LSI LOGIC CORP
Form 10-K
March 26, 2002

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2001

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 NO. 0-11674
LSI LOGIC CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	94-2712976
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification N

1551 MCCARTHY BOULEVARD
MILPITAS, CALIFORNIA 95035
(Address of principal executive offices) (Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (408) 433-8000

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock, $0.01 par value	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
NONE
(Title of class)

Indicate by check mark whether the Registrant (1) has filed all reports

required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark 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 the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [ ]

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing price of the Common Stock on March 8, 2002 as reported on the New York Stock Exchange, was approximately $18.58. Shares of Common Stock held by each executive officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 8, 2002, the Registrant had 369,190,586 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the following document are incorporated by reference into Parts III, of this Form 10-K Report: Proxy Statement for Registrant's 2002 Annual Meeting of Stockholders.

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of risks and uncertainties, including the risk factors set forth below and elsewhere in this Report. See "Risk Factors" in Part I, Item 1 and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 below. Statements made herein are as of the date of the filing of this Form 10-K with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. We expressly disclaim any obligation to update information presented herein, except as may otherwise be required by law.

PART I

ITEM 1. BUSINESS

GENERAL

LSI Logic Corporation (together with its subsidiaries collectively referred to as LSI Logic or the Company and referred to as we, us and our) is a leader in the design, development, manufacture, and marketing of complex, high-performance integrated circuits and storage systems. We are focused on the four markets of consumer products, communications, storage components, and storage area network systems. Our integrated circuits are used in a wide range of communication devices, including devices used for wireless, broadband, data networking, and set-top box applications. We also provide other types of integrated circuit products and board-level products for use in consumer applications, high-performance storage controllers, and systems for storage area networks.

We operate in two segments -- the Semiconductor segment and the Storage Area Network (SAN) Systems segment -- in which we offer products and services for a variety of electronic systems applications. Our products are marketed primarily to original equipment manufacturers (OEMs) who sell products targeted for applications in four major markets, which are:

- Consumer Products;

- Communications;

- Storage Components; and

- Storage Area Network Systems.

In the Semiconductor segment, we use advanced process technology and comprehensive design methodologies to design, develop, manufacture and market highly complex integrated circuits. These system-on-a-chip solutions include both application specific integrated circuits, commonly referred to as ASICs and standard products, as well as Redundant Array of Independent Disks (RAID) host bus adapters and related products; and services. ASICs are designed for specific applications defined by the customer, whereas standard products are for market applications that we define. See also "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of Part II herein.

We have developed methods of designing integrated circuits based on a library of building blocks of industry-standard electronic functions, interfaces, and protocols. Among these is our CoreWare design methodology. Our advanced submicron manufacturing process technologies allow our customers to combine one or more CoreWare library elements with memory and their own proprietary logic to integrate a highly complex, system-level solution on a single chip. (Our G10, G11, G12 and Gflx submicron process technologies are more fully described in the section on Manufacturing below.) We have developed and use complementary metal oxide semiconductor (CMOS) process technologies to manufacture our integrated circuits.

In the SAN Systems segment, our enterprise storage systems are designed, manufactured, and sold by our wholly owned subsidiary -- LSI Logic Storage Systems, Inc. Our high-performance, highly scalable open storage area network systems and storage solutions are available through leading original equipment manufacturers, or OEMs, and a worldwide network of resellers. Products and solutions distributed through these channels may exclude LSI Logic Storage Systems' brand identification. When included, LSI Logic Storage Systems brand identity may appear alone or in tandem with third-party brand identification.

LSI Logic Corporation was incorporated in California on November 6, 1980, and was reincorporated in Delaware on June 11, 1987. Our principal offices are located at 1551 McCarthy Boulevard, Milpitas, California 95035, and our telephone number at that location is (408) 433-8000. Our home page on the Internet is at www.lsilogic.com.

BUSINESS STRATEGY

SEMICONDUCTOR BUSINESS STRATEGY

Our objective is to continue to be an industry leader in the design and manufacture of highly integrated, complex integrated circuits and other electronic components and system-level products that provide our customers with silicon-based system-level solutions. To achieve this objective, our business

strategy includes the following key elements:

- Target Growth Markets and Selected Customers. We concentrate our sales and marketing efforts on leading OEM customers in targeted growth markets, led by the communications, consumer, storage components, and storage area network systems applications. Our engineering expertise is focused on developing technologies that will meet the needs of leading-edge customers in order to succeed in these market areas.

- Emphasize CoreWare Methodology and System-on-a-Chip Capability. Our CoreWare design methodology enables the integration of one or more pre-designed circuit elements with customer-specified elements and memory to create system capabilities on a single chip. This results in higher product functionality, higher performance, greater differentiation, and faster time to market. We also have used this design methodology to develop proprietary standard products.

- Promote Highly Integrated Design and Manufacturing Technology. We use proprietary and leading third-party electronic design automation, or EDA, software design tools. Our design tool environment is highly integrated with our manufacturing process requirements so that it will accurately simulate product performance. This reduces design time and project cost. We continually evaluate and, as appropriate, develop expertise with third-party EDA tools from leading and emerging suppliers of such products.

- Provide Flexibility in Design Engineering. We engage with customers of our semiconductor products under various arrangements whereby the extent of the engineering support we provide will be determined in accordance with the customer's requirements. For example, a customer may primarily use its own engineers for substantial development of its product design and retain our support for silicon-specific engineering work. We also enter into engineering design projects, including those on a "turn-key" basis.

- Maintain High-Quality and Cost-Effective Manufacturing. We operate our own manufacturing facilities in order to control our deployment of advanced wafer fabrication technology, our manufacturing costs, and our response to customer delivery requirements. We also use independent wafer foundry services when appropriate and may seek to fill unused capacity in our own foundries by offering such services to third parties. We perform substantially all of our packaging, assembly, and final test operations through subcontractors in Asia. Our production operations in Gresham, Oregon, and Tsukuba, Japan, and our assembly and test subcontractors in Asia are ISO-9002 certified, an important international measure for quality.

- Leverage Alliances with Key Partners. We are continually seeking to establish relationships with key partners in a diverse range of semiconductor and storage-system technologies to promote new products, services, operating standards, and manufacturing capabilities and to avail ourselves of cost efficiencies that may be obtained through collaborative development.

- Develop and Drive Industry Standards to Achieve Market Advantage. We have been a leader in developing and promoting important industry standard architectures, functions, protocols, and interfaces. We believe that this strategy will enable us to quickly launch new standard-based products, allowing our customers to achieve time-to-market and other

competitive advantages.

- Operate Worldwide. We market our products and engage with our customers on a worldwide basis through direct sales, marketing, and field technical staff and through independent sales representatives and distributors. Our network of design centers located in major markets allows us to provide customers with highly experienced engineers, to interact with customer engineering management and system architects, to develop designs for new products, and to provide continuing after-sale customer support.

SAN SYSTEMS BUSINESS STRATEGY

- Highly Leveraged Core Competencies. In the SAN systems market, we leverage expertise used to develop our semiconductors, storage input/output components, storage management software, and storage systems in the development of scalable storage solutions. We use the full scope of our technical expertise to design and develop interoperable, easy-to-manage, leading price/performance products.

- Modular Design Philosophy. Our flexible approach to storage system design allows elements of a system to be configured and/or customized together or separately to meet customer requirements. Benefits to our customers include investment protection, reduced support costs, and a common management interface and features. This allows customers to start with pilot projects and later scale to full implementation.

- Flexible Business Models. Our strategy is to provide flexible, customizable solutions with room for value-added components, software, and services provided by the channel. Our modular product set allows OEMs and resellers to devise a solution to best meet their needs and to satisfy customers.

PRODUCTS AND SERVICES

SEMICONDUCTOR PRODUCTS

In our semiconductor components business, we design, manufacture and supply ASICs, standard products, host adapter boards and host adapter boards software to customers competing in global consumer, communications and storage markets.

ASICs are semiconductors that are designed for a unique, customer-specified applications. Standard products, which incorporate our intellectual property building blocks, are sold directly to customers for incorporation into system-level products. Both our ASICs and standard products are predominantly designed and manufactured using our proprietary process technologies.

Consumer Products. For the consumer market, we offer a broad array of products, including both application specific standard products and custom solutions.

Consumer standard products. We design, develop, manufacture and sell semiconductor devices, software and reference designs for digital video and audio applications. We enable new digital video and audio applications. We are focused on providing solutions into rapidly growing applications such as DVD players, digital set-top boxes, cable modems, broadcast encoders, video editing systems, as well as emerging applications such as DVD recorders, home servers, residential gateways and personal video recorders.

Consumer custom solutions. We also design, manufacture and sell systems on a chip (SoC) for consumer applications. We focus on consumer market segments employing our intellectual property portfolio,

design methodology and turnkey product offerings (including manufacturing, assembly and test) to provide a complete solution. Our main focus is in the video game console market. We plan to expand into digital cameras and camcorders, portable digital audio and video, personal digital assistant multimedia products and other emerging multimedia applications where an effective standard solution is not available.

In May 2001, LSI Logic acquired C-Cube Microsystems, Inc., a leader in digital media processing for $893.7 million. The acquisition of C-Cube enhanced the Company's presence in the worldwide cable modem, cable set-top box, DVD and other major consumer markets in the semiconductor segment. In addition, the acquisition enabled LSI Logic to have a strong market presence in the growing China semiconductor market.

Storage Components

Our ASIC and standard product solutions to customers in worldwide storage component markets make possible data storage and transmission between a host computer and peripheral devices such as magnetic and optical disk drives, scanners, printers, and disk and tape-based storage systems. We offer industry leading standard products including product families in Fibre Channel, SCSI, SCSI expanders, integrated circuits for motherboard or adapter applications, host adapter boards, and software. Our storage components also include a product family of PCI-RAID host adapters featuring IDE, SCSI and Fibre Channel interfaces, along with software and utilities for storage configuration and management. We also offer ASIC solutions to customers, who develop Fibre Channel SAN switches and host adapters, storage systems, and hard disk drive and tape peripherals. Our Fibre Channel offerings include the GigaBlaze high performance 2Gb/s FC transceiver and the Merlin family of high-performance Fibre Channel protocol controllers.

We provide tools, libraries, semiconductor processes and packaging products that enable our OEM customers to reliably develop high-performance designs for advanced computer systems. We provide a suite of MIPS cores and ARM processors, in addition to industry-standard bus interface cores such as USB, IEEE 1394, and PCI.

Communications and ASIC Technology

Reflecting that ASIC technology is the primary method of engagement for LSI Logic in serving global communications markets, the Company in early 2002 announced the consolidation of its Communications business and its ASIC technology and product development activities.

Communications products. We offer a blend of high-performance, high-integration and low-power silicon solutions that are pivotal in development of Internet infrastructure. We develop ASICs using ARM-based processor, digital signal processor (DSP), high-speed transceiver and mixed-signal cores. LSI Logic targets the following global communications markets: high speed metropolitan and wide area networks (WAN), optical networking, wireless communications infrastructure, wireless local area networks, home networking, residential broadband gateways, and digital subscriber lines (DSL).

We develop and market a portfolio of standard, high-speed communications interfaces for our own standard products and as building block cores in customer-specific ASIC designs. LSI Logic focuses on serving customers in the Local Area Network (LAN) enterprise market, the emerging Metro sector and the Wide Area Network (WAN) telecommunications market.

ASIC Technology

Our CoreWare design methodology offers a comprehensive design approach for creating a system on a chip efficiently, predictably, and rapidly. Our CoreWare libraries include industry standard, intellectual property building blocks. Our emphasis on cell-based product lines reflects the market preference for use of this methodology to develop advanced integrated circuits. Customers obtain greater flexibility in the design of system-level products using our cell-based technology. Our CoreWare cells are connected together electronically to form an entire system on a single chip. These system-on-a-chip solutions can be used in ASICs or standard products focused on the communications, consumer and storage markets.

Our ASIC customers utilize our engineering design capabilities in a variety of ways. Typically, the ASIC design process involves participation by both LSI Logic and customer engineers.

We engage our customers early in their new system product development process and accept large design assignments where we share development costs with the customer. We provide advice on the product design strategies to optimize product performance and suitability for the targeted application. In addition, our capabilities include support in the areas of architecture and system-level design simulation, verification, and synthesis used in the development of complex integrated circuits.

Our software design tool environment supports and automatically performs key elements of the design process from circuit concept to physical layout of the circuit design. The design tool environment features a combination of internally developed proprietary software and third-party tools that are highly integrated with our manufacturing process requirements. The design environment includes expanded interface capabilities with a range of third-party tools from leading EDA vendors and features hardware/software co-verification capability.

After completion of the ASIC engineering design effort, we produce and test prototype circuits for shipment to the customer. We then begin volume production of integrated circuits that have been developed through one or more of the arrangements described above in accordance with the customer's quantity and delivery requirements.

SAN SYSTEMS PRODUCTS

In the SAN Systems segment, we offer a broad line of network storage that spans customer enterprises from workgroup to data center. Our product lines range from intelligent controller and drive modules to complete storage systems. These offerings allow our products to be integrated on a component basis or aggregated into a complete storage solution, increasing OEM flexibility in creating differentiated products. Modular products also allow our indirect channel partners to customize solutions, bundling our products with value-added components, software, and services.

- SAN Storage. Our MetaStor brand storage systems, distributed by StorageTek and LSI Logic sales representatives are based on highly available and scalable hardware and software components integrated into fully tested storage area networks for the enterprise market.

- MetaStor E-Series. The MetaStor E-Series storage systems for storage area networks combine fibre channel performance with our proprietary Multi-Pathing Architecture to deliver high performance for a wide variety of applications. Highly available and fully redundant dual-active

controllers, efficiently managed with SANtricity Storage Manager software, differentiate our storage from that of our competitors.

The MetaStor E-Series storage family supports all high-use operating systems, including Windows NT, Solaris(TM), HP-UX, AIX, SGI, IRIX, NetWare and Linux platforms. Our products allow customers to dynamically increase storage capacity from 36 gigabytes (billions of information bytes) to as much as 39 terabytes (trillions of information bytes) per system. Customers can expand storage to their computer applications, maintain redundant records and change configurations even when their systems are operating. The result is a growth-oriented, highly available, easy to manage system.

- SANtricity Storage Manager Software. This storage management software enables users to consolidate storage through the SANshare storage-partitioning feature. In addition, this software provides a single management interface and remote access capabilities, allowing centralized management of all MetaStor storage. An enhanced graphical user interface makes the software quite easy to use. Other features provide for automatic device discovery and one-button configuration.

- Network-Attached Storage. The MetaStor N-Series is a family of network-attached storage solutions that enables users to share files among a variety of hosts, regardless of operating systems, lowering the cost of ownership by consolidating storage and management functions in a single, open storage

environment. Features include multi-protocol support, a high-performance file system, hot recovery point-in-time copies, flexible backup solutions, and enterprise-level storage management.

- Storage Virtualization. The ContinuStor Director is an intelligent storage management system that provides storage virtualization, heterogeneous storage, and host support and local and remote mirroring capabilities. Storage Virtualization is an emerging method of managing storage without regard to its physical characteristics, enabling the interoperability of storage devices from different manufacturers in a more efficient manner. This generally results in a significant reduction of storage management complexity, improvements in capacity utilization and more cost-effective business continuance and disaster recovery implementations with respect to data storage.

- Storage Controller Modules. Designed from the chip-level up, our storage controller modules support both Ultra2 SCSI and Fibre Channel interfaces. Using LSI Logic ASICs, the controllers deliver superior performance for both high-transaction volumes and large data block workloads. Combined with our drive modules, each controller module manages scalable capacity up to 39 terabytes. Modules can either be rack-mounted or installed desk-side configurations. Other features include HotScale technology for dynamic system expansion and reconfiguration, redundant dual-active controllers and automatic fail-over for maximum data availability.

- Storage Drive Modules. Our storage drive modules increase storage capacity and performance as needs change. Drive modules use our chip capabilities to monitor power, temperature, and fans, and to relay information back to the controller. Advanced technology from industry disk drive vendors is integrated into the modules to maximize capacity and minimize floor space requirements.

As a major open computing vendor, we deliver storage systems that operate

within the Windows NT, UNIX, Solaris, NetWare, and Linux operating-system environments. These products are targeted at key data storage applications, including:

- Internet servers;

- Electronic commerce;

- Data warehousing;

- On-line transaction processing;

- Video delivery, editing and production; and

- Migration of mission critical applications off mainframe computers.

In 2001, LSI Logic Storage Systems, Inc. enhanced its entire product line when it introduced the E4600, the E4600HPCx and SANtricity Storage Manager 8.0 software. These new products extend the range of applicability to better serve market segments that demand the highest levels of connectivity, performance and storage capacity.

We offer a toll-free 24 hours-a-day, 7 days-a-week technical support hotline for customers worldwide using the MetaStor line of network- and server-attached enterprise storage systems. We also offer a number of flexible services and support programs that allow customers to choose the level of telephone and onsite support appropriate to their needs.

MARKETING AND DISTRIBUTION

SEMICONDUCTOR MARKETING AND DISTRIBUTION

The highly competitive semiconductor industry is characterized by rapidly changing technology, short product cycles, and emerging standards. Our marketing strategy requires that we accurately forecast trends in the evolution of product and technology development. We must then act upon this knowledge in a timely manner to develop competitively priced products offering superior performance. As part of this strategy, we are active in the formulation and adoption of critical industry standards that influence the design specifications

of our products. Offering products with superior price and performance characteristics is essential to satisfy the rapidly changing needs of our customers in the dynamic communications, consumer and storage markets.

Our semiconductor products and design services are primarily sold through our network of direct sales and marketing, field engineering offices and sales representatives located in North America, Europe, Japan, China and elsewhere in Asia. Our sites are interconnected by means of advanced computer networking systems that allow for the continuous, uninterrupted exchange of information that is vital for the proper execution of our sales and marketing activities. International sales are subject to risks common to export activities, including governmental regulations, tariff increases and other trade barriers and currency fluctuations.

We rely primarily on direct sales and marketing, but we also work with independent distributors in North America, Europe, Japan and elsewhere in Asia. Some of our distributors possess engineering capabilities and design and purchase both ASICs and standard products from us for resale to their customers. Other distributors focus solely on the sale of standard products. Our agreements

with distributors generally grant limited rights to return standard product inventory and obtain credits for price reductions applicable to standard products held in inventory. We maintain appropriate reserves to account for these factors. However, owing to the relatively small quantities of products held in inventory by our distributors, we believe that these arrangements do not result in material financial exposure for our company.

SAN SYSTEMS MARKETING AND DISTRIBUTION

SAN systems products are sold worldwide both on a direct basis to OEMs and through indirect channels to end-users. The MetaStor brand of scalable SAN systems is exclusively marketed through a worldwide network of value-added resellers, system integrators and distributors. We closely manage these relationships to meet the diverse needs of end-users. Our marketing efforts are driven by an industry-wide trend toward the implementation of storage area networks to maximize performance, availability and efficiency.

Our direct sales force provides customized SAN systems solutions generally to large, well-known manufacturers of computer equipment. Our product development strategy focuses on implementing the latest storage technologies to improve the performance of our hardware and software storage solutions. As a pioneer in the development of redundant array of independent disks (RAID) technology, and as a member of the Fibre Channel Industry Association and Storage Networking Industry Association, we are continually driving industry standards for fibre channel and SAN solutions.

In January 2002, the Company and Storage Technology Corporation (StorageTek) announced an alliance under which StorageTek will become the worldwide master distributor of co-branded open storage products. Further, the companies will market a full line of scalable, high performance, high availability disk storage systems that will be engineered and manufactured by LSI Logic Storage Systems and sold, installed and supported by StorageTek.

CUSTOMERS

We seek to leverage our expertise in the fields of communications, consumer, storage components and SAN systems by marketing our products and services to market leaders. Our strategic-account focus is on larger, well-known companies that produce high-volume products incorporating our semiconductors and storage system products. We recognize that this strategy may result in increased dependence on a limited number of customers for a substantial portion of our revenues. It is possible that we will not achieve significant sales volumes from one or more of the customers we have selected. While this could result in lower revenues and higher unit costs owing to an under-utilization of our resources, we believe this strategy provides us with the greatest opportunity to drive further growth in sales and unit volumes.

We operate in a rigorous competitive environment and our continued success requires that we consistently develop and manufacture products that meet the needs of our customers. There is no assurance that we will achieve significant sales revenues from one or more of our strategic customers. This could result in lower revenues for our company.

In 2001, Sony accounted for approximately 18% of our consolidated revenues. No other customer accounted for greater than 10% of consolidated revenues.

MANUFACTURING

SEMICONDUCTOR MANUFACTURING

Our semiconductor manufacturing operations convert a design into packaged silicon chips and support customer requirements for volume production. Manufacturing begins with fabrication of custom-diffused silicon wafers. Layers of metal interconnects are deposited onto the wafer and patterned using customized photo masks. Wafers are then tested and cut into die. Die that pass initial tests are then sent to the assembly process where the fabricated circuits are assembled into plastic package or laminate substrate ball grid array. The finished devices undergo additional testing and quality assurance before shipment. Dedicated computer systems are used in this comprehensive testing sequence. The test programs use the basic functional test criteria from the design simulation. The customer specifies the functional test criteria for ASIC circuits.

We own and operate manufacturing operations in the United States, Japan, and Hong Kong. In January 2002, we announced a restructuring of the Japan manufacturing facility. In addition, we utilize external wafer foundries located in Taiwan and Malaysia. We use high-performance CMOS process technologies in the volume manufacture of our products. The production operations are fully computer-integrated to increase efficiency and reduce costs.

Semiconductor process technologies are identified in terms of the size of channel length within the transistors, measured in millionths of a meter called "microns." The measurement of the channel length is expressed in two ways: effective electrical channel length and drawn gate length. The effective electrical channel length is smaller than the drawn gate length. In this Report on Form 10-K, we use the electrical effective channel length to identify our process technologies.

Our advanced submicron manufacturing processes are capable of producing products with an effective electrical channel length within each transistor as small as 0.13-micron in our G12 technology. Our 0.18-micron (G11 process technology) allows up to 24 million usable gates on a single chip. Our G10 process technology is capable of producing 0.25-micron effective channel length products. We have a joint development technology for Gflx, a new flexible process technology capable of combining all of the system functions to create totally new classes of products on a single chip. The Gflx technology is more than twice as dense as the previous generation G12 process technology, allowing designers to incorporate added functions onto a single chip. The 0.10-micron effective channel length Gflx process technology offers 78 million usable logic gates. These advanced process technologies allow for greater circuit density and increased functionality on a single chip.

A majority of our wafers are fabricated in our factories in Gresham, Oregon and Tsukuba, Japan. The rest of the wafers are manufactured at our external wafer foundries in Taiwan and Malaysia. The factories in Gresham and Tsukuba are ISO-9002 certified -- an important internationally recognized standard for quality. In July 1999, the older of the two Tsukuba factories, which produced 0.38-micron products, was closed after eleven years of service. This action was taken as part of a comprehensive restructuring and cost reduction plan commenced in 1998. In January 2002, the Company announced a restructuring of the Japan manufacturing facility. In October 2001, the manufacturing facility in Colorado Springs, Colorado, which produced 0.65-micron, 0.54-micron and 0.25-micron wafers, was closed after ten years of service. This action was taken as part of a comprehensive restructuring and cost reduction plan that commenced in April 2001.

Our newest manufacturing facility is located in Gresham, Oregon on 325 acres outside of Portland. This facility is equipped for advanced manufacturing operations and is designed to accommodate our expansion requirements well into the foreseeable future. The plant is equipped to produce eight-inch wafers hosting products manufactured to the G10, G11, G12, and Gflx processes.

On April 4, 2001, we announced a co-development and foundry supply agreement with Taiwan Semiconductor Manufacturing Company Ltd. (TSMC). This agreement is part of our strategy to "outsource," that is to procure a larger portion of our wafer requirements from external sources. As a result of our

joint development efforts with TSMC we anticipate purchasing, consistent with our "outsourcing" strategy, such portion of our wafer volume requirements based on the 0.13-micron process technology that we do not manufacture ourselves. In addition, we anticipate being able to defer the need to expand our manufacturing capacity for the 0.13-micron technology beyond the time when products designed for that technology would begin volume production. We also anticipate collaborating with TSMC on further advancement in wafer fabrication technology.

Our fixed costs for manufacturing are high and are expected to remain high because we must continually make significant capital expenditures and add new advanced capacity in order to remain competitive. If demand for our products does not absorb the additional capacity, the increase in fixed costs and operating expenses related to increases in production capacity may result in a material adverse impact on our operating results and financial condition. (Additional risk factors are set forth in the Risk Factors section below.)

We offer a wide range of packaging solutions for system-on-a-chip designs. We have also developed a high-performance, high-density interconnect packaging technology, known as flip chip, which essentially replaces the wires that connect the edge of the die to a package with solder bumps spread over the entire external surface of the die. This technology enables us to reach exceptional performance and lead-count levels in packages required for process technologies of 0.18 micron and below. We also offer a mini-ball grid array package that features a smaller package size without sacrificing electrical and thermal performance. We also offer a wide array of plastic wire-bond packaging options.

Final assembly (i.e., assembly in a plastic or laminate substrate package) and test operations are conducted by our Hong Kong affiliate through independent subcontractors in the Philippines, Malaysia, South Korea, Taiwan, and Hong Kong. We also utilize subcontractors in Thailand for the assembly and test of our host adapter boards.

Both manufacturing and sales of our semiconductor products may be impacted by political and economic conditions abroad. Protectionist trade legislation in either the United States or foreign countries, such as a change in the current tariff structures, export compliance laws or other trade policies, could adversely affect our ability to manufacture or sell products in or into foreign markets. We cannot guarantee that current arrangements with our component suppliers or assembly, testing and packaging subcontractors will continue, and we do not maintain an extensive inventory of assembled components. The failure to secure assembly and test capacity could affect our sales and result in a material adverse impact on our operating results and financial condition.

Development of advanced manufacturing technologies in the semiconductor industry frequently requires that critical selections be made as to those vendors from which essential equipment (including future enhancements) and after-sales services and support will be purchased. Some of our equipment selections require that we procure certain specific types of materials or components specifically designed to our specifications. Therefore, when we implement specific technology choices, we may become dependent upon certain sole-source vendors. Accordingly, our capability to switch to other technologies and vendors may be substantially restricted and a switch may involve significant

expense and could delay our technology advancements and decrease manufacturing capabilities.

The semiconductor equipment and materials industries also include a number of vendors that are relatively small and have limited resources. Several of these vendors supply us with equipment and/or services. We do not have long-term supply or service agreements with vendors of certain critical items, and shortages could occur in various essential materials due to interruption of supply or increased demand in the industry. Given the limited number of suppliers of certain of the materials and components used in our products, if we experience difficulty in obtaining essential materials in the future we cannot be assured that alternative suppliers will be available to meet our needs. Such disruptions could materially affect our operations, which could have a material adverse impact on our operating results and financial condition.

The primary raw materials used in the manufacturing of semiconductors include raw wafers and certain chemicals used in the processing of semiconductors. The raw wafers are obtained primarily from suppliers in Japan and their U.S. subsidiaries, whereas other material inputs are obtained on a local basis. Our operations

also depend upon a continuing adequate supply of electricity, natural gas and water. These energy sources have historically been available on a continuous basis and in adequate quantities for our needs. However, given the recent power shortage in California, it is possible that other areas of the country, including Oregon, may experience similar shortages. An interruption in the supply of raw materials or energy inputs for any reason would have an adverse effect on our manufacturing operations.

Our manufacturing facilities incorporate sophisticated computer integrated manufacturing systems, which depend upon a mix of our proprietary software and systems and software purchased from third parties. Failure of these systems would cause a disruption in the manufacturing process and could result in a delay in completion and shipment of products.

SAN SYSTEMS MANUFACTURING

The manufacturing of SAN systems products involves the assembly and testing of components, including our semiconductors, which are then integrated into final products.

SAN systems product and manufacturing designs are highly modularized for flexibility. Our manufacturing operations include Configure to Order and Assemble to Order capabilities. These processes have been implemented in an effort to reduce requisite lead times for the delivery of product.

- US Manufacturing. Our US manufacturing facility in Wichita, Kansas, assembles and tests high performance array controllers, rack-mount modules and complete storage systems.

ISO-9001 certification at our Kansas manufacturing facility has been maintained since April 1992. This facility is currently certified ISO 9001:2000 compliant as of October 2001. Product quality is achieved through employee training, automated testing, and sample auditing. Supply line management extends quality through the component and subassembly supplier base with continuous reporting and supplier/product qualification programs.

- European Manufacturing. The Company maintains a manufacturing facility in Cork, Ireland through an agreement with Flextronics International Ltd.

This facility is capable of assembly and testing of high performance array controllers, rack-mount modules and complete storage systems.

The Irish site was established to provide flexibility in satisfying European demand and to serve as a backup site in the event natural or human-made disasters affect the manufacturing capacity of the Wichita, Kansas facility. The Irish site is certified as ISO 9001:2000 compliant as of December 2001.

Our SAN systems manufacturing operations are based primarily on an integrated Enterprise Resource Planning (ERP) manufacturing application system purchased from a third party. This ERP system is augmented with several of our proprietary software tools that support the production process through automated product configuration and automated electronic testing. Failure of these systems would cause a disruption in the manufacturing process and could result in delays of product shipments and/or customer billings.

Our manufacturing facility in Wichita, Kansas depends upon a continuous supply of electricity from a single utility provider. Any natural or manmade disruptions could materially affect our operating results and financial condition.

BACKLOG

SEMICONDUCTOR BACKLOG

In the Semiconductor segment, we generally do not have long-term volume purchase contracts with our customers. Instead, customers place purchase orders that are subject to acceptance by us. The timing of the design activities for which we receive payment and the placement of orders included in our backlog at any particular time is generally within the control of the customer. For example, there could be a significant time lag between the commencement of design work and the delivery of a purchase order for the units of a developed product. Also, customers may from time to time revise delivery quantities or delivery schedules to

reflect their changing needs. For these reasons, our backlog as of any particular date is not a meaningful indicator of future sales.

SAN SYSTEMS BACKLOG

In the SAN Systems segment, our large customers who are original equipment manufacturers place orders that are subject to acceptance by us in accordance with their requirements and our delivery lead time capabilities. In our reseller channel, we typically receive requests for product to be delivered within two weeks or less. Accordingly, our backlog as of any particular date is not a meaningful indicator of future sales.

COMPETITION

SEMICONDUCTOR COMPETITORS

The semiconductor industry is intensely competitive and characterized by constant technological change, rapid product obsolescence, evolving industry standards and price erosion. Many of our competitors are larger, diversified companies with substantially greater financial resources. Some of these also are customers who have internal semiconductor design and manufacturing capacity. We also compete with smaller and emerging companies whose strategy is to sell products into specialized markets or to provide a portion of the products and services that we offer.

Our major competitors include large domestic companies such as IBM Corporation, Agere Systems, Inc., Texas Instruments, Inc., and Agilent Technologies, Inc. Other competitors in strategic markets include Adaptec, Inc., QLogic Corporation, PMC-Sierra, Inc., Broadcom Corporation, and Conexant Systems, Inc.

We also face competition from certain large foreign corporations, including Philips Electronics, N.V., ST Microelectronics, S.A., and Toshiba Corporation.

The principal competitive factors in the industry include:

- design capabilities;

- differentiating product features;

- product performance characteristics;

- time to market;

- price;

- manufacturing processes; and

- utilization of emerging industry standards.

We believe that we presently compete favorably with respect to these factors. It is possible, however, that other custom design solutions will be developed by our competitors that could have a material adverse impact on our competitive position. Our competitors may also decide from time to time to aggressively lower prices of products that compete with us in order to sell related products or achieve strategic goals. Strategic pricing by competitors can place strong pricing pressure on our products in certain transactions, resulting in lower selling prices and lower gross profit margins for those transactions.

The markets into which we sell our semiconductor products are subject to severe price competition. We expect to continue to experience declines in the selling prices of our semiconductor products over the life cycle of each product. In order to offset or partially offset declines in the selling prices of our products, we must continue to reduce the costs of products through product design changes, manufacturing process changes, and yield improvements. We do not believe that we can continually achieve cost reductions that fully offset the price declines of our products, and therefore gross profit margin percentages will generally decline for existing products over their life cycles.

We are increasingly emphasizing our CoreWare design methodology and system-on-a-chip capability. Competitive factors that are important to the success of this strategy include:

- selection, quantity and quality of our CoreWare library elements;

- our ability to offer our customers systems level expertise; and

- quality of software to support system-level integration.

Although there are other companies that offer similar types of products and related services, we believe that we currently compete favorably with those companies. However, competition in this area is increasing, and there is no

assurance that our CoreWare methodology approach and product offerings will continue to receive market acceptance. Customers in our targeted markets frequently require system-level solutions. Our ability to deliver complete solutions may also require that we succeed in obtaining licenses to necessary software and integrating this software with our semiconductors.

SAN SYSTEMS COMPETITORS

The SAN systems market is characterized by many of the same pressures found in the semiconductor industry. We believe that important competitive factors in the storage-systems market include the following:

- product performance and price;
- support for new industry and customer standards;
- scalability;
- interoperability with other network devices;
- features and functionality;
- availability;
- reliability, technical service, and support;
- quality of system integration;
- existence and accessibility of differentiating features; and
- quality and availability of supporting software.

Our failure to compete successfully with respect to any of these or other factors could have a material adverse effect on our results of operations and financial condition. Our SAN systems products compete primarily with products from independent storage providers such as EMC Corporation, Hitachi Data Systems Corporation and MTI Technology Corporation. In addition, many of our current and potential customers in this market have internal storage divisions that produce products that compete directly or indirectly with our storage-system products. There is no assurance that these customers, which include Hewlett-Packard Company, IBM Corporation, Sun Microsystems, Inc., Silicon Graphics and NCR, will continue to purchase our storage systems products.

PATENTS, TRADEMARKS AND LICENSES

The Company has filed a number of patent applications and currently holds numerous patents, expiring from 2002 to 2021, relating to certain of our products and technologies in both the Semiconductor and the SAN Systems segments. In both segments, we also maintain trademarks for certain of our products and services and claim copyright protection for certain proprietary software and documentation. Patents, trademarks, and other forms of protection for our intellectual property are important, but we believe our future success principally depends upon the technical competence and creative skills of our personnel.

In the Semiconductor segment, we also protect our trade secret and other proprietary information through agreements with our customers, suppliers, employees, and consultants and through other security measures. We have entered into certain cross-license agreements that generally provide for the non-exclusive

licensing of rights to design, manufacture, and sell products and, in some cases, for cross-licensing of future improvements developed by either party.

We continue to expand our portfolio of patents and trademarks. We offer a staged incentive to engineers to identify, document and submit invention disclosures. We have developed an internal review procedure to maintain a high level of disclosure quality and to establish priorities and plans for filings both in the United States and abroad. The review process is based solely on engineering and management judgment, with no assurance that a specific filing will issue, or if issued, will deliver any lasting value to us. There is no assurance that the rights granted under any patents will provide competitive advantages to us or will be adequate to safeguard and maintain our proprietary rights. Moreover, the laws of certain countries in which our products are or may be manufactured or sold may not protect our products and intellectual property rights to the same extent as the U.S. legal system.

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 rights 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 can generally be obtained on commercially reasonable terms. Nevertheless, there is no assurance that licenses will be obtained on acceptable terms or that a claim will not result in litigation or other administrative proceedings.

In the SAN Systems segment, we own a portfolio of patents and patent applications concerning a variety of storage technologies. We also maintain trademarks for certain of our products and services and claim copyright protection for certain proprietary software and documentation. Similar to the Semiconductor segment, we protect our trade secrets and other proprietary information through agreements and other security measures, and have implemented internal procedures to identify patentable inventions and pursue protection in selected jurisdictions.

Please see Item 3, Legal Proceedings for information regarding pending patent litigation against LSI; please also refer to the additional risk factors set forth in the Risk Factors section; and Note 12 of the Notes to Consolidated Financial Statements for additional information.

RESEARCH AND DEVELOPMENT

Our industry is characterized by rapid changes in products, design tools, and process technologies. We must continue to improve our existing products, design-tool environment and process technologies and to develop new ones in a cost-effective manner to meet changing customer requirements and emerging industry standards. If we are not able to successfully introduce new products, design tools and process technologies or to achieve volume production of products at acceptable yields using new manufacturing processes, there could be a material adverse impact on our operating results and financial condition.

We operate research and development facilities in California, Colorado, Oregon and Kansas. The following table shows our expenditures on research and development activities for each of the last three fiscal years (in thousands).

YEAR	AMOUNT	PERCENT OF REVENUE

2001	$503,108	28%
2000	$378,936	14%
1999	$297,554	14%

Research and development expenses primarily consist of salaries and related costs of employees engaged in ongoing research, design and development activities and subcontracting costs.

WORKING CAPITAL

Information regarding our working capital practices is incorporated herein by reference from Item 7 of Part II hereof under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Financial Condition and Liquidity".

FINANCIAL INFORMATION ABOUT GEOGRAPHIC AREAS

This information is included in Note 11 ("Segment Reporting") of Notes to Financial Statements and Supplementary Data, which information is incorporated herein by reference to Item 8 of Part II hereof.

ENVIRONMENTAL REGULATION

Federal, state and local regulations, in addition to those of other nations, impose various environmental controls on the use and discharge of certain chemicals and gases used in semiconductor processing. Our facilities have been designed to comply with these regulations, and we believe that our activities conform to current environmental regulations. However, increasing public attention has been focused on the environmental impact of electronics and semiconductor manufacturing operations. While to date we have not experienced any material adverse impact on our business from environmental regulations, we cannot assure you that such regulations will not be amended so as to impose expensive obligations on us in the future. In addition, violations of environmental regulations or impermissible discharges of hazardous substances could result in the necessity for the following actions:

- additional capital improvements to comply with such regulations or to restrict discharges;

- liability to our employees and/or third parties; and/or

- business interruptions as a consequence of permit suspensions or revocations or as a consequence of the granting of injunctions requested by governmental agencies or private parties.

EMPLOYEES

As of December 31, 2001, we had 6,737 full-time employees.

In January 2002, the Company announced a series of restructuring actions to tailor the Company to its current lower level of revenues. These actions included reducing the worldwide workforce by approximately 1,400 positions or 20 percent of the Company's workforce.

Our future success depends upon the continued service of our key technical and management personnel and on our ability to continue to attract and retain qualified employees, particularly those highly skilled design, process, and test

engineers involved in the manufacture of existing products and the development of new products and processes. We currently have favorable employee relations, but the competition for such personnel is intense, and the loss of key employees or the inability to hire such employees when needed could have a material adverse input on our business and financial condition.

SEASONALITY

The Company's business is largely focused on the communications and consumer products markets. As a result, the Company's results may follow a seasonal pattern, with stronger growth in the second half of the year, reflecting the buying patterns of the Company's customers.

RISK FACTORS

Keep these risk factors in mind when you read "forward-looking" statements elsewhere in this Form 10-K and in the documents incorporated herein by reference. These 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.

We operate in a cyclical industry and a general economic downturn may reduce our revenues. The semiconductor industry is cyclical in nature and is characterized by wide fluctuations in product supply and demand. In 2001, the economic growth in the United States slowed significantly, which in turn, led to a severe downturn in the semiconductor industry. During a period of industry overcapacity, profitability can drop sharply as factory utilization declines and high fixed costs of operating wafer fabrication facilities are spread over a lower net revenue base. The Company's overall business bottomed in 2001 and the Company is on track to restore profitability in the near future. However, any additional terrorist activities may adversely affect the U.S. economy. In turn, we may face interruption of production and services due to increased security measures in light of recent terrorist activities, which may affect the recovery of the Company in 2002 and adversely impact its operating results and financial condition.

Our product and process development activities occur in a highly competitive environment characterized by rapid technological change. The Semiconductor and SAN 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 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 will be adversely impacted.

In addition, we must continue to develop and introduce new products that compete effectively on the basis of price and performance and that satisfy customer requirements. We continue to emphasize engineering development and acquisition of CoreWare building blocks and integration of our CoreWare libraries into our design capabilities. 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 assure you 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.

We operate highly complex and costly manufacturing facilities. The manufacture and introduction of our products is a complicated process. We confront challenges in the manufacturing process that require us to:

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

We do not control the timing or size of orders for our products. We generally do not have long-term volume production contracts with our customers. There is a risk that we will be unable to meet sudden increases in demand beyond our current manufacturing capacity, which may result in additional capital expenditures and production costs. On the other hand, order volumes below anticipated levels may result in the under-utilization of our manufacturing facilities, resulting in higher per unit costs, which could adversely affect our operating results and financial condition.

Our manufacturing facilities are subject to disruption. Our newest wafer fabrication site located in Gresham, Oregon is a highly complex, state-of-the-art facility. Anticipated production rates depend upon the reliable operation and effective integration of a variety of hardware and software components. There is no assurance that all of these components will be fully functional or successfully integrated on time or that the facility will achieve the forecasted yield targets. The capital expenditures required to bring the facility to full operating capacity may be greater than we anticipate and result in lower margins.

Operations at any of our primary manufacturing facilities, or at any of our test and assembly subcontractors, may be disrupted for reasons beyond our control, including work stoppages, fire, earthquake, floods or other natural disasters. Recently, California experienced a power shortage. Any future shortages could subject us to electrical "blackouts" or other unscheduled interruption of electrical power.

We outsource a substantial portion of wafers manufactured. The Company has developed outsourcing arrangements for the manufacture of some of its products based on a process technology that the Company does not possess. There is no assurance that the third party manufacturer will be able to produce and deliver wafers that meet the Company's specifications or that it will be able to provide successfully the process technology it has committed. If the third party is not able to deliver products and process technology on a timely and reliable basis, the Company's results of operations could be adversely affected.

We have significant capital requirements to maintain and grow our

business. In order to remain competitive, we must continue to make significant investments in new facilities and capital equipment. During 2002, we anticipate that we will spend less than $200 million on capital assets and that we will be required to spend potentially larger amounts thereafter. In addition, the high level of capital expenditures required to remain competitive results in relatively high fixed costs. If demand for our products does not absorb additional capacity, the fixed costs and operating expenses related to increases in our production capacity could have a material adverse impact on our operating results and financial condition.

We finance our capital expenditure needs from operating cash flows, bank financing and capital market financing. As of December 31, 2001, we had convertible notes outstanding of approximately $1.3 billion. As of December 31, 2001, we have two operating leases financed by several commercial banks. We may need to seek additional equity or debt financing from time to time, including issuance of warrants and 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.

We are exposed to fluctuations in foreign currency exchange rates. We have international subsidiaries and distributors that operate and sell our products globally. Further, we purchase a substantial portion of our raw materials and manufacturing equipment from foreign suppliers, and incur labor and other operating costs in foreign currencies, particularly in our Japanese manufacturing facilities. As a result, we are exposed to the risk of changes in foreign currency exchange rates or declining economic conditions in these countries.

We do business in Europe and face risks associated with the Euro. A new European currency was implemented in January 1999 to replace the separate currencies of eleven western European countries, and beginning in January 2002, was the only effective currency in these countries. This has required changes in our operations as we modified systems and commercial arrangements to deal with the new currency.

We procure parts and raw materials from limited domestic and foreign sources. We use a wide range of parts and raw materials in the production of our semiconductors, host adapter boards, and storage systems, including silicon wafers, processing chemicals, and electronic and mechanical components. We do not generally have guaranteed supply arrangements with our suppliers and do not maintain an extensive inventory of parts and materials for manufacturing. We purchase some of these parts and materials from a limited number of vendors and some from a single supplier. On occasion, we have experienced difficulty in securing an adequate volume and quality of parts and materials. 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 new and current product shipments. If we cannot obtain adequate materials for

manufacture of our products, there could be a material adverse impact on our operating results and financial condition.

We operate in highly competitive markets. We compete in markets that are intensely competitive and that exhibit both rapid technological change and continual price erosion. 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 ASIC products 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 develop internal design and production capabilities to manufacture their own products, thereby displacing 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. To remain competitive, we continually evaluate our worldwide operations, looking for additional cost savings and technological improvements.

Our future competitive performance depends on a number of factors, including our ability to:

- properly identify target markets;
- accurately identify emerging technological trends and demand for product features and performance characteristics;
- develop and maintain competitive products;
- enhance our products by adding innovative features that differentiate our products from those of our competitors;
- bring products to market on a timely basis at competitive prices;
- respond effectively to new technological changes or new product announcements by others;
- adapt products and processes to technological changes; and
- adopt and/or set emerging industry standards.

We may not meet our design, development and introduction schedules for new products or enhancements to our existing and future products. In addition, our products may not achieve market acceptance or sell at favorable prices.

We are dependent on a limited number of customers. We are increasingly dependent on a limited number of customers for a substantial portion of revenues as a result of our strategy to focus our marketing and selling efforts on select, large-volume customers. One customer represented 18% of our total consolidated revenues for the year ended December 31, 2001. In the Semiconductor segment, one customer represented 21% of total Semiconductor revenues for the year ended December 31, 2001. In the SAN Systems segment, there were two customers with revenues representing 21% each, and one customer with revenues representing 13% of total SAN Systems revenues for the year ended December 31, 2001.

Our operating results and financial condition could be affected if:

- we do not win new product designs from major 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.

We utilize indirect channels of distribution over which we exercise limited

control. We derive a material percentage of product revenues from independent reseller and distributor channels. Our financial results could be adversely affected if our relationship with these resellers or distributors were to deteriorate or if the financial condition of these resellers or distributors were to decline. Given the current economic environment, the risk of

distributors going out of business is significantly increased. 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. This 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.

Our Company operations are affected by cyclical fluctuations. The Semiconductor and SAN Systems segments in which we compete are subject to cyclical fluctuations in demand. In 2001, we experienced declines in sales or the prices of our products as a result of the following:

- rapid technological change, product obsolescence, and price erosion in our products;
- maturing product cycles in our products or products sold by our customers;
- increases in worldwide manufacturing capacity for semiconductors, resulting in declining prices; reduced product demand;
- excess inventory within the supply chain; and
- decline of the United States and worldwide economy, causing declines in our product markets or the markets of our suppliers and customers.

The semiconductor industry has in the past experienced periods of rapid expansion of production capacity. Even when the demand for our products remains constant, the availability of additional excess production capacity in the industry creates competitive pressure that can degrade pricing levels, which can reduce revenues. Furthermore, customers who benefit from shorter lead times may defer some purchases to future periods, which could affect our demand and revenues for the short term. As a result, we may experience downturns or fluctuations in demand in the future and experience adverse effects on our operating results and financial condition.

We engage in acquisitions and alliances giving rise to economic and technological risks. We intend to continue to make investments in companies, products and technologies, either through acquisitions or investment alliances. Acquisitions and investment activities often involve risks, including the need to:

- acquire timely access to needed capital for investments related to acquisitions and alliances;
- conduct acquisitions that are timely relative to existing business opportunities;
- successfully prevail over competing bidders for target acquisitions at an acceptable price;

- invest in companies and technologies that contribute to the growth of our business;

- retain the key employees of the acquired operation;

- incorporate acquired operations into our business and maintain uniform standards, controls, and procedures; and

- develop the capabilities necessary to exploit newly acquired technologies.

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 manage any growth effectively. Failure to manage growth effectively and to integrate acquisitions could adversely affect our operating results and financial condition.

There is uncertainty associated with our research and development investments. Our research and development activities are intended to maintain and enhance our competitive position by utilizing the latest advances in the design and manufacture of semiconductors and storage systems including networking, communications and storage technologies. Technical innovations are inherently complex and require long development cycles and the commitment of extensive engineering resources. We must incur substantial research and development costs to confirm the technical feasibility and commercial viability of a product that in the end may not be successful. If we are not able to successfully and timely complete our research and

development programs, we may face competitive disadvantages. There is no assurance that we will recover the development costs associated with such programs or that we will be able to secure the financial resources necessary to fund future research and development efforts.

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 expectation of analysts, and as a result of 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, in particular, and that have often been unrelated to the operating performance of such companies. In addition, the price of our securities may also be affected by general global, economic and market conditions, and the cost of operations in one or more of our product markets. While we cannot predict the individual effect that these factors may have on the price or our securities, these factors, either individually or in the aggregate, could result in significant variations in 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 we are required to redeem any of the convertible securities for cash it may affect our liquidity position.

Our global operations expose the Company to numerous international business risks. We have substantial business activities in Asia and Europe. Both manufacturing and sales of our products may be adversely impacted by changes in political and economic conditions abroad. A change in the current tax laws, tariff structures, export laws, regulatory requirements or trade policies in either the United States or foreign countries could adversely impact our ability to manufacture or sell our products in foreign markets. Moreover, a significant decrease in sales by our customers to end users in either Asia or Europe could

result in a decline in orders.

We subcontract test and assembly functions to independent companies located in Asia. A reduction in the number or capacity of qualified subcontractors or a substantial increase in pricing could cause longer lead times, delays in the delivery of products to customers, or increased costs.

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, patent applications and trademarks. 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, rather than on patent and trademark protection.

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 rights 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 can generally be obtained on commercially reasonable terms. Nevertheless, there is no assurance that licenses will be obtained on acceptable terms or that a claim will not result in litigation or other administrative proceedings. Resolution of whether the Company's product or intellectual property has infringed on valid rights held by others could have a material adverse effect on the Company's financial position or results of operation and may require material changed in production processes and products

See Item 3 "Legal Proceedings" contained in Part I of this Report.

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. We do, however, maintain key person life insurance for one of our employees. The expansion of high technology companies in Silicon Valley, Colorado, Oregon and elsewhere where we operate our business has increased demand and competition for qualified personnel, and despite the economic slowdown, competition for these personnel is intense. Our continued growth and future operating results will depend upon our ability to attract, hire and retain significant numbers of qualified employees.

See also the Critical Accounting Policies contained in Part II, Item 7 of the Management's Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 2. PROPERTIES

The Company's Milpitas facilities are leased and contain the Company's corporate executive headquarters (for both the Semiconductor segment and the SAN Systems segment), administration and engineering offices. The Company maintains leased facilities in Fremont California, housing engineering offices, logistics and warehouses.

The Company owns the land and buildings housing its manufacturing facilities for the Semiconductor segment in Gresham, Oregon, Tsukuba, Japan, Fort Collins, Colorado, and owns the manufacturing control, assembly and test facilities in Tsuen Wan, Hong Kong.

In April 2001, the Company announced the closure of its Colorado Springs fabrication facility in August 2001. In May 2001, the Company entered into a definitive agreement to sell the facility to a third party. On August 1, 2001, the Company announced the termination of the agreement to sell the facility. The Company closed the facility in October 2001 and intends to dispose the assets within the next 12 months.

In September 2001, the Company announced the consolidation of its U.S. manufacturing operations at Gresham, Oregon, and the transfer of process research and development from Santa Clara, California, to Gresham, Oregon. As a result, the Company closed the Santa Clara manufacturing facility. The lease for this facility will expire in 2003. The Company does not plan on subleasing this facility at this time.

In the SAN Systems segment, the Company owns the manufacturing and executive offices site in Wichita, Kansas.

In addition, we maintain leased sales and engineering offices, regional office space for our field sales, marketing and design center offices for both our Semiconductor segment and our SAN Systems segment at various locations in North America, Europe, Japan and elsewhere in Asia. We also maintain design centers at various distributor locations. We also maintain leased executive offices, design centers and sales offices in Bracknell, UK and Tokyo, Japan. Leased facilities described above are subject to operating leases that expire in 2002 through 2011. (See Note 12 of Notes to Consolidated Financial Statements.)

We have plans to acquire additional equipment for some of the above facilities, but we believe that our existing facilities and equipment are well maintained, in good operating condition, suitable for our operations and are adequate to meet our current requirements.

ITEM 3. LEGAL PROCEEDINGS

In late 1995, a lawsuit was filed by certain former shareholders of our Canadian subsidiary ("LSI Canada") in the Court of Queen's Bench of Alberta, Judicial District of Calgary (the "Court") in which the question of LSI Canada's value at September 7, 1995 is to be determined. At present, parties representing approximately 580,000 shares are contesting the value of $4.00 (Canadian) that was paid to the other former shareholders of LSI Canada at the time all shares of LSI Canada not then owned by the Company were acquired by the Company. Following a hearing held in March 2001, the Court dismissed the motion of the former shareholders that challenged the proprietary of the fair value proceedings initiated by LSI Canada and the jurisdiction of the Court to adjudicate the matter. In addition, the Court ruled that the portions of the application of the former shareholders to initiate a claim based upon allegations that our actions and certain named (former) directors and a (former) officer of LSI Canada were oppressive of the rights of minority shareholders of LSI Canada were to be struck and the balance of the claims were stayed. The Court also directed all of the litigants to recommence preparation for trial in the fair value proceeding and advised the litigants of the Court's intention to schedule a date for trial of that matter as soon as practicable. While we cannot give any assurances regarding the resolution of these matters, we believe that the final outcome will not have a material adverse effect on our consolidated results of operations or financial condition. No assurance can be given, however, that these matters will be resolved without our becoming obligated to make payments

or to pay other costs to the opposing parties, with the potential for having an adverse effect on our financial position or results of operations.

In February 1999, a lawsuit alleging patent infringement was filed in the United States District Court for the District of Arizona by the Lemelson Medical, Education & Research Foundation, Limited Partnership against 88 electronics industry companies, including us. The case number is CIV990377PHXRGS. The patents involved in this lawsuit are alleged to relate to semiconductor manufacturing and computer imaging, including the use of bar coding for automatic identification of articles. In September 1999, we filed an answer denying infringement, raising affirmative defenses and asserting a counterclaim for declaratory judgment of non-infringement, invalidity and unenforceability of Lemelson's patents. In December 2001, the court held a hearing on Cypress Semiconductor's and plaintiff's cross-motions for summary judgment with respect to the 4,390,586 patent. In February 2002, the court denied Cypress Semiconductor's motion for summary judgment. The court also granted the plaintiff's cross motion in part with respect to Cypress Semiconductor and denied the cross-motion with respect to all other defendants. These activities are ongoing, and as yet, no trial date has been set. While we cannot make any assurance regarding the eventual resolution of this matter, we do not believe it will have a material adverse effect on our consolidated results of operations or financial condition.

U.S. Philips Corporation, a subsidiary of Royal Philips Electronics of Netherlands, filed suits on October 17, 2001 in the U.S. District Court in New York against eight companies, including us, for allegedly infringing and inducing others to infringe Philips U.S. Patent Number 4,689,740. This patent is directed to devices and methods used with the Inter-Integrated Circuit Bus. While we cannot make any assurance regarding the eventual resolution of this matter, we do not believe it will have a material adverse effect on our consolidated results of operations or financial condition.

The Company is a party to other litigation matters and claims that are normal in the course of its operations, and while the results of such litigation and claims cannot be predicted with certainty, the Company believes that the final outcome of such matters is not expected to have a material adverse effect on the Company's consolidated results of operations and financial position.

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

Not applicable.

EXECUTIVE OFFICERS OF THE COMPANY

The executive officers of the Company, who are elected by and serve at the discretion of the Board of Directors, are as follows:

NAME	AGE	POSITION
Wilfred J. Corrigan.....	64	Chairman and Chief Executive Officer
John D'Errico.....	58	Executive Vice President, Storage Components
Thomas Georgens.....	42	Executive Vice President, SAN Systems
Jon R. Gibson.....	54	Vice President, Human Resources
Bryon Look.....	48	Executive Vice President and Chief Financial Officer
W. Richard Marz.....	58	Executive Vice President, Communications & ASIC Technology
David G. Pursel.....	56	Vice President, General Counsel and Secretary
Giuseppe Staffaroni.....	50	Executive Vice President, Consumer Products
Frank A. Tornaghi.....	47	Executive Vice President, Worldwide Sales
Joseph M. Zelayeta.....	55	Executive Vice President, Worldwide Operations

Mr. Corrigan has been associated with the Company in his present position for more than the past five years.

John D'Errico was named Executive Vice President, Storage Components in August 2000. From August 1998 to August 2000, he was Vice President, Colorado Operations. Mr. D'Errico joined us in 1984 and has held various senior management and executive positions at our manufacturing facilities in the U.S. and Japan. Mr. D'Errico served as Vice President and General Manager, Pan-Asia from April 1997 to August 1998, and Vice President, JSI from July 1994 to April 1997.

Thomas Georgens was named Executive Vice President, SAN Systems, in November 2000. In August 1998, upon the acquisition of Symbios, Inc., a storage company, he was named Senior Vice President and General Manager, SAN Systems. Mr. Georgens joined Symbios in 1996, where he served as Vice President and General Manager of Storage Systems until its acquisition by LSI Logic.

Jon Gibson was named Vice President, Human Resources in November, 2001. He joined LSI in September 1984, as Employee Relations Manager. Mr. Gibson was named Director of Human Resources in October 1987. From March 1999 until November 2001, Mr. Gibson served as Senior Director of Human Resources.

Bryon Look was named Executive Vice President and Chief Financial Officer in November 2000. Mr. Look joined us in March 1997 as Vice President, Corporate Development and Strategic Planning. Prior to joining LSI, during a 21-year career at Hewlett-Packard Company, a computer company, he held a variety of management positions in finance and research and development, with the most recent position being Manager of Business Development for Hewlett-Packard's Corporate Development department.

W. Richard Marz joined the Company in September 1995 as Senior Vice President, North American Marketing and Sales, and was named Executive Vice President, Geographic Markets in May 1996, a position he held until July, 2001. In July 2001, he was named Executive Vice President, ASIC Technology. In January 2002, he was named Executive Vice President, Communications and ASIC Technology.

David G. Pursel was named Vice President, General Counsel and Secretary in June 2000. He joined LSI Logic in February 1996 as Associate General Counsel, Chief Intellectual Property Counsel, and Assistant Secretary.

Giuseppe Staffaroni was named Executive Vice President, Consumer Products in January 2002. Prior to that he was named Executive Vice President Broadband Communications Group, in November 2000, having served as Vice President and General Manager of the Broadband Communications Group since November 1999. Mr. Staffaroni joined LSI Logic in 1990 as Director of Engineering in the Company's Milan, Italy design center. From January 1996 to October 1997, he was Director of Marketing, and from November 1997 to October 1999, he was Vice President and General Manager of the Communications Product Division. Prior to joining LSI Logic, Mr. Staffaroni held management positions at Texas Instruments and AT&T Microelectronics.

Frank A. Tornaghi was named Executive Vice President, Worldwide Sales in July 2001. Since joining the Company in 1984, Mr. Tornaghi has held several management positions in sales at LSI Logic and was named a vice president in 1993. Most recently, he served as Vice President, North America Sales, from May 1993 to July 2001.

Joseph M. Zelayeta was named Executive Vice President, Worldwide Operations, in September 1997. Mr. Zelayeta joined the Company in 1981. From August 1995 to September 1997, he served as Senior Vice President of Research and Development, and General Manager of U.S. Operations.

There are no family relationships between any executive officers and directors.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

On January 25, 2000, we announced a two-for-one stock split, which was declared by the Board of Directors as a 100% stock dividend payable to stockholders of record on February 4, 2000, as one new share of common stock for each share held on that date. The newly issued common stock shares were distributed on February 16, 2000. In the following table, market prices of our common stock have been restated to give retroactive recognition to the two-for-one common stock split.

Our stock trades on the New York Stock Exchange under the symbol "LSI." The high and low sales prices for the stock for each full quarterly period within the two most recent fiscal years as reported on the Exchange are:

	2001	2000
First Quarter	$15.73 - 24.99	$30.00 - 88.25
Second Quarter	$13.97 - 22.76	$43.00 - 74.94
Third Quarter	$10.80 - 24.81	$28.88 - 60.00
Fourth Quarter	$11.19 - 19.24	$16.43 - 32.63
Year	$10.80 - 24.99	$16.43 - 88.25

At March 8, 2002, there were approximately 4,408 owners of record of our common stock.

We have never paid cash dividends on our common stock. It is presently our policy to reinvest our earnings internally, and we do not anticipate paying any cash dividends to stockholders in the foreseeable future.

ITEM 6. SELECTED FINANCIAL DATA

FIVE YEAR CONSOLIDATED SUMMARY

	YEAR ENDED DECEMBER 3			
	2001	2000	1999	

(IN THOUSANDS, EXCEPT PER SHAR

Revenues	$ 1,784,923	$2,737,667	$2,089,444	$
Costs and expenses:				
Cost of revenues	1,160,432	1,557,232	1,286,844	
Additional excess inventory and related charges	210,564	11,100	--	
Total cost of revenues	1,370,996	1,568,332	1,286,844	
Research and development	503,108	378,936	297,554	
Selling, general and administrative	307,310	306,962	257,712	
Acquired in-process research and development	96,600	77,438	4,600	
Restructuring of operations and other non-recurring items, net	219,639	2,781	(2,063)	
Amortization of non-cash deferred stock compensation	104,627	41,113	--	
Amortization of intangibles	188,251	72,648	46,625	
Total costs and expenses	2,790,531	2,448,210	1,891,272	
(Loss)/income from operations	(1,005,608)	289,457	198,172	
Interest expense	(44,578)	(41,573)	(39,988)	
Interest income and other, net	14,529	51,766	17,640	
Gain on sale of equity securities	5,302	80,100	48,393	
(Loss)/income before income taxes, minority interest and cumulative effect of change in accounting principle	(1,030,355)	379,750	224,217	
(Benefit)/provision for income taxes	(39,198)	142,959	65,030	
(Loss)/income before minority interest and cumulative effect of change in accounting principle	(991,157)	236,791	159,187	
Minority interest in net income of subsidiary	798	191	239	
(Loss)/income before cumulative effect of change in accounting principle	(991,955)	236,600	158,948	
Cumulative effect of change in accounting principle	--	--	(91,774)	
Net (loss)/income	$ (991,955)	$ 236,600	$ 67,174	$
Basic earnings per share:				
(Loss)/income before cumulative effect of change in accounting principle	$ (2.84)	$ 0.76	$ 0.54	$
Cumulative effect of change in accounting principle	--	--	(0.31)	
Net (loss)/income	$ (2.84)	$ 0.76	$ 0.23	$
Diluted earnings per share:				
(Loss)/income before cumulative effect of change in accounting principle	$ (2.84)	$ 0.70	$ 0.51	$
Cumulative effect of change in accounting principle	--	--	(0.28)	
Net (loss)/income	$ (2.84)	$ 0.70	$ 0.23	$
Year-end status:				
Total assets	$ 4,625,772	$4,197,487	$3,206,605	$
Long-term obligations	$ 1,630,367	$1,067,704	$ 926,228	$
Stockholders' equity	$ 2,479,885	$2,498,137	$1,855,832	$

The Company's fiscal years ended on December 31 in 2001, 2000, 1999, 1998 and 1997. During 2001, the Company recorded a $97 million in-process research and development ("IPR&D") charge associated with the acquisitions of C-Cube and AMI, which were effective on May 11, 2001 and August 31, 2001, respectively. In addition, the Company recorded $220 million in restructuring of operations and other non-recurring items, net and $105 million in amortization of non-cash deferred stock compensation. (See Notes 2

and 4 of the Notes to the Consolidated Financial Statements.) During 2000, the Company recorded a $77 million IPR&D charge associated with the acquisitions of ParaVoice, DataPath, IntraServer and the purchases of divisions of NeoMagic and Cacheware. In addition, the Company recorded $41 million in non-cash deferred stock compensation as a result of the adoption of FASB interpretation ("FIN") No. 44, "Accounting for Certain Transactions Involving Stock Compensation," which was effective July 1, 2000. (See Note 2 of the Notes to the Consolidated Financial Statements.) During 1999, the Company expensed an unamortized preproduction balance of $92 million, net of taxes, associated with the manufacturing facility in Gresham, Oregon and has presented it as a cumulative effect of a change in accounting principle in accordance with SOP No. 98-5, "Reporting on the Costs of Start-up Activities." (See Note 1 of the Notes to the Consolidated Financial Statements.) During 1998, the Company reported a charge for restructuring of operations and other non-recurring items, net of $75 million and a $146 million IPR&D charge related to the acquisition of Symbios on August 6, 1998.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We operate in an industry sector where stock values are highly volatile and may be influenced by economic and other factors beyond our control. We believe that our future operating results will continue to be subject to quarterly variations based upon a wide variety of factors. See additional discussion contained in "Risk Factors" set forth in Part I, Item 1 of this Annual Report on Form 10-K for the year ended December 31, 2001, which is incorporated by reference into this Part II, Item 7.

Statements in this discussion and analysis include forward-looking information within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended. These statements involve known and unknown risks and uncertainties. Our actual results in future periods may be significantly different from any future performance suggested in this report. Risks and uncertainties that may affect our results may include, among others:

FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

- The current economic downturn;
- Cyclical nature of both the Semiconductor and SAN Systems industries and the markets addressed by our products;
- Availability and extent of utilization of manufacturing capacity;
- Price erosion;

- Competitive factors;
- Timing of new product introductions;
- Changes in product mix;
- Fluctuations in manufacturing yields;
- Product obsolescence;
- Business and product market cycles;
- Economic and technological risks associated with our acquisition and alliance activities; and
- The ability to develop and implement new technologies.

Our operating results could also be impacted by sudden fluctuations in customer requirements, currency exchange rate fluctuations and other economic conditions affecting customer demand and the cost of operations in one or more of the global markets in which we do business. We operate in a technologically advanced, rapidly changing and highly competitive environment. We predominantly sell custom products to customers operating in a similar environment. Accordingly, changes in the conditions of any of our customers may have a greater impact on our operating results and financial condition than if we predominantly offered standard products that could be sold to many purchasers. While we cannot predict what effect these various factors may have on our financial results, the aggregate effect of these and other factors could result in significant volatility in our future performance. To the extent our performance may not meet expectations published by external sources, public reaction could result in a sudden and significantly adverse impact on the market price of our securities, particularly on a short-term basis.

We have international subsidiaries and distributors that operate and sell our products globally. Further, we purchase a substantial portion of our raw materials and manufacturing equipment from foreign suppliers and incur labor and other operating costs in foreign currencies, particularly in our Japanese manufacturing facilities. As a result, we are exposed to the risk of changes in foreign currency exchange rates or declining economic conditions in these countries. We utilize forward exchange and purchased currency option contracts to manage our exposure associated with net asset and liability positions and cash flows denominated in non-functional currencies. (See Note 6 of the Notes to the Consolidated Financial Statements, hereafter referred

to as the Notes.) There is no assurance that these hedging transactions will eliminate exposure to currency rate fluctuations that could affect our operating results.

Our corporate headquarters and some of our manufacturing facilities are located near major earthquake faults. As a result, in the event of a major earthquake, we could suffer damages that could significantly and adversely affect our operating results and financial condition.

Where more than one significant factor contributed to changes in results from year to year, we have quantified material factors throughout the MD&A where practicable.

While management believes that the discussion and analysis in this report is adequate for a fair presentation of the information, we recommend that you

read this discussion and analysis in conjunction with the remainder of this Annual Report on Form 10-K.

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. Note 1 of the Notes describes the significant accounting policies essential to the consolidated financial statements. The preparation of these financial statements requires estimates and assumptions that affect the reported amounts and disclosures.

We believe the following to be critical accounting policies. That is, they are both important to the portrayal of the Company's financial condition and results, and they require critical management judgments and estimates about matters that are inherently uncertain. Although we believe that our judgments and estimates are appropriate and correct, actual future results may differ from our estimates.

Inventory reserves. We establish reserves for estimated excess or obsolete inventory based upon assumptions about demand and market conditions generally over the following 12 months. We operate in a volatile industry sector characterized by rapid changes in technology and market conditions.

Valuation of long-lived and intangible assets and goodwill. We operate our own wafer fabrication facilities and make significant capital expenditures to ensure that we are technologically competitive. In addition, we have actively pursued the acquisition of businesses which have resulted in significant goodwill and intangible assets. We assess the impairment of long-lived assets, identifiable intangibles and related goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors which we consider could trigger an impairment review include the following: (i) significant negative industry or economic trends; (ii) exiting an activity in conjunction with a restructuring of operations; (iii) current, historical or projected losses that demonstrate continuing losses associated with an asset; or (iv) a significant decline in our market capitalization relative to net book value. When we determine that there is an indicator that the carrying value of long-lived assets, identifiable intangibles and related goodwill may not be recoverable, we measure impairment based on estimates of future cash flow. These estimates include assumptions about future conditions within the Company and the industry.

Restructuring reserves. We have recorded reserves for restructuring costs related to the restructuring of operations. The restructuring costs include payments to employees for severance, lease and contract termination fees, decommissioning costs for fabrication equipment, and other costs to close facilities. The reserves are recorded at the time we announce a plan to exit certain activities and are based on estimates of the costs and length of time to exit those activities.

Income taxes. We have recorded a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized. We have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance.

OVERVIEW

Revenues decreased 35% to $1.78 billion in 2001 from $2.74 billion in 2000.

The decrease was primarily the result of decreased demand, most notably for products used in broadband access, networking infrastructure, storage infrastructure applications, and storage area network ("SAN") systems, reflecting the economic downturn in the industry. The decline in revenues was partially offset by the additional revenues from acquisitions of C-Cube Microsystems, Inc. ("C-Cube") and the RAID division of American Megatrends, Inc. ("AMI") in 2001.

Gross profit margin decreased to 23% in 2001 from 43% in 2000 primarily as a result of decreased revenue for higher margin products, higher manufacturing variances and period costs as a percentage of revenues and additional excess inventory and related charges of $210.6 million for 2001 as compared to $11.1 million in 2000. The decrease in gross profit margin was offset in part by cost-saving measures undertaken during 2001 discussed further in Note 4 of the Notes. Operating expenses increased 61% to $1.4 billion in 2001 from $880 million in 2000. The increase was primarily a result of the operating expenses of C-Cube and AMI, a $219.6 million charge for restructuring and other non-recurring items, net, and other acquisition-related charges of $96.6 million for in-process research and development ("IPR&D"), $104.6 million for amortization of non-cash deferred stock compensation and $188.3 million in amortization of intangibles. (See Notes 2 and 4 of the Notes.) Research and development ("R&D") costs increased by $124.2 million in 2001 due to additional costs incurred in connection with acquisitions in 2001 and continued core business spending, which was offset in part by cost-saving measures undertaken during the year. Selling, general and administrative ("SG&A") costs remained relatively flat from year to year. Incremental, post-acquisition SG&A expenses of C-Cube and AMI were largely offset by cost-saving measures undertaken during the year. For the years ended December 31, 2001 and 2000, gains on sale of investments in equity securities were $5.3 million and $80.1 million, respectively. For the year ended December 31, 2001, we recorded a net loss of $992.0 million, or $2.84 loss per diluted share, compared to net income for the same period in 2000 of $236.6 million, or $0.70 income per diluted share. A further discussion on results of operations is covered below.

Cash and short-term investments decreased by 11% to $1.01 billion as of December 31, 2001 from $1.13 billion as of December 31, 2000. The decrease is primarily attributable to lower cash flows from our continuing operations. Some of the major transactions that impacted cash and short-term investments during the year were as follows:

- Payments for acquisitions made in 2001.

- In the third quarter of 2001, we amended the master lease and security agreements entered into in April 2001 and March 2000. (See Note 12 of the Notes.) Pursuant to the amendments, we participated as a debt holder in the lease transactions replacing some of the existing banks. As of December 31, 2001, our debt contribution of $242 million was recorded as non-current assets on the balance sheet. We cash collateralized $54 million of the remaining debt and equity investments of the lessors. This was also recorded as non-current assets and deposits.

- On October 30, 2001, we issued $490 million of 4% Convertible Subordinated Notes due in 2006, increasing our long term liabilities to $1.5 billion at December 31, 2001 from $936.1 million at December 31, 2000. (See Note 8 of the Notes.)

Our significant cash position provides us with the capital to make strategic acquisitions and to continue investing in key technologies.

Stock split. On January 25, 2000, we announced a two-for-one common stock split, which was declared by the Board of Directors as a 100% stock dividend payable to stockholders of record on February 4, 2000 as one new share of common

stock for each share held on that date. The newly issued common stock shares were distributed on February 16, 2000. In the following discussion and analysis, stockholders' equity has been restated to give retroactive recognition to the two-for-one common stock split announced on January 25, 2000 for all periods presented by reclassifying the par value of the newly issued shares arising from the split from additional paid-in capital to common stock. In addition, all references in the financial statements to number of shares, per share amounts, stock option data and market prices of our common stock have been restated.

Acquisitions and other major transactions. We are continually exploring strategic acquisitions that build upon our existing library of intellectual property and increase our leadership position in the markets where we operate.

2001

During 2001, we acquired C-Cube Microsystems Inc. and certain tangible and intangible assets associated with the Redundant Array of Independent Disks, or RAID, business of American Megatrends, Inc. The acquisitions were accounted for as purchases and, accordingly, the estimated fair value of assets acquired and liabilities assumed and the results of operations were included in our Consolidated Financial Statements as of the effective date of each acquisition through the end of the period. The acquisitions are summarized below. (See Note 2 of the Notes.)

COMPANY	ACQUISITION DATE	PURCHASE PRICE	CONSIDERATION	IPR&D	GOODWILL	I I
			(AMOUNTS IN MILLIONS)			
C-Cube	May 2001	$893.7	40.2 million shares, 10.6 million options, 0.8 million warrants	$77.5	$572.1	
RAID Division of AMI	August 2001	240.5	Cash 0.8 million restricted shares	19.1	128.9	

On April 4, 2001, we announced a co-development and foundry supply agreement with Taiwan Semiconductor Manufacturing Company Ltd. ("TSMC"). This agreement is part of our strategy to "outsource," that is to procure a larger portion of our wafer requirements from external sources. As a result of our joint development efforts with TSMC we anticipate purchasing, consistent with our "outsourcing" strategy, such portion of our wafer volume requirements based on the 0.13-micron process technology that we do not manufacture ourselves. In addition, we anticipate being able to defer the need to expand our manufacturing capacity for the 0.13-micron technology beyond the time when products designed for that technology would begin volume production. We also anticipate collaborating with TSMC on further advancement in wafer fabrication technology.

2000

During 2000, we acquired a division of NeoMagic Corporation ("NeoMagic"), a division of Cacheware, Inc. ("Cacheware"), Intraserver Technology, Inc. ("Intraserver"), DataPath Systems, Inc. ("DataPath"), ParaVoice Technologies, Inc. ("ParaVoice") and Syntax Systems, Inc. ("Syntax"). The acquisitions were accounted for as purchases and accordingly, the estimated fair value of assets acquired and liabilities assumed and the results of operations were included in our consolidated financial statements as of the effective date of each

acquisition through the end of the period. These transactions are summarized below. There were no significant differences between the accounting policies of LSI and the companies acquired. (See Note 2 of the Notes.)

COMPANY	ACQUISITION DATE	PURCHASE PRICE	CONSIDERATION	IPR&D	GOODWILL	IDENTIFIE INTANGIBL
				(AMOUNTS IN MILLIONS)		
Division of NeoMagic	April 2000	$ 15.4	Cash	$6.4	$ 1.9	$ 5.8
Division of Cacheware	April 2000	22.2	Cash	8.3	8.5	5.2
Intraserver	May 2000	62.9	1.2 million shares, 0.2 million options	1.6	50.8	17.5
DataPath	July 2000	420.8	7.5 million shares, 1.6 million options	54.2	154.0	17.4
ParaVoice	October 2000	38.6	Cash	6.9	10.4	21.2
Syntax	November 2000	58.8	1.4 million shares, 0.6 million options	--	42.0	25.4

In the second quarter of 2001, the NeoMagic research project was abandoned and the remaining intangibles and goodwill recorded in connection with the project were written off. See the discussion under restructuring of operations and other non-recurring items for details.

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1999

On June 22, 1999, we combined with SEEQ Technology, Inc. ("SEEQ") in a transaction accounted for as a pooling of interests. All financial information has been restated retroactively to reflect the combined operations of LSI Logic and SEEQ as if the combination has occurred at the beginning of the earliest period presented. (See Note 2 of the Notes.)

RESULTS OF OPERATIONS

Revenue. Total revenues decreased 35% to $1.78 billion in 2001 from $2.74 billion in 2000. Revenues for the Semiconductor segment decreased 33% to $1.57 billion in 2001 from $2.34 billion in 2000. The decrease was primarily attributable to decreased demand, most notably for products used in broadband access, networking infrastructure and storage infrastructure applications, reflecting the economic downturn in the semiconductor industry. The decline in revenues in this sector was offset partially by the additional revenues from C-Cube and AMI. Revenues for the SAN Systems segment decreased 47% to $211.3 million in 2001 from $399.1 million in 2000 due to decreased demand reflecting industry declines for all products sold in the SAN Systems segment. As the economic trends reverse, we expect to see sequential quarterly growth in revenues of up to 3% in the first quarter of 2002 from the $406 million in the fourth quarter of 2001.

Total revenues increased 31% to $2.74 billion in 2000 from $2.09 billion in 1999. Revenues for the Semiconductor segment increased 29% to $2.34 billion in 2000 from $1.81 billion in 1999. Significant factors that contributed to this revenue growth included increased demand for semiconductor products used in broadband communications, networking infrastructure and storage infrastructure applications, particularly in broadband access and networks, and storage components. Revenues for the SAN Systems segment increased 43% to $399.1 million

in 2000 from $279.3 million in 1999. The increase was attributable to growth in demand for all products used in the SAN Systems segment.

One customer represented 18% of our total consolidated revenues for the year ended December 31, 2001 and another customer represented 12% and 11% of our total consolidated revenues for each of the years ended December 31, 2000 and 1999, respectively. One customer represented 21% of total revenues in the Semiconductor segment for the year ended December 31, 2001. During 2000, no customer represented 10% or more of total revenues in the Semiconductor segment. During 1999, one customer represented 10% of total Semiconductor revenues. In the SAN Systems segment, there were two customers with revenues representing 21% each, and one customer representing 13% of total SAN Systems revenues for the year ended December 31, 2001. During 2000, there were three customers with revenues representing 31%, 17% and 13% of total SAN Systems revenues. During 1999, there were three customers with revenues representing 29%, 27% and 14% of SAN Systems revenues.

Revenues from domestic operations were $880.8 million, representing 49% of consolidated revenues for 2001, as compared to $1.7 billion and $1.2 billion for 2000 and 1999, representing 61% and 58% of consolidated revenues, respectively. The decline in domestic revenues is mainly due to the severity of the economic downturn in the U.S. as compared to Pan Asia and Japan.

Operating costs and expenses. Key elements of the consolidated statements of operations, expressed as a percentage of revenues for the respective segment, were as follows:

	2001	2000	1999
CONSOLIDATED:			
Gross profit margin	23%	43%	38%
Research and development	28%	14%	14%
Selling, general and administrative	17%	11%	12%
(Loss)/income from operations	(56)%	11%	9%

Key elements of the statement of operations for the Semiconductor and SAN Systems segments, expressed as a percentage of revenues, were as follows:

	2001	2000	1999
SEMICONDUCTOR SEGMENT:			
Gross profit margin	22%	44%	39%
Research and development	30%	15%	15%
Selling, general and administrative	15%	11%	12%
(Loss)/income from operations	(60)%	10%	10%

	2001	2000	1999

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Schedule of Non-Cash Financing

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Transactions		
Option issued to underwriter	1,966,666	1,966,666
Deferred underwriting fees	5,468,000	5,468,000
Issuance of note payable for treasury		
Stock		25,000
Warrant obligation in connection with sale of units in offering	$ 19,912,796	$ 19,912,796

See accompanying notes to financial statements.

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HAPC, INC.

(formerly HEALTHCARE ACQUISITION PARTNERS CORP.)

(a corporation in the development stage)

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

1. Basis of Presentation

The financial statements for the six months ended June 30, 2006 are unaudited. In the opinion of management, all adjustments (consisting only of normal recurring accruals) have been made that are necessary to present fairly the financial position of HAPC, Inc. (formerly Healthcare Acquisition Partners Corp.) (the Company) as of June 30, 2006 and the results of its operations and its cash flows for the six months ended June 30, 2006 and period from August 15, 2005 (inception) to June 30, 2006 in conformity with generally accepted accounting principles. Operating results for the interim period are not necessarily indicative of the results to be expected for the full year.

2. Nature of Operations and Summary of Significant Accounting Policies

The Company was incorporated in Delaware on August 15, 2005 as a blank check company whose objective is to acquire through a merger, capital stock exchange, asset acquisition or other similar business combination, one or more operating businesses primarily in the healthcare sector.

Practically all activity through June 30, 2006 relates to the Company s formation and the initial public offering described below. The Company has selected December 31 as its fiscal year end. The registration statement for the Company s initial public offering (the Public Offering) was declared effective on April 11, 2006. The Company consummated the Public Offering on April 18, 2006 and received gross proceeds of $100,000,002. Legal fees totaling $497,000 and underwriting costs totaling $2,600,000 have been paid from these proceeds. The Company s management has broad discretion with respect to the specific application of the net proceeds of the Public Offering (as described in Note 3), although substantially all of the net proceeds of the Public Offering are intended to be applied toward consummating a business combination with one or more operating businesses whose fair value is, either individually or collectively, at least 80% of the Company s net assets at the time of such acquisition (Business Combination).

In evaluating a prospective target business, the Company will consider, among other factors, its financial condition and results of operations; growth potential; experience and skill of management; availability of additional personnel; capital requirements; competitive position; barriers to entry into other industries; stage of development of products, processes or services; degree of current or potential market acceptance of the products, processes or services; proprietary features and degree of intellectual property or other protection of the products, processes or services; the regulatory environment of the industry; and costs associated with effecting the Business Combination. These criteria are not intended to be exhaustive. Any evaluation relating to the merits of a particular Business Combination will be based, to the extent relevant, on the above factors, as well as other considerations deemed relevant by the Company in effecting a Business Combination consistent with its business objective.

There are no assurances the Company will be able to successfully effect a Business Combination.

Of the proceeds of the Public Offering, $96,877,683 including interest, net of tax payments, is being held in a trust account (Trust Account) and invested in a money market fund, fully collateralized by U.S. government securities until the earlier of (i) the consummation of the first Business Combination or (ii) the distribution of the Trust Account as described below. The amount in the Trust Account includes $5,468,000 of contingent underwriting compensation (the Discount) which will be paid to the

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HAPC, INC.

(formerly HEALTHCARE ACQUISITION PARTNERS CORP.)

(a corporation in the development stage)

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

2. Nature of Operations and Summary of Significant Accounting Policies (Continued)

underwriters if a Business Combination is consummated, but which will be forfeited in part if public stockholders elect to have their shares redeemed for cash if a Business Combination is not consummated. The remaining amount of the proceeds may be used to pay business, legal accounting, due diligence on prospective acquisitions and continuing general and administrative expenses.

The Company, after signing a definitive agreement for the acquisition of a target business, will submit such transaction for stockholder approval. In the event that stockholders owning 20% or more of the shares sold in the Public Offering vote against the Business Combination and exercise their conversion rights described below, the Business Combination will not be consummated. The Company s stockholders prior to the Public Offering (the Initial Stockholders) have agreed to vote their 1,750,001 shares of common stock in accordance with the vote of the majority in interest of all other stockholders of the Company (Public Stockholders) with respect to any Business Combination. The Initial Stockholders have agreed not to acquire any additional shares of the registrant in connection with or following the Public Offering. After consummation of a Business Combination, these voting safeguards will no longer be applicable.

The Company s Amended and Restated Certificate of Incorporation provides for mandatory liquidation of the Company in the event that the Company does not consummate a Business Combination within 18 months from the date of the consummation of the Public Offering, or 24 months from the consummation of the Public Offering if certain extension criteria have been satisfied. In the event of liquidation, it is likely that the per share value of the residual assets remaining available for distribution (including Trust Account assets) will be less than the initial public offering price per share in the Public Offering (assuming no value is attributed to the Warrants contained in the Units to be offered in the Public Offering discussed in Note 3).

Cash and cash equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Accounting for Warrants and Derivative Instruments

On April 18, 2006, the Company consummated its initial public offering of 16,666,667 units. On May 18, 2006, the Company sold 208,584 Units (the Overallotment Units) to FTN Midwest Securities Corp., the lead underwriter in the Company s initial public offering, pursuant to a partial exercise by FTN Midwest Securities Corp. of its overallotment option. The Overalloment Units were sold at the offering price of $6.00 per Unit, minus FTN Midwest Securities Corp. s 7% underwriting discount. Each unit consists of one share of common stock and two redeemable common stock purchase warrants. Each warrant entitles the holder to purchase from the Company one share of its common stock at an exercise price of $5.00.

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HAPC, INC.

(formerly HEALTHCARE ACQUISITION PARTNERS CORP.)

(a corporation in the development stage)

NOTES TO FINANCIAL STATEMENTS

2. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Accounting for Warrants and Derivative Instruments (Continued)

In September 2000, the Emerging Issues Task Force issued EITF 00-19, Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in, a Company s Own Stock, (EITF 00-19) which requires freestanding contracts that are settled in a company s own stock, including common stock warrants, to be designated as equity instrument, asset or a liability. Under the provisions of EITF 00-19, a contract designated as an asset or a liability must be carried at fair value on a company s balance sheet, with any changes in fair value recorded in the company s results of operations. A contract designated as an equity instrument must be included within equity, and no fair value adjustments are required from period to period. In accordance with EITF 00-19, the 33,750,502 warrants issued to purchase stock are separately accounted for as liabilities. The fair value of these warrants is shown on the Company s balance sheet and the unrealized changes in the values of these warrants are shown in the Company s statement of operations as Gain (loss)on warrant liabilities. These warrants are freely traded on the Over The Counter Bulletin Board. Consequently, the fair value of these warrants are estimated as the market price of the warrant at each period end. To the extent the market price increases or decreases, the Company s warrant liabilities will also increase or decrease, including the effect on the Company s statement of operations.

Income taxes

The Company uses the liability method for reporting income taxes, under which current and deferred tax liabilities and assets are recorded in accordance with enacted tax laws and rates. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Under the liability method, the amounts of deferred tax liabilities and assets at the end of each period are determined using the tax rate expected to be in effect when taxes are actually paid or recovered. Future tax benefits are recognized when it is more likely than not that such benefits will be realized.

Recently issued accounting pronouncements

Management does not believe that any recently issued, but not yet effective, accounting standards if currently adopted would have a material effect on the accompanying financial statements.

Loss per common share

Loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period.

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HAPC, INC.

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NOTES TO FINANCIAL STATEMENTS

2. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Accounting for Warrants and Derivative Instruments (Continued)

Stock based compensation

The Company applied APB No. 25 (Accounting for Stock Issued to Employees) and related Interpretations in accounting for stock based compensation. Accordingly, compensation for shares issued to officers and directors is measured using their intrinsic value at the date of opportunity to acquire such shares and recognized as compensation expense ratably over the vesting period. Effective January 1, 2006, the Company will be applying the provisions of SFAS No. 123(R).

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates.

Cash concentration of credit risk

The Company maintains cash balances with financial institutions, which, at times, may exceed the Federal Deposit Insurance Corporation limit. The Company has not experienced any losses to date as a result of this policy, and management believes there is little risk of loss.

3. Initial Public Offering

On April 18, 2006, the Company sold 16,666,667 units (Units) to the public at a price of $6.00 per unit. Each Unit consists of one share of the Company s common stock, $.0001 par value, and two Redeemable Common Stock Purchase Warrants (Warrants). Each Warrant will entitle the holder to purchase from the Company one share of common stock at an exercise price of $5.00 commencing on the later of the completion of a Business Combination or one year from the effective date of the Offering and expiring five years from the effective date of the Offering. The Company may call the Warrants for redemption in whole and not in part at a price of $.01 per Warrant at any time after the Warrants become exercisable. They cannot be redeemed unless the Warrant holders receive written notice not less than 30 days prior to the redemption; and, if, and only if, the reported last sale price of the common stock equals or exceeds $8.50 per share for any 20 trading days within a 30 trading day period ending on the third business day prior to the notice of redemption to Warrant holders. In connection with the Public Offering, the Company paid to FTN Midwest Securities Corp. an underwriting discount of 7% of the public offering price and a non accountable expense allowance of 1% of the public offering price.

In addition, on April 18, 2006, the Company issued to FTN Midwest Securities Corp., for $100, an option to purchase up to a total of 833,333 units. The units issuable upon exercise of this option are identical to those offered in the Public Offering, except that each of the warrants underlying this option entitles the holder to purchase one share of our common stock at a price of $6.25. This option is exercisable at $7.50 per unit commencing on the later of the consummation of a Business Combination and one year from the

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NOTES TO FINANCIAL STATEMENTS

3. Initial Public Offering (Continued)

date of the prospectus and expiring five years from the date of the prospectus. The option may only be exercised or converted by the option holder.

The warrants issuable upon exercise of the option will be exercisable only if at the time of exercise (i) a registration statement under the Securities Act of 1933, as amended (the Securities Act), with respect to the common stock underlying the warrants issuable upon exercise of the option is effective, or (ii) in the opinion of counsel to the Company or counsel to the option holder reasonably satisfactory to the Company, the exercise of the warrants is exempt from the registration requirements of the Securities Act and such securities are qualified for sale or exempt from qualification under applicable securities laws of the states or other jurisdictions in which the registered holders reside. The warrants may not be exercised by, or securities issued to, any registered holder in any state in which such exercise or issuance would be unlawful. The option holder is not entitled to receive a net cash settlement or other settlement in lieu of physical settlement if the common stock underlying the warrants, or securities underlying the option, as applicable, are not covered by an effective registration statement.

The sale of the option was accounted for as an equity transaction. Accordingly, there was no net impact on the Company s financial position or results of operations, except for the recording of the $100 proceeds from the sale. The Company determined that the fair value of the option on the date of sale was $2.36 per unit, or $1,966,666 total, using an expected life of five years, volatility of 47% and a risk-free interest rate of 3.98%. Accordingly, this amount was recorded as an expense of the offering resulting in a charge directly to stockholders equity.

The volatility calculation of 47% is based on the 180 day average volatility of a representative sample of forty-one (41) healthcare industry companies (the Sample Companies) with market capitalization under $200 million. Because it does not have a trading history, the Company needed to estimate the potential volatility of its common stock price. The volatility will depend on a number of factors, which cannot be ascertained at this time. The Company referred to the 180 day average volatility of the Sample Companies because Management believes that the average volatility of such companies is a reasonable benchmark to use in estimating the expected volatility of the Company s common stock post-business combination. Although an expected life of five years was taken into account for purposes of assigning a fair value to the options, if the Company does not consummate a business combination within the prescribed time period and liquidates, the options would become worthless.

On May 18, 2006, the Company sold 208,584 Units (the Overallotment Units) to FTN Midwest Securities Corp. pursuant to a partial exercise by FTN Midwest Securities Corp. of its overallotment option. The Overallotment Units were sold at the offering price of $6.00 per Unit, minus FTN Midwest Securities Corp. s 7% underwriting discount.

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NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

4. Restatement And Reclassification Of Previously Issued Financial Statements

In February 2007, the Company concluded that it was necessary to restate its annual financial statements for the interim periods ended April 18, 2006, June 30, 2006 and September 30, 2006 to reflect gains and losses related to the classification of and accounting for the warrants to purchase common stock associated with the units sold at the initial public offering of the Company, including the overallotment shares issued on May 18, 2006. The Company had previously classified the value of these warrants to purchase common stock, when applicable, as equity. After further review in connection with the presentation of the Company s Preliminary Proxy Statement related to the acquisition contemplated by the Stock Purchase Agreement dated September 29, 2006 by and among the Company, I-Flow Corporation, a Delaware corporation (I-Flow), and InfuSystem Inc., a California corporation and wholly-owned subsidiary of I-Flow (InfuSystem), the Company has determined that these instruments should have been classified as liabilities and, therefore, the fair value of each instrument must be recorded as a liability on the Company s balance sheet. Changes in the fair values of these instruments will result in adjustments to the amount of the recorded liabilities, and the corresponding gain or loss will be recorded in the Company s statement of operations.

The fair market value of the Company s 33,750,502 warrants outstanding at June 30, 2006 was $10,125,151 or $.30 per warrant.

The accompanying financial statements for the six months ended June 30, 2006 have been restated to effect the changes described in Note 2. The impact of the adjustments related to the classification of and accounting for the warrants for the period from inception to June 30, 2006 and for the three and six months ended June 30, 2006 is summarized below.

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HAPC, INC.

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NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

4. Restatement And Reclassification Of Previously Issued Financial Statements (Continued)

Statement of Operations

	For the period from August 15, 2005 (date of inception) through June 30, 2006		
	As Previously Reported	Adjustments	As Restated
General and Administrative expenses	$ (4,584,453)	$	$ (4,584,453)
Interest income	857,032		857,032
Interest expense	(1,311)		(1,311)
Gain on warrant liabilities		9,787,645	9,787,645
Income (loss) before provision for taxes	(3,728,732)	9,787,645	6,058,913
Provision for income taxes	191,893		191,893
Net income (loss)	**$ (3,920,625)**	**$ 9,787,645**	**$ 5,867,020**
Weighted average shares outstanding - basic	6,284,410	6,284,410	6,284,410
Net income (loss) per share - basic	$ (0.62)	$ 1.55	$ 0.93

As a result of recording the change in the fair value of warrant liability, the Company has reported net income for the period ended June 30, 2006 compared to a net loss as previously reported. Such net income is solely attributable to the gain resulting from the change in the fair value of the warrant liability during the period. If the per share effect of potential common shares issued upon exercise of the warrants, aggregating 33,750,502, were included in diluted loss per share, the effect would be anti-dilutive. Accordingly, such per share effect has not been included.

	For the three months ended June 30, 2006		
	As Previously Reported	Adjustments	As Restated
General and Administrative expenses	$ (2,362,781)	$	$ (2,362,781)
Interest income	857,032		857,032
Interest expense	(223)		(223)
Gain on warrant liabilities		9,787,645	9,787,645
Income (loss) before provision for taxes	(1,505,972)	9,787,645	8,281,673
Provision for income taxes	191,149		191,149

Net income (loss)	**$ (1,697,121)**	**$ 9,787,645**	**$ 8,090,524**
Weighted average shares outstanding - basic	15,403,969	15,403,969	15,403,969
Net income (loss) per share - basic	$ (0.11)	$ 0.64	$ 0.53

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HAPC, INC.

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NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

4. Restatement And Reclassification Of Previously Issued Financial Statements (Continued)

As a result of recording the change in the fair value of warrant liability, the Company has reported net income for the period ended June 30, 2006 compared to a net loss as previously reported. Such net income is solely attributable to the gain resulting from the change in the fair value of the warrant liability during the period. If the per share effect of potential common shares issued upon exercise of the warrants, aggregating 33,750,502, were included in diluted loss per share, the effect would be anti-dilutive. Accordingly, such per share effect has not been included.

	For the six months ended June 30, 2006		
	As Previously Reported	Adjustments	As Restated
General and Administrative expenses	$ (4,559,970)	$	$ (4,559,970)
Interest income	857,032		857,032
Interest expense	(1,011)		(1,011)
Gain on warrant liabilities		9,787,645	9,787,645
Income (loss) before provision for taxes	(3,703,949)	9,787,645	6,083,696
Provision for income taxes	191,893		191,893
Net income (loss)	**$ (3,895,842)**	**$ 9,787,645**	**$ 5,891,803**
Weighted average shares outstanding - basic	8,614,703	8,614,703	08,614,703
Net income (loss) per share - basic	$ (0.45)	$ 1.14	$ 0.68

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NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006

4. Restatement And Reclassification Of Previously Issued Financial Statements (Continued)

The following table sets forth the effects for the restatement adjustment on the Company s balance sheet as of June 30, 2006:

	June 30, 2006 As Previously Reported	Adjustments	June 30, 2006 As Restated
ASSETS			
Current assets:			
Cash and cash equivalents	$ 997,268	$	$ 997,268
Cash held in trust account	96,877,683		96,877,683
Prepaid expenses	482,100		482,100
Total assets	**$ 98,357,051**		**$ 98,357,051**
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)			
Current Liabilities:			
Accrued expenses	$ 12,500	$	$ 12,500
Stockholder advance	100		100
Deferred underwriting fees	5,468,000		5,468,000
Warrant liabilities		10,125,151	10,125,151
Total Liabilities	**6,105,908**	**10,125,151**	**15,605,751**
COMMITMENTS			
Common Stock subject to conversion 3,373,363 and 0 shares, respectively, at conversion value	18,990,500		18,990,500
Stockholders Equity (Deficit)			
Preferred stock, $.0001 par value; authorized 1,000,000 shares; none issued and outstanding			
Common stock, $.0001 par value; authorized 200,000,000 shares; issued 21,041,918 and 4,166,667, respectively and outstanding 18,625,252 and 1,750,001, respectively	2,104		2,104
Additional paid-in capital	77,429,123	(19,912,796)	57,254,327
Retained Earnings (Deficit accumulated) during the development stage	(3,920,625)	9,787,645	5,867,020
Total stockholders equity (deficit)	**73,510,602**	**(10,125,151)**	**63,385,541**

Total liabilities and stockholders equity	**$ 98,357,051**	**$**	**$ 98,357,051**

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The following table sets forth the effects for the restatement of the Company s statement of stockholders equity (deficit) for the nine month period ended June 30, 2006:

	Common Stock		Paid-in	Deficit Accumulated	Treasury Stock		
	Shares	Par Value $0.0001 Amount	Capital in Excess of Par	During the Development Stage	Shares	Amount	Total Stockholders Equity
Balance at June 30, 2006 (as previously reported)	21,041,918	$ 2,104	$ 77,429,123	$ (3,920,625)	(2,416,666)	$	$ 73,510,602
Restatement adjustments			(19,912,796)	9,787,645			(10,125,151)
Balances at June 30, 2006 (as restated)	**21,041,918**	**$ 2,104**	**$ 57,516,327**	**$ 5,867,020**	**(2,416,666)**	**$**	**$ 63,385,451**

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The following table sets forth the effects for the restatement of the Company s statements of cash flows for the six month period ended June 30, 2006 and for the period from August 15, 2005 (inception) to June 30, 2006:

	Six Months Ended June 30, 2006 (As Previously Reported)	Six Months Ended June 30, 2006 Adjustments	Six Months Ended June 30, 2006 (As Restated)
Cash flows from operating activities:			
Net (loss) income	$ (3,895,842)	$ 9,787,645	$ 5,891,803
Adjustment to reconcile net income to net cash used in operating activities:			
Gain on warrant liabilities		(9,787,645)	(9,787,645)
Changes in Assets and Liabilities:			
Interest income on investments held in trust	(854,039)		(854,039)
Withdrawal from investments held in trust	191,149		191,149
Amortization of stock based compensation	4,381,517		4,381,517
Increase in prepaid expenses and taxes	(673,249)		(673,249)
Decrease in other deferred offering costs	165,088		165,088
Increase (decreases) in accrued expenses	(81,454)		(81,454)
Increase in income taxes payable	191,149		191,149
Net cash used in operating activities	**(575,681)**		**(575,681)**
Cash flows from investing activities:			
Purchase of investments held in trust	(96,214,793)		(96,214,793)
Net cash used in operating activities	**(96,214,793)**		**(96,214,793)**
Cash flows from financing activities:			
Advance from initial stockholder			
Proceeds from note payable			
Payment of notes payable	(85,000)		(85,000)
Payment of deferred offering costs	(3,392,354)		(3,392,354)
Proceeds from public offering	81,885,657		81,885,657
Proceeds from issuance of shares of stock subject to possible conversion	19,365,849		19,365,849
Net cash provided by financing activities	**97,774,152**		**97,774,152**
Net change in cash	**983,678**		**983,678**
Cash, beginning of period	**13,590**		**13,590**
Cash, end of period	**$ 997,268**	**$**	**$ 997,268**
Supplemental Disclosures of Cash Flow Information:			
Schedule of Non-Cash Financing Transactions			
Option issued to underwriter	1,966,666	1,966,666	1,966,666
Deferred underwriting fees	5,468,000	5,468,000	5,468,000
Issuance of note payable for treasury Stock			25,000
Warrant obligation in connection with sale of units in offering	$	$ 19,912,796	$ 19,912,796

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	For the period from August 15, 2005 (inception) to June 30, 2006 As Previously Reported	For the period from August 15, 2005 (inception) to June 30, 2006 Adjustments	For the period from August 15, 2005 (inception) to June 30, 2006 As Restated
Cash flows from operating activities:			
Net income	$ (3,920,625)	$ 9,787,645	$ 5,867,020
Adjustment to reconcile net income to net cash used in operating activities:			
Gain on warrant liabilities		(9,787,645)	(9,787,645)
Changes in Assets and Liabilities:			
Interest income on investments held in trust	(854,039)		(854,039)
Withdrawal from investments held in trust	191,149		191,149
Amortization of stock based compensation	4,405,924		4,405,924
Increase in prepaid expenses and taxes	(673,249)		(673,249)
Increase (decreases) in accrued expenses	12,500		12,500
Increase in income taxes payable	191,149		191,149
Net cash used in operating activities	**(647,191)**		**(647,191)**
Cash flows from investing activities:			
Purchase of investments held in trust	(96,214,793)		(96,214,793)
Net cash used in operating activities	**(96,214,793)**		**(96,214,793)**
Cash flows from financing activities:			
Advance from initial stockholder	100		100
Proceeds from note payable	60,000		60,000
Payment of notes payable	(85,000)		(85,000)
Payment of deferred offering costs	(3,392,354)		(3,392,354)
Proceeds from public offering	81,910,657		81,910,657
Proceeds from issuance of shares of stock subject to possible conversion	19,365,849		19,365,849
Net cash provided by financing activities	**97,859,252**		**97,859,252**
Net change in cash	**997,268**		**997,268**
Cash, beginning of period			
Cash, end of period	**$ 997,268**	**$**	**$ 997,268**
Supplemental Disclosures of Cash Flow Information:			
Schedule of Non-Cash Financing Transactions			
Option issued to underwriter	1,966,666		1,966,666
Deferred underwriting fees	5,468,000		5,468,000
Issuance of note payable for treasury Stock	25,000		25,000
Warrant obligation in connection with sale of units in offering	$	$ 19,912,796	$ 19,912,796

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NOTES TO FINANCIAL STATEMENTS

5. Investments Held in Trust

Investments held in trust at June 30, 2006, consist of a United States Treasury money market account with a fair market value of $96,877,683. There were no investments held in trust as of December 31, 2005.

6. Notes Payable

The Company issued a $60,000 unsecured promissory note to Healthcare Acquisition Holdings, LLC (Holdings), a Company owned by certain directors of the Company. The note bears interest at a rate of 3% per annum and is payable on the earlier of September 28, 2006 or the date the Company consummates the Public Offering. Due to the short-term nature of the note, the fair value of the note approximates its carrying amount.

On December 30, 2005, the Company issued an unsecured $25,000 note, on similar terms to the $60,000 note payable, to Holdings to acquire the 4,166,667 common shares that Holdings received upon formation of the Company.

Both notes were re-paid in full in May 2006 and are no longer outstanding.

7. Commitments

The Company s chief executive officer receives annual compensation of $50,000 for serving as an officer and $50,000 for serving as a director. The Company s chief financial officer receives annual compensation of $50,000 and the Company s independent directors each receive annual compensation of $50,000.

The Company has entered into agreements with FTN Midwest Securities Corp. and certain officers and directors whereby each of them has agreed to present the Company, for its consideration, with any opportunity to acquire all or substantially all of the outstanding equity securities of, or otherwise acquire a controlling equity interest in, an operating business in the healthcare, or a healthcare-related, sector, provided that they are under no obligation to present the Company with any opportunity involving a business in the healthcare, or a healthcare-related, sector seeking a strategic combination with another operating business in the healthcare, or a healthcare-related, sector.

The Company currently utilizes and will continue to utilize certain administrative, technological and secretarial services, as well as certain limited office space provided by FTN Midwest Securities Corp. until the consummation of a Business Combination by the Company. The Company has agreed to pay $1 per year for such services commencing on the effective date of the Public Offering and continuing monthly thereafter.

Our initial stockholders are entitled to demand that we register the resale of their shares of common stock at any time six months following the consummation of the acquisition, pursuant to the terms of their respective lock-up agreements.

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NOTES TO FINANCIAL STATEMENTS

7. Commitments (Continued)

The Company has agreed to reimburse our initial stockholders for (a) any income tax liability incurred by our initial stockholders as a result of the award of their shares and/or the vesting of such shares (other than tax liability due as a result of their sale of such shares) and (b) all reasonable out-of-pocket expenses incurred by the initial stockholders in connection with their activities on the Company s behalf.

8. Common and Preferred Stock

Effective December 30, 2005, Holdings sold the 4,166,667 common shares that it had received upon formation of the Company back to the Company. The shares were purchased for a $25,000 note payable. Simultaneously, the Company transferred 1,750,001 of these common shares to certain members of its management team resulting in compensation of $8,435,005 to them, computed at $4.82 per share. Of this amount, $24,407 and $4,381,517 was charged to expense for the periods ended December 31, 2005 and June 30, 2006, respectively. The Company will recognize the remaining $6,213,982 of compensation as an expense ratably over the forfeiture period of the shares. Each individual receiving shares has agreed to forfeit a portion of their shares if they cease to be an officer or director prior to the following dates (other than as a result of (i) disability, (ii) death, (iii) removal by the Company without cause, or (iv) resignation for Good Reason, the portion of the shares to be forfeited is as follows:

Termination of Services Prior To:	Shares Forfeited
June 30, 2006	100%
December 31, 2006	75%
June 30, 2007	50%
December 31, 2007	25%

The 2,416,666 shares of our common stock transferred back to us and not transferred to members of the Company s management team on December 30, 2005 are being held as treasury shares and reserved for transfer by the Company s board of directors to present or future officers, directors or employees.

The Company is authorized to issue 1,000,000 shares of preferred stock with such designations, voting and other rights and preferences as may be determined from time to time by the Board of Directors.

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NOTES TO FINANCIAL STATEMENTS

9. Subsequent Events

On July 24, 2006, the Company reserved for grant to two of its Directors 2,416,666 shares of its common stock. These shares were originally held as treasury shares and reserved for transfer to present or future officers, directors or employees.

The grants may not be transferred prior to the date that is the later of six months after the completion of a business combination or April 11, 2007 (being the first anniversary of the Company s initial Public Offering).

As a result of the above, the Company will take a charge of $13,049,996 in its quarter ended September 30, 2006 which is based upon the number of shares reserved (2,416,666) at the July 24, 2006 closing stock price of $5.40 per share.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Forward-Looking Statements

This Amendment No. 2 to Quarterly Report on Form 10-Q/A includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may , should , could , would , expect , plan , anticipate , estimate , continue , or the negative of such terms or other similar expressions. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those described in our other Securities and Exchange Commission filings. The following discussion should be read in conjunction with our Financial Statements and related Notes thereto included elsewhere in this report and the Audited Financials included in our other Securities and Exchange Commission Filings.

Management s Discussion and Analysis of Financial Condition and Results of Operations has been revised for the effects of the restatement in Note 4.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates. Management believes the following critical accounting policies, among others, involve its more significant judgments and estimates used in the preparation of the financial statements.

Share-Based Payment

Management uses certain assumptions relating to determining the value of share-based payments based on fair value. These can include, as appropriate, relevant modeling techniques such as the Black-Scholes model and analyses of the valuation of various derivative securities of other comparable publicly traded companies.

Valuation of Warrants

Fair values for traded securities and derivatives are based on quoted market prices. Where market prices are not readily available, as in the case of the Company s warrants as of the date of issuance, fair values are determined using methods requiring judgment and estimates. Before the warrants were publicly traded, the Company allocated the unit price between the share of common and the warrants issued based upon relative fair value determined, among other things, by reference to comparative companies. The warrants included in the units sold in the Company s initial public offering began to be publicly traded on the Over the Counter Bulletin Board on June 15, 2006, and consequently the market value of the warrants is reflected as the fair value of the warrants at each period end. To the extent that the market prices of the Company s warrants increase or decrease, the Company s derivative liabilities will also increase or decrease with a corresponding impact on its statement of operations.

Overview

We were organized as a Delaware corporation on August 15, 2005, to serve as a vehicle to acquire, through a merger, capital stock exchange, asset acquisition or other similar business combination, one or more operating businesses primarily in the healthcare sector. Our initial business combination must be with a target business or businesses whose fair market value is at least equal to 80% of net assets at the time of such acquisition. We intend to utilize cash derived from the proceeds of our initial public offering, our capital stock, debt or a combination of cash, capital stock and debt, in effecting a business combination.

Results of Operations for the Quarter Ending June 30, 2006

During the quarter ended June 30, 2006, we completed our Public Offering. Additional formation and operating costs of $2,362,781 were offset by interest income totaling $857,032, earned on proceeds from the Public Offering, and a non-cash gain of $9,787,645 on warrant liabilities, resulting in a net income for the six and three months ending June 30, 2006 of $5,891,803 and $8,090,524, respectively.

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Liquidity and Capital Resources

On April 18, 2006, we consummated our Public Offering of 16,666,667 units sold to the public at a price of $6.00 per unit. Each Unit consists of one share of the Company s common stock, $.0001 par value, and two Redeemable Common Stock Purchase Warrants (Warrants). Each Warrant will entitle the holder to purchase from the Company one share of common stock at an exercise price of $5.00 commencing on the later of the completion of a Business Combination or one year from the effective date of the Offering and expiring five years from the effective date of the Offering. The Company may call the Warrants for redemption in whole, but not in part, at a price of $.01 per Warrant at any time after the Warrants become exercisable. They cannot be redeemed unless the Warrant holders receive written notice not less than 30 days prior to the redemption; and if, and only if, the reported last sale price of the common stock equals or exceeds $8.50 per share for any 20 trading days within a 30 trading day period ending on the third business day prior to the notice of redemption to Warrant holders.

On May 18, 2006, we sold an additional 208,584 units (the Overallotment) pursuant to a partial exercise by FTN Midwest Securities Corp. of its overallotment option. Net proceeds (including the Overallotment) after underwriting, legal, accounting, and printing costs amounted to approximately $97,859,000 which includes a contingent underwriting fee of $5,468,000. $96,877,683 is being held in a Trust account. We will use substantially all of the net proceeds of the Public Offering to acquire a target business, including identifying and evaluating prospective acquisition candidates, selecting the target business, and structuring, negotiating and consummating the business combination.

Commencing on April 18, 2005 and ending upon the acquisition of a target business, we will incur a fee of $1 per year for office space and certain other additional general and administrative services from FTN Midwest Securities Inc.

We granted a purchase option to the representative of the underwriter at the closing of the Public Offering on April 18, 2006 to acquire 833,333 units for $100. The units issuable upon exercise of this option are identical to those offered in the Public Offering, except that each of the warrants underlying this option entitles the holder to purchase one share of our common stock at a price of $6.25. This option is exercisable at $7.50 per unit commencing on the later of the consummation of a Business Combination and one year from the date of the prospectus and expiring five years from the date of the prospectus. The option may only be exercised or converted by the option holder.

The sale of the option was accounted for as an equity transaction. Accordingly, there was no net impact on the Company s financial position or results of operations, except for the recording of the $100 proceeds from the sale. The Company has determined that the fair value of the option on the date of sale was $2.36 per unit, or approximately $1,966,666 total, using an expected life of five years, volatility of 47% and a risk-free interest rate of 3.98%. Accordingly, this amount was recorded as an expense of the offering resulting in a charge directly to the stockholders equity.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure material information required to be disclosed in our reports that we file or submit under the Securities Exchange Act of 1934,

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as amended, or the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, with a company have been detected.

As of the end of the period covered by our Form 10-Q, we carried out an evaluation, under the supervision and with the participation of the Audit Committee and management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) and 15d-15(e) of the Exchange Act. The Chief Executive Officer and Chief Financial Officer originally concluded that our disclosure controls and procedures were effective, at the reasonable assurance level However, because of the material weakness discussed below, management has reconsidered, and contemporaneously concluded in connection with the filing of this 10-Q/A, that our disclosure controls and procedures were ineffective. A material weakness, as defined by the Public Company Accounting Oversight Board, is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Management determined that a material weakness existed in the Company s financial closing and reporting process as of September 30, 2006. Specifically, the Company does not have sufficient resources with the appropriate expertise to adequately evaluate complex transactions entered into by the Company and determine the appropriate application of generally accepted accounting principles (GAAP). This material weakness resulted in the error in accounting for the effects of our warrants issued to purchase common stock.

In light of the material weakness, we performed additional procedures to ensure that the condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles. Accordingly, management believes that the financial statements included in this Form 10-Q/A fairly present in all material respects our financial condition, results of operation and cash flows for the periods presented.

Change in Internal Control

We are in the process of implementing improved procedures and controls designed to increase our ability to evaluate complex transactions and determine the appropriate application of GAAP. These include a review of the resources and personnel dedicated to the preparation of our financial statements. There were no material changes in our internal control over financial reporting in connection with the evaluation required by Rule 13a-15(d) under the Exchange Act that occurred during the quarter ended September 30, 2006, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. However, subsequently we have begun to take the remedial actions described above. It is expected that these remedial actions will be completed by the end of the second quarter of our 2007 fiscal year.

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PART II-OTHER INFORMATION

Item 6. Exhibits.

Exhibits

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

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

HAPC, INC.

By: /s/ Erin S. Enright
Name: Erin S. Enright
Title: Chief Financial Officer

Date: February 14, 2007