NORDSTROM INC
Form 10-K
March 19, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
(Mark One)
þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended February 3, 2018
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 001-15059
NORDSTROM, INC.
(Exact name of registrant as specified in its charter)

Washington	91-0515058
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1617 Sixth Avenue, Seattle, Washington	98101
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (206) 628-2111
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common stock, without par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES þ NO ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ¨ NO þ
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 þ NO ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES þ NO ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES ¨ NO þ

As of July 28, 2017 the aggregate market value of the Registrant's voting and non-voting stock held by non-affiliates of the Registrant was approximately $6.4 billion using the closing sales price on that day of $48.56. On March 12, 2018, 167,790,511 shares of common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2018 Annual Meeting of Shareholders scheduled to be held on May 29, 2018 are incorporated into Part III.

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PART I

Item 1. Business.

DESCRIPTION OF BUSINESS

Founded in 1901 as a retail shoe business in Seattle, Nordstrom later incorporated in Washington state in 1946 and went on to become one of the leading fashion retailers based in the U.S. We provide customers with a differentiated and seamless customer experience through our robust ecommerce platform and high-quality store portfolio in top North American markets. As of March 19, 2018, we operate 363 U.S. stores located in 40 states as well as six Nordstrom full-line stores in Canada. The west coast of the U.S. is the area in which we have the largest presence. We have two reportable segments, which include Retail and Credit.

As of March 19, 2018, the Retail segment includes:

- 117 Nordstrom-branded full-line stores in the U.S., including Nordstrom Local
- six Canada full-line stores
- full-price Nordstrom.com website and mobile application
- 235 off-price Nordstrom Rack stores
- off-price Nordstromrack.com/HauteLook website and mobile application
- seven Trunk Club clubhouses and TrunkClub.com website
- two “Last Chance” clearance stores
- two Jeffrey boutiques

Through these multiple retail channels, we strive to deliver the best customer experience possible. We offer an extensive selection of high-quality brand-name and private label merchandise focused on apparel, shoes, cosmetics and accessories.

Our integrated Nordstrom full-line stores and digital store allow us to provide our customers with a seamless shopping experience. In-store purchases are primarily fulfilled from that store’s inventory, but when inventory is unavailable at that store, it may also be shipped to our customers from our fulfillment centers in Cedar Rapids, Iowa and Elizabethtown, Pennsylvania (“East Coast”), or from other Nordstrom full-line stores. Online purchases are primarily shipped to our customers from our Cedar Rapids and East Coast fulfillment centers, but may also be shipped from our Nordstrom full-line stores. We engage with our customers on their terms, blurring the lines between the digital and in-store experience. Our customers can pick up online orders in our Nordstrom full-line stores if inventory is available at one of our locations, or reserve clothes online to try in store in many of our locations. Nordstrom Local is a test retail concept that is focused on services, providing customers convenient access to personal stylists, alterations, online orders and more. We also leverage the expertise of our salespeople to enable customers to receive personalized product recommendations on their mobile phones through our digital Style Board selling tool. These capabilities allow us to better serve customers across various channels and improve sales.

Nordstrom Rack stores purchase merchandise primarily from the same vendors carried in Nordstrom full-line stores and also serve as outlets for clearance merchandise from our Nordstrom stores and other retail channels. Nordstromrack.com/HauteLook offers a consistent selection of off-price merchandise, as well as limited-time sale events on fashion and lifestyle brands and are integrated with a single customer log-in, shared shopping cart and streamlined checkout process. Nordstromrack.com combines the technology expertise of HauteLook with the merchant expertise of Nordstrom Rack. Online purchases are primarily shipped to our customers from our San Bernardino, California and East Coast fulfillment centers. Furthermore, we can accommodate returns from these sites by mail or at any Nordstrom Rack location.

Through our Credit segment, our customers can access a variety of payment products and services, including a selection of Nordstrom-branded Visa® credit cards in the U.S. and Canada, as well as a Nordstrom-branded private label credit card and a debit card for Nordstrom purchases. When customers use a Nordstrom-branded credit or debit card, they also participate in our loyalty program that provides benefits based on their level of spending. Although the primary purposes of our Credit segment are to foster greater customer loyalty and drive more sales, we also receive credit card revenue through our program agreement with TD Bank, N.A. (“TD”) (see Note 2: Credit Card Receivable

Transaction in Item 8).

We invested early in our omni-channel capabilities, integrating our operations, merchandising and technology across our stores and online, in both our Nordstrom full-price and Nordstrom Rack off-price businesses. Today, we have more than 60 combinations in which merchandise is ordered, fulfilled and delivered. Though this has enabled us to serve customers in multiple ways, we are focused on providing a seamless experience for our customer across stores and online. As a result of the evolution of our operations, our reportable segments have become progressively more integrated such that we will change our reportable segments to one reportable segment to align with how management will view the results of our operations in the first quarter of 2018. For more information about our business and our reportable segments, see Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 15: Segment Reporting in Item 8.

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FISCAL YEAR
We operate on a 52/53-week fiscal year ending on the Saturday closest to January 31st. References to 2017 relate to the 53-week fiscal year ended February 3, 2018. References to any other years included within this document are based on a 52-week fiscal year.
RETURN POLICY
We have a fair and reasonable approach to returns, handling them on a case-by-case basis with the ultimate objective of making our customers happy. We have no formal return policy on how long we accept returns at our Nordstrom full-line stores or online at Nordstrom.com. Our goal is to take care of our customers, which includes making returns and exchanges easy, whether in stores or online, where we offer free shipping on purchases and returns. Our Nordstrom Rack stores generally accept returns up to 90 days from the date of purchase with the original price tag and sales receipt and accept returns of Nordstromrack.com/HauteLook merchandise. Nordstromrack.com/HauteLook generally accepts returns of apparel, footwear, accessories and HauteLook home products within 90 days from the date of shipment. Beginning in 2018, our off-price channels accept returns 45 days from the date of purchase or shipment.
SEASONALITY
Our business, like that of other retailers, is subject to seasonal fluctuations. Due to our Anniversary Sale in July and the holidays in the fourth quarter, our sales are typically higher in the second and fourth quarters than in the first and third quarters of the fiscal year. Consistent with the timing in 2016, our 2017 Anniversary Sale began in the third week of July and extended one week into the third quarter.
NORDSTROM REWARDS
Our Nordstrom Rewards™ loyalty program, which rewards customers based on their level of spending, is one area that enables us to directly engage and strengthen relationships with customers while driving incremental sales and trips. Upon reaching certain point thresholds, customers receive Nordstrom Notes® (“Notes”), which can be redeemed for goods or services. In May 2016, we expanded the program to any customer interested in participating, when historically this program was offered only to Nordstrom cardholders. Notes can be earned and redeemed at Nordstrom full-line stores, Nordstrom.com, Nordstrom Rack and Nordstromrack.com/HauteLook. Nordstrom cardholders can also earn rewards at Trunk Club. Customers who participate in our Nordstrom Rewards loyalty program through our credit and debit cards receive additional benefits including reimbursements for alterations, Personal Triple Points days, shopping and fashion events and early access to the Anniversary Sale.
COMPETITIVE CONDITIONS
We operate in a highly competitive business environment. We compete with other international, national, regional and local retailers, including internet-based businesses, omni-channel department stores, specialty stores, off-price stores and boutiques, that may carry similar lines of merchandise. Our specific competitors vary from market to market. We believe the keys to competing in our industry are providing great customer service and customer experiences in stores and online. This includes offering compelling price and value, fashion newness, quality of products, selection, convenience, technology, product fulfillment, personalization and appealing, relevant store environments in top locations.
INVENTORY
We plan our merchandise purchases and receipts to coincide with expected sales trends. For instance, our merchandise purchases and receipts increase prior to our Anniversary Sale, which has historically extended over the last two weeks of July. We also purchase and receive a larger amount of merchandise in the fall as we prepare for the holiday shopping season (from late November through December). At Nordstrom Rack, we invest in pack and hold inventory, which involves the strategic purchase of merchandise from some of our full-line stores’ top brands in advance of the upcoming selling seasons, to take advantage of favorable buying opportunities. This inventory is typically held for six months on average and has been an important component of Nordstrom Rack’s inventory strategy.
In order to offer merchandise that our customers want, we purchase from a wide variety of high-quality domestic and foreign suppliers. We also have arrangements with agents and contract manufacturers to produce our private label

merchandise. We expect our suppliers to meet our “Nordstrom Partnership Guidelines,” which address our corporate social responsibility standards for matters such as legal and regulatory compliance, labor, health and safety and the environment. This is available on our website at Nordstrom.com.

EMPLOYEES

During 2017, we employed approximately 72,500 employees on a full- or part-time basis. Due to the seasonal nature of our business, employment increased to approximately 75,000 employees in July 2017 and 76,000 in December 2017. All of our employees are non-union. We believe our relationship with our employees is good.

TRADEMARKS

We have 193 trademarks, each of which is the subject of one or more trademark registrations and/or trademark applications. Our most notable trademarks include Nordstrom, Nordstrom Rack, HauteLook and Trunk Club. Our most notable brand trademarks include Halogen, BP., Nordstrom, Zella, Caslon, Tucker+Tate and 14th & Union. Each of our trademarks is renewable indefinitely, provided that it is still used in commerce at the time of the renewal.

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CAUTIONARY STATEMENT

Certain statements in this Annual Report on Form 10-K contain or may suggest “forward-looking” information (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties including, but not limited to, our anticipated financial outlook for the fiscal year ending February 2, 2019, our anticipated annual total and comparable sales rates, our anticipated new store openings in existing, new and international markets, our anticipated Return on Invested Capital and trends in our operations. Such statements are based upon the current beliefs and expectations of our management and are subject to significant risks and uncertainties. Our actual future results may differ materially from historical results or current expectations depending upon factors including, but not limited to:

Strategic and Operational

- successful execution of our customer strategy to provide a differentiated and seamless experience across all Nordstrom channels,
- timely and effective implementation of our plans to evolve our business model, including development of applications for electronic devices, improvement of customer-facing technology, timely delivery of products purchased digitally, enhancement of inventory management systems, greater and more fluid inventory availability between our digital channels and retail store locations, and greater consistency in marketing and pricing strategies, as well as our ability to manage the costs associated with this evolving business model,
- our ability to evolve our business model as necessary to respond to the business and retail environment, as well as fashion trends and consumer preferences, including changing expectations of service and experience in stores and online,
- our ability to properly balance our investments in existing and new store locations, especially our investments in our Nordstrom Men’s Store NYC and Nordstrom NYC,
- successful execution of our information technology strategy,
- our ability to effectively utilize data in strategic planning and decision making,
- timely completion of construction associated with newly planned stores, relocations and remodels, all of which may be impacted by the financial health of third parties and consumer traffic to the locations,
- efficient and proper allocation of our capital resources,
- effective inventory management processes and systems, fulfillment and supply chain processes and systems, disruptions in our supply chain and our ability to control costs,
- the impact of any systems or network failures, cybersecurity and/or security breaches, including any security breach of our systems or those of a third-party provider that results in the theft, transfer or unauthorized disclosure of customer, employee or Company information or compliance with information security and privacy laws and regulations in the event of such an incident,
- the effect of the publicly announced exploration by members of the Nordstrom family of a possible “going private transaction” on our relationships with our customers, employees, suppliers and partners, on our operating results and on our business generally,
- our ability to safeguard our reputation and maintain our vendor relationships,
- our ability to maintain relationships with and motivate our employees and to effectively attract, develop and retain our future leaders, which could be impacted by the uncertainty about the possibility of a “going private transaction”,
- our ability to realize the expected benefits, respond to potential risks and appropriately manage costs associated with our program agreement with TD,
- the effectiveness of planned advertising, marketing and promotional campaigns in the highly competitive and promotional retail industry,
- market fluctuations, increases in operating costs, exit costs and overall liabilities and losses associated with owning and leasing real estate,
- potential goodwill impairment charges, future impairment charges and fluctuations in the fair values of reporting units or of assets in the event projected financial results are not achieved within expected time frames,

- compliance with debt and operating covenants, availability and cost of credit, changes in our credit rating and changes in interest rates,
- the timing, price, manner and amounts of future share repurchases by the Company, if any, or any share issuances by the Company,

Economic and External

- the impact of the seasonal nature of our business and cyclical customer spending,
- the impact of economic and market conditions and the resultant impact on consumer spending and credit patterns,
- the impact of economic, environmental or political conditions in the U.S. and countries where our third-party vendors operate,
- weather conditions, natural disasters, health hazards, national security or other market and supply chain disruptions, or the prospects of these events and the resulting impact on consumer spending patterns or information technology systems and communications,

Legal and Regulatory

- our compliance with applicable domestic and international laws, regulations and ethical standards, including those related to employment and tax, and the outcome of claims and litigation and resolution of such matters,
- the impact of the current regulatory environment and financial system, health care, and tax reforms,
- the impact of changes in accounting rules and regulations, changes in our interpretation of the rules or regulations, or changes in underlying assumptions, estimates or judgments.

These and other factors, including those factors described in Item 1A: Risk Factors, could affect our financial results and cause actual results to differ materially from any forward-looking information we may provide. We undertake no obligation to update or revise any forward-looking statements to reflect subsequent events, new information or future circumstances, except as may be required by law.

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SEC FILINGS

We file annual, quarterly and current reports, proxy statements and other documents with the Securities and Exchange Commission (“SEC”). All the materials we file with the SEC are publicly available at the SEC’s Public Reference Room at 100 F Street NE, Washington, DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website at www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

WEBSITE ACCESS

Our website address is Nordstrom.com. Our annual and quarterly reports on Form 10-K and Form 10-Q (including related filings in eXtensible Business Reporting Language (“XBRL”) format), current reports on Form 8-K, proxy statements, our executives’ statements of changes in beneficial ownership of securities on Form 4 and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) are available for free on or through our website as soon as reasonably practicable after we electronically file the report with or furnish it to the SEC. Interested parties may also access a webcast of quarterly earnings conference calls and other financial events through our website.

CORPORATE GOVERNANCE

We have a long-standing commitment to upholding a high level of ethical standards. In addition, as the listing standards of the New York Stock Exchange (“NYSE”) and the rules of the SEC require, we have adopted Codes of Business Conduct and Ethics for our employees, officers and directors (“Codes of Ethics”) and Corporate Governance Guidelines. Our Codes of Ethics, Corporate Governance Guidelines and Committee Charters for the Audit, Compensation, Corporate Governance and Nominating, Finance and Technology Committees are posted on our website. Any amendments to these documents, or waivers of the requirements they contain, will also be available on our website.

For printed versions of these items or any other inquiries, please contact:

Nordstrom Investor Relations
1617 Sixth Avenue, Suite 500
Seattle, Washington 98101
(206) 303-3200
invrelations@nordstrom.com

Item 1A. Risk Factors.

Our business faces many risks. We believe the risks described below outline the items of most concern to us.

RISKS DUE TO STRATEGIC AND OPERATIONAL FACTORS

Our inability to successfully execute our customer strategy or our plans to evolve our business model could negatively impact our business and future profitability and growth.

The retail environment is rapidly evolving with customer shopping preferences continuing to shift to digital channels. Computers and mobile electronic devices allow customers to browse and transact anywhere and anytime. Our customer strategy focuses on providing a differentiated and seamless experience across all Nordstrom channels, whether in store or in the digital environment. We are enhancing our customer shopping experience in our stores and online, including mobile and social channels, by pursuing a heightened focus on digital technology to fuel our growth. Our growth strategies in this area span the development of applications for electronic devices, improvement of customer-facing technology, timely delivery of products purchased digitally, enhancement of inventory management systems, greater and more fluid inventory availability between digital and retail locations, and greater consistency in marketing and pricing strategies. In addition, these strategies will require further expansion and reliance on data science and analytics across all our channels. This business model has a high variable cost structure driven by fulfillment and marketing costs and will continue to require investment in cross-channel operations and supporting technologies.

With the accelerated pace of change in the retail environment, we may not be able to meet our customers' changing expectations of how they shop in stores or through digital channels. If we do not successfully implement and expand our digital initiatives, or do not seamlessly integrate or maintain them properly, we may fall short of our customer's expectations, impacting our brand, reputation, profitability and growth. In addition, if customers shift to digital channels at a different pace than we anticipate, we may need to quickly modify our initiatives and investments, which may adversely impact our profitability and harm our competitive position. We also may not gather accurate and relevant data or effectively utilize that data, which may impact our strategic planning and decision making.

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Our business could suffer if we do not appropriately assess and react to competitive market forces and changes in customer behavior.

We compete with other international, national, regional and local retailers, including internet-based businesses, omni-channel department stores, specialty stores, off-price stores and boutiques, that may carry similar lines of merchandise. Digital channels continue to facilitate comparison shopping, intensifying competition in the retail market. If we fail to adequately anticipate and respond to customer and market dynamics, we may lose market share or our ability to remain competitive, causing our sales and profitability to suffer. If we do not properly allocate our capital between the store and digital environment or between the full-price and off-price channels, or adjust the effectiveness and efficiency of our stores and digital channels, our overall sales and profitability could suffer.

Our customer relationships and sales may be negatively impacted if we do not anticipate and respond to consumer preferences and fashion trends or manage inventory levels appropriately.

Our ability to predict or respond to constantly changing fashion trends, consumer preferences and spending patterns significantly impacts our sales and operating results. If we do not identify and respond to emerging trends in consumer spending and preferences quickly enough, we may harm our ability to retain our existing customers or attract new customers. If we purchase too much inventory, we may be forced to sell our merchandise at lower average margins, which could harm our business. Conversely, if we fail to purchase enough merchandise, we may lose opportunities for additional sales and potentially harm relationships with our customers.

The investment in existing and new store locations, including our Nordstrom Men’s Store NYC and Nordstrom NYC, may outpace our expected returns.

The locations of our existing stores and planned store openings are assessed based upon desirability, demographics, and retail environment. This involves certain risks, including properly balancing our capital investments between new stores, relocations, remodels, technology and digital channels, assessing the suitability of locations, especially in new domestic and international markets, and constructing, furnishing and supplying a store in a timely and cost-effective manner. In particular, we plan to open our Nordstrom Men’s Store NYC in Spring 2018 and our Nordstrom NYC store in 2019.

Sales at our stores may not meet projections, particularly in light of the changing trends between digital and brick-and-mortar shopping channels, which could adversely affect our return on investment. As we enter into new domestic and international markets, such as Manhattan and Canada, our efforts will require additional management attention and resources and may distract us from executing our core operations.

Even if we take appropriate measures to safeguard our information security and privacy environment from security breaches, our customers and our business could still be exposed to risk.

Nordstrom, our subsidiaries and, in some instances, our third-party vendors collect, store and transmit customers’ personal information, consumer preferences and credit card information. In addition, our operations involve the collection, storage and transmission of employee information and our financial and strategic data. Security breaches of this information may be the result of intentional or inadvertent activities by our employees or by third parties with whom we have business relationships that may result in the unauthorized release of customer or employee personal or confidential information.

Any measures we implement to prevent a security or cybersecurity threat may not be completely effective and may have the potential to harm relations with our customers and employees or decrease activity on our websites by making them more difficult to use. In addition, the regulatory environment surrounding information security, cybersecurity and privacy is increasingly demanding, with new and constantly changing requirements.

Security breaches and cyber incidents and their remediation, whether at Nordstrom, our third-party providers or other retailers, could expose us to a risk of loss or misappropriation of this information, litigation, regulatory enforcement action, fines, information technology system failures or network disruptions, potential liability, reputation damage and loss of customers’ trust and business, any of which could adversely impact our financial performance. Any such breaches or incidents could subject us to financial losses, investigation, notification and remediation costs, which may not be covered by our insurance policies. If there is additional information that is later discovered related to such security breach or incident, there could be further loss of shareholders' and customers' trust and business based upon their reactions to this additional information. Additionally, we could be subject to external credit card fraud. To the extent that any incident results in the loss, damage or misappropriation of information, we may be materially adversely affected by claims from our customers, financial institutions, regulators, payment card networks and other third parties.

Our business may be impacted by information technology system failures or network disruptions.

Our ability to transact with customers and operate our business depends on the efficient operation of our computer and communications systems. If we encounter an interruption or deterioration in critical processes or experience the loss of critical data, which may result from natural disasters, accidents, power disruptions, telecommunications failures, acts of terrorism or war, computer viruses, physical or electronic break-ins, security or cybersecurity threats or attacks or third-party or other disruptions, our business could be harmed. Depending on the severity of the failure, our disaster recovery plans may be inadequate or ineffective. These events could also damage our reputation, result in loss of sales and be expensive to remedy.

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Improvements to our merchandise buying and fulfillment processes and systems could adversely affect our business if not successfully executed.

We are making investments to improve our merchandise planning, procurement, allocation and fulfillment capabilities through changes in personnel, processes, location logistics and technology over a period of several years. If we encounter challenges associated with change management, the ability to hire and retain key personnel involved in these efforts, implementation of associated information technology or adoption of new processes, our ability to continue to successfully execute our strategy or evolve our strategy with changes in the retail environment could be adversely affected. As a result, we may not derive the expected benefits to our sales and profitability, or we may incur increased costs relative to our current expectations.

The possibility of a "going private transaction" by the Nordstrom family could negatively impact our operating results, business and relationships with our customers, employees, suppliers and partners.

In June 2017, members of the Nordstrom family formed a group (the "Group") to explore the possibility of pursuing a "going private transaction" involving the acquisition by the Group of 100% of our outstanding shares of common stock (a "Going Private Transaction"). The Board of Directors also formed a special committee (the "Special Committee") comprised of independent directors to act on the Company's behalf in connection with such exploration by the Group and any possible transaction. In October 2017, the Group informed the Special Committee that the Group has suspended active exploration of a Going Private Transaction for the balance of the year. The Group also informed the Special Committee that it intends to continue its efforts to explore the possibility of making a going private proposal after the conclusion of the holiday season. In March 2018, the Group delivered an indicative proposal to the Special Committee regarding a Going Private Transaction. The Special Committee determined that the price proposed is inadequate. No assurances can be given regarding the terms and details of any such transaction, that any proposal made by the Group, if any, will be accepted by the Special Committee, that definitive documentation relating to a transaction will be executed, or that a transaction will be consummated in accordance with that documentation, if at all. We do not plan to disclose developments or provide updates on the progress or status of any potential Going Private Transaction until the Special Committee deems further disclosure is appropriate or required. Speculation regarding any developments related to the review of a Going Private Transaction and perceived uncertainties related to our future could cause our stock price to fluctuate significantly.

The possibility of a Going Private Transaction or any other alternative may expose us and our operations to a number of risks and uncertainties, including the potential failure to retain, attract or strengthen our relationships with key personnel, current and potential customers, suppliers, and partners, which may cause them to terminate, or not to renew or enter into, arrangements with us; the potential incurrence of expenses associated with the retention of legal, financial and other advisors regardless of whether any transaction is consummated; distractions and disruptions in our business; and exposure to potential litigation in connection with this process and effecting any transaction, any of which could adversely affect our business, financial condition and results of operations as well as the market price of our common stock.

Our customer, employee and vendor relationships could be negatively affected if we fail to maintain our corporate culture and reputation.

We have a well-recognized culture and reputation that consumers may associate with a high level of integrity, customer service and quality merchandise, and it is one of the reasons customers shop with us and employees choose us as a place of employment. Any significant damage to our reputation, including factors outside our control or on social media, could diminish customer trust, weaken our vendor relationships, reduce employee morale and productivity and lead to difficulties in recruiting and retaining qualified employees. Additionally, management may not accurately assess the impact of significant legislative changes, including those that relate to privacy, employment matters and health care, impacting our relationship with our customers or our workforce and adversely affecting our sales and operations.

If we do not effectively design and implement our strategic and business planning processes to attract, retain, train and develop talent and future leaders, our business may suffer.

We rely on the experience of our senior management, who have specific knowledge relating to us and our industry that is difficult to replace, and the talents of our workforce to execute our business strategies and objectives. We have succession plans in place and our Board of Directors reviews these succession plans. If our succession plans do not adequately cover significant and unanticipated turnover, the loss of the services of any of these individuals, or any resulting negative perceptions of our business, could damage our reputation and our business. Additionally, our ability to maintain relationships with and motivate our employees and to effectively attract, develop and retain our future leaders, could be impacted by the uncertainty about the possibility of a Going Private Transaction.

Our program agreement with TD could adversely impact our business.

The program agreement with TD was consummated on terms that allow us to maintain customer-facing activities while TD provides Nordstrom-branded payment methods and payment processing services. If we fail to meet certain service levels, TD has the right to assume certain individual servicing functions. If we lose control of such activities and functions, if we do not successfully respond to potential risks and appropriately manage potential costs associated with the program agreement with TD, or if these transactions negatively impact the customer service associated with our cards, resulting in harm to our business reputation and competitive position, our operations, cash flows and returns to shareholders could be adversely affected. If TD became unwilling or unable to provide these services or if there are changes to the risk management policies implemented under our program agreement with TD, our results may be negatively impacted.

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Ownership and leasing real estate exposes us to possible liabilities and losses.

We own or lease the land and/or buildings for all of our stores and are therefore subject to all of the risks associated with owning and leasing real estate. In particular, the value of the assets could decrease, their operating costs could increase, or a store may not be opened as planned due to changes in the real estate market, demographic trends, site competition, dependence on third-party performance or overall economic environment. Additionally, we are potentially subject to liability for environmental conditions, exit costs associated with disposal of a store, commitments to pay base rent for the entire lease term or operate a store for the duration of an operating covenant.

Investment and partnerships in new business strategies and acquisitions could disrupt our core business.

We have invested in or are pursuing strategic growth opportunities, which may include acquisitions of, or investments in, other businesses, as well as new technologies or other investments to provide a superior customer shopping experience in our stores and digital channels. Additionally, our business model will continue to rely more on partnerships with third parties for certain strategic initiatives and technologies. If these investments, acquisitions or partnerships do not perform as expected or create operational difficulties, we may record impairment charges. If we do not realize our anticipated return on investments, our profitability and growth could be adversely affected.

If we fail to appropriately manage our capital, we may negatively impact our operations and shareholder return.

We utilize working capital to finance our operations, make capital expenditures and acquisitions, manage our debt levels and return value to our shareholders through dividends and share repurchases. Changes in the credit and capital markets, including market disruptions, limited liquidity and interest rate fluctuations, may increase the cost of financing or restrict access to a potential source of liquidity. A deterioration in our capital structure or the quality and stability of our earnings could result in noncompliance with our debt covenants or a downgrade of our credit rating, constraining the financing available to our Company. If our access to financing is restricted or our borrowing costs increase, our operations and financial condition could be adversely impacted. Further, if we do not properly allocate our capital to maximize returns, our operations, cash flows and returns to shareholders could be adversely affected.

The concentration of stock ownership in a small number of our shareholders could limit our shareholders’ ability to influence corporate matters.

We have regularly reported in our annual proxy statements the holdings of members of the Nordstrom family, including Bruce A. Nordstrom, our former Co-President and Chairman of the Board, his sister Anne E. Gittinger and members of the Nordstrom family within our Executive Team. According to the Schedule 13D/A filed with the SEC on March 5, 2018, these individuals beneficially owned an aggregate of approximately 31% of our common stock. As a result, either individually or acting together, they may be able to exercise considerable influence over matters requiring shareholder approval. In addition, as reported in our periodic filings, our Board of Directors has from time to time authorized share repurchases. While these share repurchases may be offset in part by share issuances under our equity incentive plans and as consideration for acquisitions, the repurchases may nevertheless have the effect of increasing the overall percentage ownership held by these shareholders. The corporate law of the State of Washington, where the Company is incorporated, provides that approval of a merger or similar significant corporate transaction requires the affirmative vote of two-thirds of a company’s outstanding shares. The beneficial ownership of these shareholders may have the effect of discouraging offers to acquire us, delay or otherwise prevent a significant corporate transaction because the consummation of any such transaction would likely require the approval of these shareholders. As a result, the market price of our common stock could be affected.

RISKS DUE TO ECONOMIC AND EXTERNAL MARKET FACTORS

Our revenues and operating results are affected by the seasonal nature of our business and cyclical trends in consumer spending.

Our business, like that of other retailers, is subject to seasonal fluctuations and cyclical trends in consumer spending. Due to our Anniversary Sale in July and the holidays in the fourth quarter, our sales are typically higher in the second and fourth quarters than in the first and third quarters of the fiscal year. Any factor that negatively impacts these selling seasons could have an adverse effect on our results of operations for the entire year. To provide shareholders a better understanding of management’s expectations surrounding results, we provide public guidance on our expected operating and financial results for future periods comprised of forward-looking statements subject to certain risks and uncertainties.

A downturn in economic conditions and other external market factors could have a significant adverse effect on our business and stock price.

During economic downturns, fewer customers may shop for the high-quality items in our stores and on our websites, as these products may be seen as discretionary, and those who do shop may limit the amount of their purchases. This reduced demand may lead to lower sales, higher markdowns and an overly promotional environment or increased marketing and promotional spending.

Additionally, factors such as results differing from guidance, changes in sales and operating income in the peak seasons, changes in our market valuations, performance results for the general retail industry, announcements by us or our industry peers or changes in analysts' recommendations may still impact the price of our common stock and our shareholder returns.

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Our stores located in shopping malls may be adversely affected by any declines in consumer traffic of malls.
The majority of our stores are located within shopping malls and benefit from the abilities that we and other anchor tenants have to generate consumer traffic. A substantial decline in mall traffic, the development of new shopping malls, the availability of locations within existing or new shopping malls, the success of individual shopping malls and the success of other anchor tenants may negatively impact our ability to maintain or grow our sales in existing stores, as well as our ability to open new stores, which could have an adverse effect on our financial condition or results of operations.
Our business depends on third parties for the production, supply or delivery of goods, and a disruption could result in lost sales or increased costs.
The continued success of our operations is tied to our timely receipt of quality merchandise from third parties. Our process to identify qualified vendors and access quality products in an efficient manner on acceptable terms and cost can be complex. Violations of law with respect to quality and safety by our importers, manufacturers or distributors could result in delays in shipments and receipt of goods or damage our reputation, resulting in lost sales. These vendors may experience difficulties due to economic or political conditions or the countries in which merchandise is manufactured could become subject to new trade restrictions, including increased customs restrictions, tariffs or quotas. Additionally, changes in tax and trade policies that impact the retail industry, such as increased taxation on imported goods, could have a material adverse effect on our business, results of operations and liquidity.
The results of our Credit operations could be adversely affected by changes in market conditions.
Revenues earned under our program agreement with TD are indirectly subject to economic and market conditions that are beyond our control, including, but not limited to, interest rates, consumer credit availability, demand for credit, consumer debt levels, payment patterns, delinquency rates, employment trends and other factors. Changes in these economic and market conditions could impair our revenues and profitability.
Our business and operations could be materially and adversely affected by supply chain disruptions, port disruptions, severe weather patterns, natural disasters, widespread pandemics and other natural or man-made disruptions.
These disruptions could cause, among other things, a decrease in consumer spending that would negatively impact our sales, staffing shortages in our stores, distribution centers or corporate offices, interruptions in the flow of merchandise to our stores, disruptions in the operations of our merchandise vendors or property developers, increased costs and a negative impact on our reputation and long-term growth plans. We have a significant amount of our total sales, stores and square footage in the west coast of the United States, particularly in California, which increases our exposure to market-disrupting conditions in this region.
RISKS DUE TO LEGAL AND REGULATORY FACTORS
We are subject to certain laws, litigation, regulatory matters and ethical standards, and our failure to comply with or adequately address developments as they arise could adversely affect our reputation and operations.
Our policies, procedures and practices and the technology we implement are designed to comply with federal, state, local and foreign laws, rules and regulations, including those imposed by the SEC, consumer protection and other regulatory agencies, the marketplace, and foreign countries, as well as responsible business, social and environmental practices, all of which may change from time to time. Compliance with laws and regulations and/or significant legislative changes may cause our business to be adversely impacted, or even limit or restrict the activities of our business. In addition, if we fail to comply with applicable laws and regulations or implement responsible business, social, environmental and supply chain practices, we could be subject to damage to our reputation, class action lawsuits, legal and settlement costs, civil and criminal liability, increased cost of regulatory compliance, losing our ability to accept credit and debit card payments from our customers, restatements of our financial statements, disruption of our business and loss of customers. Any required changes to our employment practices could result in the loss of employees, reduced sales, increased employment costs, low employee morale and harm to our business and results of operations. In addition, political and economic factors could lead to unfavorable changes in federal, state and foreign tax laws, which may affect our tax assets or liabilities and adversely affect our results of operations. We are also regularly involved in various litigation matters that arise in the ordinary course of business. Litigation or

regulatory developments could adversely affect our business and financial condition.

Changes to accounting rules and regulations could affect our financial results or financial condition.

Accounting principles and related pronouncements, implementation guidelines and interpretations with regard to a wide variety of accounting matters that are relevant to our business, including, but not limited to, revenue recognition, merchandise inventories, leasing, goodwill, impairment of long-lived assets, stock-based compensation and tax matters are highly complex and involve subjective assumptions, estimates and judgments. Changes in these rules and regulations, changes in our interpretation of the rules or regulations or changes in underlying assumptions, estimates or judgments could adversely affect our financial performance or financial position.

Item 1B. Unresolved Staff Comments.

None.

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Item 2. Properties.

The following table summarizes the number of retail stores we own or lease, and the percentage of total store square footage represented by each listed category as of February 3, 2018:

	Number of stores			
	Nordstrom Full-Line Stores[1]	Nordstrom Rack and Other[2]	% of total store square footage	
Leased stores on leased land	26	242	44	%
Owned stores on leased land	63	—	37	%
Owned stores on owned land	33	1	18	%
Partly owned and partly leased store	1	—	1	%
Total	123	243	100	%

[1] Nordstrom full-line stores include U.S. full line stores, Canada full-line stores and Nordstrom Local.

[2] Other includes Trunk Club clubhouses, Jeffrey boutiques and Last Chance stores.

The following table summarizes our retail store openings and closures for fiscal 2017 and announced retail store openings and closures for fiscal 2018 by state/province:

	Number of stores					
Fiscal year	2017			Announced 2018		
State/Province	Nordstrom Full-Line Stores[1]		Nordstrom Rack and Other[2]	Nordstrom Full-Line Stores[1]		Nordstrom Rack and Other[2]
Openings						
U.S.						
Arizona	—		—	—		1
California	1		3	—		1
Florida	—		1	—		—
Illinois	—		2	—		1
Indiana	—		1	—		—
Maryland	—		1	—		—
Minnesota	—		2	—		—
New Jersey	—		—	—		1
New York	—		1	1		—
Oregon	—		1	—		—
Pennsylvania	—		—	—		1
Tennessee	—		1	—		—
Texas	—		2	—		1
Washington	—		2	—		—
Canada						
Alberta	—		—	—		2
Ontario	1		—	—		4
Total Openings	2		17	1		12
Closures						
California	(1	)	—	—		—
Oregon	—		—	(1	)	—
Virginia	(1	)	—	—		—
Total Closures	(2	)	—	(1	)	—

[1] Nordstrom full-line stores include U.S. full line stores, Canada full-line stores and Nordstrom Local.

[2] Other includes Trunk Club clubhouses, Jeffrey boutiques and Last Chance stores.

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The following table lists our retail store count and square footage by state/province as of February 3, 2018:

Retail stores by channel	Nordstrom Full-Line Stores[1]		Nordstrom Rack and Other[2]		Total	
State/Province	Count	Square Footage (000's)	Count	Square Footage (000's)	Count	Square Footage (000's)
U.S.						
Alabama	—	—	1	35	1	35
Alaska	1	43%	43%			

Three months ended July 2, 2006 compared to the three months ended July 3, 2005

The consolidated gross profit margin as a percentage of revenues decreased to 42.7% for the three months ended July 2, 2006 from 44.0% for the three months ended July 3, 2005.

Semiconductor segment:

The gross profit margin as a percentage of revenues for the Semiconductor segment was 48.9% for the three months ended July 2, 2006. A more detailed description of factors affecting the gross profit margins for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005 is as follows:

Manufacturing variances for the Gresham facility were more favorable for the three months ended July 2, 2006 compared to the three months ended July 3, 2005 as a result of yield improvements and operating cost savings attributable to write-downs recorded in the second half of 2005 related to the impairment of the Gresham manufacturing facility. These improvements were offset by:

An unfavorable shift in product mix including selling fewer semiconductors for applications such as video games for the three months ended July 2, 2006,

Lower average selling prices for semiconductors used in DVD-R products,

Stock-based compensation expense associated with the adoption of SFAS 123R as of January 1, 2006. See Note 2 of the Notes to the Consolidated Condensed Financial Statements (the Notes).

Storage Systems segment:

The gross profit margin as a percentage of revenues for the Storage Systems segment decreased to 32.4% for the three months ended July 2, 2006 from 34.3% for the three months ended July 3, 2005. The decrease in gross profit margins is attributable to start -up costs related to the introduction of our new mid-range system product and stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006.

Six months ended July 2, 2006 compared to the six months ended July 3, 2005

The consolidated gross profit margin as a percentage of revenues was flat for the six months ended July 2, 2006 as compared to the six months ended July 3, 2005. The consolidated gross margin as a percentage of revenues was 42.8% and 43.1% for the six months ended July 2, 2006 and July 3, 2005, respectively.

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Semiconductor segment:

The gross profit margin as a percentage of revenues for the Semiconductor segment was flat for the six months ended July 2, 2006 as compared to the six months ended July 3, 2005. The Semiconductor segment gross margin as a percentage of revenues is 47.8% for the six months ended July 2, 2006 and July 3, 2005. A more detailed description of factors affecting the gross profit margins in the first half of 2006 as compared to the same period of 2005 is as follows:

Manufacturing variances for the Gresham facility were more favorable for the first six months of 2006 compared to the same period of 2005 as a result of yield improvements and operating cost savings attributable to write-downs recorded for the six months ended July 3, 2005 related to the impairment of the Gresham manufacturing facility. These improvements were offset by:

An unfavorable shift in product mix including selling fewer semiconductors for applications such as video games for the three months ended July 2, 2006,

Lower average selling prices for semiconductors used in DVD-R products, and

Stock-based compensation expense associated with the adoption of SFAS 123R as of January 1, 2006 (See Note 2 of the Notes).

Storage Systems segment:

The gross profit margin as a percentage of revenues for the Storage Systems segment increased to 34.5% for the six months ended July 2, 2006 from 33.5% for the six months ended July 3, 2005. The increase in gross profit margins is attributable to improved product mix associated with the introduction of our new high-end controller product in June of 2005 and material cost reductions in the first half of 2006. These increases were offset in part by the start-up costs related to the introduction of our new mid-range system product and stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006.

During the three months ended July 2, 2006, we completed the sale of our Gresham, Oregon semiconductor manufacturing facility to ON Semiconductor for approximately $105.0 million in cash. Under the terms of the agreement, ON Semiconductor offered employment to substantially all of the LSI manufacturing employees based at the Gresham site, with the remaining non-manufacturing workforce expected to continue their employment with LSI. ON Semiconductor also entered into additional agreements with LSI, including a multi-year wafer supply and test agreement, intellectual property license agreement, transition services agreement and a facilities use agreement.

We own our Storage Systems segment manufacturing facility in Wichita, Kansas. In addition, we acquire wafers, assembly and test services from vendors in Taiwan, Japan, Malaysia, Korea, Mexico, Thailand, Singapore and China and outsource a portion of our Storage Systems segment manufacturing to facilities in Ireland. Utilizing diverse manufacturing locations allows us to better manage potential disruption in the manufacturing process due to economic and geographic risks associated with each location.

Our operating environment, combined with the resources required to operate in the Semiconductor and Storage Systems industries, requires that we manage a variety of factors. These factors include, among other things:

Competitive pricing pressures;

Product mix;

Factory capacity and utilization;

Geographic location of manufacturing;

Manufacturing yields;

Availability of certain raw materials;

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Adoption of new industry standards;

Terms negotiated with third-party subcontractors; and

Foreign currency fluctuations.

These and other factors could have a significant effect on our gross profit margin in future periods.

Research and development:

	Three months ended		Six months ended	
	July 2, 2006	**July 3, 2005**	**July 2, 2006**	**July 3, 2005**
	(in millions)			
Semiconductor segment	$ 77.6	$ 77.6	$159.2	$156.8
Percentage of revenues	25%	24%	26%	25%
Storage Systems segment	$ 22.8	$ 22.6	$ 43.4	$ 43.5
Percentage of revenues	13%	15%	12%	14%
Consolidated	$100.4	$100.2	$202.6	$200.3
Percentage of revenues	21%	21%	21%	22%

Three months ended July 2, 2006 compared to the three months ended July 3, 2005

Research and development (R&D) expenses remained relatively flat for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005.

Semiconductor segment:

R&D expenses in the Semiconductor segment remained relatively flat for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. R&D expenses for the Semiconductor segment increased primarily as the result of an increase in stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006 and higher salaries due to annual merit increases, offset by lower depreciation and amortization related expenses and lower spending on design engineering programs.

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Storage Systems segment:

R&D expenses in the Storage Systems segment remained relatively flat for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. R&D expenses as a percentage of Storage Systems segment revenues were 12.5% for the second quarter of 2006 as compared to 14.5% for the same period of 2005 due to an increase in revenues for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005, offset in part by an increase in stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006.

Six months ended July 2, 2006 compared to the six months ended July 3, 2005

R&D expenses increased $2.3 million or 1.1% during the first six months ended July 2, 2006 as compared to the six months ended July 3, 2005.

Semiconductor segment:

R&D expenses in the Semiconductor segment increased $2.4 million or 1.5% in the six months ended July 2, 2006 as compared to the six months ended July 3. 2005. The increase in R&D expenses for the Semiconductor segment is primarily the result of an increase in stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006, and higher salaries due to annual merit increases, offset primarily by lower depreciation and amortization related expenses and lower spending on design engineering programs.

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Storage Systems segment:

R&D expenses in the Storage Systems segment remained relatively flat in the first six months of 2006 as compared to the same period of 2005. R&D expenses as a percentage of Storage Systems segment revenues were 12.1% for the first six months of 2006 as compared to 14.4% for the same period of 2005 due to an increase in revenues year over year, offset in part by an increase in stock-based compensation expense associated with the adoption of SFAS 123R on January 1, 2006 .

Selling, general and administrative:

	Three months ended		Six months ended	
	July 2, 2006	**July 3, 2005**	**July 2, 2006**	**July 3, 2005**
	(in millions)			
Semiconductor segment	$43.2	$ 38.3	$ 83.5	$ 75.5
Percentage of revenues	14%	12%	14%	12%
Storage Systems segment	$21.4	$ 22.0	$ 50.0.	$ 43.4
Percentage of revenues	12%	14%	14%	14%
Consolidated	$64.6	$ 60.3	$133.5	$118.9
Percentage of revenue	13%	13%	14%	13%

Three months ended July 2, 2006 compared to the three months ended July 3, 2005

Consolidated selling, general and administrative (SG&A) expenses increased $4.3 million or 7.1% for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. Silicon Graphics, a customer of ours, filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on May 8, 2006. As a result of this action, we recorded a $1.3 million charge for the three months ended July 2, 2006 because we do not believe the receivable balance as of July 2, 2006 is collectible. This charge mainly relates to the Storage Systems segment. We perform ongoing credit evaluations of our customers financial condition and require collateral as considered necessary.

Semiconductor segment:

SG&A expenses for the Semiconductor segment increased $4.9 million or 12.8% for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. The increase in the Semiconductor segment was primarily due to an increase in stock-based compensation associated with SFAS 123R (See Note 2 of the Notes), offset in part by lower sales commissions.

Storage Systems segment:

SG&A expenses for the Storage Systems segment decreased $0.6 million or 2.7% for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. The decrease in SG&A expenses for the three months ended July 2, 2006 as compared to the three months ended July 3, 2005 is mainly attributable to cost cutting measures put in place over the last 12 months. The decreases were offset by:

A $1.3 million charge recorded in the three months ended July 2, 2006 to reduce a receivable balance with a customer, Silicon Graphics, as discussed above; and

Stock-based compensation associated with the adoption of SFAS 123R.

Six months ended July 2, 2006 compared to the six months ended July 3, 2005

Consolidated SG&A expenses increased $14.6 million or 12.3% during the six months ended July 2, 2006 as compared to the three months ended July 3, 2005. Silicon Graphics, a customer of ours, filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on May 8, 2006. As a result of this action, we recorded a $6.9 million charge for the six months ended July 2, 2006 because we do not believe the receivable balance as of July 2, 2006 is collectible. Of this charge, $6.7 million relates to the Storage Systems segment and $0.2 million relates to the Semiconductor segment. We perform ongoing credit evaluations of our customers financial condition and require collateral as considered necessary.

Semiconductor segment:

SG&A expenses for the Semiconductor segment increased $8.0 million or 10.6% for the six months of 2006 as compared to the same period of 2005. The increase in the Semiconductor segment was primarily due to an increase in stock-based compensation associated with SFAS 123R, offset in part by lower sales commissions.

Storage Systems segment:

SG&A expenses for the Storage Systems segment increased $6.6 million or 15.2% in the first six months of 2006 as compared to the same period of 2005. The increase in SG&A expenses for the first six months of 2006 as compared to the first six months of 2005 is mainly due to the following:

A $6.7 million charge recorded for the six months ended July 2, 2006 to reduce a receivable balance with Silicon Graphics, as discussed above;

An increase in expense associated with new product launches; and

Stock-based compensation associated with the adoption of SFAS 123R.

Restructuring of operations and other items: We recorded a net credit of $21.6 million and a net credit of $16.0 million in restructuring of operations and other items for the three and six months ended July 2, 2006, respectively. Of these credits, $21.9 million and $17.3 million were recorded in the Semiconductor segment and a charge of $0.3 million and a charge of $1.3 million were recorded in the Storage Systems segment for the three and six months ended July 2, 2006, respectively. We recorded charges of $7.2 million and $8.7 million in restructuring of operations and other items for the three and six months ended July 3, 2005, respectively, primarily in the Semiconductor segment. See Note 3 of the Notes. For a complete discussion of the 2005 restructuring actions, please refer to our Annual Report on Form 10-K for the year ended December 31, 2005.

Stock-based compensation: On January 1, 2006, we adopted SFAS 123R, using the modified prospective transition method. Using the modified prospective transition method of adopting SFAS 123R, we began recognizing compensation expense for all share-based awards granted after January 1, 2006 plus unvested awards granted prior to January 1, 2006. Under this method of implementation, no restatement of prior periods has been made. Stock-based compensation expense under SFAS 123R in the consolidated condensed statements of operations for the three and six months ended July 2, 2006 was $13.3 million and $25.1 million, respectively.

The estimated fair value of our equity-based awards, less expected forfeitures, is amortized over the awards vesting period on a straight-line basis. The implementation of SFAS 123R did not have a significant impact on cash flows from operations during the three and six months ended July 2, 2006. See Note 2 to the Notes for a further discussion on stock-based compensation.

Amortization of intangibles: Amortization of intangible assets was $10.8 million and $22.0 million for the three and six months ended July 2, 2006, respectively, as compared to $17.6 million and $35.2 million for the three and six months ended July 3, 2005, respectively. The decrease is primarily a result of certain intangible assets becoming fully amortized during 2005 and also due to the write-off of certain intangible assets acquired in a purchase business combination for the three months ended July 2, 2006. As of July 2, 2006, we had approximately $20.6 million of intangible assets, net of accumulated amortization that will continue to amortize.

Interest expense: Interest expense increased slightly by $0.1 million to $6.4 million for the three months ended July 2, 2006 from $6.3 million for the three months ended July 3, 2005. Interest expense decreased slightly by $0.3 million to $12.7 million for the six months ended July 2, 2006 from $13.0 million for the six months ended July 3, 2005. The decrease is due to a lower debt balance from the repurchase of $149.7 million of the 2001 Convertible Notes in the second quarter of 2005.

Interest income and other, net: Interest income and other, net, was $10.3 million for the three months ended July 2, 2006 as compared to $11.5 million for the three months ended July 3, 2005. Interest income increased to $11.9 million for the three months ended July 2, 2006 from $5.5 million for the three months ended July 3, 2005. The increase in interest income is mainly due to higher returns and higher average cash and short-term investment balances during the three months ended July 2, 2006 as compared to the three months ended July 3, 2005. Other expenses, net of $1.6 million for the three months ended July 2, 2006 included a $1.1 million charge for points on foreign currency forward contracts, a pre-tax loss of $0.2 million on the sale of certain marketable available-for-

sale equity securities of a certain technology company that was acquired by another technology company (see Note 4 of the Notes) and other miscellaneous items that net to an expense of $0.3 million. Other income, net of $6.0 million for the three months ended July 2, 2005 included a pre-tax gain of $4.1 million on the repurchase of the 2001 Convertible Notes, a pre-tax gain of $2.4 million on certain marketable available-for-sale equity securities (see Note 4 of the Notes) and other miscellaneous items that net to an expense of $0.5 million.

Interest income and other, net increased to $19.8 million during the six months ended July 2, 2006 as compared to $16.9 million for the six months ended July 3, 2005. Interest income increased to $21.1 million during the first six months of 2006 from $11.6 million for the same period of 2005. The increase in interest income is mainly due to higher returns and higher average cash and short-term investment balances for the six months ended July 2, 2006 as compared to the six months ended July 3, 2005. Other expenses, net of $1.3 million for the six months ended July 2, 2006, included a $2.2 million charge for points on foreign currency forward contracts, a pre-tax loss of $0.2 million on the sale of certain marketable available-for-sale equity securities of a certain technology company that was acquired by another company for the three months ended July 2, 2006 (see Note 4 of the Notes) and other miscellaneous items, offset in part by a pre-tax gain of $1.4 million on the sale of certain marketable available-for-sale equity securities for the three months ended April 2, 2006 (see Note 4 of the Notes). Other income, net of $5.3 million in the first six months of 2005 included a pre-tax gain of $4.1 million on the repurchase of the 2001 Convertible Notes, a pre-tax gain of $2.9 million on sales of certain marketable available-for-sale equity securities for the three months ended July 3, 2005 and other miscellaneous expense items.

Provision for income taxes: During the three and six months ended July 2, 2006 we recorded income tax expenses of $5.1 million and $11.6 million, respectively. For the three and six months ended July 3, 2005, we recorded income tax expenses of $6.3 million and $12.5 million, respectively. The expenses primarily relate to foreign income taxes.

The provision for income taxes for the three months ended July 2, 2006 includes tax benefits of $2.6 million relating to settlements of tax audits in foreign jurisdictions, which were treated as discrete items allocable to the quarter.

Excluding certain foreign jurisdictions, our management believes that the future benefit of deferred tax assets, including stock based compensation awards, is more than likely not to be realized.

FINANCIAL CONDITION, CAPITAL RESOURCES AND LIQUIDITY

Cash, cash equivalents and short-term investments increased to $1.2 billion at July 2, 2006, from $938.9 million at December 31, 2005. The increase is mainly due to cash and cash equivalents provided by operating and financing activities, partially offset by net cash outflows for investing activities as described below.

Working capital. Working capital increased by $137.9 million to $1.0 billion at July 2, 2006, from $877.4 million as of December 31, 2005. The increase in working capital is attributable to the following:

Cash, cash equivalents and short-term investments increased by $261.7 million.

Accrued salaries, wages and benefits decreased by $18.4 million primarily due to timing differences in payment of salaries, benefits and performance-based compensation.

Current portion of long-term obligation decreased by $1.3 million due to the amortization of deferred gain on the terminated Swaps.

The increase in working capital was offset, in part, by the following:

Prepaid expenses and other current assets decreased by $77.4 million primarily due to decreases in assets held for sale of $100.3 million mainly due to the sale of our Gresham Oregon manufacturing facility and two Colorado facilities, offset in part by an increase in other receivable of $15.0 million from ON Semiconductor in connection with the sale of Gresham manufacturing facility and $7.7 million from the sale of our ZSP digital signal processor unit, an increase in prepaid software maintenance and other miscellaneous items which are individually insignificant. (See Note 3 of the Notes).

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Inventories decreased by $21.0 million to $173.8 million as of July 2, 2006, from $194.8 million as of December 31, 2005. The decline in inventory levels reflects a) our continued focus on supply chain management and b) inventory sold to ON Semiconductor as part of the sale of the Gresham manufacturing facility.

Accounts payable increased by $17.1 million due to the timing of invoice receipt and payments.

Accounts receivable decreased by $12.5 million to $310.8 million as of July 2, 2006 from $323.3 million as of December 31, 2005. The decrease is mainly attributed to lower revenues and improved collections during the three months ended July 2, 2006 as compared to the three months ended December 31, 2005.

Other accrued liabilities increased by $8.9 million due to increases in the restructuring reserve (Note 3 of the Notes) and deferred revenue, offset in part by other miscellaneous items which are individually insignificant.

Income taxes payable increased by $6.5 million due to the timing of income tax payments made and the income tax provision recorded during the six months ended July 2, 2006.

Cash and cash equivalents generated from operating activities. During the six months ended July 2, 2006, we generated $149.0 million of net cash and cash equivalents from operating activities compared to $119.1 million generated during the six months ended July 3, 2005. Cash and cash equivalents generated by operating activities for the six months ended July 2, 2006, were the result of the following:

Net income adjusted for non-cash transactions. The non-cash items and other non-operating adjustments are quantified in our Consolidated Condensed Statements of Cash Flows included in this Form 10-Q; and

A net increase in assets and liabilities, including changes in working capital components from December 31, 2005 to July 2, 2006, as discussed above.

The adoption of SFAS 123R did not have an impact on cash flows from operations for the six months ended July 2, 2006.

Cash and cash equivalents (used in)/ provided by investing activities. Cash and cash equivalents used in investing activities were $86.9 million for the six months ended July 2, 2006, as compared to $16.0 million provided by investing activities for the six months ended July 3, 2005. The primary investing activities for the six months ended July 2, 2006 were as follows:

Purchases of debt and equity securities available for sale, net of sales and maturities; and

Proceeds from sale of Gresham, Oregon manufacturing facility, two Colorado facilities and intellectual property, net of purchases of property, equipment and software.

We expect capital expenditures to be approximately $45.0 million in 2006. In recent years, we have reduced our level of capital expenditures as a result of our focus on establishing strategic supplier alliances with foundry semiconductor manufacturers, which enables us to have access to advanced manufacturing capacity, and reduces our capital spending requirements.

Cash and cash equivalents provided by/ (used in) financing activities. Cash and cash equivalents provided by financing activities for the six months ended July 2, 2006 were $32.1 million as compared to $135.4 million used in financing activities for the six months ended July 3, 2005. The primary financing activities for the three months ended July 2, 2006 were the issuance of common stock under our employee stock option and purchase plans.

We may seek additional equity or debt financing from time to time. We believe that our existing liquid resources and funds generated from operations, combined with funds from such financing and our ability to borrow funds will be adequate to meet our operating and capital requirements and obligations for the foreseeable future. However, we cannot be certain that additional financing will be available on favorable terms. Moreover, any future equity or convertible debt financing will decrease the percentage of equity ownership of existing stockholders and may result in dilution, depending on the price at which the equity is sold or the debt is converted.

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Contractual Obligations

The following table summarizes our contractual obligations at July 2, 2006, and the effect of these obligations is expected to have on our liquidity and cash flow in future periods.

	Payments due by period				
	Less than 1 year	1 3 years	4 5 years	After 5 years	Total
Contractual Obligations			(in millions)		
Convertible Subordinated Notes	$271.8	$	$350.0	$	$ 621.8
Operating lease obligations	41.8	53.2	37.6	13.8	146.4
Purchase commitments	374.9	55.5	0.1		430.5
Total	$688.5	$108.7	$387.7	$13.8	$1,198.7

Convertible Subordinated Notes

As of July 2, 2006, we had $271.8 million of Convertible Subordinated Notes due in November 2006 (2001 Convertible Notes) and $350.0 million of Convertible Subordinated Notes due in May 2010 (2003 Convertible Notes). All of the Convertible Notes are subordinated to all existing and future senior debt and are convertible at the holder s option, at any time prior to the maturity date of the Convertible Notes, into shares of our common stock. The 2001 and 2003 Convertible Notes have conversion prices of approximately $26.34 per share and $13.42 per share, respectively. The 2001 Convertible Notes are redeemable at our option, in whole or in part, on at least 30 days notice at any time on or after the call date, which is two years before the due date. We cannot elect to redeem the 2003 Convertible Notes prior to maturity. Each holder of the 2001 and 2003 Convertible Notes has the right to cause us to repurchase all of such holder s convertible notes at 100.0% of their principal amount plus accrued interest upon the occurrence of any fundamental change to us, which includes a transaction or event such as an exchange offer, liquidation, tender offer, consolidation, merger or combination. Interest is payable semiannually.

Fluctuations in our stock price impact the prices of our outstanding convertible securities and the likelihood of the convertible securities being converted into cash or equity. If we are required to redeem any of the Convertible Notes for cash, it may affect our liquidity position. In the event they do not convert to equity, we believe that our current cash position and expected future operating cash flows will be adequate to meet these obligations as they mature. From time to time, we redeem or repurchase Convertible Notes.

Operating Lease Obligations

We lease real estate, certain non-manufacturing equipment and software under non-cancelable operating leases.

Purchase Commitments

We maintain certain purchase commitments, primarily for raw materials, with suppliers and for some non-production items. Purchase commitments for inventory materials are generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among our different suppliers.

In connection with the sale of the Gresham, Oregon manufacturing facility in May of 2006, we entered into a multi-year wafer supply agreement. The wafer supply agreement includes a minimum purchase commitment whereby LSI has agreed to purchase $198.8 million in wafers from ON Semiconductor from the date of the sale through the second quarter of 2008. These commitments have been included in the table above.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires estimates and assumptions that affect the reported amounts and disclosures. For a detailed discussion of our critical accounting policies, please see the Critical Accounting Policies contained in Part II, Item 7 of the 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, 2005. A new critical accounting policy has been added with the adoption of SFAS 123R effective January 1, 2006.

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Stock-Based compensation:

On January 1, 2006, we adopted SFAS 123R, using the modified prospective transition method. In accordance with the modified prospective transition method, we began recognizing compensation expense for all share-based awards granted after January 1, 2006 plus unvested awards granted prior to January 1, 2006. Under this method of implementation, no restatement of prior periods has been made. Stock-based compensation expense under SFAS 123R in the consolidated condensed statements of operations for the three and six months ended July 2, 2006 was approximately $13.3 million and $25.1 million, respectively. See Note 2 of the Notes for a description of our equity compensation plans and a more detailed discussion of the adoption of SFAS 123R.

Stock Options

The fair value of each option grant is estimated on the date of grant using a reduced form calibrated binomial lattice model (the Lattice Model). This model requires the use of historical data for employee exercise behavior and the use of assumptions as follows:

Employee Stock Options Granted	**Three months ended July 2, 2006**	**Six months ended July 2, 2006**
Weighted average estimated grant date fair value	$ 3.95	$ 3.59
Weighted average assumptions in calculation:		
Expected life (years)	4.35	4.29
Risk-free interest rate	5%	5%
Volatility	48%	48%
Dividend yield		

The expected life 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 Model. The expected life of employee stock options is impacted by all of the underlying assumptions and calibration of our model.

We used an equally weighted combination of historical and implied volatilities as of the grant date. The historical volatility is the standard deviation of the daily stock returns for LSI from the date of our initial public offering in 1983. We used implied volatilities of near-the-money LSI traded call options since stock options are call options that are granted at the money. The historical and implied volatilities were annualized and equally weighted to determine the volatilities as of the grant date. Prior to January 1, 2006, we used historical implied stock price volatilities in accordance with SFAS 123 for purposes of its pro forma information. Our management believes that the equally weighted combination of historical and implied volatilities is more representative of future stock price trends than historical implied volatilities.

The risk-free interest rate assumption is based upon observed interest rates for constant maturity treasuries appropriate for the term of our employee stock options. The estimated kurtosis and skewness are technical measures of the distribution of stock price returns that are based on stock price return history as well as consideration of academic analyses.

The Lattice Model assumes that employees exercise behavior is a function of the option s remaining vested life and the extent to which the option is in-the-money. The Lattice Model estimates the probability of exercise as a function of these two variables based on the entire history of exercises and cancellations on all past option grants made by us since the initial public offering in 1983.

As stock-based compensation expense recognized in the consolidated condensed statement of operations for the three months ended July 2, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. 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. Forfeitures were estimated based on historical experience. For our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

Employee Stock Purchase Plans

The Company also has two employee stock purchase plans (ESPPs US ESPP and IESPP) under which rights are granted to all employees to purchase shares of common stock at 85.0% of the lesser of the fair market value of such shares at the beginning of a 12-month offering period or the end of each six-month purchase period within such an offering period, typically in May and November. Compensation expense is calculated using the fair value of the employees purchase rights under the Black-Scholes model. During the three months ended July 2, 2006, a total of 1.9 million shares related to the ESPPs were issued. There were approximately 20.1 million shares of common stock reserved for issuance under the ESPPs as of July 2, 2006. The stock-based compensation expense for the three months ended July 2, 2006 stemming from the May 14, 2006 ESPP grants was not significant

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because the majority of employees of the Company enrolled in the 12-month purchase period in November of 2005 and will not re-enroll until November of 2006. For disclosure purposes, we have included the assumptions that went into the calculation of fair value for the May 2006 as follows:

Employee Stock Purchase Plans Granted	**Three months ended July 2, 2006**
Weighted average estimated grant date fair value	$ 3.05
Weighted average assumptions in calculation:	
Expected life (years)	0.8
Risk-free interest rate	5%
Volatility	39%
Dividend yield	

Restricted Stock Awards

The cost of these awards is determined using the fair value of our common stock on the date of the grant and compensation expense is recognized over the vesting period on a straight-line basis.

Our determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective assumptions. We use third-party consultants to assist in developing the assumptions used in as well as calibrating the Lattice Model. We are responsible for determining the assumptions used in estimating the fair value of its share based payment awards. 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 our 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 our 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.

Recent Accounting Pronouncements

The information contained in Item 1 of Note 1 of the Notes under the heading Recent Accounting Pronouncements is hereby incorporated by reference into this Item 2.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no significant changes in the market risk disclosures during the three months ended July 2, 2006, as compared to the discussion in Part II, Item 7a of our Annual Report on Form 10-K for the year ended December 31, 2005.

Item 4. Controls and Procedures

Our management evaluated, with the participation of our chief executive officer and our chief financial officer, the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 promulgated under the Securities Exchange Act of 1934 as of July 2, 2006. Based on this evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

During the three months ended July 2, 2006, there have been no changes in our internal control over financial reporting (as defined in Rule 13a-15 under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

This information is included in Note 11 (Legal Matters) of the Notes to the Unaudited Consolidated Condensed Financial Statements, which information is incorporated herein by reference from Item 1 of Part I hereof.

Item 1A. Risk Factors

We are subject to a number of risks. Some of these risks are endemic to the semiconductor industry and are the same or similar to those disclosed in our previous SEC filings, and some new risks may arise in the future. The reader should carefully consider all of these risks and other information in this Form 10-Q before investing in our stock. The fact that certain risks are endemic to the high-technology industry does not lessen the significance of these risks.

As a result of these risks, our business, financial conditions or results of operations could be materially and adversely affected. This could cause the trading price of our common stock to decline, and stockholders might lose some or all of their investment.

Please consider these risk factors when you read forward-looking statements elsewhere in this Form 10-Q and in the documents incorporated herein by reference. Forward-looking statements are statements that relate to our expectations for future events and time periods. Generally, the words, anticipate, expect, intend and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties, and actual results could differ materially from those anticipated in the forward-looking statements.

General economic weakness and geopolitical factors may harm our operating results and financial condition. The semiconductor industry is cyclical in nature and is characterized by wide fluctuations in product supply and demand. In the past, the industry has experienced periods of rapid expansion of production capacity followed by periods of significant downturn. Even when the demand for our products remains constant, the availability of additional excess production capacity in the industry creates competitive pressures that can degrade pricing levels, which can reduce revenues. In addition, our results of operations are dependent on the global economy. Any geopolitical factors such as terrorist activities, armed conflict or global health conditions, which adversely affect the global economy, may adversely impact our operating results and financial condition. In addition, goodwill and other long-lived assets could be impacted by a decline in revenues because impairment is measured based upon estimates of future cash flows. These estimates include assumptions about future conditions within our company and industry.

We depend entirely on independent foundry subcontractors to manufacture our semiconductor products; accordingly, any failure to secure and maintain sufficient foundry capacity could materially and adversely affect our business. During the three months ended July 2, 2006, we completed the sale of the Gresham, Oregon semiconductor manufacturing facility to ON Semiconductor. As a result of this transaction, we are completely dependent on foundry subcontractors for the manufacture of our semiconductor products. In conjunction with the sale of the facility, we entered into a wafer supply and test agreement with ON Semiconductor. Other foundry subcontractors, located in Asia, currently manufacture the remainder of our semiconductor devices.

Availability of foundry capacity has in the recent past been reduced due to strong demand. In addition, the occurrence of a public health emergency could further affect the production capabilities of our manufacturers by resulting in quarantines or closures. If we are unable to secure sufficient capacity at our existing foundries, or in the event of a quarantine or closure at any of these foundries, our revenues, cost of revenues and results of operations would be negatively impacted. If any of our foundries experiences a shortage in capacity, or suffers any damage to its facilities due to earthquakes or other natural disasters, experiences power outages, encounters financial difficulties or experiences any other disruption of foundry capacity, we may need to qualify an alternative foundry in a timely manner. Even our current foundries need to have new manufacturing processes qualified if there is a disruption in an existing process. We typically require several months to qualify a new foundry or process before we can begin shipping products. We may experience a significant interruption in the supply of the affected products, depending on the success and timeliness of a qualification.

Because we rely exclusively on outside foundries with limited capacity, we face several significant risks, including:

- a lack of guaranteed wafer supply and potential wafer shortages and higher wafer prices;

limited control over delivery schedules, quality assurance, manufacturing yields and production costs; and

the unavailability of, or potential delays in obtaining access to, key process technologies.

In addition, the manufacture of integrated circuits is a highly complex and technologically demanding process. Although we work closely with our foundries to minimize the likelihood of reduced manufacturing yields, our foundries have, from time to time, experienced lower than anticipated manufacturing yields. This often occurs during the production of new products or the installation and start-up of new process technologies. Poor yields from our foundries could result in product shortages or delays in product shipments, which could seriously harm our relationships with our customers and materially and adversely affect our results of operations.

The ability of each foundry to provide us with semiconductor devices is limited by its available capacity and existing obligations. Although we have entered into contractual commitments to supply specified levels of products to some of our customers, we do not have a long-term volume purchase agreement or a significant guaranteed level of production capacity with any of our foundries. Foundry capacity may not be available when we need it or at reasonable prices. Availability of foundry capacity has in the recent past been reduced from time to time due to strong demand. We place our orders on the basis of our customers purchase orders or our forecast of customer demand, and the foundries can allocate capacity to the production of other companies products and reduce deliveries to us on short notice. It is possible that other foundry customers that are larger and better financed than we are, or that have long-term agreements with our main foundries, may induce our foundries to reallocate capacity to them. This reallocation could impair our ability to secure the supply of components that we need. Although we use a number of independent foundries to manufacture our semiconductor products, most of our components are not manufactured at more than one foundry at any given time nor are our products typically designed to be manufactured in more than one specific process at. Accordingly, if one of our foundries is unable to provide us with components as needed, we could experience significant delays in securing sufficient supplies of those components. Also, our third party foundries typically migrate capacity to newer, state-of-the-art manufacturing processes on a regular basis, which may create capacity shortages for our products designed to be manufactured on an older process. We cannot assure you that any of our existing or new foundries will be able to produce integrated circuits with acceptable manufacturing yields, or that our foundries will be able to deliver enough semiconductor devices to us on a timely basis, or at reasonable prices. These and other related factors could impair our ability to meet our customers needs and have a material and adverse effect on our operating results.

Although we may utilize new foundries for other products in the future, in using new foundries we will be subject to all of the risks described in the foregoing paragraphs with respect to our current foundries.

Our target markets are characterized by rapid technological change. The Semiconductor and Storage Systems segments in which we conduct business are characterized by rapid technological change, short product cycles and evolving industry standards. We believe our future success depends, in part, on our ability to improve on existing technologies and to develop and implement new ones in order to continue to reduce semiconductor chip size and improve product performance and manufacturing yields. We must also be able to adopt and implement emerging industry standards in a timely manner and to adapt products and processes to technological changes. If we are not able to implement new process technologies successfully or to achieve volume production of new products at acceptable yields, our operating results and financial condition may be adversely impacted.

We operate in highly competitive markets. Our competitors include many large domestic and foreign companies that have substantially greater financial, technical and management resources than we do. Several major diversified electronics companies offer custom solutions and/or other standard products that are competitive with our product lines. Other competitors are specialized, rapidly growing companies that sell products into the same markets that we target. Some of our large customers may also design and manufacture products that compete with our products. There is no assurance that the price and performance of our products will be superior relative to the products of our competitors. As a result, we may experience a loss of competitive position that could result in lower prices, fewer customer orders, reduced revenues, reduced gross profit margins and loss of market share.

We are dependent on a limited number of customers. A limited number of customers account for a substantial portion of our revenues. International Business Machines Corporation and Seagate Technology represented approximately 18% and 12%, respectively, of our total consolidated revenues for the three months ended July 2, 2006.

Our operating results and financial condition could be significantly affected if:

- we do not win new product designs from major existing customers;

- major customers reduce or cancel their existing business with us;

major customers make significant changes in scheduled deliveries; or

there are declines in the prices of products that we sell to these customers.

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We are potentially subject to credit risk from accounts receivable. A majority of the our trade receivables are derived from sales to large multinational computer, communication, networking, storage and consumer electronics manufacturers, with the remainder distributed across other industries. We perform ongoing credit evaluations of our customers financial condition and require collateral when considered necessary. However, we cannot provide assurance that our accounts receivable balances will be paid on time or at all. Silicon Graphics, a customer of ours, bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on May 8, 2006. As a result of this action, we recorded $1.3 million and $6.9 million charges for the three and six months ended July 2, 2006 because we do not believe the receivable balance as of July 2, 2006 is collectible. The majority of the charges for the three and six months ended July 2, 2006 related to the Storage Systems segment.

Our new products may not achieve market acceptance. We introduce many new products each year. We must continue to develop and introduce new products that compete effectively on the basis of price and performance and that satisfy customer requirements. Our cores and standard products are intended to be based upon industry standard functions, interfaces, and protocols so that they are useful in a wide variety of systems applications. Development of new products and cores often requires long-term forecasting of market trends, development and implementation of new or changing technologies and a substantial capital commitment. We cannot provide assurance that the cores or standard products that we select for investment of our financial and engineering resources will be developed or acquired in a timely manner or will enjoy market acceptance.

The storage manufacturing facility we operate is complex. We own our own Storage Systems segment manufacturing facility in Wichita, Kansas. The manufacture and introduction of our Storage Systems products is a complicated process. We confront challenges in the manufacturing process that require us to:

- maintain a competitive manufacturing cost structure;
- exercise stringent quality control measures to ensure high yields;
- effectively manage the subcontractors engaged in the wafer fabrication, test and assembly of products; and
- update equipment and facilities as required for leading edge production capabilities.

We procure parts and raw materials from a limited number of domestic and foreign sources. We do not maintain an extensive inventory of parts and materials for manufacturing. We purchase a portion of our requirements for parts and raw materials from a limited number of sources, primarily from suppliers in Japan and their U.S. subsidiaries, and we obtain other material inputs on a local basis. There is no assurance that, if we have difficulty in obtaining parts or materials in the future, alternative suppliers will be available, or that these suppliers will provide parts and materials in a timely manner or on favorable terms. As a result, we may be adversely affected by delays in product shipments. If we cannot obtain adequate materials for manufacture of our products or if such materials are not available at reasonable prices, there could be a material adverse impact on our operating results and financial condition.

We utilize indirect channels of distribution over which we have limited control. Our financial results could be adversely affected if our relationship with resellers or distributors were to deteriorate or if the financial condition of these resellers or distributors were to decline. In addition, as our business grows, we may have an increased reliance on indirect channels of distribution. There can be no assurance that we will be successful in maintaining or expanding these indirect channels of distribution. Failure to do so could result in the loss of certain sales opportunities. Furthermore, the partial reliance on indirect channels of distribution may reduce our visibility with respect to future business, thereby making it more difficult to accurately forecast orders.

We engage in acquisitions and alliances giving rise to financial and technological risks. We are continually exploring strategic acquisitions that build upon our existing library of intellectual property, human capital and engineering talent, and increase our leadership position in the markets where we operate. We did not complete any material acquisitions or alliances for the three months ended July 2, 2006. Mergers and acquisitions of high-technology companies bear inherent risks. No assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results or financial condition. We must continue to manage any growth effectively. Failure to manage growth effectively and to integrate acquisitions could adversely affect our operating results and financial condition.

In addition, we intend to continue to make investments in companies, products and technologies through strategic alliances. Investment activities often involve risks, including the need to acquire timely access to needed capital for investments related to alliances and to invest in companies and technologies that contribute to the growth of our business.

During the three months ended July 2, 2006, we completed the sale of the Gresham, Oregon manufacturing facility as part of our strategy to transition to a fabless semiconductor manufacturing model. Our new strategy includes the expansion of our working relationships with major foundry partners and the adoption of a roadmap leading to the production of advanced semiconductors utilizing 65-nanometer and below process technology on 300-mm or 12-inch wafers. As a result of this transaction, we are completely dependent on foundry subcontractors for the manufacture of our semiconductor products. In conjunction with the sale of the facility, we entered into other agreements with ON Semiconductor, including, but not limited to a wafer supply and test agreement and an intellectual property license agreement.

The price of our securities may be subject to wide fluctuations. Our stock has experienced substantial price volatility, particularly as a result of quarterly variations in results, the published expectations of analysts and announcements by our competitors and us. In addition, the stock market has experienced price and volume fluctuations that have affected the market price of many technology companies and that have often been unrelated to the operating performance of such companies. The price of our securities may also be affected by general global, economic and market conditions. While we cannot predict the individual effect that these and other factors may have on the price of our securities, these factors, either individually or in the aggregate, could result in significant variations in stock price during any given period of time. These fluctuations in our stock price also impact the price of our outstanding convertible securities and the likelihood of the convertible securities being converted into cash or equity. If our stock price is below the conversion price of our convertible bonds on the date of maturity, they may not convert into equity and we may be required to redeem our outstanding convertible securities for cash. However, in the event they do not convert to equity, we believe that our current cash position and expected future operating cash flows will be adequate to meet these obligations as they mature.

We may rely on capital and bank markets to provide liquidity. In order to finance strategic acquisitions, capital assets needed in our manufacturing facilities and other general corporate needs, we may rely on capital and bank markets to provide liquidity. As of July 2, 2006, we had convertible notes outstanding of approximately $622 million. We may need to seek additional equity or debt financing from time to time. Historically, we have been able to access capital and bank markets, but we may not be able to access these markets in the future or on terms that are acceptable to us. The availability of capital in these markets is affected by several factors, including geopolitical risk, the interest rate environment and the condition of the economy as a whole. Moreover, any future equity or equity-linked financing may dilute the equity ownership of existing shareholders. In addition, our own operating performance, capital structure and expected future performance impact our ability to raise capital. We believe that our current cash, cash equivalents, short-term investments and future cash provided by operations will be sufficient to fund our needs in the foreseeable future. This includes repaying our existing convertible debt when due. However, if our operating performance falls below expectations, we may need additional funds.

We design and develop highly complex semiconductors and storage systems. As technology advances to smaller geometries, there are increases in the complexity, time and expense associated with the design, development and manufacture of semiconductors. We must incur substantial research and development costs to confirm the technical feasibility and commercial viability of any products that in the end may not be successful. Therefore, we cannot guarantee that any new semiconductor or storage products will result in market acceptance.

The high technology industry in which we operate is prone to intellectual property litigation. Our success is dependent in part on our technology and other proprietary rights, and we believe that there is value in the protection afforded by our patents, copyright, trademarks and other intellectual property rights. We have a program whereby we actively protect our intellectual property by acquiring patent and other intellectual property rights. However, the industry is characterized by rapidly changing technology and our future success depends primarily on the technical competence and creative skills of our personnel.

As is typical in the high technology industry, from time to time we have received communications from other parties asserting that certain of our products, processes, technologies or information infringe upon their patent rights, copyrights, trademark or other intellectual property rights. We regularly evaluate such assertions. In light of industry practice, we believe, with respect to existing or future claims that any licenses or other rights that may be necessary may generally be obtained on commercially reasonable terms. Nevertheless, there is no assurance that licenses will be obtainable on acceptable terms or that a claim will not result in litigation or other administrative proceedings. Resolution of whether our product or intellectual property has infringed on valid rights held by others could have a material adverse effect on our results of operations or financial position and may require material changes in production processes and products.

See Legal Matters in Note 11 of the Notes regarding pending patent litigation.

We may not be able to adequately protect or enforce our intellectual property rights, which could harm our competitive position. Our success and future revenue growth will depend, in part, on our ability to protect our intellectual property. We primarily rely on patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to protect our proprietary technologies and processes. Despite our efforts to protect our proprietary technologies and processes, it is possible that competitors or other unauthorized third parties may obtain, copy, use or disclose our technologies and processes. We currently hold more than 3,500 U.S. patents. However, we cannot assure you that any additional patents will be issued. Even if a new patent is issued, the claims allowed may not be sufficiently broad to protect our technology. In addition, any of our existing or future patents may be challenged, invalidated or circumvented. As such, any rights granted under these patents may not provide us with meaningful protection. We may not have foreign patents or pending applications corresponding to our U.S. patents and applications. Even if foreign patents are granted, effective enforcement in foreign countries may not be available. If our patents do not adequately protect our technology, our competitors may be able to offer products similar to ours. Our competitors may also be able to develop similar technology independently or design around our patents. Some or all of our patents have in the past been licensed and likely will in the future be licensed to certain of our competitors through cross-license agreements.

Certain of our software (as well as that of our customers) may be derived from so-called open source software that is generally made available to the public by its authors and/or other third parties. Such open source software is often made available to us under licenses, such as the GNU General Public License. These licenses impose certain obligations on us in the event we were to distribute derivative works of the open source software. These obligations may require us to make source code for the derivative works available to the public, and/or license such derivative works under a particular type of license, rather than the forms of license customarily used to protect our intellectual property. While we believe we have complied with our obligations under the various applicable licenses for open source software, in the event the copyright holder of any open source software were to successfully establish in court that we had not complied with the terms of a license for a particular work, we could be required to release the source code of that work to the public and/or stop distribution of that work. With respect to our proprietary software, we generally license such software under terms that prohibit combining it with open source software as described above. Despite these restrictions, parties may combine our proprietary software with open source software without our authorization, in which case we may nonetheless be required to release the source code of our proprietary software.

Our Storage Systems manufacturing facility is subject to disruption. Operations at the Wichita, Kansas manufacturing facility may be disrupted for reasons beyond our control, including work stoppages, fire, earthquake, tornado, floods or other natural disasters, which could have a material adverse effect on our results of operation or financial position.

We depend on third-party subcontractors to assemble, obtain packaging materials for, and test substantially all of our current semiconductor products. If we lose the services of any of our subcontractors or if these subcontractors are unable to obtain sufficient packaging materials, shipments of our products may be disrupted, which could harm our customer relationships and adversely affect our revenues. Third-party subcontractors located in Asia assemble, obtain packaging materials for, and test substantially all of our current semiconductor products. Because we rely on third-party subcontractors to perform these functions, we cannot directly control our product delivery schedules and quality assurance. This lack of control has resulted in the past, and could result in the future, in product shortages or quality assurance problems that could delay shipments of our products or increase our manufacturing, assembly or testing costs.

If our third-party subcontractors are unable to obtain sufficient packaging materials for our products in a timely manner, we may experience a significant product shortage or delay in product shipments, which could seriously harm our customer relationships and materially and adversely affect our net revenues. If any of these subcontractors experiences capacity constraints or financial difficulties, suffers any damage to its facilities, experiences power outages or any other disruption of assembly or testing capacity, we may not be able to obtain alternative assembly and testing services in a timely manner. Due to the amount of time that it usually takes us to qualify assemblers and testers, we could experience significant delays in product shipments if we are required to find alternative assemblers or testers for our components. Any problems that we may encounter with the delivery, quality or cost of our products could damage our customer relationships and materially and adversely affect our results of operations. We are continuing to develop relationships with additional third-party subcontractors to assemble and test our products. However, even if we use these new subcontractors, we will continue to be subject to all of the risks described above.

We depend on third-party subcontractors to manufacture all of our current board products. Third-party subcontractors manufacture all of our current board products. Because we rely on third-party subcontractors to perform this function, we cannot directly control our product delivery schedules and quality assurance. This lack of control has resulted in the past, and could result in the future, in product shortages or quality assurance problems that could delay shipments of our products or increase our manufacturing, assembly or testing costs.

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If our third-party subcontractors are unable to manufacture our products in a timely manner, we may experience a significant product shortage or delay in product shipments, which could seriously harm our customer relationships and materially and adversely affect our net sales. If any of these subcontractors experiences capacity constraints or financial difficulties, suffers any damage to its facilities, experiences power outages or encounters any other disruption of manufacturing capacity, we may not be able to obtain alternative manufacturing services in a timely manner. Due to the amount of time that it usually takes us to qualify such third party manufacturers, we could experience significant delays in product shipments if we are required to find alternatives. Any problems that we may encounter with the delivery, quality or cost of our products could damage our customer relationships and materially and adversely affect our results of operations. We are continuing to develop relationships with additional third-party manufacturers for our products. However, even if we use these new subcontractors, we will continue to be subject to all of the risks described above.

We are increasingly exposed to various legal, business, political and economic risks associated with our international operations. We currently obtain a substantial portion of our manufacturing, and all of our assembly and testing services from suppliers located outside the United States. We also frequently ship products to our domestic customers international manufacturing divisions and subcontractors. We also undertake design and development activities in Canada, China, Dubai, Germany, India, Italy, Russia, Taiwan, and the United Kingdom. We intend to continue to expand our international business activities and to open other design and operational centers abroad. Any geopolitical factors such as terrorist activities, armed conflict or global health conditions, which adversely affect the global economy, may adversely impact our international sales and could make our international operations more expensive. International operations are subject to many other inherent risks, including but not limited to:

- political, social and economic instability;
- exposure to different legal standards, particularly with respect to intellectual property;
- natural disasters and public health emergencies;
- nationalization of business and blocking of cash flows;
- trade and travel restrictions;
- the imposition of governmental controls and restrictions;
- burdens of complying with a variety of foreign laws;
- import and export license requirements and restrictions of the United States and each other country in which we operate;
- unexpected changes in regulatory requirements;
- foreign technical standards;
- changes in tariffs;
- difficulties in staffing and managing international operations;
- fluctuations in currency exchange rates;
- difficulties in collecting receivables from foreign entities or delayed revenue recognition; and

potentially adverse tax consequences.

Any of the factors described above may have a material adverse effect on our ability to increase or maintain our foreign sales.

We are exposed to fluctuations in foreign currency exchange rates. We have some exposure to fluctuations in foreign currency exchange rates. We have international subsidiaries and distributors that operate and sell our products globally. We routinely hedge these exposures in an effort to minimize the impact of currency fluctuations. However, we may still be adversely affected by changes in foreign currency exchange rates or declining economic conditions in these countries.

We must attract and retain key employees in a highly competitive environment. Our employees are vital to our success and our key management, engineering and other employees are difficult to replace. We do not generally have employment contracts with our key employees. Despite the economic slowdown of the last few years, competition for certain key technical and engineering personnel remains intense. Our continued growth and future operating results will depend upon our ability to attract, hire and retain significant numbers of qualified employees.

The adoption of new accounting standards related to the expensing of stock awards adversely affected our results for the six months ended July 2, 2006 and is expected to negatively impact the results of operations in subsequent periods. Future changes in financial accounting standards or practices or existing taxation rules or practices may also cause adverse unexpected fluctuations and affect our reported results of operations. On January 1, 2006, we adopted SFAS 123R. In accordance with the modified prospective transition method, we began recognizing compensation expense for all share-based awards on or granted after January 1, 2006, plus unvested awards granted prior to January 1, 2006. Under this method of implementation, no restatement of prior periods has been made. The adoption of SFAS 123R has a significant impact on our operating results as share-based compensation expense is charged directly against reported earnings. Numerous judgments and estimates are involved in the calculation of the expense and the changes to those estimates, or different judgments could result in a significant impact on the financial statement.

Financial accounting standards in the United States are constantly under review and may be changed from time to time. Once implemented, these changes could result in material fluctuations in our financial results of operations and/or the way in which such results of operations are reported. Similarly, we are subject to taxation in the United States and a number of foreign jurisdictions. Rates of taxation, definitions of income, exclusions from income, and other tax policies are subject to change over time. Changes in tax laws in a jurisdiction in which we have reporting obligations could have a material impact on our results of operations.

We face uncertainties related to the effectiveness of internal controls. Public companies in the United States are required to review their internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002. It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will achieve its stated goal under all potential future conditions, regardless of how remote.

Although our management has determined, that our disclosure controls and procedures were effective as of July 2, 2006, we cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our internal controls in the future. A material weakness in our internal controls over financial reporting would require management and our independent public accounting firm to evaluate our internal controls as ineffective. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

Internal control deficiencies or weaknesses that are not yet identified could emerge. Over time we may identify and correct deficiencies or weaknesses in our internal controls and, where and when appropriate, report on the identification and correction of these deficiencies or weaknesses. However, the internal control procedures can provide only reasonable, and not absolute, assurance that deficiencies or weaknesses are identified. Deficiencies or weaknesses that are not yet identified could emerge and the identification and corrections of these deficiencies or weaknesses could have a material impact on the results of operations for us.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On July 28, 2000, our Board of Directors authorized a new stock repurchase program in which up to 5 million shares of the our common stock may be repurchased in the open market from time to time. There is no expiration date for the plan. There are 3.5 million shares available for repurchase under this plan as of July 2, 2006. We did not repurchase any shares during the three months ended July 2, 2006.

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Item 4. Submission of Matters to a Vote of Security Holder.

The annual meeting of stockholders was held on May 11, 2006 in San Jose, California. At the meeting, the stockholders voted on and approved the following proposals. The results of voting were as follows:

Proposal 1. To elect seven directors to serve for the ensuing year and until their successors are elected.

Director	Votes For	Votes Withheld
T.Z. Chu	333,599,121	8,508,438
Malcolm R. Currie	325,899,296	16,208,263
James H. Keyes	328,630,524	13,477,035
R. Douglas Norby	310,768,266	31,339,293
Matthew J. O Rourke	328,787,067	13,320,492
Gregorio Reyes	330,371,492	11,736,067
Abhijit Y. Talwalkar	335,204,217	6,903,342

Proposal 2. To approve an amendment to the Company s Employee Stock Purchase Plan to increase the number of shares of common stock reserved for issuance thereunder by 9,000,000.

Votes For	Votes Against	Abstentions	Broker Non-Votes
210,657,061	19,378,803	2,766,824	109,304,871

Proposal 3. To approve an amendment to the Company s International Employee Stock Purchase Plan to increase the number of shares of common stock reserved for issuance thereunder by 1,000,000.

Votes For	Votes Against	Abstentions	Broker Non-Votes
210,551,743	19,423,440	2,827,506	109,304,870

Proposal 4. To ratify the appointment of PricewaterhouseCoopers LLP as the independent registered public accounting firm of the Company for its 2006 fiscal year.

Votes For	Votes Against	Abstentions	Broker Non-Votes
333,316,584	6,309,584	2,481,391	

Item 5. Other Matters

On May 23, 2005, Wilfred J. Corrigan s status as an employee of the Company ceased. On June 13, 2005, the Company entered into a letter agreement (the Letter Agreement) with Mr. Corrigan summarizing the payments and benefits Mr. Corrigan would receive in accordance with his employment agreement dated September 20, 2001, and as disclosed in the Company s Quarterly Report on Form 10-Q for the quarter ended July 3, 2005. In the Form 10-Q for the quarter ended July 3, 2005, we previously disclosed that Mr. Corrigan s total payments would amount to $5.3 million in the aggregate. In addition to the payments and benefits provided for in the employment agreement, pursuant to the Letter Agreement and a plan adopted on May 4, 2000 by the LSI Logic Board of Directors, the medical benefits for Mr. Corrigan s dependent child would continue after the expiration of Mr. Corrigan s health, dental and vision benefits, until she reaches age 65.

Item 6. Exhibits

10.55 Wafer Supply and Test Services Agreement between LSI Logic Corporation and Semiconductor Components Industries, LLC, as of May 16, 2006. Incorporated by reference to exhibit filed with the Quarterly Report on Form 10-Q on April 27, 2006 by ON Semiconductor Corporation.+

10.56 Letter Agreement dated June 13, 2005 between LSI Logic Corporation and Wilfred J. Corrigan.

31.1 Certification of the Chief Executive Officer pursuant to Securities and Exchange Act Rules 13a-15(e) and 15d-1(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-1(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**

+ Schedules to this exhibit not filed herewith shall be furnished to the SEC upon request. Portions of this exhibit have been omitted pursuant to a request for confidential treatment.

** Furnished not filed.

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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.

LSI LOGIC CORPORATION
(Registrant)

Date: August 10, 2006

By /s/ Bryon Look

Bryon Look
Executive Vice President &
Chief Financial Officer

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