ADVANCED MICRO DEVICES INC
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended October 1, 2006

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 001-07882

ADVANCED MICRO DEVICES, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**94-1692300** **(I.R.S. Employer** **Identification No.)**
One AMD Place	**94088**

Sunnyvale, California
(Address of principal executive offices) **(Zip Code)**
Registrant s telephone number, including area code: (408) 749-4000

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

Indicate by check mark whether the registrant is 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.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

Indicate the number of shares outstanding of the registrant s common stock, $0.01 par value, as of November 1, 2006: 548,606,149.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Advanced Micro Devices, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations

(Unaudited)

	Quarters Ended		Nine Months Ended	
	October 1, 2006	September 25, 2005	October 1, 2006	September 25, 2005
	(In thousands except per share amounts)			
Net sales	$ 1,327,622	$ 1,263,866	$ 3,876,147	$ 3,320,372
Net sales to related party (see Note 4)		258,889		688,929
Total net sales	1,327,622	1,522,755	3,876,147	4,009,301
Cost of sales	645,264	896,261	1,724,663	2,469,663
Gross margin	682,358	626,494	2,151,484	1,539,638
Research and development	277,380	289,018	820,230	814,724
Marketing, general and administrative	285,806	258,748	851,373	698,974
Operating income	119,172	78,728	479,881	25,940
Interest income	31,188	9,510	94,658	23,589
Interest expense	(17,637)	(30,615)	(58,743)	(80,513)
Other income (expense), net	(1,975)	(3,456)	(13,863)	(10,463)
Income (loss) before minority interest, equity in net income (loss) of Spansion Inc., and income taxes	130,748	54,167	501,933	(41,447)
Minority interest in consolidated subsidiaries	(6,941)	21,227	(20,471)	105,985
Equity in net income (loss) of Spansion Inc.	(10,204)		(40,914)	
Provision (benefit) for income taxes	(20,852)	(606)	32,722	(5,358)
Net income	$ 134,455	$ 76,000	$ 407,826	$ 69,896
Net income per common share:				
Basic	$ 0.28	$ 0.19	$ 0.85	$ 0.18
Diluted	$ 0.27	$ 0.18	$ 0.82	$ 0.17
Shares used in per share calculation:				
Basic	486,331	399,025	478,318	395,839
Diluted	496,772	443,681	497,332	409,586

See accompanying notes to condensed consolidated financial statements.

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Advanced Micro Devices, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

	October 1, 2006	December 25, 2005*
	(In thousands except par value and share amounts)	
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,384,526	$ 633,067
Marketable securities	972,377	1,002,742
Spansion Senior Subordinated Notes		158,957
Total cash and cash equivalents and marketable securities	2,356,903	1,794,766
Accounts receivable	699,822	818,305
Allowance for doubtful accounts	(11,799)	(12,774)
Accounts receivable, net	688,023	805,531
Inventories:		
Raw materials	25,775	17,762
Work-in-process	332,439	225,003
Finished goods	107,502	145,866
Total inventories	465,716	388,631
Deferred income taxes	74,981	92,606
Prepaid expenses and other current assets	305,045	334,016
Receivable from Spansion (see Note 4)	21,193	143,286
Total current assets	3,911,861	3,558,836
Property, plant and equipment:		
Land and land improvements	50,321	28,814
Buildings and leasehold improvements	1,309,936	1,027,822
Equipment	4,786,117	3,309,869
Construction in progress	453,473	1,121,100
Total property, plant and equipment	6,599,847	5,487,605
Accumulated depreciation and amortization	(3,195,968)	(2,786,605)
Property, plant and equipment, net	3,403,879	2,701,000
Other assets	386,839	303,294
Receivable from Spansion (see Note 4)	5,416	3,307
Net investment in Spansion (see Note 3)	671,249	721,342
Total assets	$ 8,379,244	$ 7,287,779

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	October 1, 2006	December 25, 2005*
	(In thousands except par value and share amounts)	
	(unaudited)	
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 865,060	$ 622,610
Accounts payable to Spansion (see Note 4)	36,289	233,224
Accrued compensation and benefits	147,250	226,874
Accrued liabilities	473,477	388,998
Income taxes payable	17,790	3,326
Deferred income on shipments to distributors	115,571	141,898
Current portion of long-term debt and capital lease obligations	44,950	43,224
Other current liabilities	191,824	161,807
Total current liabilities	1,892,211	1,821,961
Deferred income taxes	75,861	92,606
Long-term debt and capital lease obligations	644,357	1,327,065
Other long-term liabilities	482,204	459,322
Minority interest in consolidated subsidiaries	272,116	234,988
Commitments and contingencies (see Note 8)		
Stockholders equity:		
Capital stock:		
Common stock, par value $0.01; 750,000,000 shares authorized; shares issued: 493,836,693 as of October 1, 2006 and 442,196,017 as of December 25, 2005; shares outstanding: 487,120,380 as of October 1, 2006 and 435,526,719 as of December 25, 2005	4,871	4,355
Capital in excess of par value	4,051,291	2,800,306
Treasury stock, at cost (6,716,313 shares as of October 1, 2006 and 6,669,298 shares as of December 25, 2005)	(92,612)	(90,138)
Retained earnings	881,632	473,678
Accumulated other comprehensive income	167,313	163,636
Total stockholders equity	5,012,495	3,351,837
Total liabilities and stockholders equity	$ 8,379,244	$ 7,287,779

* Amounts as of December 25, 2005 were derived from the December 25, 2005 audited financial statements.

See accompanying notes to condensed consolidated financial statements.

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Advanced Micro Devices, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

	Nine Months Ended October 1, 2006	Nine Months Ended September 25, 2005
	(In thousands)	
	(unaudited)	
Cash flows from operating activities:		
Net income (loss)	$ 407,826	$ 69,896
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority interest of consolidated subsidiaries	20,473	(105,985)
Depreciation	519,118	900,948
Amortization	47,098	41,138
Reduction of provision for doubtful accounts	(975)	(2,042)
Equity in loss of Spansion Inc.	40,914	
Change in deferred income taxes	286	(21,121)
Charge due to partial redemption of 7.75% Senior Notes	3,822	
Foreign grant and subsidy amortization	(109,795)	(82,660)
Forfeited interest on debt conversion	754	
Net loss on disposal of property, plant and equipment	7,409	1,395
Net gain realized on sale of available-for-sale securities	(2,312)	
Stock-based compensation expense recognized under employee stock compensation plans	49,609	743
Non-cash foreign exchange loss	7,515	
Recognition of deferred gain on sale-leaseback of building and equipment	(1,360)	(1,260)
Gain on Spansion s repurchase of its 12.75% Senior Subordinated Notes	(9,751)	
Tax benefit on minority interest in net loss of subsidiaries		9,054
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable	119,111	(108,673)
Decrease (increase) in receivables from related parties	93,729	(40,076)
Increase in inventories	(76,392)	(55,935)
(Increase) decrease in prepaid expenses and other current assets	(21,402)	20,883
Increase in other assets	(169,511)	(5,044)
Increase (decrease) in taxes payable	14,464	(34,900)
Refund of customer deposits under long-term purchase agreements		(17,500)
Net increase in accounts payables and accrued liabilities	269,250	351,164
(Decrease) increase in accounts payables and accrued liabilities to related parties	(194,496)	21,049
Decrease in accrued royalties to related party		(4,062)
Increase in amounts payable to Spansion Pension Trust		8,564
Net cash provided by operating activities	1,015,384	945,576
Cash flows from investing activities:		
Purchases of property, plant and equipment	(1,190,582)	(1,184,033)
Proceeds from sale of property, plant and equipment	4,423	7,132
Repayment of loans by Spansion	21,564	
Purchases of available-for-sale securities	(1,941,727)	(819,729)
Proceeds from sale and maturity of available-for-sale securities	1,971,658	560,771
Proceeds from Spansion s repurchase of its 12.75% Senior Subordinated Notes	175,000	
Other	1,858	(9,125)
Net cash used in investing activities	(957,806)	(1,444,984)

Cash flows from financing activities:		
Proceeds from borrowings		93,978
Borrowings under revolving loan		77,489
Repayment of debt and capital lease obligations	(212,857)	(185,420)
Proceeds from foreign grants and subsidies	201,780	159,932
Proceeds from sale-leaseback transactions		78,145
Proceeds from equity offering	494,618	
Proceeds from limited partners contribution		54,401

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	Nine Months Ended October 1, 2006	Nine Months Ended September 25, 2005
	(In thousands) (unaudited)	
Proceeds from issuance of common stock under stock-based compensation plans	213,254	120,870
Other	(2,914)	(8,013)
Net cash provided by financing activities	693,881	391,382
Effect of exchange rate changes on cash and cash equivalents		(4,236)
Net increase (decrease) in cash and cash equivalents	751,459	(112,262)
Cash and cash equivalents at beginning of period	633,067	918,377
Cash and cash equivalents at end of period	$ 1,384,526	$ 806,115
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest, net of amounts capitalized	$ 41,812	$ 52,231
Income taxes	$ 8,620	$ 38,588
Non-cash activities:		
Equipment sale-leaseback transaction	$	$ 78,145
Conversion of 4.75% Convertible Senior Debentures	$ 499,833	$
Assets acquired under capital lease	$ 17,991	$ 119,002

See accompanying notes to condensed consolidated financial statements.

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Advanced Micro Devices, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation and Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements of Advanced Micro Devices, Inc. and subsidiaries (the Company or AMD) have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. The results of operations for the interim periods shown in this report are not necessarily indicative of results to be expected for the full fiscal year ending December 31, 2006. In the opinion of the Company s management, the information contained herein reflects all adjustments necessary for a fair presentation of the Company s results of operations, financial position and cash flows. All such adjustments are of a normal recurring nature. The unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended December 25, 2005.

The Company uses a 52- to 53-week fiscal year ending on the last Sunday in December. The quarter and nine months ended October 1, 2006 consisted of 13 weeks and 40 weeks. The quarter and nine months ended September 25, 2005 consisted of 13 weeks and 39 weeks.

Certain prior period amounts have been reclassified to conform to the current period presentation of segment information. (See Note 6.)

Principles of Consolidation

The accompanying condensed consolidated financial statements include the financial position and operating results of the Company and its wholly- and majority-owned subsidiaries. All intercompany balances have been eliminated upon consolidation. On December 21, 2005, Spansion Inc. (Spansion) completed its initial public offering (IPO) of its Class A common stock. Prior to the IPO, Spansion was the Company s majority-owned subsidiary, and the Company held a 60 percent controlling ownership interest in Spansion. Consequently, Spansion s financial position, results of operations and cash flows through December 20, 2005 were included in the Company s consolidated statements of operations and statements of cash flows. Following the IPO, the Company s ownership interest in Spansion was diluted from 60 percent to approximately 38 percent. As a result, the Company no longer exercises control over Spansion s operations. Therefore, from December 21, 2005, the Company uses the equity method of accounting to record its proportionate share of Spansion s net income (loss).

Foreign Currency Translation/Transactions

Prior to 2006, the functional currency of the Company s foreign subsidiaries was the U.S. dollar, except for AMD Saxony Limited Liability Company & Co. KG (AMD Saxony) and AMD Fab 36 LLC & Co. KG (AMD Fab 36 KG) whose functional currency was the euro. Beginning in 2006, the functional currency of AMD Saxony and AMD Fab 36 KG is the U.S. dollar. The change in the functional currency of these subsidiaries is accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 52, *Foreign Currency Translation* (SFAS 52), and reflects the change in economic facts and circumstances pertaining to these subsidiaries. Under the requirements of SFAS 52, the Company assessed the various economic factors relating to AMD Saxony and AMD Fab 36 KG and concluded that due to changes in facts, circumstances, scope of operations and business practices, the U.S. dollar is now the currency of the primary economic environment in which these subsidiaries operate, and, therefore, their functional currency. Consequently, beginning in the first quarter of fiscal 2006, these subsidiaries assets and liabilities denominated in non-U.S. dollars have been remeasured into U.S. dollars at current exchange rates for monetary assets and liabilities and historical exchange rates for non-monetary assets and liabilities. Net sales, cost of sales and expenses have been remeasured at average exchange rates in effect during each period. Net sales, cost of sales and expenses related to the previously noted non-monetary balance sheet accounts have been remeasured at historical exchange rates. Gains or losses resulting from foreign currency remeasurement have been included in net income. Translation adjustments from

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prior periods will continue to remain in accumulated other comprehensive income. In accordance with the equity method of accounting, the Company includes its proportionate share of the translation adjustments relating to Spansion Japan, a subsidiary of Spansion Inc., whose functional currency is the Japanese yen, in accumulated other comprehensive income.

Stock-Based Compensation

On December 26, 2005, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases pursuant to the Employee Stock Purchase Plan, based on estimated fair values. The Company adopted SFAS 123R using the modified prospective transition method. In accordance with the modified prospective transition method, the Company has not restated its consolidated financial statements for prior periods. Under this transition method, stock-based compensation expense for the quarter and nine months ended October 1, 2006 includes stock-based compensation expense for all of the Company s stock-based compensation awards granted prior to, but not yet vested as of, December 26, 2005, based on the grant-date fair value estimated in accordance with the provision of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), as well as stock-based compensation expense for all stock-based compensation awards granted on or after December 26, 2005 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior to the adoption of SFAS 123R, the Company recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*.

Upon adoption of SFAS 123R, the Company changed its method of attributing the value of stock-based compensation expense from the multiple-option (i.e., accelerated) approach to the single option (i.e., straight-line) method. Compensation expense for share-based awards granted prior to December 26, 2005 will continue to be subject to the accelerated multiple option method specified in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28), while compensation expense for stock-based awards granted on or after December 26, 2005 will be recognized using a straight-line, single option method.

Also, upon adoption of SFAS 123R, the Company changed its method of valuation for stock option awards from the Black-Scholes-Merton (Black-Scholes) option-pricing model, which was previously used for the Company s pro forma information disclosures of stock-based compensation expense as required under SFAS 123, to a lattice-binomial option-pricing model.

SFAS 123R requires that the cash flows resulting from excess tax benefits related to stock compensation be classified as cash flows from financing activities.

In March 2005, the Securities and Exchange Commission (SEC) issued *Staff Accounting Bulletin No. 107* (SAB 107) regarding the SEC s interpretation of SFAS 123R and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R. See Note 2 for a further discussion on stock-based compensation.

The Company s determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

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SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates in order to derive the Company s best estimate of awards ultimately expected to vest. The Company estimated forfeitures based on its historical experience. In the Company s pro forma information required under SFAS 123 for the periods prior to 2006, the Company accounted for forfeitures as they occurred.

As a result of adopting SFAS 123R, the Company s income from operations, income before taxes and net income for the quarter ended October 1, 2006 are $7 million, $7 million, and $4 million lower, respectively, and the Company s income from operations, income before taxes and net income for the nine months ended October 1, 2006 are $26 million, $26 million, and $16 million lower, respectively, than they would have been if it had continued to account for share-based compensation under APB Opinion No. 25. Basic and diluted earnings per share for the quarter ended October 1, 2006 are $0.01 and $0.01 lower, and basic and diluted earnings per share for the nine months ended October 1, 2006 are $0.03 and $0.03 lower, respectively, than they would have been if it had continued to account for share-based compensation under APB Opinion No. 25.

Recent Accounting Pronouncements

In June 2006, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 06-2 *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences*. Under this consensus, sabbatical leave or other similar benefits provided to an employee are considered to accumulate, as that term is used in SFAS 43, provided that (a) the employee is required to complete a minimum service period to be entitled to the benefit, (b) there is no increase to the benefit if the employee provides additional years of service, (c) the employee continues to be a compensated employee during his or her absence, and (d) the employer does not require the employee to perform any duties during his or her absence. If these conditions are met, companies are required to accrue for sabbatical leave or other similar benefits as they are earned. The accounting required under this consensus will be effective for fiscal years beginning after December 15, 2006. Upon adoption, companies can choose to apply the guidance using either of the following approaches: (a) a change in accounting principle through retrospective application to all periods presented, or (b) a change in accounting principle through a cumulative-effect adjustment to the balance in retained earnings at the beginning of the year of adoption. The Company is currently evaluating the accounting guidance and will adopt the consensus as required at the beginning of its fiscal year 2007.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosures. It will be effective for fiscal years beginning after December 15, 2006. The provisions of FIN 48 apply to all tax positions upon initial adoption of FIN 48. Only tax positions that meet the recognition threshold criteria at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. The Company is currently evaluating the accounting and disclosure requirements of FIN 48 and will adopt it as required at the beginning of its fiscal year 2007.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 does not require any new fair value measurements but clarifies the fair value definition, establishes a fair value hierarchy that prioritizes the information used to develop assumptions used for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 clarifies that the fair value is the exchange price in an orderly transaction between market participants to sell the asset or transfer the liability in the market. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data for example, the reporting entity s own data. It emphasizes that fair value is a market-based measurement, not an entity-specific measurement and a fair value measurement should therefore be based on the assumptions that market participants would use in pricing the asset or liability. SFAS 157 expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition, including the inputs used to measure fair value and the effect of such measurements on earnings for the period. It will be effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years with earlier application encouraged. The Company is currently evaluating the accounting and disclosure requirements of SFAS 157 and plans to adopt it as required at the beginning of its fiscal year 2008.

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In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Post-retirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132* (SFAS 158). SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit post-retirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. It requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position. SFAS 158 also requires disclosure in the notes to financial statements of additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. For publicly traded companies, the recognition and related disclosure provisions will be effective as of the end of the fiscal years ending after December 15, 2006. The measurement date provisions will be effective for fiscal years ending after December 15, 2008. The Company does not have or sponsor a defined benefit postretirement plan; however, Spansion Inc., an investee that the Company is accounting for under the equity method of accounting, does sponsor such a plan for certain of its employees. Upon adoption of SFAS 158 by Spansion Inc., the Company expects to recognize its proportionate share of the accounting effect which will impact its net investment balance in Spansion Inc. and its other comprehensive income. The Company does not believe the impact of the adoption of SFAS 158 will be material to its consolidated financial statements.

2. Stock-Based Incentive Compensation Plans.

Stock-Based Incentive Program Description

The Company s stock-based incentive programs are intended to attract, retain and motivate highly qualified employees. These programs are described more fully in the notes to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 25, 2005. On April 29, 2004, the Company s stockholders approved the 2004 Equity Incentive Plan (the 2004 Plan). Equity awards are made from the 2004 Plan. Under the 2004 Plan, stock options cannot be exercised until they become vested. Generally, stock options vest and become exercisable over a three- to four-year period from the date of grant. Stock options expire at the times established by the Company s Compensation Committee of the Board of Directors, but not later than 10 years after the grant date. In addition, shares that are released from or reacquired by the Company from outstanding awards under the 2004 Plan become available for grant under the 2004 Plan and may be reissued as new awards. The Company also has stock options outstanding from previous equity compensation plans. Stock options available for grant under these prior equity compensation plans that were in effect before April 29, 2004 were consolidated into the 2004 Plan. In conjunction with the adoption of SFAS 123R, the Company reviewed its stock-based incentive programs and decided to issue primarily restricted stock units in lieu of stock options.

Under the 2004 Plan, the Company can grant full value awards. These full value awards can consist of restricted stock or restricted stock units. Following is a description of the material terms of the full value awards that may be granted under the 2004 Plan:

Restricted Stock. Restricted stock awards can be granted to any employee, director or consultant. Restricted stock based on continued service may not fully vest for three years from the date of grant. Restricted stock that is performance based may not fully vest for one year from the date of grant.

Restricted Stock Units. Restricted stock units are awards that can be granted to any employee, director or consultant and that obligate the Company to issue a specific number of shares of the Company s common stock in the future if the vesting terms and conditions are satisfied. Restricted stock units based on continued service may not fully vest for at least three years from the date of grant. Restricted stock units that are performance based may not fully vest for at least one year from the date of grant.

Valuation and Expense Information under SFAS 123R

The following table summarizes stock-based compensation expense related to employee stock options, restricted stock and restricted stock units and employee stock purchases under the Company s Employee Stock Purchase Plan

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under SFAS 123R for the quarter and nine months ended October 1, 2006, which was allocated in the condensed consolidated statement of operations as follows:

	Quarter Ended October 1, 2006 (In thousands)	Nine Months Ended October 1, 2006 (In thousands)
Stock-based compensation included as a component of:		
Cost of sales	$ 1,932	$ 5,921
Research and development	6,110	17,038
Marketing, general and administrative	8,468	26,650
Total stock-based compensation expense related to employee stock options, restricted stock, restricted stock units, and employee stock purchases	16,510	49,609
Tax benefit	(4,890)	(14,822)
Stock-based compensation expense related to employee stock options, restricted stock, restricted stock units, and employee stock purchases, net of tax	$ 11,620	$ 34,787

As of October 1, 2006, the Company had $30 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock options that will be recognized over the weighted average period of 1.13 years. Also, as of October 1, 2006, the Company had $70 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock and restricted stock units that will be recognized over the weighted average period of 1.71 years.

Upon adoption of SFAS 123R, the Company began estimating the value of employee stock options on the date of grant using a lattice-binomial option-pricing model (lattice-binomial model). Prior to the adoption of SFAS 123R, for purposes of the pro forma disclosure information that the Company provided in accordance with SFAS 123, the value of each employee stock option was estimated on the date of grant using the Black-Scholes option-pricing model.

The Company s employee stock options have various restrictions including vesting provisions and restrictions on transfer, and must be exercised prior to their expiration date. The Company believes that the lattice-binomial model is more capable of incorporating the features of the Company s employee stock options than closed-form models such as the Black-Scholes model.

The use of the lattice-binomial model requires the use of extensive actual employee exercise behavior data and the use of a number of complex assumptions including expected volatility of the Company s common stock, risk-free interest rate, and expected dividends. The weighted-average estimated value of employee stock options granted for the quarter and nine months ended October 1, 2006 was $7.87 and $12.67 per share, using the lattice-binomial model with the following weighted-average assumptions:

	Quarter Ended October 1, 2006	Nine Months Ended October 1, 2006
Expected volatility	52.58%	51.92%
Risk-free interest rate	4.89%	4.82%
Expected dividends	0%	0%

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The Company used a combination of the historical volatility of its common stock and the implied volatility for two-year traded options on the Company s common stock as the expected volatility assumption required by the lattice-binomial model, which is consistent with SFAS 123R and SAB 107. The implied volatility was based upon the availability of actively traded options on the Company s common stock. The Company believes that the use of implied volatility is more representative of future stock price trends for the two-year periods covered by the actively traded options maturities than simply using historical volatility alone. The Company believes that this blended approach provides a better estimate of the expected future volatility of the Company s common stock over the expected life of its stock options. Prior to 2006, the Company had used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information disclosures of stock-based compensation expense.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employee stock options. The expected dividend yield is zero as the Company does not expect to pay dividends in the future.

The expected term of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and is a derived output of the lattice-binomial model. The expected term of employee stock options is impacted by all of the underlying assumptions and calibration of the lattice-binomial model. The lattice-binomial model assumes that employees exercise behavior is a function of the option s remaining vested term and the extent to which the option is in-the-money. The lattice-binomial model estimates the probability of exercise as a function of these two variables based on the past ten year history of exercises, post-vesting cancellations, and outstanding options on all option grants other than pre-vesting forfeitures made by the Company. The expected term for option grants made for the quarter and nine months ended October 1, 2006 derived from the lattice-binomial model was 4.14 and 4.13 years.

The Company uses third-party analyses to assist in developing the assumptions used in, as well as calibrating, its lattice-binomial model. The Company is responsible for determining the assumptions used in estimating the fair value of its stock-based payment awards.

Restricted Stock Awards

Restricted stock and restricted stock units vest in accordance with the terms and conditions established by the Compensation Committee of the Board of Directors, and are based either on continued service or continued service and performance. The cost of these awards is determined using the fair value of the Company s common stock on the date of the grant, and the compensation expense is recognized over the service period.

Certain Company employees have been granted performance-based restricted stock and performance-based restricted stock units. The number of shares ultimately received under these awards depends on actual performance against specified performance goals. The performance period is generally one to three years from the date of grant.

Employee Stock Purchase Plan (ESPP)

Under the ESPP, eligible employees may purchase the Company s common stock through payroll deductions at a price equal to 85 percent of the lower of the fair market value at the beginning of the applicable offering period or at the end of each applicable three-month purchase period. The Company issued approximately 454,000 shares and approximately 1,093,000 shares under the ESPP during the quarter and nine months ended October 1, 2006. The ESPP compensation expense is calculated using the fair value of the employees purchase rights at the grant date under the Black-Scholes model.

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Pro Forma Information Under SFAS 123 For Periods Prior to 2006

The following table presents the effect on net income (loss) and earnings per share as if the Company had applied the fair-value recognition provisions of SFAS 123 to all of its share-based compensation awards for the quarter and nine months ended September 25, 2005:

	Quarter Ended September 25, 2005	Nine Months Ended September 25, 2005
	(In thousands except per share amounts)	
Net income as reported	$ 76,000	$ 69,896
Add: employee stock-based compensation expense included in reported net income (loss), net of related tax effects under APB 25	271	728
Less: employee stock-based compensation expense determined under the fair-value based method, net of related tax effects.	(8,768)	(107,288)
Net income (loss) pro forma	67,503	(36,664)
Basic net income per common share as reported	$ 0.19	$ 0.18
Diluted net income per common share as reported	$ 0.18	$ 0.17
Basic net income (loss) per common share pro forma	$ 0.17	$ (0.09)
Diluted net income (loss) per common share pro forma	$ 0.16	$ (0.09)

The summary of the changes in stock options outstanding under the Company s stock-based compensation plans for the nine months ended October 1, 2006 is presented below:

	Nine Months Ended October 1, 2006	
	Number of Shares	Weighted-Average Exercise Price
	(In thousands except share price)	
Options:		
Outstanding at beginning of period	45,928	$ 15.14
Granted	1,272	$ 29.84
Canceled	(900)	$ 29.66
Exercised	(14,250)	$ 12.82
Outstanding at end of period	32,050	$ 16.35
Exercisable at end of period	25,649	$ 15.66

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The following table summarizes the ranges of the exercise prices of outstanding and exercisable options as of October 1, 2006:

	Options outstanding			Options exercisable	
Range of exercise prices	Number of shares	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number of shares	Weighted-average exercise price
			(Shares in thousands)		
$ 0.01 - 11.69	6,368	4.94	$ 9.10	5,376	$ 8.84
$ 11.70 - 14.86	11,187	5.24	$ 14.42	9,299	$ 14.50
$ 14.89 - 22.35	10,498	5.20	$ 17.76	8,285	$ 17.09
$ 22.38 - 45.50	3,997	4.99	$ 29.61	2,689	$ 28.93
Total	32,050	5.13	$ 16.35	25,649	$ 15.66

As of October 1, 2006, the weighted average remaining contractual life of stock options exercisable was 4.96 years and their aggregate intrinsic value was $249 million. The total intrinsic value of stock options exercised during the quarter and nine months ended October 1, 2006 was $11 million and $329 million, respectively. The total intrinsic value of stock options exercised during the quarter and nine months ended September 25, 2005 was $44 million and $73 million, respectively.

The summary of the changes in restricted stock awards outstanding under the Company s 2004 Plan during the nine months ended October 1, 2006 is presented below:

	Nine Months Ended October 1, 2006	
	Number of Shares	Weighted-Average Grant Date Fair Value
	(In thousands except share price)	
Unvested balance at beginning of period	1,067	$ 21.46
Granted	3,135	$ 30.81
Forfeited	(45)	$ 30.55
Vested	(221)	$ 34.77
Unvested balance at end of period	3,936	$ 28.06

The total fair value of shares vested for the quarter and nine months ended October 1, 2006 was $6,913,000 and $7,676,000.

Non-Employee Stock Options and Restricted Stock Units

In connection with Spansion s IPO, unvested stock options and restricted stock units of the Company that are held by Spansion employees are subject to variable accounting under EITF Issue No. 96-18, *Accounting for Equity Investments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. The fair value of unvested stock options and restricted stock units was measured pursuant to the Black-Scholes option pricing model at October 1, 2006 using prevalent market price assumptions because such awards were issued prior to the adoption of SFAS 123R.

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The compensation expense for the quarter and nine months ended October 1, 2006 related to these awards was approximately $2.4 million and $6.1 million. In accordance with EITF Issue No. 00-12, *Accounting by an Investor for Stock-Based Compensation Granted to Employees of an Equity Method Investee*, the compensation expense was recorded in the Company s condensed consolidated statements of operations in the same caption as equity in net income (loss) of Spansion Inc. As of October 1, 2006, the number of shares covered by unvested stock options and restricted stock units outstanding and held by Spansion employees was approximately 686,000 shares.

3. Net Investment in and Equity Interest in Net Income (Loss) of Spansion Inc.

On December 21, 2005, Spansion Inc. completed its IPO of 47,264,000 shares of its Class A common stock as well as its offering of notes to the Company and institutional investors with an aggregate principal amount of $425 million. As a result of the IPO, the Company owns a total of 48,529,403 shares, or approximately 38 percent, of Spansion s outstanding common stock. Pursuant to the terms of a Stockholders Agreement, the Company cannot transfer any shares of Spansion s common stock, except to majority owned subsidiaries, until the earlier of December 13, 2006 or the date Spansion s Board of Directors sets for the conversion of the Class D common stock into Class A common stock. However, Spansion, AMD and Fujitsu agreed to waive this provision with respect to a portion of the shares of Spansion s common stock owned by AMD and Fujitsu, and in October 2006, Spansion Inc. filed a registration statement on Form S-1 in order to allow the Company s indirect wholly owned subsidiary, AMD Investments, Inc. and Fujitsu Limited to sell an aggregate of 35 million shares of Class A common stock in a registered offering, of which 21 million would be sold by AMD Investments. See Note 14.

Following the IPO, the Company s ownership interest was diluted from 60 percent to approximately 38 percent. As a result, the Company no longer exercises control over Spansion s operations and, from December 21, 2005, Spansion s financial position, results of operations and cash flows are no longer consolidated with the Company s. Therefore, the Company uses the equity method of accounting to reflect its proportionate share of Spansion s net income or loss in accordance with the provisions of APB Opinion No. 18 (as amended), *The Equity Method of Accounting for Investments in Common Stock*. Under the equity method of accounting, the Company records its proportionate share of Spansion s net income or loss based on the most recently available quarterly financial statements. In addition, the Company also reflects its proportionate share of the change in Spansion s accumulated other comprehensive income (loss) on its condensed consolidated balance sheet.

In determining the Company s share of the net loss from Spansion under the equity method of accounting, certain adjustments, primarily related to the elimination of intercompany transactions, are made to Spansion s reported results (see Note 4). These adjustments are included in the caption Equity interest in net income (loss) of Spansion Inc. on the Company s condensed consolidated statements of operations.

As of October 1, 2006, the carrying value of the Company s net equity investment in Spansion amounted to approximately $671 million, and the fair value of this investment was approximately $809 million based on the closing price of Spansion s Class A common stock on September 29, 2006, the last trading day of the fiscal quarter. On October 24, 2006, the Company entered into a credit agreement with Morgan Stanley Senior Funding, Inc., as Syndication Agent and Administrative Agent, Wells Fargo Bank, N.A., as Collateral Agent, and other lenders that may become party thereto from time to time (Credit Agreement), pursuant to which the Company borrowed an aggregate amount of $2.5 billion (Term Loan) to finance a portion of the Acquisition. In connection with the Credit Agreement, the Company granted a security interest in, among other things, its equity investment in Spansion Inc. to the Collateral Agent. The proceeds from any sale of this investment must be used to prepay the Term Loan. See Note 14.

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4. Related-Party Transactions

The following table represents the significant balances receivable from or payable to Spansion as of October 1, 2006 and December 25, 2005, of which none had the legal right of offset:

	October 1, 2006	December 25, 2005
	(In thousands)	
Investment in Spansion Senior Notes	$	$ 158,957
Other receivable from Spansion (short-term)	21,193	121,585
Other receivable from Spansion (long-term)	5,416	
Notes receivable from Spansion (short-term)		21,701
Notes receivable from Spansion (long-term)		3,307
Accounts payable to Spansion	36,289	233,224

In connection with Spansion s IPO, the Company entered into various amended and restated service agreements, a non-compete agreement and a patent cross-license agreement with Spansion. Under the amended services agreements, the Company agreed to provide, among other things, information technology, facilities, logistics, tax, finance and human resources services to Spansion for a specified period. Under the amended patent cross-license agreement, Spansion pays royalties to the Company based on a percentage of Spansion s net sales.

In addition, the Company had entered into an agency agreement with Spansion pursuant to which the Company agreed to ship products to and invoice Spansion s customers in the Company s name on behalf of Spansion until Spansion had the capability to do so on its own. Prior to shipping the product to Spansion s customers, the Company purchased the applicable product from Spansion and paid Spansion the same amount that it invoiced Spansion s customers. In performing these services, the Company acted as Spansion s agent for the sale of Spansion s Flash memory products, and the Company did not receive a commission or fees for these services. Under the agreement, Spansion assumed full responsibility for its products and these transactions, including establishing the pricing and determining product specifications. Spansion also assumed credit and inventory risk related to these product sales. In the second quarter of 2006, Spansion began to ship its products and invoice its customers directly, and the Company no longer ships and invoices products on behalf of Spansion.

Pursuant to the agency agreement and in accordance with EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, the Company recorded sales of Spansion s Flash memory products sold by the Company on behalf of Spansion and the related cost of sales on a net basis on its condensed consolidated statements of operations. As a result, the net impact to the Company s net sales and cost of sales was zero.