Spansion Inc.
Form 10-Q
November 03, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number 000-51666

SPANSION INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**20-3898239** **(I.R.S. Employer Identification No.)**
915 DeGuigne Drive	
Sunnyvale, California **(Address of principal executive offices)**	**94088** **(Zip Code)**

Registrant s telephone number, including area code: (408) 962-2500

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Indicate the number of shares outstanding of each of the registrant s classes of common stock as of the close of business on October 30, 2006:

Class	**Number of Shares**
Class A Common Stock, $0.001 par value	96,616,090
Class B Common Stock, $0.001 par value	1
Class C Common Stock, $0.001 par value	1
Class D Common Stock, $0.001 par value	32,352,934

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Spansion Inc.

Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2006	Sept. 25, 2005	Oct. 1, 2006	Sept. 25, 2005
Net sales	$ 458,740	$	$ 855,475	$
Net sales to related parties/members (Note 6)	215,978	515,653	1,036,524	1,411,209
Total net sales	674,718	515,653	1,891,999	1,411,209
Expenses:				
Cost of sales (*including $50,911, $72,968, $164,234 and $195,538 of expenses to related parties/members*)	532,563	445,307	1,508,848	1,312,470
Research and development (*including $3,551, $5,608, $12,227 and $26,403 of expenses to related parties/members*)	90,259	74,124	266,617	220,100
Marketing, general and administrative (*including $4,019, $13,356, $21,476 and $50,835 of expenses to related parties/members*)	61,866	45,259	191,590	126,784
Operating loss	(9,970)	(49,037)	(75,056)	(248,145)
Other income (expense):				
Gain on sale of marketable securities			6,884	
Loss on early extinguishment of debt (Note 8)			(17,310)	
Interest income and other, net	3,888	432	14,167	2,496
Interest expense (*including $146, $6,549, $11,875 and $19,460 of expenses to related parties/members*)	(13,020)	(11,363)	(50,205)	(33,574)
Other expense, net	(9,132)	(10,931)	(46,464)	(31,078)
Loss before income taxes	(19,102)	(59,968)	(121,520)	(279,223)
Provision (benefit) for income taxes	3,013	1,755	1,231	(22,634)
Net loss	$ (22,115)	$ (61,723)	$ (122,751)	$ (256,589)
Net loss per common share:				
Basic and diluted	$ (0.17)	$ (0.85)	$ (0.96)	$ (3.54)
Shares used in per share calculation:				
Basic and diluted	128,800	72,549	128,470	72,549

See accompanying notes

Net loss for the three and nine months ended October 1, 2006 included stock-based compensation expense of $5.6 million and $19.8 million, respectively, which consisted of $3.2 million and $13.7 million related to the Company s stock options and restricted stock units, and $2.4 million and $6.1 million related to AMD stock options granted to the Company s employees. The Company did not provide stock-based compensation to its employees or third parties and there was no stock-based compensation expense for the three and nine months ended September 25, 2005.

As a result of adopting FASB Statement No. 123(R) on December 26, 2005, the Company s losses before income taxes and net losses for the three and nine months ended October 1, 2006 were $823,000 and $2.5 million higher, respectively, than if it had continued to account for its stock options under APB Opinion No. 25. Basic and diluted loss per share for the three and nine months ended October 1, 2006 were $0.01 and $0.02 higher, respectively, than if the Company had continued to account for its stock options under Opinion 25. See Notes 2 and 3 to the unaudited condensed consolidated financial statements for additional information.

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Spansion Inc.

Condensed Consolidated Balance Sheets

(in thousands)

	Oct. 1, 2006 (Unaudited)	**Dec. 25, 2005 (*)**
Assets		
Current assets:		
Cash and cash equivalents	$ 378,187	$ 506,439
Marketable securities		219,377
Trade accounts receivable, net	209,417	
Trade accounts receivable from related parties, net (*Note 6*)	200,243	404,575
Other receivables from related parties	3,767	14,067
Inventories:		
Raw materials	50,077	31,299
Work-in-progress	329,052	354,748
Finished goods	87,756	74,096
Total inventories	466,885	460,143
Deferred income taxes	2,466	34,452
Prepaid expenses and other current assets	44,308	33,789
Total current assets	1,305,273	1,672,842
Property, plant and equipment, net	1,630,073	1,587,763
Deferred income taxes	9,479	7,128
Other assets	31,883	34,232
Total assets	$ 2,976,708	$ 3,301,965
Liabilities and Stockholders Equity		
Current liabilities:		
Notes payable to banks under revolving loans	$	$ 43,020
Accounts payable	370,454	280,057
Accounts payable to related parties (*Note 6*)	18,604	123,801
Accrued compensation and benefits	49,363	51,534
Accrued liabilities to related parties (*Note 6*)	13,010	21,470
Other accrued liabilities	48,766	35,564
Income taxes payable	1,683	13,058
Deferred income on shipments to a related party		31,901
Deferred income on shipments	35,759	
Current portion of long-term obligations to related parties (*Note 8*)	1,000	21,638
Current portion of long-term debt	23,161	60,021
Current portion of long-term obligations under capital leases	65,727	108,876
Total current liabilities	627,527	790,940
Deferred income taxes	1,265	29,498
Long-term accrued liabilities to a related party *(Note 3)*	5,416	8,732
Long-term obligations to related parties, less current portion (*Note 8*)		162,277
Long-term debt, less current portion	436,847	256,762
Long-term obligations under capital leases, less current portion	77,794	107,019

Other long-term liabilities	17,484	24,760
Commitments and contingencies		
Stockholders equity	1,810,375	1,921,977
Total liabilities and stockholders equity	$ 2,976,708	$ 3,301,965

* Derived from audited financial statements at December 25, 2005.

See accompanying notes

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Spansion Inc.

Condensed Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Nine Months Ended Oct. 1, 2006	Sept. 25, 2005
Cash Flows from Operating Activities:		
Net loss	$ (122,751)	$ (256,589)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	409,539	413,990
Loss on early extinguishment of debt	17,310	
Increase in provision for doubtful accounts	471	470
Provision (benefit) for deferred income taxes	2,902	(22,272)
Gain on sale and disposal of property, plant and equipment	(1,362)	(933)
Gain on sale of marketable securities	(6,884)	
Compensation recognized under employee stock plans	19,797	
Changes in operating assets and liabilities:		
Decrease (increase) in trade accounts receivable from related parties/members	204,497	(5,380)
Decrease (increase) in other receivables from related parties/members	10,300	(4,550)
Increase in trade accounts receivable	(210,053)	
Increase in inventories	(6,740)	(21,687)
Increase in prepaid expenses and other current assets	(10,519)	(25,643)
Decrease (increase) in other assets	353	(15,323)
(Decrease) increase in accounts payable and accrued liabilities to related parties/members	(110,982)	46,359
Increase in accounts payable and accrued liabilities	104,753	115,229
(Decrease) increase in accrued compensation and benefits	(8,541)	21,190
Decrease in income taxes payable	(11,375)	(19,615)
Decrease in deferred income on shipments to a related party/member	(31,901)	(3,763)
Increase in deferred income on shipments	35,759	
Net cash provided by operating activities	284,573	221,483
Cash Flows from Investing Activities:		
Proceeds from sale of property, plant and equipment	3,608	1,843
Purchases of property, plant and equipment	(470,830)	(323,870)
Proceeds from maturity and sale of marketable securities	282,583	77,950
Purchases of marketable securities	(63,612)	(20,000)
Net cash used in investing activities	(248,251)	(264,077)
Cash Flows from Financing Activities:		
Cash contributions from related parties/members		3,750
Cash distribution to related parties for stock-based compensation	(7,238)	(869)
Proceeds from sale-leaseback transactions	29,769	78,098
Proceeds from borrowings, net of issuance costs	329,044	137,504
Payments on loans from related parties/members	(197,119)	(4,890)
Payments on debt and capital lease obligations	(330,030)	(182,108)
Increase in cash held in trust		(8,013)
Net cash (used in) provided by financing activities	(175,574)	23,472

Effect of exchange rate changes on cash and cash equivalents	11,000	(42)
Net decrease in cash and cash equivalents	(128,252)	(19,164)
Cash and cash equivalents at the beginning of period	506,439	138,188
Cash and cash equivalents at end of period	$ 378,187	$ 119,024

See accompanying notes

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Description of Business

Spansion Inc. (the Company) is a semiconductor manufacturer headquartered in Sunnyvale, California, with manufacturing, research and development and assembly operations in the United States, Asia and Europe. The Company is exclusively dedicated to designing, developing, manufacturing, marketing and selling Flash memory solutions, a critical semiconductor element of many electronic products.

The Company s Flash memory devices, marketed under the Spansion® and MirrorBit® global brand names, are incorporated into a broad range of electronic products, including mobile phones, consumer electronics, automotive electronics, networking and telecommunications equipment, personal computer and PC peripheral applications.

Spansion LLC, the former joint venture 60 percent owned by Advanced Micro Devices, Inc. (AMD) and 40 percent owned by Fujitsu Limited (Fujitsu), was reorganized into Spansion Inc. in December 2005. Spansion Inc. is the holding company that completed its underwritten initial public offering (IPO) of Class A common stock on December 21, 2005 and Spansion LLC is its wholly owned operating subsidiary.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The condensed consolidated financial statements and notes thereto are unaudited. In the opinion of management, these financial statements contain all adjustments (consisting of normal recurring adjustments) that are necessary for a fair presentation of the Company s operating results, financial position and cash flows. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any subsequent interim period or for the year ending December 31, 2006.

The condensed consolidated financial statements include all the accounts of the Company and those of its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

The condensed consolidated financial statements do not include certain financial footnotes and disclosures required under U.S. generally accepted accounting principles for audited financial statements. Therefore, the unaudited condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and footnotes thereto for the year ended December 25, 2005 included in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission (SEC) on March 15, 2006.

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

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

Use of Estimates

The preparation of financial statements and disclosures in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of commitments and contingencies and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ from those estimates, and such differences may be material to the financial statements.

Financial Statements Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

Stock-Based Compensation

Treatment of AMD Stock Options

Prior to the IPO, the Company did not provide stock-based compensation to its employees or third parties. Subsequent to June 30, 2003, however, certain of the Company s employees received stock options to purchase shares of AMD common stock from the Company s then majority member, AMD. The Company accounted for AMD s stock option grants and restricted stock unit, or RSU, awards to its employees under the intrinsic value recognition and measurement principles of Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees and related interpretations, consistent with the accounting method followed by AMD for stock options and RSU awards issued to employees of the consolidated AMD group. The exercise price of these stock options was equal to the market price of AMD s common stock on the date of grant. The Company reimburses AMD for these stock options based on an agreed amount equal to the grant-date fair value of the stock options calculated using the Black-Scholes-Merton valuation model, less a 15 percent discount (the grant-date fair value). The Company recorded a liability for amounts due to AMD under this arrangement with a corresponding reduction to additional paid-in capital. Reimbursements to AMD, which commence on the last day of the quarter following the quarter in which the stock options were granted, are payable in sixteen equal quarterly installments through fiscal 2009.

Subsequent to the Company s IPO, these awards are being accounted for under variable fair value accounting following the guidance in Emerging Issues Task Force (EITF) Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Good or Services, and EITF Issue No. 00-12, Accounting by an Investor for Stock-Based Compensation Granted to Employee of an Equity Method Investee, and will continue to be remeasured to their fair value in future periods until they are fully vested, forfeited or cancelled.

Spansion Stock-Based Incentive Compensation Plans

Effective December 26, 2005, the Company adopted Financial Accounting Standards Board (FASB) Statement No. 123(R), Share-Based Payment, which requires a public entity to reflect on its income statement, instead of pro forma disclosures in its financial footnotes, the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. Statement 123(R) supersedes the Company s previous accounting under Opinion 25 for periods beginning in fiscal 2006.

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

The Company adopted Statement 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of December 26, 2005, the first day of the Company s fiscal year ending December 31, 2006. The Company s condensed consolidated financial statements as of and for the three and nine months ended October 1, 2006 reflect the impact of Statement 123(R). In accordance with the modified prospective transition method, the Company s consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of Statement 123(R).

In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 regarding the SEC s interpretation of Statement 123(R) and the valuation of share-based payments for public companies. The Company applied the provisions of SAB 107 in its adoption of Statement 123(R).

The Company estimated the fair value of its stock-based awards to employees using a Black-Scholes-Merton option pricing model. Stock-based compensation expense recognized during a period is based on the higher of the grant-date fair value of the portion of share-based payment awards that is ultimately expected to vest, or actually vest, during the period. Stock-based compensation expense recognized in the Company s condensed consolidated statement of operations for the three and nine months ended October 1, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 25, 2005 based on the grant-date fair value estimated in accordance with the pro forma provisions of Statement 123 and compensation expense for the share-based payment awards granted subsequent to December 25, 2005 based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Compensation expense for all share-based payment awards was recognized using the straight-line attribution method reduced for estimated forfeitures. The Company does not have sufficient historical forfeiture experience related to its own stock-based awards. Therefore, the Company estimated forfeitures based on AMD s historical forfeiture rates, as the Company believes these forfeiture rates to be the most indicative of its own expected forfeiture rate. Statement 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

New Accounting Pronouncements

In June 2006, the FASB ratified EITF Issue No. 06-2 Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences. Issue 06-2 provides guidelines under which sabbatical leave or other similar benefits provided to an employee are considered to accumulate, as defined in Statement 43. If such benefits are deemed to accumulate, then the compensation cost associated with a sabbatical or other similar benefit arrangement should be accrued over the requisite service period. The provisions of this Issue are effective for fiscal years beginning after December 15, 2006 and allow for either retrospective application or a cumulative effect adjustment to accumulated deficit approach upon adoption. The Company will apply the accounting prescribed by this Issue in fiscal 2007 and is currently evaluating the impact, if any, that the adoption of this Issue will have on its financial statements.

In July 2006, FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

penalties, accounting in interim periods and disclosures. It will be effective for fiscal years beginning after December 15, 2006. The provisions of this Interpretation apply to all tax positions upon initial adoption of this Interpretation. Only tax positions that meet the recognition threshold criteria at the effective date may be recognized or continue to be recognized upon adoption of this Interpretation. The cumulative effect applying the provisions of this Interpretation will be reported as an adjustment to the opening balance of retained earnings. The Company is currently evaluating the accounting and disclosure requirements of this Interpretation and expects to adopt it as required at the beginning of its fiscal year ending December 30, 2007.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS 158). This Statement requires balance sheet recognition of the overfunded or underfunded status of pension and postretirement benefit plans. Under SFAS 158, actuarial gains and losses, prior service costs or credits, and any remaining transition assets or obligations that have not been recognized under previous accounting standards must be recognized in accumulated other non-shareowners changes in equity, net of tax effects, until they are amortized as a component of net periodic benefit cost. In addition, the measurement date, the date at which plan assets and the benefit obligation are measured, is required to be the company s fiscal year end. SFAS 158 is effective for publicly-held companies for fiscal years ending after December 15, 2006, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The Company expects to adopt this Statement for the fiscal year ending December 31, 2006 and is currently evaluating the impact, if any, that the adoption of this Statement will have on its financial statements.

3. Stock-Based Compensation
AMD Stock Options

The Company paid AMD approximately $7.2 million and $0.9 million for stock options during the nine months ended October 1, 2006 and September 25, 2005. The Company s outstanding liability to AMD for stock option reimbursements as of October 1, 2006 was approximately $10.4 million, of which $5.4 million was due beyond the next twelve-month period. The Company s outstanding liability to AMD for stock option reimbursements as of December 25, 2005 was approximately $17.1 million, of which $8.7 million was due beyond the next twelve-month period after December 25, 2005.

As of October 1, 2006, there were approximately 677,000 unvested AMD stock options and RSU awards that were still held by the Company s employees, which are currently subject to variable fair value accounting. As of October 1, 2006, the total fair value of these stock options, based on a Black-Scholes-Merton option pricing model, and restricted stock unit awards was approximately $13.1 million. These stock options and RSU awards will generally vest through 2009 and, as a result, will continue to result in remeasured compensation expense each interim and annual reporting period until they are fully vested. Pro forma stock-based compensation expense in accordance with FASB Statement No. 123, Accounting for Stock-Based Compensation, related to AMD stock options granted to the Company s employees was $1.4 million and $3.7 million for the three and nine months ended September 25, 2005.

If AMD s ownership interest in the Company drops below 30 percent, any unvested AMD stock options and AMD RSU awards held by the Company s employees will be forfeited and cancelled. The

Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

Company s outstanding liability to AMD for stock option reimbursements related to the AMD stock options will be discharged and the compensation expense recorded in fiscal 2006 resulting from the changes in the market value of the AMD stock options and RSU awards associated with the cancelled AMD stock options and RSU awards held by the Company s employees will be adjusted by decreasing compensation expense in the period of cancellation.

Spansion Stock-Based Incentive Compensation Plans

Plan Description

As of October 1, 2006, the Company had one stock-based incentive plan, the 2005 Equity Incentive Plan, under which 9,500,000 shares of Class A common stock have been reserved and made available for issuance in the form of equity awards, including incentive and nonqualified stock options and RSU awards. The 2005 Equity Incentive Plan is administered by the Compensation Committee of the Company s Board of Directors, and that committee has the authority to, among other things, grant awards, delegate certain of its powers, accelerate or extend the vesting or exercisability of awards and determine the date of grant of an award. Shares that are subject to or underlie awards that expire or for any reason are cancelled, terminated or forfeited, or fail to vest will again be available for grant under the 2005 Equity Incentive Plan. The maximum term of the stock options will be 10 years from the date of grant and the exercise price of each option will be determined under the applicable terms and conditions as approved by the Compensation Committee.

The 2005 Equity Incentive Plan provides awards that may be granted to an officer or employee, a consultant or advisor, or a non-employee director of the Company or its subsidiaries; provided that, the incentive stock options granted under the 2005 Equity Incentive Plan may only be granted to employees of the Company or its subsidiaries. The exercise price of each incentive stock option will be required to be not less than 100 percent of the fair market value of our Class A common stock on the date of grant (not less than 110 percent if such stock options are granted to persons who have more than 10 percent of the total voting power of all classes of our stock).

The Company grants stock options that generally vest ratably over a period of four years and expire if not exercised by the seventh anniversary of the grant date. RSU awards have no exercise price or expiration date. The Company grants RSU awards that generally vest over a four-year period, except for awards of 2.3 million shares granted on the date of the Company s IPO (December 15, 2005), which vested 25 percent on April 28, 2006 and the remainder in equal installments quarterly over the remaining 36 months.

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

Valuation and Expense Information

The following table sets forth the total recorded stock-based compensation expense, by financial statement caption, resulting from the Company s stock options and RSU awards under Statement 123(R) for the three and nine months ended October 1, 2006:

	Three Months Ended Oct. 1, 2006	Nine Months Ended Oct. 1, 2006
	(in thousands)	
Cost of sales	$ 1,585	$ 6,839
Research and development	792	3,421
Marketing, general and administrative	792	3,421
Stock-based compensation expense under Statement 123(R) before income taxes (1)	3,169	13,681
Income tax benefit (2)		
Stock-based compensation expense under Statement 123(R) after income taxes (1)	$ 3,169	$ 13,681

(1) Stock-based compensation expense under Statement 123(R) does not include the compensation expense of AMD stock options and AMD RSU awards granted to the Company s employees, which were accounted for under EITF Issue Nos. 96-18 and 00-12, and which will continue to be remeasured to their fair value in future periods until they are fully vested. Compensation expense related to these awards was approximately $2.4 million and $6.1 million for the three and nine months ended October 1, 2006, respectively.

(2) There is no income tax benefit relating to stock option expenses because all of the Company s U.S. deferred tax assets, net of U.S. deferred tax liabilities continue to be subject to a full valuation allowance.

The weighted average fair value of the Company s stock options granted in the three and nine months ended October 1, 2006, was $8.44 and $7.95 per share, respectively. The fair value of each stock option was estimated at the date of grant using a Black-Scholes-Merton option pricing model, with the following assumptions for grants in the three and nine months ended October 1, 2006:

	Three Months Ended Oct. 1, 2006	Nine Months Ended Oct. 1, 2006
Expected volatility	55.80%	59.22%
Risk-free interest rate	5.10%	4.93%
Expected term (in years)	4.61	4.59
Dividend yield	0%	0%

The Company s dividend yield is zero because the Company has never paid dividends and does not have plans to do so over the expected life of the stock options. The expected volatility is based on the Company s recent historical volatility and the volatilities of the Company s competitors who are in the same industry sector with similar characteristics (guideline companies) given the lack of historical realized volatility data of the Company. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bond with a remaining term equal to the expected stock option life. The expected term is based on the shortcut approach provided in SAB 107 for developing the estimate of the expected life of a plain vanilla stock option. Under this approach, the expected term is presumed to be the mid-point between the average vesting date and the end of the contractual term.

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

As of October 1, 2006, the total unrecognized compensation cost related to unvested stock options and RSU awards was approximately $41.1 million after reduction for estimated forfeitures, and such stock options and RSU awards will generally vest ratably through 2010.

Stock Option and Restricted Stock Unit Activity

The following table summarizes stock option activity and related information for the period presented:

	Nine Months Ended Oct. 1, 2006			
	Number of Shares	**Weighted-Average Exercise Price**	**Weighted-Average Remaining Contractual Life (in Years)**	**Aggregate Intrinsic Value**
Options:				
Outstanding at the beginning of fiscal 2006	1,949,750	$ 12.00		
Granted	320,000	$ 14.96		
Cancelled	(152,344)	$ 12.00		
Outstanding as of October 1, 2006	2,117,406	$ 12.45	6.27	$ 8,935,453
Exercisable as of October 1, 2006 [(1)]	35,156	$ 12.00	6.21	$ 164,179

(1) There were 35,156 shares vested during the nine months ended October 1, 2006, with a total grant-date fair value of approximately $241,000.

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $16.67 as of October 1, 2006, which would have been received by the stock option holders had all stock option holders exercised their stock options as of that date.

The following table summarizes RSU award activity and related information for the period presented:

	Nine Months Ended Oct. 1, 2006	
	Number of Shares	**Weighted-Average Grant-date Fair Value**
Restricted Stock Units:		
Unvested at the beginning of fiscal year 2006	3,604,090	$ 12.00
Granted	179,867	$ 15.61

Cancelled	(177,029)	$	12.58
Vested	(690,086)	$	12.00
Unvested as of October 1, 2006	2,916,842	$	12.19

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

4. Net Loss per Share

The Company excluded 16.8 million shares issuable upon the assumed exercise of outstanding Class A common stock options and RSU awards and the assumed exchange of outstanding exchangeable debentures from the calculation of diluted earnings per share for the three and nine months ended October 1, 2006 because they had an antidilutive effect due to the net losses recorded. The Company had no potential common shares outstanding for the three or nine months ended September 25, 2005.

5. Comprehensive Loss

The following are the components of comprehensive loss:

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2006	Sept. 25, 2005	Oct. 1, 2006	Sept. 25, 2005
	(in thousands)		(in thousands)	
Net loss	$ (22,115)	$ (61,723)	$ (122,751)	$ (256,589)
Net change in cumulative translation adjustment	(20,543)	(18,151)	(2,726)	(52,695)
Net change in unrealized gains on marketable securities, net of $0 taxes			(7,291)	
Total comprehensive loss	$ (42,658)	$ (79,874)	$ (132,768)	$ (309,284)

6. Related Party Transactions

Prior to the second quarter of fiscal 2006, the Company relied on AMD and Fujitsu as sole distributors of its products. In the second quarter of fiscal 2006, the Company began selling its products directly to the customers previously served by AMD. The Company receives services from AMD and Fujitsu, including among others, certain information technology, facilities, logistics, legal, tax, finance, human resources and environmental health and safety services. Since its IPO, the Company has taken on some of these functions and the Company decreased the use of these services. The charges for these services are negotiated annually between the Company and AMD and Fujitsu based on the Company s expected requirements and the estimated future costs of the services to be provided. AMD has the right to review the proposed services to be provided by Fujitsu, and Fujitsu has the right to review the proposed services to be provided by AMD. The service charges are billed monthly on net 45 days terms.

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

The following tables present significant related party transactions and account balances between the Company and AMD (see Note 8 for separate disclosure of debt obligations to related parties):

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2006	Sept. 25, 2005	Oct. 1, 2006	Sept. 25, 2005
	(in thousands)			
Net sales to AMD [1]	$	$ 289,393	$ 336,172	$ 776,941
Cost of sales:				
Royalties to AMD	$ 1,739	$ 4,118	$ 4,837	$ 11,493
Service fees to AMD:				
Cost of sales	$ 553	$ 5,595	$ 3,272	$ 16,916
Research and development	2,984	4,088	10,273	17,054
Marketing, general and administrative	3,005	10,925	18,163	39,268
Service fees to AMD [2]	$ 6,542	$ 20,608	$ 31,708	$ 73,238
Cost of employees seconded from AMD:				
Marketing, general and administrative	$	$ 111	$	$ 1,199

(1) In the second quarter of fiscal 2006, the Company began selling its products directly to the customers previously served by AMD.

(2) Service fees to AMD are net of reimbursements from AMD for services provided to AMD by the Company.

	Oct. 1, 2006	Dec. 25, 2005
	(in thousands)	
Trade accounts receivable from AMD, net of allowance for doubtful accounts	$ 28,957	$ 205,351
Other receivables from AMD	$ 3,767	$ 13,850
Accounts payable to AMD	$ 711	$ 97,844
Royalties payable to AMD	$ 1,739	$ 6,384
Accrued liabilities to AMD	$ 10,445	$ 17,434

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Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

The following tables present the significant related party transactions and account balances between the Company and Fujitsu (see Note 8 for separate disclosure of debt obligations to related parties):

	Three Months Ended Oct. 1, 2006	Three Months Ended Sept. 25, 2005	Nine Months Ended Oct. 1, 2006	Nine Months Ended Sept. 25, 2005
	(in thousands)			
Net sales to Fujitsu	$ 215,978	$ 226,260	$ 700,352	$ 634,268
Cost of sales				
Royalties paid to Fujitsu	$ 1,739	$ 4,118	$ 4,837	$ 11,493
Other purchases of goods and services from Fujitsu and rental expense to Fujitsu	$ 31,942	$ 18,367	$ 91,721	$ 52,198
Subcontract manufacturing purchases from Fujitsu	$ 4,006	$ 8,895	$ 11,553	$ 28,150
Commercial die purchases from Fujitsu	$ 10,382	$ 31,058	$ 46,261	$ 72,041
Service fees to Fujitsu:				
Cost of sales	$ 550	$ 817	$ 1,726	$ 2,505
Research and development	567	1,502	1,893	5,086
Marketing, general and administrative	1,014	2,248	3,218	8,361
Service fees to Fujitsu	$ 2,131	$ 4,567	$ 6,837	$ 15,952
Cost of employees seconded from Fujitsu:				
Cost of sales	$	$	$ 27	$ 742
Research and development		18	61	4,263
Marketing, general and administrative		72	95	2,007
Cost of employees seconded from Fujitsu	$	$ 90	$ 183	$ 7,012

	Oct. 1, 2006	Dec. 25, 2005
	(in thousands)	
Trade accounts receivable from Fujitsu	$ 171,286	$ 199,224
Other receivables from Fujitsu	$	$ 217
Accounts payable to Fujitsu	$ 17,893	$ 25,957
Royalties payable to Fujitsu	$ 1,739	$ 6,384
Accrued liabilities to Fujitsu	$ 4,503	$

The Company licenses certain intellectual property from AMD and Fujitsu in exchange for the payment of royalties to both AMD and Fujitsu. These royalty expenses are recognized in cost of sales. The Company is required to pay AMD and Fujitsu semi-annual royalties based on net sales (minus the costs of commercial die). The royalty as a percentage of sales will decline to zero over a specified time. The term of the agreement expires in 2013.

Fujitsu provides test and assembly services to the Company on a contract basis. Also, the Company purchases commercial die from Fujitsu, which is packaged together with the Company s Flash memory devices.

Spansion Inc.

Notes to Condensed Consolidated Financial Statements - Continued

(Unaudited)

Fujitsu seconded certain employees to the Company until the second quarter of fiscal 2006. The Company paid these employees directly. AMD also seconded certain employees to the Company until the fourth quarter of fiscal 2005. The Company reimbursed AMD for the costs of these employees.

On September 28, 2006, Spansion Japan Limited, or Spansion Japan, the Company s wholly-owned subsidiary, entered into an asset purchase agreement with Fujitsu, pursuant to which Spansion Japan will sell two wafer fabrication facilities located in Aizu-Wakamatsu, Japan, which the Company refers to as the JV1/JV2 Facilities, and certain assets located in the JV1/JV2 Facilities, to Fujitsu for a purchase price of approximately $150 million plus the value of the inventory at the time of closing. Concurrently with the execution of the asset purchase agreement, Spansion Japan and Fujitsu also executed (i) a master lease agreement, pursuant to which Spansion Japan will lease certain equipment to Fujitsu to use in the JV1/JV2 Facilities, (ii) a foundry agreement, pursuant to which Fujitsu has agreed to manufacture, and the Company has agreed to purchase, wafers to be manufactured by Fujitsu for Spansion in the JV1/JV2 Facilities (the foundry agreement also includes minimum supply and purchase commitments between both the parties resulting in financial penalties if such supply and purchase commitments are not achieved) and (iii) a secondment and transfer agreement, pursuant to which Spansion Japan has agreed to second a specified number of employees to Fujitsu to work in the JV1/JV2 Facilities and ultimately to transfer certain of the employees to Fujitsu. The Company refers to these agreements collectively as the JV1/JV2 Transaction. Under the terms of the asset purchase agreement, the JV1/JV2 Transaction is scheduled to close in the second quarter of fiscal 2007.

7. Warranties and Indemnities

The Company offers a one-year limited warranty for its Flash memory products.

Changes in the Company s liability for product warranties in the three and nine months ended October 1, 2006 and September 25, 2005 are as follows:

	Three Months Ended		Nine Months Ended	
	Oct. 1, 2006	Sept. 25, 2005	Oct. 1, 2006	Sept. 25, 2005
	(in thousands)		(in thousands)	
Balance, beginning of period	$ 1,000	$ 600	$ 1,000	$ 600
Provision for warranties issued	1,293	607	2,977	1,548
Settlements	(255)	(859)	(2,497)	(3,314)
Changes in liability for pre-existing warranties during the period, including expirations	(688)	252	(130)	