impact of semiconductor manufacturing operations. This attention and other factors may lead to changes in environmental regulations that could force us to purchase additional equipment or comply with other potentially costly

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## **Table of Contents**

requirements. If we fail to control the use of, or to adequately restrict the discharge of, hazardous substances under present or future regulations, we could face substantial liability or suspension of our manufacturing operations, which could seriously harm our business, financial condition and results of operations.

We face increasing complexity in our product design as we adjust to new and future requirements relating to the materials composition of our products, including the restrictions on lead and other hazardous substances that apply to specified electronic products put on the market in the European Union as of July 1, 2006 (Restriction on the Use of Hazardous Substances Directive 2002/95/EC, also known as the RoHS Directive ) and similar legislation proposed for China and other countries (including the United States). We are redesigning our products regulated under the RoHS Directive in order to be able to continue to offer them for sale within the European Union. Certain electronic products that we maintain in inventory may be rendered obsolete if not in compliance with the RoHS Directive, which could negatively impact our ability to generate revenue from those products. Our customers and other companies in the supply chain may require us to certify that our products are RoHS compliant. Although we cannot predict the ultimate impact of any such new laws and regulations, they will likely result in additional costs or decreased revenue, and could require that we redesign or change how we manufacture our products.

### ***We face additional problems and uncertainties associated with international operations that could seriously harm us.***

International revenues accounted for approximately 72% and 62% of total revenues for the three months ended July 2, 2006 and July 3, 2005, respectively, and approximately 73% and 65% of total revenues for the six months ended July 2, 2006 and July 3, 2005, respectively. Our Philippine fabrication, assembly and test operations, as well as our international sales offices, face risks frequently associated with foreign operations including:

currency exchange fluctuations;

the devaluation of local currencies;

political instability;

changes in local economic conditions;

import and export controls; and

changes in tax laws, tariffs and freight rates.

To the extent any such risks materialize, our business, financial condition or results of operations could be seriously harmed.

### ***We compete with others to attract and retain key personnel, and any loss of, or inability to attract, such personnel would harm us.***

To a greater degree than most non-technology companies, we depend on the efforts and abilities of certain key members of management and other technical personnel. Our future success depends, in part, upon our ability to retain such personnel and to attract and retain other highly qualified personnel, particularly product and process engineers. We compete for these individuals with other companies, academic institutions, government entities and other organizations. Competition for such personnel is intense and we may not be successful in hiring or retaining new or existing qualified personnel.

If we lose existing qualified personnel or are unable to hire new qualified personnel, as needed, our business, financial condition and results of operations could be seriously harmed.

### ***Our operations and financial results could be severely harmed by certain natural disasters.***

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Our headquarters, some manufacturing facilities and some of our major vendors' facilities are located near major earthquake faults. We have not been able to maintain earthquake insurance coverage at reasonable costs. Instead, we rely on self-insurance and preventative/safety measures. If a major earthquake or other natural disaster occurs, we may need to spend significant amounts to repair or replace our facilities and equipment and we could suffer damages that could seriously harm our business, financial condition and results of operations.

*We may fail to integrate our business and technologies with those of companies that we have recently acquired and that we may acquire in the future.*

We completed two acquisitions in fiscal 2005. We may pursue additional acquisitions in the future. If we fail to integrate these businesses successfully or properly, our quarterly and annual results may be seriously harmed. Integrating these businesses, people, products and services with our existing business could be expensive, time-consuming and a strain on our resources. Specific issues that we face with regard to prior and future acquisitions include:

integrating acquired technology or products;

integrating acquired products into our manufacturing facilities;

**Table of Contents**

assimilating and retaining the personnel of the acquired companies;

coordinating and integrating geographically dispersed operations;

our ability to retain customers of the acquired company;

the potential disruption of our ongoing business and distraction of management;

the maintenance of brand recognition of acquired businesses;

the failure to successfully develop acquired in-process technology, resulting in the impairment of amounts currently capitalized as intangible assets;

unanticipated expenses related to technology integration;

the development and maintenance of uniform standards, corporate cultures, controls, procedures and policies;

the impairment of relationships with employees and customers as a result of any integration of new management personnel; and

the potential unknown liabilities associated with acquired businesses.

***We may incur losses in connection with loans made under our stock purchase assistance plan.***

We have outstanding loans, consisting of principal and cumulative accrued interest, of \$48.2 million as of July 2, 2006, to employees and former employees under the shareholder-approved 2001 employee stock purchase assistance plan. We made the loans to employees for the purpose of purchasing our common stock. Each loan is evidenced by a full recourse promissory note executed by the employee in favor of Cypress and is secured by a pledge of the shares of our common stock purchased with the proceeds of the loan. In accordance with the plan, the Chief Executive Officer and the Board of Directors do not participate in this program. To date, bad debt write-offs have been negligible. As of July 2, 2006, we had an allowance for uncollectible loans of \$8.5 million. In determining the allowance for uncollectible loans, management considered various factors, including a review of borrower demographics (including geographic location and job grade), loan quality and an independent fair value analysis of the loans and the underlying collateral. While the loans are secured by the shares of our stock purchased with the loan proceeds, the value of this collateral would be adversely affected if our stock price declined significantly.

Our results of operations may be adversely affected if a significant amount of these loans were not repaid. Similarly, if our stock price were to decrease, our employees bear greater repayment risk and we would have increased risk to our results of operations. Further, it is likely that our ability to recover outstanding loan amounts from current employees will be greater than our ability to recover these amounts from ex-employees who have left Cypress. However, we are willing to pursue every available avenue, including those covered under the Uniform Commercial Code, to recover these loans by pursuing employees and ex-employees' personal assets should the borrower not repay these loans.

During the second quarter of fiscal 2006, we implemented certain new measures for the program in an effort to minimize risks and collect the outstanding accrued interest and principal balances. These changes to the program include, but are not limited to, requirement to make periodic interest payment, collateral requirement, changes of interest rates charged on outstanding loan balances, and the requirement to use proceeds from the sale of stock options to pay down the outstanding balances in certain circumstances.

***We maintain self-insurance for certain indemnities we have made to our officers and directors.***

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Our certificate of incorporation, by-laws and indemnification agreements require us to indemnify our officers and directors for certain liabilities that may arise in the course of their service to us. We self-insure with respect to indemnifiable claims. If we were required to pay a significant amount on account of these liabilities for which we self-insure, our business, financial condition and results of operations could be seriously harmed.

***Recently implemented regulations related to equity compensation could adversely affect our ability to attract, retain and motivate key personnel.***

Historically, we have used stock options and other long-term equity incentives as a fundamental component of our employee compensation packages. We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with Cypress. The adoption of SFAS No. 123(R) required us to expense all stock-based compensation provided to employees and directors beginning in the first quarter of fiscal 2006. This regulation has made it more expensive to grant stock options to employees and has negatively impacted our reported earnings by approximately \$12.0 million and \$22.7 million during the second quarter and first half of fiscal 2006, respectively. In addition, regulations implemented by the New York Stock Exchange that prohibit NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult or expensive to grant stock options to employees, we may change our equity compensation strategy, which may make it difficult to attract, retain and motivate key employees, which in turn could materially and adversely affect our business.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table sets forth information with respect to repurchases of our common stock made during the second quarter of fiscal 2006:

Periods		Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced programs	Total dollar value of shares that may yet be purchased under the programs
April 3, 2006	April 30, 2006		\$		\$ 15,000,000
May 1, 2006	May 28, 2006				15,000,000
May 29, 2006	July 2, 2006				15,000,000

Total

**Table of Contents**

On October 14, 2002, our board of directors authorized a discretionary repurchase program to acquire shares of our common stock in the open market at any time. The actual total amount that can be repurchased is limited to \$15.0 million. This program does not have an expiration date. This was the only active stock repurchase program that we had during the second quarter of fiscal 2006.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

On August 10, 2006, the Compensation Committee (the Committee) of the Board of Directors of Cypress Semiconductor Corporation (Cypress) authorized quarterly incentive payments to its executive officers with respect of the fiscal quarter ended July 2, 2006. These payments were earned in accordance with the terms of the Cypress Key Employee Bonus Plan (the KEBP) and the Performance Profit Sharing Plan (the PPSP).

The payments were determined based upon the financial performance of Cypress and each executive's performance in the second quarter of fiscal 2006. The performance measures under the KEBP include the Company's earnings per share as well as individual strategic, operational and financial goals established for each executive prior to the commencement of the quarter, and the performance measures under the PPSP include the Company's earnings per share and the individual's percentage of success in achieving certain quarterly goals. The following table sets forth cash payments earned by our Named Executive Officers under the KEBP and the PPSP in respect of the fiscal quarter ended July 2, 2006:

NAMED EXECUTIVE OFFICER	KEBP	PPSP
T.J. Rodgers, Chief Executive Officer	\$ 220,657	\$ 6,703
Christopher Seams, Executive Vice President, Sales, Marketing and Operations	\$ 70,633	\$ 4,023
Brad W. Buss, Executive Vice President, Finance and Administration and Chief Financial Officer	\$ 58,265	\$ 3,319
Paul Keswick, Executive Vice President, New Product Development	\$ 51,505	\$ 2,934

Additionally, the Committee authorized quarterly incentive payments under the KEBP and PPSP to five other executive officers who are not Named Executive Officers in the aggregate of \$160,322 and \$11,733, respectively.

The foregoing description of the KEBP and the PPSP do not purport to be complete and are qualified in their entirety by the terms and conditions of the KEBP and PPSP, summaries of which were filed as exhibits to Cypress' Annual Report on Form 10K for the fiscal year ended January 1, 2006, as filed with the SEC on March 17, 2006.

**ITEM 6. EXHIBITS****Exhibit**

Number	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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.



**Table of Contents**

**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.

**CYPRESS SEMICONDUCTOR CORPORATION**

Date: August 11, 2006

By: /s/ Brad W. Buss  
Brad W. Buss  
Executive Vice President, Finance and Administration,  
  
Chief Financial Officer

57

**Table of Contents**

**EXHIBIT INDEX**

**Exhibit**

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