

ALTERA CORP
Form 10-Q
August 09, 2005
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 1, 2005

OR

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

For the transition period from _____ to _____

Commission file number 0-16617

ALTERA CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of

77-0016691
(I.R.S. Employer

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incorporation or organization)

Identification Number)

101 INNOVATION DRIVE

SAN JOSE, CALIFORNIA 95134

(Address of principal executive offices)(zip code)

408-544-7000

(Registrant's telephone number, including area code)

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

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

Number of shares of common stock outstanding at July 29, 2005: 372,559,302

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PART I FINANCIAL INFORMATION

ITEM 1: Financial Statements

ALTERA CORPORATION**CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited, in thousands)

| | July 1, 2005 | December 31, 2004 |
|---|---------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 749,350 | \$ 579,936 |
| Short-term investments | 453,683 | 623,312 |
| | <u>1,203,033</u> | <u>1,203,248</u> |
| Total cash, cash equivalents, and short-term investments | 1,203,033 | 1,203,248 |
| Accounts receivable, net of allowance for doubtful accounts of \$5,057 for both periods | 146,252 | 67,522 |
| Inventories | 63,588 | 67,454 |
| Deferred income taxes | 90,476 | 85,582 |
| Deferred compensation plan assets | 57,134 | 56,148 |
| Other current assets | 57,618 | 57,143 |
| | <u>1,618,101</u> | <u>1,537,097</u> |
| Total current assets | 1,618,101 | 1,537,097 |
| Long-term investments | 72,301 | |
| Property and equipment, net | 156,937 | 159,587 |
| Deferred income taxes and other assets, net | 47,321 | 49,982 |
| | <u>\$ 1,894,660</u> | <u>\$ 1,746,666</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 33,962 | \$ 31,507 |
| Accrued liabilities | 22,498 | 23,983 |
| Accrued compensation | 38,033 | 47,949 |
| Deferred compensation plan obligations | 57,134 | 56,148 |
| Deferred income and allowances on sales to distributors | 255,554 | 221,081 |
| Income taxes payable | 106,242 | 87,374 |
| | <u>513,423</u> | <u>468,042</u> |
| Total current liabilities | 513,423 | 468,042 |
| Stockholders equity: | | |
| Common stock: | | |
| \$0.001 par value; 1,000,000 shares authorized; 373,444 and 373,759 shares issued and outstanding, respectively | 373 | 374 |
| Capital in excess of par value | 414,030 | 386,058 |

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| | | |
|--------------------------------------|-------------------|-------------------|
| Retained earnings | 967,709 | 893,564 |
| Deferred stock-based compensation | (184) | (328) |
| Accumulated other comprehensive loss | (691) | (1,044) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 1,381,237 | 1,278,624 |
| | <u> </u> | <u> </u> |
| | \$ 1,894,660 | \$ 1,746,666 |
| | <u> </u> | <u> </u> |

See accompanying notes to condensed consolidated financial statements.

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ALTERA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------|------------------|------------|
| | July 1, | July 2, | July 1, | July 2, |
| | 2005 | 2004 | 2005 | 2004 |
| Net sales | \$ 285,477 | \$ 268,972 | \$ 550,299 | \$ 511,880 |
| Costs of Sales | 90,592 | 81,026 | 174,482 | 156,867 |
| Gross margin | 194,885 | 187,946 | 375,817 | 355,013 |
| Operating expenses: | | | | |
| Research and development expenses | 55,340 | 42,738 | 106,729 | 85,320 |
| Selling, general, and administrative expenses | 55,895 | 52,712 | 110,229 | 102,590 |
| Total operating expenses | 111,235 | 95,450 | 216,958 | 187,910 |
| Income from operations | 83,650 | 92,496 | 158,859 | 167,103 |
| Interest and other income, net | 8,058 | 3,272 | 12,556 | 7,008 |
| Income before income taxes | 91,708 | 95,768 | 171,415 | 174,111 |
| Provision for income taxes | (24,142) | (20,459) | (40,083) | (40,045) |
| Net income | \$ 67,566 | \$ 75,309 | \$ 131,332 | \$ 134,066 |
| Income per share: | | | | |
| Basic | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.36 |
| Diluted | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.35 |
| Shares used in computing per share amounts: | | | | |
| Basic | 373,040 | 373,696 | 372,961 | 374,723 |
| Diluted | 379,585 | 382,819 | 379,514 | 384,314 |

See accompanying notes to condensed consolidated financial statements.

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ALTERA CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in thousands)

| | Six Months Ended | |
|---|-------------------|-------------------|
| | July 1, | July 2, |
| | 2005 | 2004 |
| Cash Flows from Operating Activities: | | |
| Net income | \$ 131,332 | \$ 134,066 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 14,697 | 16,799 |
| Amortization of deferred stock-based compensation | 144 | 2,112 |
| Deferred income tax benefit | (4,251) | (3,720) |
| Tax benefit from stock plans | 14,100 | 15,500 |
| Changes in assets and liabilities: | | |
| Accounts receivable, net | (78,730) | (45,350) |
| Inventories | 3,866 | (5,662) |
| Other assets | 97 | (13,904) |
| Accounts payable and accrued liabilities | (8,565) | 26,718 |
| Deferred income and allowances on sales to distributors | 34,473 | 23,836 |
| Income taxes payable | 18,868 | 593 |
| Cash provided by operating activities | 126,031 | 150,988 |
| Cash Flows from Investing Activities: | | |
| Purchases of property and equipment | (10,812) | (9,960) |
| Purchases of available-for-sale investments | (167,884) | (70,298) |
| Proceeds from the maturity and sale of available-for-sale investments | 251,306 | 188,569 |
| Proceeds from the maturity of held-to-maturity investments | 14,470 | 47,015 |
| Purchases of intangible assets | | (1,766) |
| Cash provided by investing activities | 87,080 | 153,560 |
| Cash Flows from Financing Activities: | | |
| Proceeds from issuance of common stock through various stock plans | 38,070 | 21,465 |
| Repurchases of common stock | (81,386) | (140,534) |
| (Decrease)/increase in book overdrafts | (381) | 14,407 |
| Cash used for financing activities | (43,697) | (104,662) |
| Net increase in cash and cash equivalents | 169,414 | 199,886 |
| Cash and cash equivalents at beginning of period | 579,936 | 258,831 |
| Cash and cash equivalents at end of period | \$ 749,350 | \$ 458,717 |

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Cash paid during the period for:

| | | |
|-------------------------------------|-----------|-----------|
| Income tax payments, net of refunds | \$ 13,570 | \$ 27,368 |
|-------------------------------------|-----------|-----------|

See accompanying notes to condensed consolidated financial statements.

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ALTERA CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 Organization and Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements of Altera Corporation and subsidiaries, collectively referred to herein as "we", "us", or "our", have been prepared by us in accordance with accounting principles generally accepted in the United States of America. This financial information reflects all adjustments which are, in the opinion of our management, of a normal recurring nature and necessary for a fair statement of the results for the periods presented. The December 31, 2004 balance sheet was derived from our audited financial statements included in our 2004 Annual Report on Form 10-K. The condensed consolidated financial statements include our accounts as well as those of our wholly-owned subsidiaries after elimination of all significant intercompany balances and transactions.

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

These condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2004 included in our Annual Report on Form 10-K, as filed on March 11, 2005 with the Securities and Exchange Commission, or SEC. The results of operations for the three and six months ended July 1, 2005 are not necessarily indicative of the results to be expected for any future period.

Note 2 Balance Sheet Details:

Balance Sheet Reclassification

Certain balance sheet reclassifications have been made to prior period balances in order to conform to the current period's presentation. We made reclassifications during the first quarter of 2005 from other current assets to deferred compensation plan assets and from accrued liabilities to deferred compensation plan obligations. Such reclassifications, totaling \$56.1 million at December 31, 2004, are reflected in our prior year's condensed consolidated balance sheet. Reclassifications are reflected in our prior year's Consolidated Statement of Cash Flows as appropriate.

Inventories

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Inventories at July 1, 2005 and December 31, 2004 were comprised of the following:

| <i>(in thousands)</i> | July 1, 2005 | December 31, 2004 |
|-----------------------------------|------------------|----------------------|
| Raw materials and work in process | \$ 49,037 | \$ 55,637 |
| Finished goods | 14,551 | 11,817 |
| Total inventories | \$ 63,588 | \$ 67,454 |

We realized gross margin benefits of \$3.4 million for the three months ended July 1, 2005 and \$7.0 million for the six months ended July 1, 2005, resulting from the sale of inventory written down in 2001. These benefits were \$4.4 million and \$8.0 million for the three and six months ended July 2, 2004.

As of July 1, 2005, the book value of the inventory written down in 2001 was zero while the cost basis was \$7.2 million. The cost basis was comprised of \$4.9 million of raw materials and work in process inventory and \$2.3 million of finished goods inventory.

Table of Contents*Advances to Distributors*

We have entered into business arrangements with certain distributors to advance cash to defray their working capital costs associated with servicing our end customers. These arrangements are set forth in legal agreements and these advances are unsecured, bear no interest and are due upon demand. These advances consist of two components. The first component is an advance of anticipated price discounts and is included as a reduction to deferred income and allowances on sales to distributors. Such advances totaled \$61.9 million at July 1, 2005 and \$49.7 million at December 31, 2004. The second component is, in effect, an arrangement to finance distributors' accounts receivable and inventory and is classified as other current assets and totaled \$36.2 million at July 1, 2005 and \$38.8 million at December 31, 2004.

Long-Term Investments

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

Property and Equipment

Property and equipment at July 1, 2005 and December 31, 2004 were comprised of the following:

| <i>(in thousands)</i> | July 1, 2005 | December 31, 2004 |
|---|-----------------|----------------------|
| Land | \$ 30,779 | \$ 30,779 |
| Buildings | 121,778 | 121,378 |
| Equipment and software | 198,606 | 201,277 |
| Office furniture and fixtures | 20,074 | 20,291 |
| Leasehold improvements | 6,850 | 6,813 |
| Property and equipment, at cost | 378,087 | 380,538 |
| Accumulated depreciation and amortization | (221,150) | (220,951) |
| Property and equipment, net | \$ 156,937 | \$ 159,587 |

Note 3 Comprehensive Income:

The components of comprehensive income were as follows:

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| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|-------------------|-------------------|
| | July 1, 2005 | July 2, 2004 | July 1, 2005 | July 2, 2004 |
| Net income | \$ 67,566 | \$ 75,309 | \$ 131,332 | \$ 134,066 |
| Change in unrealized gains (losses) on investments | 900 | (2,504) | 564 | (1,899) |
| Income tax benefit (provision) | (337) | 939 | (211) | 712 |
| Comprehensive income | \$ 68,129 | \$ 73,744 | \$ 131,685 | \$ 132,879 |

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

Note 4 Income Per Share:

In accordance with Statement of Financial Accounting Standards No. 128, or SFAS No. 128, Earnings Per Share, we compute basic income per share by dividing net income available to common stockholders by the

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weighted average number of common shares outstanding during the period (excluding the dilutive effect of stock options and restricted stock). Diluted income per share reflects the dilution of potential common shares outstanding during the period. In computing diluted income per share, we adjust share count by assuming that all in-the-money options are exercised and that we repurchase shares with the proceeds of these hypothetical exercises along with the tax benefit resulting from the hypothetical option exercises. We further assume that any unamortized deferred stock-based compensation is also used to repurchase shares. In determining the hypothetical shares repurchased, we use the average stock price for the period.

Diluted income per share excludes out-of-the-money stock options and unvested restricted stock totaling 35.9 million shares for the three months ended July 1, 2005 and 30.7 million shares for the three months ended July 2, 2004, as their effect is anti-dilutive. Anti-dilutive stock options and unvested restricted stock totaled 39.0 million shares for the six months ended July 1, 2005 and 30.1 million for the six months ended July 2, 2004. While these options are currently anti-dilutive, they could be dilutive in the future. A reconciliation of basic and diluted income per share is presented below:

| | Three Months Ended | | Six Months Ended | |
|-------------------------------------|--------------------|-----------------|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 | July 1, 2005 | July 2, 2004 |
| Basic: | | | | |
| Net income | \$ 67,566 | \$ 75,309 | \$ 131,332 | \$ 134,066 |
| Weighted shares outstanding | 373,040 | 373,696 | 372,961 | 374,723 |
| Net income per share | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.36 |
| Diluted: | | | | |
| Net income | \$ 67,566 | \$ 75,309 | \$ 131,332 | \$ 134,066 |
| Weighted shares outstanding | 373,040 | 373,696 | 372,961 | 374,723 |
| Effect of dilutive securities: | | | | |
| Stock options and restricted stock | 6,545 | 9,123 | 6,553 | 9,591 |
| Diluted weighted shares outstanding | 379,585 | 382,819 | 379,514 | 384,314 |
| Net income per share | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.35 |

Note 5 Deferred Income Taxes and Other Assets, Net:

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

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Our deferred income taxes and other assets consisted primarily of the non-current portion of deferred tax assets of \$43.1 million at July 1, 2005 and \$43.9 million at December 31, 2004, and acquired intangible assets.

Our acquired intangible assets consisted of market-ready technology and other intangible assets. As of July 1, 2005, the market-ready technology had been fully amortized. We continue to amortize other intangible assets on a straight-line basis over their estimated useful lives. Amortization of all acquired intangible assets was immaterial for the three and six months ended July 1, 2005 and was \$0.6 million for the three months ended July 2, 2004 and \$3.2 million for the six months ended July 2, 2004. The net balance of our intangible assets as of July 1, 2005 was \$2.7 million, compared with \$4.0 million as of December 31, 2004.

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Note 6 Indemnification and Product Warranty:

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

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

Our product warranty liability was \$1.5 million as of July 1, 2005 and \$1.8 million as of December 31, 2004. Activities were immaterial for the three and six months ended July 1, 2005 and July 2, 2004.

Note 7 Common Stock Repurchases:

Since the inception of our share repurchase program in 1996, our Board of Directors has approved 88.0 million shares of our common stock for repurchase, of which we have repurchased a total of 70.9 million for an aggregate cost of \$1.5 billion. All shares were retired upon acquisition. At July 1, 2005, 17.1 million shares remained authorized for repurchase under the plan.

Share repurchase activities for the three months ended July 1, 2005 and July 2, 2004 and for the six months ended July 1, 2005 and July 2, 2004 were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------------|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 | July 1, 2005 | July 2, 2004 |
| <i>(In thousands, except per share amounts)</i> | | | | |
| Shares repurchased | 1,873 | 4,167 | 4,128 | 6,489 |
| Cost of shares repurchased | \$ 37,990 | \$ 88,917 | \$ 81,386 | \$ 140,534 |
| Average price per share | \$ 20.28 | \$ 21.34 | \$ 19.72 | \$ 21.66 |

Note 8 Stock-Based Compensation Plans:

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

Stock Option Plans

Our stock option program is a broad-based, long-term retention program intended to attract, motivate, and retain talented employees as well as align stockholder and employee interests. On May 10, 2005, our stockholders approved Altera's 2005 Equity Incentive Plan (the 2005 Plan). The 2005 Plan replaces our 1996 Stock Option Plan and our 1998 Director Stock Option Plan (collectively Prior Plans) before their expiration and is now Altera's only plan for providing stock-based incentive compensation to both our eligible employees and non-employee directors. On May 10, 2005, the stockholders approved 3 million shares for the 2005 Plan, plus the roll-over of all 8.9 million shares that were previously reserved for issuance but for which awards had not been made under the Prior Plans as of that date. Additionally, shares subject to awards granted under the Prior Plans that were outstanding on the effective date of the 2005 Plan, and that are later cancelled, forfeited, settled in cash or that expire by their terms, are returned to the pool of shares available for grant and issuance under the 2005 Plan. As of July 1, 2005, the 2005 Plan had a total of 13.6 million shares reserved for future

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issuance, of which 13.4 million shares were available for future grants. As of July 1, 2005, the Prior Plans had a total of 63.0 million shares reserved for future issuance for grants that were made prior to the approval of the 2005 Plan.

Awards that may be granted under the 2005 Plan include non-qualified and incentive stock options, restricted stock awards, restricted stock units, stock appreciation rights, and stock bonus awards. Awards of stock options and stock appreciation rights generally vest over four years. Awards of restricted stock and restricted stock units vest over a minimum of three years. All awards granted under the 2005 Plan have a maximum term of ten years.

Employee Stock Purchase Plan

On May 10, 2005, our stockholders approved an amendment to our 1987 Employee Stock Purchase Plan to increase the number of shares reserved for issuance from 18.7 million to 19.7 million shares. As of the end of our fiscal second quarter of 2005, 3.3 million shares were available for future issuances under this plan. Sales under the Employee Stock Purchase Plan were 438,916 shares of common stock at an average price of \$16.95 for the six months ended July 1, 2005, and 414,055 shares of common stock at an average exercise price of \$16.67 for the six months ended July 2, 2004.

Pro Forma Net Income and Net Income Per Share

The fair value of each option grant, as defined by SFAS No. 123, is estimated on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. However, options granted under our stock option plans are not freely tradable, or transferable, and have vesting restrictions. The Black-Scholes model also requires highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the fair value. Effective 2005, we modified our volatility assumption to consider both historical and implied volatility for the purpose of calculating fair value. Previously, we considered only historical volatility in deriving our volatility assumption. We will continue to monitor and refine volatility and other assumptions used to compute the fair value of option grants, as appropriate.

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

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-----------------|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 | July 1, 2005 | July 2, 2004 |
| <i>(in thousands, except per share amounts)</i> | | | | |
| Reported net income | \$ 67,566 | \$ 75,309 | \$ 131,332 | \$ 134,066 |
| Add: Stock-based employee compensation expense included in reported net income, net of tax | 46 | 347 | 96 | 1,423 |
| | (17,580) | (23,690) | (37,519) | (51,405) |

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| | | | | |
|--|-----------|-----------|-----------|-----------|
| Deduct: Stock-based employee compensation expense determined under fair value method, net of tax | | | | |
| | _____ | _____ | _____ | _____ |
| Pro forma net income | \$ 50,032 | \$ 51,966 | \$ 93,909 | \$ 84,084 |
| | _____ | _____ | _____ | _____ |
| Pro forma net income per share: | | | | |
| Basic | \$ 0.13 | \$ 0.14 | \$ 0.25 | \$ 0.22 |
| Diluted | \$ 0.13 | \$ 0.14 | \$ 0.25 | \$ 0.22 |
| Reported net income per share: | | | | |
| Basic | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.36 |
| Diluted | \$ 0.18 | \$ 0.20 | \$ 0.35 | \$ 0.35 |

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Note 9 Income Taxes:

On October 22, 2004, the American Jobs Creation Act of 2004 (Act) was signed into law. The Act creates a temporary favorable incentive for Altera to repatriate up to \$500 million of accumulated income earned abroad by including an 85 percent deduction for certain foreign earnings that are repatriated by the end of 2005, as defined in the Act, at an effective tax cost of 5.25 percent. During the three months ended July 1, 2005, we completed our initial evaluation of the Act and decided to repatriate an extraordinary dividend of \$400 million of foreign earnings which will be paid during 2005. As a result of this decision, our second quarter tax provision includes an estimated \$21 million federal tax provision related to the planned repatriation.

Our effective tax rate for the three months ended July 1, 2005 was 26%, compared with 21% for the three months ended July 2, 2004. Our effective tax rate for the six months ended July 1, 2005 and July 2, 2004 was 23%. The increase in our effective tax rate for the quarter resulted primarily from a \$21 million federal tax provision related to the planned repatriation of an extraordinary dividend of \$400 million as mentioned above. This increase was partially offset by a change in the geographic mix of income and a tax benefit of approximately \$15.2 million arising primarily from the settlement of federal and California income tax audits. The resolution of the federal and California income tax audits included tax years 1993 through 2001. For the three months ended July 1, 2005, the provision for the extraordinary dividend, partially offset by the benefit related to the settlement of income tax audits, resulted in a net increase in our second quarter tax provision of \$5.8 million or 6 percentage points.

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

Note 10 Nonqualified Deferred Compensation Plan:

We allow our U.S.-based officers, director-level employees, and our board members to defer a portion of their compensation under the Altera Corporation Nonqualified Deferred Compensation Plan (the Plan). Our Retirement Plans Committee administers the Plan. At July 1, 2005, there were approximately 130 participants in the Plan who self-direct their investments in the Plan. In the event we become insolvent, Plan assets are subject to the claims of our general creditors. Since the inception of the Plan, we have not made any matching or discretionary contributions to the Plan and Plan participants are prohibited from investing in Altera stock. There are no Plan provisions that provide for any guarantees or minimum return on investments.

Beginning in the first quarter of 2005, we account for investment income earned by the Plan as interest and other income, net. The investment income also represents an increase in the future payout to employees and is treated as current period compensation expense. During the three months ended July 1, 2005, the Plan experienced a net investment gain of \$0.7 million. This gain resulted in a \$0.7 million favorable impact to other income and an unfavorable impact to operating expenses, increasing research and development expenses by \$0.4 million and selling, general and administrative expenses by \$0.3 million. During the six months ended July 1, 2005, the Plan experienced a net investment loss of \$0.5 million. This loss resulted in a \$0.5 million unfavorable impact to other income and a favorable impact to operating expenses, reducing compensation expenses by \$0.5 million. Prior to the quarter ended April 1, 2005, investment income earned by the Plan and the corresponding compensation expense were included, net, in interest and other income. Income earned by the Plan does not, nor has it ever impacted our income before income taxes, net income, or cash balances.

Note 11 Recent Accounting Pronouncements:

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections (SFAS 154), which changes the requirements for the accounting for and reporting of voluntary changes in accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless impracticable. SFAS 154 supersedes Accounting Principles Board Opinion No. 20, Accounting Change (APB 20), which previously required that most voluntary changes in accounting principle be recognized by including in the current period's net income the cumulative effect of changing to the new accounting principle. SFAS 154 also makes a distinction between retrospective application of an accounting principle and the restatement of financial statements to reflect

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correction of an error. SFAS 154 carries forward without changing the guidance contained in APB 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 applies to voluntary changes in accounting principle that are made in fiscal years beginning after December 15, 2005. We do not expect that the adoption of SFAS 154 will have a significant impact on our financial condition or results of operations.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), or SFAS 123R, Share-Based Payment. This statement replaces SFAS 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board's Opinion No. 25 (ABP 25), Accounting for Stock Issued to Employees. SFAS 123R will require us to measure the cost of our employee stock-based compensation awards granted after the effective date of SFAS 123R based on the grant date fair value of those awards and to record that cost as compensation expense over the period during which the employee is required to perform services in exchange for the award (generally over the vesting period of the award). In addition, we will be required to record compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption of SFAS 123R. In April 2005, the SEC announced a deferral of the effective date of SFAS 123R to the registrant's fiscal year beginning on or after June 15, 2005. Altera is therefore required to implement the standard beginning in its fiscal year 2006. In addition, the SEC issued Staff Accounting Bulletin No. 107, or SAB 107, in March 2005. SAB 107 includes interpretive guidance for the initial implementation of SFAS 123R. The adoption of SFAS 123R's fair value method will have a significant and adverse impact on our results of operations, although it will have no impact on our cash flow.

In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an amendment to ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges. In addition, SFAS 151 requires that the allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred for fiscal years beginning after June 15, 2005. We, therefore, are required to adopt the standard effective with our 2006 fiscal year. We do not expect that the adoption of SFAS 151 will have a significant impact on our financial condition or results of operations.

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

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

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

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Many factors may cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this report. These factors include, but are not limited to, those risks described below under Risk Factors and those risks described under Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2004.

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CRITICAL ACCOUNTING ESTIMATES

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply these judgments and estimates and the financial statements and accompanying notes fairly represent all periods presented. However, any differences between these judgments and estimates and actual results could have a material impact on our statement of income and financial conditions. Critical accounting estimates, as defined by the Securities and Exchange Commission (SEC), are those that are most important to the portrayal of our financial condition and results of operations and require our management's most difficult and subjective judgments and estimates of matters that are inherently uncertain. Our critical accounting estimates include those regarding (1) revenue recognition; (2) valuation of inventories; and (3) taxes. For a discussion of the critical accounting estimates, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Estimates in our Annual Report on Form 10-K for the year ended December 31, 2004.

RESULTS OF OPERATIONS

Sales

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

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

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

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

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

Sales were \$285.5 million during the three months ended July 1, 2005, compared to \$269.0 million for the three months ended July 2, 2004, representing a 6% increase in sales year-over-year. The increase was driven primarily by the sales of New Products which increased 70% year-over-year predominantly due to higher sales of our Stratix and Cyclone families. The year-over-year sales increase reflects higher unit sales of our New Products, partially offset by lower sales of our Mainstream and Mature and Other products due to routine declines in average unit selling prices.

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Sales during the six months ended July 1, 2005 were \$550.3 million compared to \$511.9 million during the six months ended July 2, 2004, representing an 8% increase in sales year over year. The increase resulted from higher sales of our New Products, with sales of our Stratix and Cyclone families representing the majority of the increase. The year-over-year sales increase reflects higher unit sales of our New Products during the six months ended July 1, 2005 compared to the same period a year ago, partially offset by routine declines in average selling prices.

Sales increased 8% sequentially to \$285.5 million in the second quarter of 2005 from \$264.8 million in the first quarter of 2005. Revenue from sales of our New Products increased 25% and represented all of our sequential quarterly revenue growth. The demand for our New Products has continued to increase as customer adoption of these products remains strong and customers ramp their programs into volume production. For the three and six months ended July 1, 2005 and July 2, 2004, no single end customer provided more than 10% of our sales.

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Sales of FPGAs and CPLDs

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

| | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|--------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| FPGA | 69% | 69% | 69% | 7% | 9% | 69% | 67% | 10% |
| CPLD | 20% | 23% | 21% | -9% | 2% | 21% | 25% | -9% |
| Other | 11% | 8% | 10% | 40% | 14% | 10% | 8% | 37% |
| Total Sales | 100% | 100% | 100% | 6% | 8% | 100% | 100% | 8% |

Sales by Product Category

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

| | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|--------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| New | 40% | 25% | 34% | 70% | 25% | 37% | 22% | 80% |
| Mainstream | 36% | 43% | 39% | -13% | 0% | 37% | 45% | -10% |
| Mature and Other | 24% | 32% | 27% | -18% | -3% | 26% | 33% | -18% |
| Total Sales | 100% | 100% | 100% | 6% | 8% | 100% | 100% | 8% |

Our New Products have been developed and introduced to the marketplace over the last several years and have additional features and higher densities than their predecessors. We expect that sales of New Products will continue to increase over time as customer adoption of these products continues to be strong, and customers ramp their programs into volume production.

Sales by Market Segment

The following market segment data is derived from data that is provided to us by our distributors and end customers. With a broad base of customers, who in some cases manufacture end products spanning multiple market segments, the assignment of revenue to a market segment requires the use of estimates, judgment, and extrapolation. As such, actual results may differ from those reported. During the quarter ended July 1, 2005, we refined our methodology for classifying revenue by market segment. All prior period data has been adjusted to conform to the current period's methodology.

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

| | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|----------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| Communications | 43% | 41% | 41% | 10% | 12% | 42% | 40% | 14% |
| Industrial | 31% | 34% | 31% | -2% | 9% | 31% | 35% | -5% |
| Consumer | 16% | 14% | 17% | 20% | 2% | 17% | 14% | 22% |
| Computer and Storage | 10% | 11% | 11% | 1% | -1% | 10% | 11% | 4% |
| Total Sales | 100% | 100% | 100% | 6% | 8% | 100% | 100% | 8% |

In absolute dollars, sales grew across all market segments with the exception of the Industrial segment for the three and six months ended July 1, 2005 compared to the same period a year ago. The increase in the Communications segment for the three and six months ended July 1, 2005 compared to the same periods a year ago was primarily due to improved market conditions in the wireless and wireline subsegments. The increases in the Consumer segment for the three and six months ended July 1, 2005 compared to the same periods a year ago was due to strength in the display market and recent design wins which ramped into production. The Computer and Storage segment remained relatively flat for the three months ended July 1, 2005 and increased for the six months ended July 1, 2005 compared to the same periods a year ago due to strength in the storage and computing subsegments. The Industrial segment decreased for the three and six months ended July 1, 2005 compared to the same periods a year ago due to decreases in the military, medical, and industrial subsegments. We expect the Communications segment to continue to be the largest market segment as a percentage of our sales.

Sales by Geography

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

| | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|---------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| North America | 24% | 27% | 24% | -9% | 4% | 24% | 29% | -10% |
| Europe | 25% | 24% | 27% | 10% | 0% | 26% | 24% | 15% |
| Japan | 25% | 26% | 25% | 6% | 9% | 25% | 25% | 9% |
| Asia Pacific | 26% | 23% | 24% | 19% | 20% | 25% | 22% | 20% |

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| | | | | | | | | |
|---------------------|------|------|------|-----|----|------|------|-----|
| Total International | 76% | 73% | 76% | 12% | 9% | 76% | 71% | 14% |
| Total Sales | 100% | 100% | 100% | 6% | 8% | 100% | 100% | 8% |

In absolute dollars, sales increased in all international geographies for the three and six months ended July 1, 2005, compared to the same periods a year ago, while North America sales decreased. The decrease in North America sales was a result of the continuing transfer of end customer manufacturing from North America to international locations mainly within the Asia Pacific regions. In absolute dollars, sales increased in all geographies for the three months ended July 1, 2005 compared to the prior quarter.

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Gross Margin

| | Three Months Ended | | | Six Months Ended | |
|------------------------------|--------------------|-----------------|------------------|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | July 1, 2005 | July 2, 2004 |
| <i>(Dollars in millions)</i> | | | | | |
| Gross Margin Percentage | 68.3% | 69.9% | 68.3% | 68.3% | 69.4% |

Included in Reported Gross Margin Percentage Above:

| | | | | | |
|--|--------|--------|--------|--------|--------|
| Gross Margin Benefit from Sale of Inventory Written Down in 2001 | \$ 3.4 | \$ 4.4 | \$ 3.5 | \$ 7.0 | \$ 8.0 |
| Percentage of Sales | 1.2% | 1.6% | 1.3% | 1.3% | 1.6% |

The decreases in gross margin for the three and six months ended July 1, 2005 compared to same periods a year ago were primarily due to routine decreases in the selling prices of our products.

The gross margin benefit resulting from the sale of inventory written down in 2001 will continue to decline and will be near zero by the end of 2005. As of July 1, 2005, the book value of the inventory written down in 2001 was zero while the cost basis was \$7.2 million. The cost was comprised of \$4.9 million of raw materials and work in process inventory and \$2.3 million of finished goods inventory.

Research and Development

| | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|------------------------------|--------------------|-----------------|------------------|-----------------------|-------------------|------------------|-----------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| <i>(Dollars in millions)</i> | | | | | | | | |
| Research and Development | \$ 55.3 | \$ 42.7 | \$ 51.4 | 30% | 8% | \$ 106.7 | \$ 85.3 | 25% |
| Percentage of Sales | 19% | 16% | 19% | | | 19% | 17% | |

Research and development expenses include expenditures for labor and benefits, masks, prototype wafers, and depreciation. These expenditures were for the design of new PLD families, and the development of process technologies, new packages,

software to support new products and design tools, and IP cores.

Research and development expenses increased 30% for the three months ended July 1, 2005 and increased 25% for the six months ended July 1, 2005 compared to the same periods a year ago primarily due to higher spending on masks and prototype wafers for our next generation products and higher labor costs. Historically, the level of our research and development expenses has fluctuated in part due to the timing of the purchase of masks and prototype wafers used in the development of new products.

We will continue to make significant investments in the development of new products and focus our efforts on the development of new programmable logic devices that utilize advanced semiconductor wafer fabrication processes, as well as related development software. We are currently investing in the development of our Stratix II, MAX II, Cyclone II, and HardCopy II families, our Nios® II soft core embedded processor, our Quartus® II software, our library of IP cores, and other future products. We expect that our research and development costs will decrease in absolute dollars during the second half of 2005 as we complete our latest new product roll-outs.

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Selling, General, and Administrative

| <i>(Dollars in millions)</i> | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|--------------------------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| Selling, General, and Administrative | \$55.9 | \$52.7 | \$54.3 | 6% | 3% | \$110.2 | \$102.6 | 7% |
| Percentage of Sales | 20% | 20% | 21% | | | 20% | 20% | |

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

Selling, general, and administrative expenses increased 6% for the three months ended July 1, 2005 and increased 7% for the six months ended July 1, 2005 compared to the same periods a year ago. The increases were primarily attributable to higher spending on labor and employee-related costs. We expect that our selling, general and administrative costs will continue to increase in absolute dollars throughout the remainder of 2005 primarily due to expected increases in labor and employee related costs as we continue to add additional sales and marketing personnel to drive our revenue growth.

Interest and Other Income, Net

| <i>(Dollars in millions)</i> | Three Months Ended | | | Year-Over-Year Change | Sequential Change | Six Months Ended | | Year-Over-Year Change |
|--------------------------------|--------------------|--------------|---------------|-----------------------|-------------------|------------------|--------------|-----------------------|
| | July 1, 2005 | July 2, 2004 | April 1, 2005 | | | July 1, 2005 | July 2, 2004 | |
| Interest and Other Income, Net | \$8.1 | \$3.3 | \$4.5 | 145% | 80% | \$12.6 | \$7.0 | 80% |
| Percentage of Sales | 3% | 1% | 2% | | | 2% | 1% | |

Interest and other income, net consists mainly of interest income generated from investments in high-quality fixed income securities, as well as the mark-to-market impact of our Nonqualified Deferred Compensation Plan (the Plan). The year-over-year increases in interest and other income, net for the three and six months ended July 1, 2005 were driven primarily by increases in interest income as a result of higher investment yields. The increases in interest income were \$3.7 million for the three months ended July 1, 2005 and \$5.6 million for the six months ended July 1, 2005 compared to the same periods a year ago.

During the three months ended July 1, 2005, the Plan experienced a net investment gain of \$0.7 million. This gain resulted in a \$0.7 million favorable impact to other income and an unfavorable impact to operating expenses, increasing research and development expenses by \$0.4 million and selling, general and administrative expenses by \$0.3 million. During the six months

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ended July 1, 2005, the Plan experienced a net investment loss of \$0.5 million. This loss resulted in a \$0.5 million unfavorable impact to other income and a favorable impact to operating expenses, reducing compensation expenses by \$0.5 million. There was no impact to income before income taxes, net income or cash balances. See Note 9 Nonqualified Deferred Compensation Plan for background information regarding the Plan.

Provision for Income Taxes

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

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Our effective tax rate for the three months ended July 1, 2005 was 26%, compared with 21% for the three months ended July 2, 2004. Our effective tax rate for the six months ended July 1, 2005 and July 2, 2004 was 23%. The increase in our effective tax rate for the quarter resulted primarily from a \$21 million federal tax provision related to the planned repatriation of an extraordinary dividend of \$400 million as mentioned above. This increase was partially offset by a change in the geographic mix of income and a tax benefit of approximately \$15.2 million arising primarily from the settlement of federal and California income tax audits. The resolution of the federal and California income tax audits included tax years 1993 through 2001. For the three months ended July 1, 2005, the provision for the extraordinary dividend, partially offset by the benefit related to the settlement of income tax audits, resulted in a net increase in our second quarter tax provision of \$5.8 million or 6 percentage points.

During the three months ended July 1, 2005, we completed our initial evaluation of the American Jobs Creation Act of 2004 (Act). The Act creates a temporary favorable incentive for Altera to repatriate up to \$500 million of accumulated income earned abroad by including an 85 percent tax deduction for certain foreign earnings that are repatriated by the end of 2005 at an effective cost of 5.25 percent.

We are continuing to evaluate the Act and the potential repatriation of up to \$100 million of additional foreign earnings, with an approximate corresponding tax liability of 5.25 percent of such amount. Whether we ultimately decide to repatriate these additional funds will depend on a number of factors, including satisfactory resolution of foreign tax issues relating to the repatriation of those earnings. If we decide to repatriate additional earnings, we will record the additional income tax expense at the time of such determination. The U.S. Department of the Treasury is expected to issue additional guidance on the Act. That guidance may affect the ultimate amount of income taxes to be recognized on the foreign earnings repatriated in 2005.

Financial Condition, Liquidity, and Capital Resources

Liquidity

We derive our liquidity and capital resources primarily from our cash flows from operations. We continue to generate positive operating cash flows and remain debt-free. We also use a portion of our available cash for repurchases of our common stock under our stock repurchase program. Our cash, cash equivalents, short and long-term investments were \$1,275.3 million, or 67% of total assets, at July 1, 2005; and were \$1,203.2 million, or 69% of total assets, at December 31, 2004. We believe our current cash, cash equivalents, investments and anticipated cash generated from operations will be adequate to finance our operations for at least the next year.

Cash Flows

| <i>(in thousands)</i> | Six Months Ended | |
|---|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 |
| Net cash provided by operating activities | \$ 126,031 | \$ 150,988 |

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| | | |
|---|-------------------|-------------------|
| Net cash provided by investing activities | 87,080 | 153,560 |
| Net cash used for financing activities | (43,697) | (104,662) |
| | <u> </u> | <u> </u> |
| Net increase in cash and cash equivalents | \$ 169,414 | \$ 199,886 |
| | <u> </u> | <u> </u> |

Cash provided by operating activities was \$126.0 million for the six months ended July 1, 2005. Our positive cash flows from operating activities was primarily attributable to net income, adjusted for non-cash items, and net changes in assets and liabilities as discussed below in Working Capital.

Cash provided by investing activities was \$87.1 million for the six months ended July 1, 2005 and consisted primarily of proceeds from the maturity and sale of investments, net of purchases, of \$97.9 million, partially offset by capital expenditures of \$10.8 million.

Cash used for financing activities was \$43.7 million for the six months ended July 1, 2005, consisting of repurchases of common stock of \$81.4 million, which was partially offset by net proceeds of \$38.1 million from the issuance of common stock to employees through our stock option plans.

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Working Capital

The significant components of our working capital are liquid assets such as cash, short-term investments and trade accounts receivable, reduced by accounts payable, accrued expenses and deferred revenue. Working capital increased \$35.6 million to \$1,104.7 million as of July 1, 2005 from \$1,069.1 million as of December 31, 2004 primarily as a result of the following:

Accounts receivable increased by \$78.7 million due to an increase in gross billings during the period as distributors accumulated inventory towards the end of the six month period ended July 1, 2005. Days sales outstanding were 47 for the three months ended July 1, 2005 compared to 26 for the three months ended December 31, 2004.

Accounts payable and accrued expenses decreased by \$8.9 million mainly due to decreased accrued benefits costs as a result of annual bonus payments.

These increases in working capital were partially offset by the following:

Deferred income and allowances on sales to distributors increased by \$34.5 million as distributors maintained a higher inventory level compared to a quarter ago.

Income taxes payable increased \$18.9 million primarily as a result of an additional estimated tax provision related to the planned repatriation of unremitted foreign earnings, offset by a tax benefit arising primarily from the settlement of income tax audits during the second quarter. See Provision for Income Taxes.

Purchase Commitments and Contractual Obligations

We depend entirely upon subcontractors to manufacture our silicon wafers and provide assembly and test services. Due to lengthy subcontractor lead times, we must order these materials and services from these subcontractors well in advance, and we are obligated to pay for the materials and services once they are completed. As of July 1, 2005, we had less than \$125.0 million of outstanding purchase commitments to such subcontractors. We expect to receive and pay for these materials and services within the next four to six months.

We also lease facilities under non-cancelable lease agreements expiring at various times through 2010. There have been no significant changes to our operating lease obligations since our 2004 fiscal year end. We also enter into various non-cancelable contracts to acquire goods and services, as well as corporate guarantees and commitments, in the normal course of business.

Impact of Currency Translation and Inflation

Although we purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars, we do have international operations and are, therefore, subject to foreign currency rate exposure. For non-U.S.

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subsidiaries and branches that have assets and liabilities in local currencies, the impact of the translation of these local currencies into U.S. dollars for the three and six months ended July 1, 2005 and July 2, 2004 was immaterial. As of July 1, 2005, we had no open forward contracts; however, we may enter into contracts from time to time to hedge foreign exchange exposure. We have, in the past, entered into forward contracts to hedge against currency fluctuations associated with contractual commitments denominated in foreign currencies.

Common Stock Repurchases

Since the inception of our share repurchase program in 1996, our Board of Directors has approved 88.0 million shares of our common stock for repurchase, of which we have repurchased a total of 70.9 million for an aggregate cost of \$1.5 billion. All shares were retired upon acquisition. At July 1, 2005, 17.1 million shares remained authorized for repurchases under the plan.

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Share repurchase activities for the three months ended July 1, 2005 and July 2, 2004 and for the six months ended July 1, 2005 and July 2, 2004 were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------------|------------------|-----------------|
| | July 1, 2005 | July 2, 2004 | July 1, 2005 | July 2, 2004 |
| <i>(In thousands, except per share amounts)</i> | | | | |
| Shares repurchased | 1,873 | 4,167 | 4,128 | 6,489 |
| Cost of shares repurchased | \$ 37,990 | \$ 88,917 | \$ 81,386 | \$ 140,534 |
| Average price per share | \$ 20.28 | \$ 21.34 | \$ 19.72 | \$ 21.66 |

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections (SFAS 154), which changes the requirements for the accounting for and reporting of voluntary changes in accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless impracticable. SFAS 154 supersedes Accounting Principles Board Opinion No. 20, Accounting Change (APB 20), which previously required that most voluntary changes in accounting principle be recognized by including in the current period's net income the cumulative effect of changing to the new accounting principle. SFAS 154 also makes a distinction between retrospective application of an accounting principle and the restatement of financial statements to reflect correction of an error. SFAS 154 carries forward without changing the guidance contained in APB 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 applies to voluntary changes in accounting principle that are made in fiscal years beginning after December 15, 2005. We do not expect that the adoption of SFAS 154 will have a significant impact on our financial condition or results of operations.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), or SFAS 123R, Share-Based Payment. This statement replaces SFAS 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board's Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees. SFAS 123R will require us to measure the cost of our employee stock-based compensation awards granted after the effective date of SFAS 123R based on the grant date fair value of those awards and to record that cost as compensation expense over the period during which the employee is required to perform services in exchange for the award (generally over the vesting period of the award). In addition, we will be required to record compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption of SFAS 123R. In April 2005, the SEC announced a deferral of the effective date of SFAS 123R to the registrant's fiscal year beginning on or after June 15, 2005. Altera is therefore required to implement the standard beginning in its fiscal year 2006. In addition, the SEC issued Staff Accounting Bulletin No. 107, or SAB 107, in March 2005. SAB 107 includes interpretive guidance for the initial implementation of SFAS 123R. The adoption of SFAS 123R's fair value method will have a significant and adverse impact on our results of operations, although it will have no impact on our cash flow.

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In November 2004, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an amendment to ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current period charges. In addition, SFAS 151 requires that the allocation of fixed production overheads to the cost of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred for fiscal years beginning after June 15, 2005. We, therefore, are required to adopt the standard effective with our 2006 fiscal year. We do not expect that the adoption of SFAS 151 will have a significant impact on our financial condition or results of operations.

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RISK FACTORS

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

- (1) Our financial results depend on our ability to compete successfully in the highly competitive semiconductor industry.
- (2) Our future success depends on our ability to define, develop, and manufacture technologically-advanced products.
- (3) We depend entirely on independent subcontractors to supply us with finished silicon wafers.
- (4) We depend on independent subcontractors, located in Asia, to assemble and test our semiconductor products.
- (5) Conditions outside the control of our independent subcontractors may impact their business operations.
- (6) Our intellectual property rights may not provide meaningful protection from our competitors.
- (7) We are at risk of intellectual property infringement claims by third parties.
- (8) We may incur warranty-related liabilities.
- (9) We may be subject to product liability claims.
- (10) We depend on distributors to generate sales and fulfill our customer orders.
- (11) The length of our design-in and sales cycle could impact our future sales.
- (12) We depend on international sales for a majority of our total sales.
- (13) Our business is subject to tax risks associated with being a multinational corporation.
- (14) Our gross margins are subject to fluctuations due to many factors.

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- (15) Our financial results are affected by general economic conditions and the cyclical nature of the semiconductor industry.

- (16) We carry only limited insurance coverages.

For a discussion of these risk factors, see Management's Discussion and Analysis of Financial Condition and Results of Operations Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2004.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

Our investment portfolio consisted of fixed income securities of \$1.3 billion as of July 1, 2005. These securities, like all fixed income instruments, are subject to interest rate risk and will vary in value as market interest rates fluctuate. If market interest rates were to increase or decline immediately and uniformly by 10% from the levels as of July 1, 2005, the increase or decline in the fair value of the portfolio would not be material.

Although we purchase the majority of our materials and services in U.S. dollars and sell our products to OEMs and distributors in U.S. dollars, we do have international operations and are, therefore, subject to

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foreign currency rate exposure. To date, our exposure to exchange rate volatility has been insignificant. If foreign currency rates were to fluctuate by 10% from rates at July 1, 2005, our financial position, results of operations and cash flows would not be materially affected. However, we cannot assure you that there will not be a material impact in the future.

ITEM 4: Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of July 1, 2005. Our disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in meeting the criteria above.

As required by Section 404 of the Sarbanes-Oxley Act, we perform on-going monitoring and review of our internal controls over financial reporting. As a result of these on-going efforts, we have highlighted opportunities to further improve access, monitoring and change controls within our financial systems and subsystems.

Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of our financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles. There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with management's evaluation during the last fiscal quarter that have materially effected, or are reasonably likely to materially effect, our internal control over financial reporting. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements.

PART II OTHER INFORMATION

ITEM 2: Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

During the second quarter of 2005, we repurchased shares of our common stock as follows:

Period

(in thousands, except

footnotes and price per

share amounts)

| | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Additional Shares Authorized for Repurchase | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------|--|------------------------------------|--|--|--|
| 4/2/05-4/29/05 | 820 | \$ 19.33 | 820 | | 18,186 |

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| | | | | |
|-----------------|-------------------|-------|-------------------|-------------------|
| 4/30/05-5/27/05 | 337 | 21.17 | 337 | 17,849 |
| 5/28/05-7/1/05 | 716 | 20.95 | 716 | 17,133 |
| | <u> </u> | | <u> </u> | <u> </u> |
| Total | 1,873 | | 1,873 | |
| | <u> </u> | | <u> </u> | <u> </u> |

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

We repurchase shares under the program announced on July 15, 1996 that has no specified expiration. As of July 1, 2005, the Board of Directors had authorized, since the inception of the

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program, a total of 88.0 million shares for repurchase. No existing repurchase plans or programs expired, nor have we decided to terminate any repurchase plans or programs prior to expiration. There are no existing plans or programs under which we do not intend to make further purchases.

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

We held our Annual Meeting of Stockholders on May 10, 2005 at 4:00 p.m. The following matters were acted upon at the meeting:

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

| NOMINEES | FOR | AUTHORITY | | |
|--------------------------|-------------|------------|--|--|
| | VOTES | WITHHELD | | |
| John P. Daane | 330,403,647 | 11,431,513 | | |
| Robert W. Reed | 330,565,579 | 11,269,581 | | |
| Charles M. Clough | 333,899,123 | 7,936,037 | | |
| Robert J. Finocchio, Jr. | 334,378,712 | 7,456,448 | | |
| Kevin McGarity | 334,395,697 | 7,439,463 | | |
| Paul Newhagen | 330,527,432 | 11,307,728 | | |
| William E. Terry | 328,846,876 | 12,988,284 | | |
| Susan Wang | 335,620,687 | 6,214,473 | | |

| | FOR | VOTES | ABSTENTIONS | BROKER |
|--|-------------|-------------|-------------|------------|
| | VOTES | AGAINST | | NON- |
| | | | | VOTES |
| 2. Approval of the 2005 Equity Incentive Plan. | 256,762,569 | 42,445,151 | 1,924,563 | 40,702,877 |
| 3. Approval of an amendment to the 1987 Employee Stock Purchase Plan to increase by 1,000,000 the number of shares of common stock reserved for issuance under the plan. | 292,638,505 | 6,586,292 | 1,907,486 | 40,702,877 |
| 4. Ratification of the appointment of PricewaterhouseCoopers LLP as our independent accountants for the fiscal year ending December 30, 2005. | 333,004,745 | 6,759,580 | 2,070,835 | |
| 5. Stockholder proposal to require the expensing of stock option grants issued by the company. | 172,102,987 | 123,796,079 | 5,233,217 | 40,702,877 |
| 6. Stockholder proposal to require that directors be elected by majority vote. | 177,950,234 | 120,965,060 | 2,216,989 | 40,702,877 |

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Under SFAS 123R, Share-Based Payment, we will be required to measure the cost of our employee stock-based compensation awards granted after the effective date of SFAS 123R based on the grant date fair value of those awards and to record that cost as compensation expense over the period during which the employee is required to perform services in exchange for the award (generally over the vesting period of the award). In addition, we will be required to record compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption of SFAS 123R. We are required to implement SFAS 123R beginning in our fiscal year 2006. This implementation of SFAS 123R will satisfy the stockholder vote requesting that we begin expensing of stock option grants.

We are studying the issue of director elections by majority vote, and our Board of Directors will seriously consider the proposal that was approved by our stockholders.

ITEM 6: Exhibits

| Exhibit No. | Description |
|-------------|--|
| 10.1+ | 2005 Equity Incentive Plan.(1) |
| #10.2+ | Form of Director Stock Option Agreement under 2005 Equity Incentive Plan. |
| #10.3+ | Form of Employee Stock Option Agreement under 2005 Equity Incentive Plan. |
| #31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| #31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934. |
| #32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| #32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(1) Incorporated by reference to Appendix A of the registrant's Proxy Statement for the 2005 Annual Stockholders Meeting on May 10, 2005 filed with the Commission on April 7, 2005 (Commission File No. 0-16617).

Filed herewith.

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

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SIGNATURES

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

ALTERA CORPORATION

/s/ Nathan Sarkisian

Nathan Sarkisian, Senior Vice President

(duly authorized officer) and Chief Financial Officer

(principal financial officer)

Date: August 9, 2005

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