

SUN MICROSYSTEMS INC
Form 10-Q
February 04, 2005
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 26, 2004

or

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

For the transition period from _____ to _____

Commission file number: 0-15086

SUN MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-2805249
(I.R.S. Employer
Identification No.)

4150 Network Circle, Santa Clara, CA 95054

(Address of principal executive offices with zip code)

(650) 960-1300

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <u>Class</u> | <u>Outstanding at February 1, 2005</u> |
|------------------------------------|----------------------------------------|
| Common Stock - \$0.00067 par value | 3,377,860,900 |

Table of Contents

INDEX

PART I FINANCIAL INFORMATION

| | | |
|---------|----------------------------------------------------------------------------------------------|----|
| Item 1. | <u>Financial Statements:</u> | |
| | <u>Condensed Consolidated Statements of Operations</u> | 3 |
| | <u>Condensed Consolidated Balance Sheets</u> | 4 |
| | <u>Condensed Consolidated Statements of Cash Flows</u> | 5 |
| | <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| | <u>Independent Registered Public Accounting Firm's Review Report</u> | 14 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 15 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 39 |
| Item 4. | <u>Controls and Procedures</u> | 40 |

PART II OTHER INFORMATION

| | | |
|---------|-------------------------------------------------------------|----|
| Item 1. | <u>Legal Proceedings</u> | 41 |
| Item 4. | <u>Submissions of Matters to a Vote of Security Holders</u> | 41 |
| Item 6. | <u>Exhibits</u> | 42 |

| | | |
|--------------------------|--|----|
| <u>SIGNATURES</u> | | 43 |
|--------------------------|--|----|

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in millions, except per share amounts)

| | Three Months Ended | | Six Months Ended | |
|-----------------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | December 26, 2004 | December 28, 2003 | December 26, 2004 | December 28, 2003 |
| Net revenues: | | | | |
| Products | \$ 1,840 | \$ 1,944 | \$ 3,516 | \$ 3,578 |
| Services | 1,001 | 944 | 1,953 | 1,846 |
| Total net revenues | 2,841 | 2,888 | 5,469 | 5,424 |
| Cost of sales: | | | | |
| Cost of sales-products | 1,065 | 1,107 | 2,069 | 2,072 |
| Cost of sales-services | 578 | 573 | 1,129 | 1,128 |
| Total cost of sales | 1,643 | 1,680 | 3,198 | 3,200 |
| Gross margin | 1,198 | 1,208 | 2,271 | 2,224 |
| Operating expenses: | | | | |
| Research and development | 447 | 471 | 863 | 938 |
| Selling, general and administrative | 712 | 828 | 1,396 | 1,626 |
| Restructuring charges | 24 | (10) | 132 | (9) |
| Purchased in-process research and development | | | | 1 |
| Total operating expenses | 1,183 | 1,289 | 2,391 | 2,556 |
| Operating income (loss) | 15 | (81) | (120) | (332) |
| Gain (loss) on equity investments, net | 9 | (36) | 5 | (61) |
| Interest income, net | 33 | 20 | 64 | 41 |
| Income (loss) before income taxes | 57 | (97) | (51) | (352) |
| Provision for income taxes | 39 | 28 | 78 | 59 |
| Net income (loss) | \$ 18 | \$ (125) | \$ (129) | \$ (411) |
| Net income (loss) per common share-basic | \$ 0.01 | \$ (0.04) | \$ (0.04) | \$ (0.13) |

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| | | | | |
|------------------------------------------------------------------------------|---------|-----------|-----------|-----------|
| Net income (loss) per common share-diluted | \$ 0.01 | \$ (0.04) | \$ (0.04) | \$ (0.13) |
| Shares used in the calculation of net income (loss) per common share basic | 3,360 | 3,262 | 3,349 | 3,248 |
| Shares used in the calculation of net income (loss) per common share diluted | 3,400 | 3,262 | 3,349 | 3,248 |

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions)

| | December 26, | June 30, |
|-------------------------------------------------------------|------------------|------------------|
| | 2004 | 2004 |
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,863 | \$ 2,141 |
| Short-term marketable debt securities | 1,776 | 1,460 |
| Accounts receivable, net | 1,840 | 2,339 |
| Inventories | 429 | 464 |
| Deferred and prepaid tax assets | 88 | 62 |
| Prepaid expenses and other current assets | 872 | 837 |
| | <u>6,868</u> | <u>7,303</u> |
| Total current assets | 6,868 | 7,303 |
| Property, plant and equipment, net | 1,903 | 1,996 |
| Long-term marketable debt securities | 3,825 | 4,007 |
| Goodwill | 406 | 406 |
| Other acquisition-related intangible assets, net | 90 | 127 |
| Other non-current assets, net | 642 | 664 |
| | <u>\$ 13,734</u> | <u>\$ 14,503</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt and short-term borrowings | \$ | \$ 257 |
| Accounts payable | 963 | 1,057 |
| Accrued payroll-related liabilities | 603 | 622 |
| Accrued liabilities and other | 1,193 | 1,308 |
| Deferred revenues | 1,313 | 1,617 |
| Warranty reserve | 236 | 252 |
| | <u>4,308</u> | <u>5,113</u> |
| Total current liabilities | 4,308 | 5,113 |
| Long-term debt | 1,145 | 1,175 |
| Long-term deferred revenues | 519 | 557 |
| Other non-current obligations | 1,242 | 1,220 |
| Total Stockholders equity | 6,520 | 6,438 |
| | <u>\$ 13,734</u> | <u>\$ 14,503</u> |

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in millions)

| | Six Months Ended | |
|-------------------------------------------------------------------------------------------|------------------|-----------------|
| | December 26, | December 28, |
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net loss | \$ (129) | \$ (411) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 329 | 361 |
| Amortization of other intangible assets and unearned equity compensation | 49 | 46 |
| Deferred taxes | (3) | |
| Loss (gain) on equity investments, net | (5) | 61 |
| Purchased in-process research and development | | 1 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 510 | 178 |
| Inventories | 37 | (63) |
| Prepaid and other assets | (79) | (59) |
| Accounts payable | (88) | 4 |
| Other liabilities | (445) | (449) |
| Net cash provided by (used in) operating activities | 176 | (331) |
| Cash flows from investing activities: | | |
| Purchases of marketable debt securities | (2,943) | (5,065) |
| Proceeds from sales of marketable debt securities | 2,287 | 5,029 |
| Proceeds from maturities of marketable debt securities | 508 | |
| Proceeds from sales of equity investments, net | 13 | 10 |
| Acquisition of property, plant and equipment, net | (141) | (127) |
| Acquisition of spare parts and other assets | (42) | (26) |
| Payments for acquisitions, net of cash acquired | | (190) |
| Net cash used in investing activities | (318) | (369) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock, net | 114 | 113 |
| Principal payments on borrowings | (250) | |
| Net cash provided by (used in) financing activities | (136) | 113 |
| Net decrease in cash and cash equivalents | (278) | (587) |
| Cash and cash equivalents, beginning of period | 2,141 | 2,015 |
| Cash and cash equivalents, end of period | \$ 1,863 | \$ 1,428 |
| Supplemental disclosures of cash flow information: | | |

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| | | |
|----------------------------------------------------------------------------------------------|-------------------|-------------------|
| Interest paid (net of interest received from swap agreements of \$36 and \$36, respectively) | \$ 13 | \$ 13 |
| | <u> </u> | <u> </u> |
| Income taxes paid (net of refunds of \$11 and \$67, respectively) | \$ 100 | \$ 74 |
| | <u> </u> | <u> </u> |
| Supplemental schedule of noncash investing activities: | | |
| Stock and options issued in connection with acquisitions | \$ | \$ 16 |
| | <u> </u> | <u> </u> |

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

Sun Microsystems, Inc. s, (Sun) business is singularly focused on providing products and services for network computing. Network computing has been at the core of the company s offerings for the 22 years of our existence and is based on the premise that the power of a single computer can be increased dramatically when interconnected with other computer systems for the purposes of communication and sharing of computing power. Together with our partners, we provide network computing infrastructure solutions that comprise Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions (formerly known as Professional services) and Knowledge services. Our customers use our products and services to build mission-critical network computing environments on which they operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

Sun s first three quarters in fiscal year 2005 end on September 26, 2004, December 26, 2004, and March 27, 2005. In fiscal year 2004, the quarters ended on September 28, 2003, December 28, 2003, and March 28, 2004. The fourth quarter in all fiscal years ends on June 30.

Basis of Presentation

The accompanying condensed consolidated financial statements (Interim Financial Statements) include the accounts of Sun and its subsidiaries. Intercompany accounts and transactions have been eliminated.

These Interim Financial Statements have been prepared in accordance with generally accepted accounting principles in the United States of America (U.S. GAAP) for interim financial information and the rules and regulations of the Securities and Exchange Commission for interim financial statements and accounting policies, consistent, in all material respects, with those applied in preparing our audited consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004, filed with the Securities and Exchange Commission on September 13, 2004 (Form 10-K). These Interim Financial Statements are unaudited but reflect all adjustments (consisting of normal recurring adjustments) management considers necessary for a fair presentation of our financial position, operating results and cash flows for the interim periods presented. The results for the interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated balance sheet as of June 30, 2004 has been derived from the audited consolidated balance sheet as of that date. The information included in this report should be read in conjunction with our Form 10-K.

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Computation of Net Income (Loss) per Common Share

Basic net income (loss) per common share is computed using the weighted-average number of common shares outstanding (adjusted for treasury stock and common stock subject to repurchase activity) during the period.

Diluted net income (loss) per common share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist primarily of stock options.

Because we earned an \$18 million profit during the three months ended December 26, 2004, 40 million common equivalent shares were included in that quarter in the computation of diluted net income per share. If we had earned a profit during the six months ended December 26, 2004, we would have added 29 million common equivalent shares to our basic weighted-average shares outstanding to compute the diluted weighted-average shares outstanding. If we had earned a profit during the three and six months ended December 28, 2003, we would have added 24 million and 26 million common equivalent shares, respectively, to our basic weighted-average shares outstanding to compute the diluted weighted-average shares outstanding.

Stock Option Plans

Statement of Financial Accounting Standard No. 123, *Accounting for Stock-Based Compensation* (SFAS 123) amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* permits companies to measure the compensation cost of stock-based awards based on their estimated fair value at the date of grant and recognize that amount over

Table of Contents

the related service period. Therefore, as permitted by SFAS 148, we currently apply the existing accounting rules under APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. In general, as the exercise price of all options granted under our stock option plans is equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost is recognized in net income (loss). However, under these plans, options to purchase shares of common stock may also be granted at less than fair market value, which results in compensation expense equal to the difference between the market value on the date of grant and the purchase price. This expense is recognized on a straight-line basis over the vesting period of the shares. As required by SFAS 148, we provide pro forma net income (loss) and pro forma net income (loss) per common share disclosures for stock-based awards, as if the fair-value-based method defined in SFAS 123 had been applied.

The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the three and six months ended December 26, 2004 and December 28, 2003, respectively:

| <u>Options</u> | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|-------------------------------------------|---------------------------|---------------------|-------------------------|---------------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>December 26,</u> | <u>December 28,</u> |
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| | | | | |
| Expected life (in years) | 5.8 | 6.4 | 6.0 | 6.4 |
| Interest rate | 3.69% | 3.45% | 3.62% | 3.42% |
| Volatility | 68.04% | 67.51% | 68.36% | 67.44% |
| Dividend yield | | | | |
| Weighted-average fair value at grant date | \$ 2.90 | \$ 2.73 | \$ 2.52 | \$ 2.70 |

| <u>Employee Stock Purchase Plan</u> | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|-------------------------------------------|---------------------------|---------------------|-------------------------|---------------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>December 26,</u> | <u>December 28,</u> |
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| | | | | |
| Expected life (in years) | 0.5 | 0.5 | 0.5 | 0.5 |
| Interest rate | 1.36% | 1.10% | 1.25% | 1.11% |
| Volatility | 40.72% | 56.08% | 41.88% | 58.12% |
| Dividend yield | | | | |
| Weighted-average fair value at grant date | \$ 1.05 | \$ 0.96 | \$ 1.02 | \$ 0.98 |

If the fair values of the options granted during a fiscal year had been recognized as compensation expense on a straight-line basis over the vesting period of the grant, stock-based compensation costs would have impacted our net income (loss) after tax and net income (loss) per common share, as follows (in millions, except per share amounts):

| | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|------------------------------|---------------------------|---------------------|-------------------------|---------------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>December 26,</u> | <u>December 28,</u> |
| | <u>2004</u> | <u>2003</u> | <u>2004</u> | <u>2003</u> |
| | | | | |
| Pro forma net income (loss): | | | | |

Pro forma net income (loss):

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| | | | | |
|------------------------------------------------------------------------------------------------------------------------|-----------|-----------|-----------|-----------|
| Net income (loss) after tax | \$ 18 | \$ (125) | \$ (129) | \$ (411) |
| Add: stock-based compensation costs included in reported net income (loss) (net of tax effects of none in all periods) | 5 | 5 | 10 | 15 |
| Deduct: stock-based compensation costs (net of tax effects of none in all periods) under SFAS 123 | (171) | (218) | (366) | (441) |
| Pro forma net income (loss) after tax | \$ (148) | \$ (338) | \$ (485) | \$ (837) |
| Pro forma basic and diluted net income (loss) per common share: | | | | |
| Pro forma shares used in the calculation of pro forma net income (loss) per common share - basic and diluted | 3,360 | 3,262 | 3,349 | 3,248 |
| Pro forma net income (loss) per common share - basic and diluted | \$ (0.04) | \$ (0.10) | \$ (0.14) | \$ (0.26) |
| Reported net income (loss) per common share - basic and diluted | \$ 0.01 | \$ (0.04) | \$ (0.04) | \$ (0.13) |

Recent Pronouncements

In March 2004, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-01 provides guidance on other-than-temporary impairment models for marketable debt and equity securities accounted for under SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and non-marketable equity securities accounted for under the cost method. The EITF developed a basic three-step model to evaluate whether an investment is other-than-temporarily impaired. The Financial Accounting Standards Board (FASB) issued EITF 03-01-1 in September 2004 which delayed the effective date of the recognition and measurement provisions of EITF 03-01. We do not expect the adoption of EITF 03-01 to have a material impact on our results of operations and financial condition.

Table of Contents

In October 2004, The American Jobs Creation Act of 2004 (the Act) was signed into law. The Act creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned outside the U.S. at an effective tax rate of 5.25%. On December 21, 2004, the FASB issued their staff position, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (SFAS 109-2). SFAS 109-2 allows companies additional time to evaluate the impact of the law and to record the tax effect of repatriation over several interim periods as they complete their assessment of repatriating all or a portion of these unremitted earnings. We are currently evaluating the effects of the Act's repatriation provision and expect to complete and execute our plan by the end of fiscal 2006 pending technical corrections by Congress and additional clarification by the Treasury Department. Until that time, we expect to make no change in our current intention to indefinitely reinvest accumulated earnings of foreign subsidiaries. Should we decide to repatriate these earnings, which, at June 30, 2004, did not exceed \$1.1 billion of cumulative net undistributed earnings, a one-time charge to Sun's consolidated results of operations would be recorded. Due to the complexity and uncertainty of applying the provisions of the Act, the income tax effects of such repatriation cannot be reasonably estimated at this time.

In November 2004, the FASB issued SFAS 151, Inventory Costs. SFAS 151 requires the allocation of fixed production overhead costs be based on the normal capacity of the production facilities and unallocated overhead costs recognized as an expense in the period incurred. In addition, other items such as abnormal freight, handling costs and wasted materials require treatment as current period charges rather than a portion of the inventory cost. SFAS 151 is effective for inventory costs incurred during periods beginning after June 15, 2005. We are currently assessing the impact of the adoption of SFAS 151 to our results of operations and financial condition.

In December 2004, the FASB issued SFAS 123 (revised 2004), Share-Based Payment. SFAS 123R requires measurement of all employee stock-based compensation awards using a fair value method and the recording of such expense in the consolidated financial statements. In addition, the adoption of SFAS 123R will require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R is effective beginning in our first quarter of fiscal 2006. We are evaluating the requirements of SFAS 123R and we expect that the adoption of SFAS 123R will have a material impact on our results of operations and financial condition. We have not yet determined whether the adoption of SFAS 123R will result in stock-based compensation charges that are similar to the current pro forma disclosures under SFAS 123.

In December 2004, the FASB issued SFAS 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS 153 is effective for nonmonetary asset exchanges beginning in our first quarter of fiscal 2006. We do not believe adoption of SFAS 153 will have a material impact on our results of operations and financial condition.

3. GOODWILL AND OTHER ACQUISITION-RELATED INTANGIBLE ASSETS

On December 26, 2004 and June 30, 2004, we had goodwill with a carrying value of \$406 million. Our goodwill by reportable segment was \$326 million for Product Group and \$80 million for Sun Services as of December 26, 2004 and June 30, 2004.

Information regarding our other acquisition-related intangible assets is as follows (in millions):

| Gross Carrying Amount | | Accumulated Amortization | | Net |
|-----------------------|--------------|--------------------------|--------------|--------------|
| June 30, | December 26, | June 30, | December 26, | December 26, |
| Additions | | Additions | | |

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| | <u>2004</u> | — | <u>2004</u> | <u>2004</u> | — | <u>2004</u> | <u>2004</u> |
|------------------------------|---------------|-----------|---------------|-----------------|-----------|----------------|--------------|
| Developed technology | \$ 383 | \$ | \$ 383 | \$ (295) | \$ | \$ (22) | \$ 66 |
| Customer base and other | 50 | | 50 | (45) | | (1) | 4 |
| Acquired workforce and other | 86 | | 86 | (52) | | (14) | 20 |
| | <u>\$ 519</u> | <u>\$</u> | <u>\$ 519</u> | <u>\$ (392)</u> | <u>\$</u> | <u>\$ (37)</u> | <u>\$ 90</u> |

Amortization expense of other acquisition-related intangible assets was \$19 million and \$37 million for the three and six months ended December 26, 2004, respectively, and \$15 million and \$30 million for the three and six months ended December 28, 2003, respectively.

Table of Contents

Estimated amortization expense for other acquisition-related intangible assets for acquisitions completed prior to December 26, 2004 for the fiscal years ending June 30, is as follows (in millions):

| | |
|-----------------------------------------------------------------------------------------|-------------------|
| 2005 (including \$37 million of amortization expense for the first half of fiscal 2005) | \$ 72 |
| 2006 | 39 |
| 2007 | 16 |
| | <u> </u> |
| | <u>\$ 127</u> |

4. BALANCE SHEET DETAILS

Inventories

Inventories consisted of the following (in millions):

| | December 26, 2004 | June 30, 2004 |
|-----------------|----------------------|-------------------|
| Raw materials | \$ 60 | \$ 78 |
| Work in process | 154 | 131 |
| Finished goods | 215 | 255 |
| | <u> </u> | <u> </u> |
| | <u>\$ 429</u> | <u>\$ 464</u> |

Deferred Revenues

The following table sets forth an analysis of the deferred revenue activity for the three months ended September 26, 2004 and December 26, 2004 (in millions):

| | Deferred services revenues | Other deferred revenues | Total |
|-----------------------------------|-------------------------------|----------------------------|-------------------|
| Balance at June 30, 2004 | \$ 1,612 | \$ 562 | \$ 2,174 |
| Revenue deferred ⁽¹⁾ | 256 | 261 | 517 |
| Revenue recognized ⁽¹⁾ | (410) | (411) | (821) |
| | <u> </u> | <u> </u> | <u> </u> |

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| | | | |
|-----------------------------------|-------------------|-------------------|-------------------|
| Balance at September 26, 2004 | 1,458 | 412 | 1,870 |
| Revenue deferred | 285 | 225 | 510 |
| Revenue recognized | (343) | (205) | (548) |
| | <u> </u> | <u> </u> | <u> </u> |
| Balance at December 26, 2004 | \$ 1,400 | \$ 432 | \$ 1,832 |
| Less short-term portion | (940) | (373) | (1,313) |
| | <u> </u> | <u> </u> | <u> </u> |
| Total long-term deferred revenues | \$ 460 | \$ 59 | \$ 519 |
| | <u> </u> | <u> </u> | <u> </u> |

(1) As revised from the first quarter of fiscal 2005 which reported total revenue deferred of \$1,461 million and total revenue recognized of \$1,765 million.

Warranty Reserve

We accrue for our product warranty costs at the time of shipment. The product warranty costs are estimated based upon our historical experience and specific identification of the product requirements.

The following table sets forth an analysis of the warranty reserve activity for the six months ended December 26, 2004 (in millions):

| | |
|-------------------------------|-------------------|
| Balance at June 30, 2004 | \$ 252 |
| Charged to costs and expenses | 154 |
| Utilization | (170) |
| | <u> </u> |
| Balance at December 26, 2004 | \$ 236 |
| | <u> </u> |

5. RESTRUCTURING CHARGES AND WORKFORCE REBALANCING EFFORTS

Fiscal 2004 Restructuring Plan

In March 2004, our Board of Directors and management approved a plan to reduce our cost structure and improve operating efficiencies by reducing our workforce, exiting facilities, and implementing productivity improvement initiatives and expense reduction measures (Fiscal 2004 Restructuring Plan). This plan included reducing our workforce by at least 3,300 employees

Table of Contents

across all levels, business functions, operating units, and geographic regions. Through the end of the second quarter of fiscal 2005, we reduced our workforce by approximately 3,600 employees under this plan. This plan also included eliminating excess facility capacity in light of revised facility requirements and other actions. In accordance with SFAS No. 112, Employers Accounting for Post Employment Benefits and SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), in the second quarter and first half of fiscal 2005 we recognized a total of \$25 million and \$135 million, respectively, in charges associated with the Fiscal 2004 Restructuring Plan, consisting of \$19 million and \$39 million, respectively, in workforce reduction charges and \$6 million and \$96 million, respectively, in excess facility charges.

We may record additional charges related to our workforce and facilities reductions over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving Sun as determined by local employment laws and as we exit facilities. Certain costs related to the facilities reductions that do not meet the initial recognition criteria of SFAS 146 will be expensed as they are incurred and will be reflected as restructuring charges in our Consolidated Statements of Operations.

In addition, we anticipate incurring additional charges associated with productivity improvement initiatives and expense reduction measures. The total amount and timing of these charges will depend upon the nature, timing, and extent of these future actions.

Fiscal 2003 Restructuring Plan, Fiscal 2002 Restructuring Plan and Fiscal 2001 Facility Exit Plan

We committed to restructuring plans in fiscal 2003 and 2002 (Fiscal 2003 Restructuring Plan and Fiscal 2002 Restructuring Plan, respectively) and a facility exit plan in fiscal 2001 (Fiscal 2001 Facility Exit Plan). We recorded initial restructuring charges in fiscal 2003, 2002 and 2001 based on assumptions and related estimates that we deemed appropriate for the economic environment that existed at the time these estimates were made. However, due to the uncertainty of the commercial real estate market, primarily in the U.S., and the final settlement of certain lease obligations, we have made appropriate adjustments to the initial restructuring charges.

The following table sets forth an analysis of the restructuring accrual activity for the six months ended December 26, 2004 (in millions):

| | Fiscal 2004 | | Fiscal 2003 | | Fiscal 2002 | Fiscal 2001 | Total |
|-----------------------------------|--------------------|-------------------|--------------------|------------|--------------------|--------------------|--------|
| | Restructuring Plan | | Restructuring Plan | | Restructuring Plan | Facility Exit Plan | |
| | Severance | Facilities | Severance | Facilities | Facilities | Facilities | |
| | and Benefits | Related and Other | and Benefits | Related | Related | Related | |
| Balance as of June 30, 2004 | \$ 166 | \$ 88 | \$ 1 | \$ 90 | \$ 153 | \$ 45 | \$ 543 |
| Severance and benefits | 39 | | | | | | 39 |
| Lease costs | | 89 | | | | | 89 |
| Property and equipment impairment | | 13 | | | | | 13 |
| Provision adjustments | | (6) | | (1) | (1) | (1) | (9) |

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| | | | | | | |
|---------------------------------|-------|--------|-------|--------|-------|--------|
| Total restructuring charges | 39 | 96 | (1) | (1) | (1) | 132 |
| Cash paid | (144) | (25) | (1) | (10) | (16) | (205) |
| Non-cash | | (12) | | 1 | | (11) |
| Balance as of December 26, 2004 | \$ 61 | \$ 147 | \$ 80 | \$ 136 | \$ 35 | \$ 459 |

Our accrued liability for all four plans was net of approximately \$115 million of estimated sublease income to be generated from sublease contracts not yet negotiated. Our ability to generate this amount of sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated, is highly dependent upon the economic conditions, particularly commercial real estate market conditions in certain geographies, at the time we negotiate the lease termination and sublease arrangements with third parties. The amounts we have accrued represent our best estimate of the obligations we expect to incur in connection with these plans, and could be subject to change. Adjustments may be required as conditions and facts change throughout the implementation period.

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of December 26, 2004 for facility related leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of December 26, 2004, \$163 million of the \$459 million accrual was classified as current and the remaining \$296 million was classified as non-current.

The above restructuring charges are based on estimates that are subject to change. Changes to the previous estimates have been reflected as Provision adjustments in the above table in the period the changes in estimates were made.

Table of ContentsWorkforce Rebalancing Efforts

Prior to the initiation of our Fiscal 2004 Restructuring Plan, we had initiated certain workforce rebalancing efforts during the first six months of fiscal 2004. As a result, we incurred \$55 million of separation costs during this period. Approximately \$3 million, \$14 million, and \$38 million of these separation costs were included in cost of sales, research and development and selling, general and administrative expenses, respectively. During fiscal 2004 and the first half of fiscal 2005, we paid \$54 million and \$1 million, respectively.

6. COMPREHENSIVE INCOME (LOSS)

The components of comprehensive income (loss), net of related taxes, were as follows (in millions):

| | Three Months Ended | | Six Months Ended | |
|----------------------------------------------------------------|---------------------------|---------------------|-------------------------|---------------------|
| | December 26, | December 28, | December 26, | December 28, |
| | 2004 | 2003 | 2004 | 2003 |
| Net income (loss) | \$ 18 | \$ (125) | \$ (129) | \$ (411) |
| Change in unrealized value on investments, net | 1 | (5) | 9 | (7) |
| Change in unrealized fair value of derivative instruments, net | (9) | | (8) | 1 |
| Translation adjustments, net | 108 | 90 | 86 | 31 |
| | \$ 118 | \$ (40) | \$ (42) | \$ (386) |

The components of accumulated other comprehensive income, net of related taxes, were as follows (in millions):

| | December 26, | June 30, |
|--------------------------------------------------|---------------------|-----------------|
| | 2004 | 2004 |
| Unrealized losses on investments, net | \$ (8) | \$ (17) |
| Unrealized losses on derivative instruments, net | (14) | (6) |
| Cumulative translation adjustments, net | 282 | 196 |
| | \$ 260 | \$ 173 |

7. INCOME TAXES

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For the second quarter and first half of fiscal 2005, we recorded an income tax provision of \$39 million and \$78 million, respectively, as compared with an income tax provision of \$28 million and \$59 million for the corresponding periods of fiscal 2004. These tax provisions were recorded for taxes due on income generated in certain state and foreign tax jurisdictions and also include adjustments for the difference between estimated amounts recorded and actual liabilities resulting from the filing of prior years' tax returns.

We are currently under examination by the Internal Revenue Service (IRS) for tax returns filed in the fiscal years 1997 through 2000. In addition, the examination for fiscal years 2001 and 2002 commenced in fiscal 2005. Although the ultimate outcome of these examinations are unknown, we believe that adequate amounts have been provided for any adjustments that may result from the current examinations and that the final outcomes will not have a material adverse effect on Sun's results of operations.

We have provided adequate amounts for anticipated tax audit adjustments in the U.S., state and other foreign tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes and interest may be due. If events occur which indicate payment of these amounts are unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

8. OPERATING SEGMENTS

We design, manufacture, market and service network computing infrastructure solutions that consist of Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions and Knowledge services. Effective July 1, 2004, our President and Chief Operating Officer was identified as the Chief Operating Decision Maker (CODM) as defined by SFAS No. 131,

Disclosures About Segments of an Enterprise and Related Information (SFAS 131). Following his appointment, we reorganized Sun and the effects of these changes to our business organization did not result in a change to our operating segment disclosure. The CODM continues to manage our company based primarily on broad functional categories of sales, services, manufacturing, product development and engineering and marketing and strategy. The CODM reviews financial information on revenues and gross margins for products and services. The CODM also reviews operating expenses certain of which have been allocated to our two segments described below.

Table of Contents

We operate in two segments: Product Group and Sun Services. Our Product Group segment comprises our end-to-end networking architecture of computing products including our Computer Systems and Network Storage systems product lines. In the Sun Services segment, we provide a full range of services to existing and new customers, including Support services, Client solutions and Knowledge services.

We have a Worldwide Operations (WWOPS) organization and a Global Sales Organization (GSO) that, respectively, manufacture and sell all of our products. The CODM holds the GSO accountable for overall products and services revenue and margins at a consolidated level. GSO and WWOPS each manage the majority of our accounts receivable and inventory. In addition, we have a Worldwide Marketing Organization (WMO) that is responsible for developing and executing Sun's overall corporate, strategic and product marketing and advertising strategies. The CODM looks to this functional organization for advertising, pricing and other marketing strategies for the products and services delivered to market. Operating expenses (primarily sales, marketing and administrative) related to the GSO and the WMO are not allocated to the reportable segments and, accordingly, are included under the Other segment reported below.

Segment information

The following table presents revenues, interdivision revenues and operating income (loss) for our segments. The Other segment consists of certain functional groups that did not meet the requirements for a reportable segment as defined by SFAS 131, such as GSO and WMO and other miscellaneous functions such as Corporate (in millions):

| | Product | Sun | | |
|----------------------------|----------------|-----------------|--------------|--------------|
| | Group | Services | Other | Total |
| | <u>Group</u> | <u>Services</u> | <u>Other</u> | <u>Total</u> |
| Three Months Ended: | | | | |
| December 26, 2004 | | | | |
| Revenues | \$ 1,840 | \$ 1,001 | \$ | \$ 2,841 |
| Interdivision revenues | 163 | 100 | (263) | |
| Operating income (loss) | 329 | 388 | (702) | 15 |
| December 28, 2003 | | | | |
| Revenues | \$ 1,944 | \$ 944 | \$ | \$ 2,888 |
| Interdivision revenues | 180 | 108 | (288) | |
| Operating income (loss) | 329 | 284 | (694) | (81) |
| | | | | |
| | Product | Sun | | |
| | Group | Services | Other | Total |
| | <u>Group</u> | <u>Services</u> | <u>Other</u> | <u>Total</u> |
| Six Months Ended: | | | | |
| December 26, 2004 | | | | |
| Revenues | \$ 3,516 | \$ 1,953 | \$ | \$ 5,469 |
| Interdivision revenues | 338 | 204 | (542) | |
| Operating income (loss) | 574 | 752 | (1,446) | (120) |
| December 28, 2003 | | | | |
| Revenues | \$ 3,578 | \$ 1,846 | \$ | \$ 5,424 |
| Interdivision revenues | 328 | 217 | (545) | |
| Operating income (loss) | 482 | 542 | (1,356) | (332) |

9. LEGAL PROCEEDINGS

On February 11, 2002, Eastman Kodak Company (Kodak) filed a lawsuit against us entitled, Eastman Kodak Company v. Sun Microsystems, Inc., Civil Action No. 02-CV-6074, in the United States District Court for the Western District of New York and filed an amended complaint in that same court on March 22, 2002. Kodak alleged that some of our products, including aspects of our Java™ technology, infringe one or more Kodak patent claims contained in the following Kodak patents: U.S. Patent No. 5,206,951, U.S. Patent No. 5,421,012 and U.S. Patent No. 5,226,161 (collectively, the Litigated Kodak Patents). Kodak further alleged that we contributed to and induced infringement of one or more claims of the Litigated Kodak Patents. Effective October 7, 2004, we reached an agreement with Kodak to settle all claims in the lawsuit. As a result of the settlement, we received a release for any past infringement by Sun's Java technology of any patent held by Kodak (collectively, the Kodak Patent Portfolio) and a release for any past infringement whatsoever of the Litigated Kodak Patents and other specified patents held by Kodak (collectively, the Broadly Released Kodak Patents). Furthermore, Sun received a perpetual, non-exclusive, worldwide irrevocable license to the Kodak Patent Portfolio for the benefit of the Java technology and to the Broadly Released Kodak Patents for any and all purposes. In return, we paid Kodak \$92 million. Of this amount, \$10 million was expensed in fiscal 2004 and \$55 million was expensed to cost of sales-products in the first quarter of fiscal 2005. The remaining amount represents the estimated future benefit that we will obtain from the licenses granted under the settlement. This \$27 million intangible asset was recorded in other non-current assets and is being amortized ratably to cost of sales-products over the remaining patent life through fiscal 2010.

Table of Contents

On April 20, 2004, we were served with a complaint in a case entitled Gobeli Research (Gobeli) v. Sun Microsystems, Inc. and Apple Computer, Inc. (Apple). The complaint alleges that Sun products, including our Solaris™ Operating System, infringe on a Gobeli patent related to a system and method for controlling interrupt processing. Gobeli claims that Apple's OS 9 and OS X operating systems violate that same patent. The case is pending in the United States District Court for the Eastern District of Texas. We have filed a response denying liability and stating various affirmative defenses, and we intend to present a vigorous defense.

We entered into settlement agreements with the United States Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS) on December 15, 2003 addressing certain BIS charges that we had violated export control regulations. The settlement included a one year suspended denial of our worldwide export privileges, which expired on December 15, 2004 without incident. Had we violated export control laws during the one year suspension period, the BIS order would have denied us worldwide export privileges, which would have had a material effect on the results of operations and financial condition.

10. RELATED PARTIES

We occasionally conduct transactions with entities that are or were considered related parties. Intuit Inc. (Intuit) is considered a related party because Stephen Bennett, the President and Chief Executive Officer of Intuit was appointed a member of the Board of Directors of Sun effective June 28, 2004. The amount of net revenues and expenses pertaining to transactions with Intuit since Mr. Bennett's appointment were not material.

11. SUBSEQUENT EVENTS

On January 10, 2005, we acquired SevenSpace, Inc. (SevenSpace), a privately-held company based in Ashburn, Virginia, by means of a merger pursuant to which we paid approximately \$49 million in cash for all of the outstanding shares of capital stock of SevenSpace. In addition, all outstanding options to purchase SevenSpace capital stock were exchanged for options to purchase our common stock. SevenSpace delivers remote system monitoring and management across heterogeneous environments, including enterprise applications, databases, operating systems and network devices and will enhance our managed services offerings by adding support for non-Sun platforms.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders, Sun Microsystems, Inc.

We have reviewed the condensed consolidated balance sheet of Sun Microsystems, Inc. as of December 26, 2004, and the related condensed consolidated statements of operations for the three-month and six-month periods ended December 26, 2004 and December 28, 2003, and the condensed consolidated statements of cash flows for the six-month periods ended December 26, 2004 and December 28, 2003. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Sun Microsystems, Inc. as of June 30, 2004, and the related consolidated statements of operations, stockholders equity, and cash flows for the year then ended not presented herein, and in our report dated September 10, 2004, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of June 30, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

San Jose, California

February 2, 2005

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is intended to be an overview of the areas that management believes are important in understanding the results of the quarter. This overview is not intended as a substitute for the detail provided in the following pages or for the condensed consolidated financial statements and notes that appear elsewhere in this document.

Executive Overview

Sun provides network computing infrastructure solutions that include Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions (formerly known as Professional services) and Knowledge services. Sun's solutions are based on major Sun technology innovations such as the Java platform, the Solaris operating system, Sun Java products and N1™ Grid architecture and the SPARC® microprocessor technology, as well as other widely deployed technologies such as the Linux operating system and x86 microprocessor-based systems. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare. We sell end-to-end networking architecture platform solutions, including products and services, in most major markets worldwide through a combination of direct and indirect channels.

During the second quarter of fiscal 2005, we experienced a year over year decrease in total net revenues of approximately 2%, which included a favorable foreign currency impact of approximately 3%. Our Products net revenue was unfavorably impacted by increased competition and a continuing market shift in overall computer system demand towards the usage of enterprise and entry level servers. This decrease was partially offset by the increases in both Support services and Client solutions revenue. Additionally, we experienced a sequential quarterly increase in total net revenues of approximately 8%, which included a favorable foreign currency impact of approximately 2%. This sequential increase reflects the normal seasonal trend we experience between our first and second quarters.

During the second quarter of fiscal 2005, our year over year gross margin remained relatively flat. Our Products gross margin decreased by 1.0 percentage points primarily due to the unfavorable impact of discounting actions, partially offset by manufacturing and component cost reductions. Our Services gross margin increased by 3.0 percentage points primarily due to the favorable impact of volume efficiencies, cost reductions and productivity measures. Additionally, our sequential quarterly Products gross margin percentage increased by 2.0 percentage points. This increase was primarily due to the approximately 3 percentage point difference associated with the \$55 million first quarter charge to product cost of sales related to the Kodak litigation settlement, partially offset by our discounting actions in the second quarter. Sequentially, Services gross margin increased by 0.2 percentage points primarily due to our seasonal increase in revenue volume efficiencies and continued focus on cost containment.

Sequentially, our research and development expenses increased by \$31 million and our sales, general and administrative expenses increased by \$28 million primarily due to seasonal factors which included the July shutdown benefits reflected in the first quarter, additional pay days in the second quarter and a salary increase that was implemented in the second quarter. These increases were partially offset by our on-going cost structure actions that included reducing our global workforce and property portfolio and implementing productivity improvement initiatives and expense reduction measures. The ongoing reductions in our global workforce and property portfolio resulted in a net restructuring charge of \$24 million in the second quarter of fiscal 2005.

During the first half of fiscal 2005, our operating activities provided cash flows of \$176 million and at December 26, 2004 we had a total cash, cash equivalents and marketable debt securities position of approximately \$7.5 billion.

Subsequent to the announcement of our second quarter and first half of fiscal 2005 results on January 13, 2005, we obtained additional information that required us to reduce our previously announced results by approximately \$1 million as a result of certain immaterial adjustments that are reflected in our condensed consolidated financial statements.

Critical Accounting Policies

The accompanying discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. We are required to make estimates and judgments in many areas, including those related to fair value of derivative financial instruments, recording of various accruals, bad debt and inventory reserves, the useful lives of long-lived assets such as property and equipment, warranty obligations and potential losses from contingencies and litigation. We believe the policies disclosed are the most critical to our financial statements because their application places the most significant demands on management's judgment. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors.

Table of Contents

We believe there have been no significant changes during the three and six months ended December 26, 2004 to the items that we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004.

RESULTS OF OPERATIONS

During the second quarter of fiscal 2005, our consolidated results of operations were favorably impacted by approximately \$5 million due to certain adjustments, which are individually and in the aggregate immaterial to our results of operations and financial condition for this period.

Net Revenues

(dollars in millions, except revenue per employee dollars in thousands)

| | Three Months Ended | | | Six Months Ended | | |
|-----------------------------------------|--------------------|--------------|---------|------------------|--------------|--------|
| | December 26, | December 28, | Change | December 26, | December 28, | Change |
| | 2004 | 2003 | | 2004 | 2003 | |
| Computer Systems products | \$ 1,505 | \$ 1,568 | (4.0)% | \$ 2,859 | \$ 2,850 | 0.3% |
| Network Storage products | 335 | 376 | (10.9)% | 657 | 728 | (9.8)% |
| Products net revenue | \$ 1,840 | \$ 1,944 | (5.3)% | \$ 3,516 | \$ 3,578 | (1.7)% |
| Percentage of total net revenues | 64.8% | 67.3% | | 64.3% | 66.0% | |
| Support services | \$ 774 | \$ 745 | 3.9% | \$ 1,519 | \$ 1,476 | 2.9% |
| Client solutions and Knowledge services | 227 | 199 | 14.1% | 434 | 370 | 17.3% |
| Services net revenue | \$ 1,001 | \$ 944 | 6.0% | \$ 1,953 | \$ 1,846 | 5.8% |
| Percentage of total net revenues | 35.2% | 32.7% | | 35.7% | 34.0% | |
| Total net revenues | \$ 2,841 | \$ 2,888 | (1.6)% | \$ 5,469 | \$ 5,424 | 0.8% |
| Revenue per employee ⁽¹⁾ | \$ 88 | \$ 80 | 10.0% | \$ 166 | \$ 151 | 9.9% |

| | December 26, | December 28, | Change |
|---------------------------------------------------|--------------|--------------|--------|
| | 2004 | 2003 | |
| Services contract penetration rate ⁽²⁾ | 51.6% | 44.1% | 7.5pts |

(1) Revenue per employee is calculated by dividing the revenue during the period, by the average number of employees during the period, including contractors. We use this as a measure of our productivity.

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- (2) The services contract penetration rate is calculated by dividing the number of systems under a Support service contract, by the installed base. Systems under a Support service contract represent the total number of systems under an active Support service contract as of the last day of a fiscal quarter. Installed base is defined as the total number of units in active use which is calculated by dividing the number of units shipped, by our estimate of the product's useful life. These estimates range between three and five years, varying by product, and are a function of system type, product complexity, degree of self-support attributes, the level of criticality to a customer and the average selling price. The services contract penetration rate is a key measure we use to assess the performance of the Support services business as it measures our ability to capture an ongoing revenue stream from the Computer Systems and Network Storage products we sell.

Due to the generally weakened U.S. dollar during the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, our total net revenues were favorably impacted by foreign currency exchange rates. The net foreign currency impact to our total net revenues is difficult to precisely measure because of the various hedging strategies we employ. However, our best estimate of the foreign exchange benefit during the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, approximated 3% of total net revenue. Our best estimate of the composition of the 3% foreign exchange benefit of total net revenue during the second quarter of fiscal 2005 as compared with the second quarter of fiscal 2004, approximated a benefit of approximately 2% of products net revenue and a benefit of approximately 5% of services net revenue.

Products Net Revenue

Products net revenue consists of revenue generated from the sale of Computer Systems and Network Storage products.

Table of Contents

During the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, Computer Systems revenue decreased during the second quarter of fiscal 2005 primarily due to decreased unit sales of data center servers. Additionally during the second quarter of fiscal 2005, Computer systems revenue was adversely impacted by decreased unit sales of mid-range enterprise servers. The decreased unit sales in these periods were due to intense competition and a continuing market shift in overall computer system demand towards the usage of enterprise and entry level servers. The decrease in Computer Systems revenue was partially offset by: (1) increased unit sales of entry level servers, which included servers running on our SPARC and AMD's Opteron™ x86 processors, and Netra™ servers; and (2) increased software sales, driven in part by increases in our Java Enterprise System subscriber count. During the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, Network Storage revenue decreased due to reduced sales of mid-range storage systems and low-end components, partially offset by increased unit sales of entry level storage systems.

Services Net Revenue

Services net revenue consists of revenue generated from Support services, Client solutions and Knowledge services.

Support services revenue consists primarily of maintenance contract revenue, which is recognized ratably over the contractual period. During the second quarter and first half of fiscal 2005 as compared with the corresponding periods in fiscal 2004, Support services net revenue was favorably impacted by an increase in average contract value and an increase in the number of systems under a Support services contract. We believe the increase in the number of systems under a Support services contract is primarily due to our continuing emphasis in recent periods on solution sales which include support services as an essential elements of a solution sale. The percentage point increase in the services contract penetration rate is due to a continued increases in the systems under contract and a decrease in the number of active systems that comprise the installed base.

Client solutions and Knowledge services revenue consists primarily of revenue generated from professional services such as technical consulting that helps our customers plan, implement and manage distributed network computing environments. Excluding the benefit of foreign exchange, there was an overall increase in Client solutions and Knowledge services revenues during the second quarter and first half of fiscal 2005 as compared with the corresponding periods in fiscal 2004 due to increased professional services-related revenues in both periods. These increases were primarily due to the success of our solution-based selling strategy internationally, particularly in EMEA.

Net Revenues by Geographic Area

(dollars in millions)

| | Three Months Ended | | | Six Months Ended | | |
|-------------------------------------------|--------------------|--------------|--------|------------------|--------------|--------|
| | December 26, | December 28, | Change | December 26, | December 28, | Change |
| | 2004 | 2003 | | 2004 | 2003 | |
| United States (U.S.) | \$ 1,130 | \$ 1,214 | (6.9)% | \$ 2,235 | \$ 2,376 | (5.9)% |
| Percentage of total net revenues | 39.8% | 42.0% | | 40.9% | 43.8% | |
| Americas-Other (Canada and Latin America) | \$ 165 | \$ 152 | 8.6% | \$ 275 | \$ 268 | 2.6% |

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| | | | | | | |
|----------------------------------------|----------|----------|--------|----------|----------|------|
| Percentage of total net revenues | 5.8% | 5.3% | | 5.0% | 4.9% | |
| EMEA (Europe, Middle East and Africa) | \$ 1,037 | \$ 1,031 | 0.6% | \$ 2,010 | \$ 1,853 | 8.5% |
| Percentage of total net revenues | 36.5% | 35.7% | | 36.7% | 34.2% | |
| APAC (Asia, Australia and New Zealand) | \$ 509 | \$ 491 | 3.7% | \$ 949 | \$ 927 | 2.4% |
| Percentage of total net revenues | 17.9% | 17.0% | | 17.4% | 17.1% | |
| Total International revenues | \$ 1,711 | \$ 1,674 | 2.2% | \$ 3,234 | \$ 3,048 | 6.1% |
| Percentage of total net revenues | 60.2% | 58.0% | | 59.1% | 56.2% | |
| Total net revenues | \$ 2,841 | \$ 2,888 | (1.6)% | \$ 5,469 | \$ 5,424 | 0.8% |

United States (U.S.)

Net revenues in the U.S. declined during the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004 primarily due to a decrease in Products net revenue. In the U.S., our sales mix has traditionally included a higher proportion of product sales, which has contributed to the challenge in growing revenue in this geographic market as we continue to experience intense competitive pressures, especially in selling our high-end server products in certain key sectors. In the government sector, we continue to experience intense competition and reduced spending in certain areas which have traditionally been sources of relative competitive strength. In the telecommunications sector, the fiscal 2004 trend of increased spending did not continue into the first half of fiscal 2005 as increased merger and acquisition activity in the sector was correlated to reduced customer spending patterns in key accounts. Partially offsetting the decline in revenue from the government and telecommunications sectors was second quarter growth in the financial services sector driven by increased purchases from our Wall Street customer base.

Table of Contents

The following table sets forth net revenues in geographic markets contributing significantly to changes in international net revenues during the second quarter and first half of fiscal 2005:

(dollars in millions)

| | <u>Three Months Ended</u> | | | <u>Six Months Ended</u> | | |
|-----------------------------------|----------------------------------|-------------|---------------|----------------------------------|-------------|---------------|
| | <u>December 26, December 28,</u> | | | <u>December 26, December 28,</u> | | |
| | <u>2004</u> | <u>2003</u> | <u>Change</u> | <u>2004</u> | <u>2003</u> | <u>Change</u> |
| United Kingdom (UK) | \$ 222 | \$ 214 | 3.7% | \$ 514 | \$ 412 | 24.8% |
| Germany ⁽¹⁾ | \$ 228 | \$ 221 | 3.2% | \$ 419 | \$ 402 | 4.2% |
| Japan | \$ 190 | \$ 192 | (1.0)% | \$ 373 | \$ 377 | (1.1)% |
| Central and Northern Europe (CNE) | \$ 181 | \$ 187 | (3.2)% | \$ 333 | \$ 332 | 0.3% |

(1) Beginning in the second quarter of fiscal 2005, the Germany geographic market has been restated to no longer include Austria.

United Kingdom (UK)

During the second quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, net revenues in the UK increased slightly, primarily due to the benefit of foreign exchange. During the first half of fiscal 2005, as compared with the corresponding period of fiscal 2004, net revenues in the UK grew across the majority of products and services categories. Support services and Client solutions revenues increased during the first half of fiscal 2005 as compared to the corresponding period of fiscal 2004. In the UK, our revenue mix has included a higher proportion of services revenues when compared to other geographic markets such as the U.S. and Japan, which has contributed to our overall revenue growth in this geographic market. During the first half of fiscal 2005, the government sector primarily contributed to the increase in revenue as compared with the corresponding period of fiscal 2004. Revenues during the first half of fiscal 2005 included \$62 million recognized in the first quarter of fiscal 2005, which was related to the first phase of a multi-year solution-based sale to a health care services provider.

Germany

During the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, net revenues in Germany increased slightly, primarily due to the benefit of foreign exchange, partially offset by the moderate decline in second quarter Products revenue. Products revenue has been adversely impacted by intense competition, especially for data center servers, and total net revenues have been adversely impacted by a challenging economic environment. Despite these challenges, the government and telecommunications sectors remained a source of overall revenue strength during the second quarter of fiscal 2005.

Japan

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During the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, net revenues in Japan were relatively flat primarily due to a slight increase in Support services revenue and the benefit of foreign exchange, offset by a decrease in Products revenue. This decrease in Products revenue in Japan is primarily a result of the implementation of the initial elements of our broad-based strategic alliance with Fujitsu. Irrespective of the impact of this alliance, we believe our actions to adjust to the intense competitive business environment have contributed towards stabilization of this geographic market's revenue.

Central and Northern Europe (CNE)

Net revenues in CNE slightly decreased during the second quarter and were flat during the first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004 including the benefit of foreign exchange. The decrease in total net revenues during the second quarter was primarily due to a decrease in year over year Products revenue. During the first half of fiscal 2005, we experienced year over year increases in Support services and Client solutions revenue associated with a growth in revenues in the manufacturing and retail sectors.

Table of Contents**Gross Margin**

(dollars in millions)

| | Three Months Ended | | | Six Months Ended | | |
|------------------------------------|--------------------|--------------|----------|------------------|--------------|----------|
| | December 26, | December 28, | Change | December 26, | December 28, | Change |
| | 2004 | 2003 | | 2004 | 2003 | |
| Products gross margin | \$ 775 | \$ 837 | (7.4)% | \$ 1,447 | \$ 1,506 | (3.9)% |
| Percentage of products net revenue | 42.1% | 43.1% | (1.0)pts | 41.2% | 42.1% | (0.9)pts |
| Services gross margin | \$ 423 | \$ 371 | 14.0% | \$ 824 | \$ 718 | 14.8% |
| Percentage of services net revenue | 42.3% | 39.3% | 3.0pts | 42.2% | 38.9% | 3.3pts |
| Total gross margin | \$ 1,198 | \$ 1,208 | (0.8)% | \$ 2,271 | \$ 2,224 | 2.1% |
| Percentage of total net revenues | 42.2% | 41.8% | 0.4pts | 41.5% | 41.0% | 0.5pts |

Products Gross Margin

Products gross margin percentage is influenced by numerous factors including product mix, pricing, geographic mix, currency exchange rates and the mix between sales to resellers and end-users, third-party costs (including both raw material and manufacturing costs), volume, warranty costs and charges related to excess and obsolete inventory. Many of these factors influence, or are interrelated with, other factors. As a result, it is difficult to precisely quantify the impact of each item individually. Accordingly, the following quantification of the reasons for the change in the products gross margin percentage is an estimate only.

During the second quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, our products gross margin percentage decreased by 1.0 percentage points due to: planned list price reductions and sales discounting actions by approximately 5 percentage points and changes in product mix to a greater proportion of lower margin products by approximately 2 percentage points. Offsetting these decreases were cost reductions due to supply chain restructuring, product cost engineering and continued use of dynamic bidding events which collectively benefited gross margin by approximately 4 percentage points. Further benefiting products gross margin was a reduction in channel program and other reserves of approximately 2 percentage points.

During the first half of fiscal 2005 as compared with the corresponding period of fiscal 2004, our products gross margin percentage decreased by 0.9 percentage point due to: (1) the adverse impact of the first quarter's Kodak litigation settlement recorded as cost of product sales by approximately 2 percentage points; (2) planned list price reductions and sales discounting actions of approximately 4 percentage points; and (3) changes in product mix to a greater proportion of lower margin products of approximately 2 percentage points. Offsetting these decreases were cost reductions due to supply chain restructuring, product cost engineering and continued use of dynamic bidding events which benefited gross margin by approximately 5 percentage points. Further benefiting products gross margin was a reduction in channel program and other reserves of approximately 2 percentage points.

Services Gross Margin

Services gross margin percentage is influenced by numerous factors including services mix, pricing, geographic mix, currency exchange rates and third-party costs. Many of these factors influence, or are interrelated with, other factors. As a result, it is difficult to precisely quantify the impact of each item individually. Accordingly, the following quantification of the reasons for the change in the services gross margin percentage is an estimate only.

During the second quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, our services gross margin increased by 3.0 percentage points due to: (1) revenue volume efficiencies of approximately 3 percentage points; and (2) costs savings associated with our workforce reductions of approximately 1 percentage point. These increases were partially offset by the negative impact of increased costs associated with a shift in product mix to solution-based sales of approximately 1 percentage point.

During the first half of fiscal 2005 as compared with the corresponding period of fiscal 2004, our services gross margin increased by 3.3 percentage points due to: (1) revenue volume efficiencies of approximately 4 percentage points; and (2) costs savings associated with our workforce reductions of approximately 1 percentage point. These increases were partially offset by the negative impact of increased costs associated with a shift in product mix to solution-based sales of approximately 2 percentage points.

Table of Contents

To the extent we experience a shift in product mix to solution-based sales, which have a greater proportion of Client solutions, this shift may negatively impact our services gross margin.

Operating Expenses

(dollars in millions)

| | Three Months Ended | | | Six Months Ended | | |
|-----------------------------------------------|--------------------|--------------|---------|------------------|--------------|---------|
| | December 26, | December 28, | Change | December 26, | December 28, | Change |
| | 2004 | 2003 | | 2004 | 2003 | |
| Research and development | \$ 447 | \$ 471 | (5.1)% | \$ 863 | \$ 938 | (8.0)% |
| Percentage of total net revenues | 15.7% | 16.3% | | 15.8% | 17.3% | |
| Selling, general and administrative | \$ 712 | \$ 828 | (14.0)% | \$ 1,396 | \$ 1,626 | (14.1)% |
| Percentage of total net revenues | 25.1% | 28.7% | | 25.5% | 30.0% | |
| Restructuring charges | \$ 24 | \$ (10) | N/M* | \$ 132 | \$ (9) | N/M* |
| Percentage of total net revenues | 0.8% | (0.3)% | | 2.4% | (0.2)% | |
| Purchased in-process research and development | \$ | \$ | N/M* | \$ | \$ 1 | N/M* |
| Percentage of total net revenues | % | % | | % | 0.0% | |
| Total operating expenses | \$ 1,183 | \$ 1,289 | (8.2)% | \$ 2,391 | \$ 2,556 | (6.5)% |

* Not meaningful

Research and Development (R&D) Expenses

R&D expenses decreased by \$24 million during the second quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) \$34 million in cost savings associated with workforce reductions; and (2) \$19 million in cost savings associated with reduced discretionary and outside services spending and the reduction of depreciation and amortization. These decreases were partially offset by a \$28 million increase in variable compensation costs associated with accrued bonuses and compensation and other costs associated with previous acquisitions.

R&D expenses decreased by \$75 million during the first half of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) \$67 million in cost savings associated with workforce reductions; (2) \$25 million in cost savings associated with discretionary and outside services spending; (3) \$14 million in payroll related savings due to fewer days in the first quarter; and (4) \$12 million reduction of depreciation and amortization. These decreases were partially offset by a \$29 million increase in accrued bonus compensation and a \$23 million increase in compensation and other costs associated with previous acquisitions.

We believe that to maintain our competitive position in a market characterized by rapid rates of technological advancement, we must continue to invest significant resources in new systems, software, and microprocessor development, as well as continue to enhance existing products.

Selling, General and Administrative (SG&A) Expenses

SG&A expenses decreased by \$116 million during the second quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) \$66 million in cost savings associated with workforce reductions and rebalancing efforts; (2) \$33 million in occupancy cost savings associated with facilities exit actions; (3) \$15 million in reductions in legal costs; and (4) \$12 million reduction of depreciation and amortization. These decreases were partially offset by a \$23 million increase in variable compensation costs associated with salaries and bonuses.

SG&A expenses decreased by \$230 million during the first half of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) \$127 million in cost savings associated with workforce reductions and rebalancing efforts; (2) \$54 million in occupancy cost savings associated with facilities exit actions; (3) \$15 million in reductions in legal costs; (4) \$24 million reduction of depreciation and amortization; (5) \$19 million in reductions in marketing related costs; and (6) \$13 million in payroll related savings related to fewer payroll days in the first half of fiscal 2005. These decreases were partially offset by a \$33 million increase in variable compensation costs associated with bonuses and salaries.

Table of Contents

We are continuing to focus our efforts on achieving additional operating efficiencies by reviewing and improving upon our existing business processes and cost structure. We expect, on a dollar basis, to decrease our full fiscal year SG&A expenditures as compared to fiscal 2004.

Restructuring Charges and Workforce Rebalancing Efforts

Fiscal 2004 Restructuring Plan

In March 2004, our Board of Directors and management approved a plan to reduce our cost structure and improve operating efficiencies by reducing our workforce, exiting facilities, and implementing productivity improvement initiatives and expense reduction measures (Fiscal 2004 Restructuring Plan). This plan included reducing our workforce by at least 3,300 employees across all levels, business functions, operating units, and geographic regions. Through the end of the second quarter of fiscal 2005, we reduced our workforce by approximately 3,600 employees under this plan. This plan also included eliminating excess facility capacity in light of revised facility requirements, and other actions. In accordance with SFAS No. 112, *Employers' Accounting for Post Employment Benefits* and SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), in the second quarter and first half of fiscal 2005 we recognized a total of \$25 million and \$135 million, respectively, in charges associated with the Fiscal 2004 Restructuring Plan, consisting of \$19 million and \$39 million, respectively, in workforce reduction charges and \$6 million and \$96 million, respectively, in excess facility charges.

We may record additional charges related to our workforce and facilities reductions over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving Sun as determined by local employment laws and as we exit facilities. Certain costs related to the facilities reductions that do not meet the initial recognition criteria of SFAS 146 will be expensed as they are incurred and will be reflected as restructuring charges in our Consolidated Statements of Operations.

In addition, we anticipate incurring additional charges associated with productivity improvement initiatives and expense reduction measures. The total amount and timing of these charges will depend upon the nature, timing, and extent of these future actions.

Fiscal 2003 Restructuring Plan, Fiscal 2002 Restructuring Plan and Fiscal 2001 Facility Exit Plan

We committed to restructuring plans in fiscal 2003 and 2002 (Fiscal 2003 Restructuring Plan and Fiscal 2002 Restructuring Plan, respectively) and a facility exit plan in fiscal 2001 (Fiscal 2001 Facility Exit Plan). We recorded initial restructuring charges in fiscal 2003, 2002 and 2001 based on assumptions and related estimates that we deemed appropriate for the economic environment that existed at the time these estimates were made. However, due to the uncertainty of the commercial real estate market, primarily in the U.S., and the final settlement of certain lease obligations, we have made appropriate adjustments to the initial restructuring charges.

The following table sets forth an analysis of the restructuring accrual activity for the six months ended December 26, 2004 (in millions):

| Fiscal 2004 | Fiscal 2003 | Fiscal 2002 | Fiscal 2001 |
|-------------|-------------|-------------|-------------|
|-------------|-------------|-------------|-------------|

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| | <u>Restructuring Plan</u> | | <u>Restructuring Plan</u> | | <u>Restructuring Plan</u> | <u>Facility</u> | <u>Total</u> |
|----------------------------------------|---------------------------|-------------------|---------------------------|-------------------|---------------------------|-------------------|---------------|
| | <u>Severance</u> | <u>Facilities</u> | <u>Severance</u> | <u>Facilities</u> | <u>Facilities</u> | <u>Exit</u> | |
| | | | | | | <u>Plan</u> | |
| | | | | | | <u>Facilities</u> | |
| <u>and</u> | <u>Related and</u> | <u>and</u> | <u>Facilities</u> | <u>Facilities</u> | <u>Facilities</u> | | |
| <u>Benefits</u> | <u>Other</u> | <u>Benefits</u> | <u>Related</u> | <u>Related</u> | <u>Related</u> | | |
| Balance as of June 30, 2004 | \$ 166 | \$ 88 | \$ 1 | \$ 90 | \$ 153 | \$ 45 | \$ 543 |
| Severance and benefits | 39 | | | | | | 39 |
| Lease costs | | 89 | | | | | 89 |
| Property and equipment impairment | | 13 | | | | | 13 |
| Provision adjustments | | (6) | | (1) | (1) | (1) | (9) |
| Total restructuring charges | 39 | 96 | | (1) | (1) | (1) | 132 |
| Cash paid | (144) | (25) | (1) | (10) | (16) | (9) | (205) |
| Non-cash | | (12) | | 1 | | | (11) |
| Balance as of December 26, 2004 | \$ 61 | \$ 147 | \$ | \$ 80 | \$ 136 | \$ 35 | \$ 459 |

Our accrued liability for all four plans was net of approximately \$115 million of estimated sublease income to be generated from sublease contracts not yet negotiated. Our ability to generate this amount of sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated, is highly dependent upon the economic conditions, particularly commercial real estate market conditions in certain geographies, at the time we negotiate the lease termination and sublease arrangements

Table of Contents

with third parties. The amounts we have accrued represent our best estimate of the obligations we expect to incur in connection with these plans, and could be subject to change. Adjustments may be required as conditions and facts change throughout the implementation period.

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of December 26, 2004 for facility related leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of December 26, 2004, \$163 million of the \$459 million accrual was classified as current and the remaining \$296 million was classified as non-current.

The above restructuring charges are based on estimates that are subject to change. Changes to the previous estimates have been reflected as Provision adjustments in the above table in the period the changes in estimates were made.

Workforce Rebalancing Efforts

Prior to the initiation of our Fiscal 2004 Restructuring Plan, we had initiated certain workforce rebalancing efforts during the first six months of fiscal 2004. As a result, we incurred \$55 million of separation costs during this period. Approximately \$3 million, \$14 million, and \$38 million of these separation costs were included in cost of sales, research and development and selling, general and administrative expenses, respectively. During fiscal 2004 and the first half of fiscal 2005, we paid \$54 million and \$1 million, respectively.

Gain (Loss) on Equity Investments

(dollars in millions)

| | <u>Three Months Ended</u> | | | <u>Six Months Ended</u> | | |
|----------------------------------------|---------------------------|---------------------|---------------|-------------------------|---------------------|---------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>Change</u> | <u>December 26,</u> | <u>December 28,</u> | <u>Change</u> |
| | <u>2004</u> | <u>2003</u> | | <u>2004</u> | <u>2003</u> | |
| Gain (loss) on equity investments, net | \$ 9 | \$ (36) | N/M* | \$ 5 | \$ (61) | N/M* |
| Percentage of total net revenues | 0.3% | (1.2)% | | 0.1% | (1.1)% | |

* Not meaningful

In the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, our equity investments portfolio, which primarily consists of investments in publicly traded and privately-held technology companies, was positively impacted by gains on the sale of certain equity investments of \$11 million and \$121 million, respectively. These gains were partially offset by declining equity valuations in the technology sectors in which we have invested. The gain on equity investments of \$9 million in the second quarter of fiscal 2005 and \$5 million in the first half of fiscal 2005 was primarily related to gains on the sale of certain equity investments, partially offset by a net decline in the valuation of warrants and a decline in value of our equity investments portfolio that was considered other than temporary.

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As of December 26, 2004, our equity investments portfolio of \$96 million consisted of \$31 million in marketable equity securities, \$49 million in equity investments in privately-held companies and warrants and \$16 million in investments in venture capital funds and other joint ventures. The ongoing valuation of our investment portfolio remains uncertain and may be subject to fluctuations based on whether we participate in additional financing activity or other events occur outside of our control which impact the valuation of our investee companies.

Interest Income, net

(dollars in millions)

| | <u>Three Months Ended</u> | | | <u>Six Months Ended</u> | | |
|----------------------------------|---------------------------|---------------------|---------------|-------------------------|---------------------|---------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>Change</u> | <u>December 26,</u> | <u>December 28,</u> | <u>Change</u> |
| | <u>2004</u> | <u>2003</u> | | <u>2004</u> | <u>2003</u> | |
| Interest income, net | \$ 33 | \$ 20 | 65.0% | \$ 64 | \$ 41 | 56.1% |
| Percentage of total net revenues | 1.2% | 0.7% | | 1.2% | 0.8% | |

In the second quarter and first half of fiscal 2005 as compared with the corresponding periods of fiscal 2004, interest income, net, increased \$13 million and \$23 million, respectively. These increases were due to higher cash and marketable debt securities balances primarily associated with the \$1.9 billion in cash received from the Microsoft settlement in the fourth quarter of fiscal 2004 and higher interest rates, partially offset by higher realized losses on the sale of certain marketable debt securities.

At December 26, 2004, the average duration of our portfolio of marketable debt securities decreased to 0.67 year from 0.93 at December 28, 2003. In general, we would expect the volatility of this portfolio to decrease as its duration decreases.

Table of Contents

Our interest income and expense are sensitive primarily to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on our cash equivalents and marketable debt securities, which are predominantly short-term fixed income instruments. To better match the interest rate characteristics of our investment portfolio and our issued fixed-rate unsecured senior debt securities, we have entered into interest rate swap transactions so that the interest associated with these debt securities effectively becomes variable.

Income Taxes

(dollars in millions)

| | <u>Three Months Ended</u> | | | <u>Six Months Ended</u> | | |
|-------------------------------------------------|---------------------------|---------------------|---------------|----------------------------------|-------------|---------------|
| | <u>December 26,</u> | <u>December 28,</u> | <u>Change</u> | <u>December 26, December 28,</u> | | <u>Change</u> |
| | <u>2004</u> | <u>2003</u> | | <u>2004</u> | <u>2003</u> | |
| Income tax provision | \$ 39 | \$ 28 | 39.3% | \$ 78 | \$ 59 | 32.2% |
| Percentage of income (loss) before income taxes | 68.4% | N/A | | N/A | N/A | |

For the second quarter and first half of fiscal 2005, we recorded an income tax provision of \$39 million and \$78 million, respectively, as compared with an income tax provision of \$28 million and \$59 million for the corresponding periods of fiscal 2004. These tax provisions were recorded for taxes due on income generated in certain state and foreign tax jurisdictions and also include adjustments for the difference between estimated amounts recorded and actual liabilities resulting from the filing of prior years' tax returns.

We currently have provided a full valuation allowance on our U.S. deferred tax assets and a partial valuation allowance on our Japan deferred tax assets. We intend to maintain this valuation allowance until sufficient positive evidence exists to support reversal of the valuation allowance. Likewise, the occurrence of negative evidence with respect to our foreign deferred tax assets could result in an increase to the valuation allowance. Our income tax expense recorded in the future will be reduced or increased to the extent of offsetting decreases or increases to our valuation allowance.

Our future effective tax rate will continue to be calculated based on the statutory tax rate imposed on projected annual pre-tax income or loss in various jurisdictions and will be affected by changes in valuation allowance.

Stock Options and Incentive Plans

Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We primarily rely on three stock option plans that provide broad discretion to our Board of Directors to create appropriate equity incentives for members of our Board of Directors and our employees. Substantially all of our employees participate in our stock option program.

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Information with respect to stock option and stock purchase rights activity for the six months ended December 26, 2004, is as follows (in millions, except per share amounts):

| | Shares | Outstanding Options | |
|------------------------------|--------|---------------------|------------------|
| | | Number | Weighted Average |
| Available for Grant | | of Shares | Exercise Price |
| Balance at June 30, 2004 | 256 | 603 | \$ 12.85 |
| Grants and assumptions | (64) | 64 | \$ 3.84 |
| Exercises | | (21) | \$ 2.60 |
| Cancellations | 58 | (59) | \$ 14.44 |
| Balance at December 26, 2004 | 250 | 587 | \$ 12.07 |

Table of Contents

The following table summarizes significant ranges of outstanding and exercisable options at December 26, 2004 (shares and aggregate intrinsic value in millions):

| Range of Exercise Prices | Outstanding Options | | | | | Options Exercisable | | | |
|--------------------------|---------------------|------------|-----------------|---------------|--------------|---------------------|-----------------|---------------|-------------|
| | Weighted | | | | | Weighted | | | |
| | Average | Weighted | | | | | | | |
| | Remaining | Average | Aggregate | Potential | Average | Aggregate | Potential | | |
| | Life | Exercise | Intrinsic | Dilution | Exercise | Intrinsic | Dilution | | |
| Shares | in Years | Price | Value | Percentage | Shares | Price | Value | Percentage | |
| \$0.01 - \$5.44 | 303 | 5.7 | \$ 3.95 | \$ 451 | 9.0% | 108 | \$ 4.05 | \$ 150 | 3.2% |
| \$5.44 - \$6.01 | 13 | 3.4 | 5.63 | | 0.4% | 9 | 5.69 | | 0.2% |
| \$6.02 - \$10.00 | 86 | 4.6 | 8.38 | | 2.5% | 50 | 8.25 | | 1.5% |
| \$10.01 - \$15.00 | 38 | 3.4 | 12.62 | | 1.1% | 34 | 12.63 | | 1.0% |
| \$15.01 - \$20.00 | 70 | 3.9 | 17.93 | | 2.1% | 50 | 17.77 | | 1.5% |
| \$20.01 - \$40.00 | 40 | 3.3 | 38.05 | | 1.2% | 34 | 37.73 | | 1.0% |
| \$40.00 - \$108.38 | 37 | 3.5 | 49.92 | | 1.1% | 30 | 49.91 | | 0.9% |
| | 587 | 4.8 | \$ 12.07 | \$ 451 | 17.4% | 315 | \$ 15.80 | \$ 150 | 9.3% |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between Sun's closing stock price of \$5.44 on December 23, 2004 (last trading day of our second quarter of fiscal 2005), and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on December 26, 2004. This amount changes based on the fair market value of Sun's stock.

The potential dilution percentage is computed by dividing the options in the related range of exercise prices by the shares of common stock issued, adjusted for treasury stock, as of December 26, 2004 (3,375 million shares) and does not reflect the potential proceeds from the exercise price of the options.

The 587 million options outstanding will vest as follows (in millions):

| | Q2 05 and Remainder of | | | | | | | Total |
|-------------------|------------------------|------|------|------|------|------|------|-------|
| | prior | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | |
| Number of Options | 315 | 38 | 79 | 65 | 48 | 30 | 12 | 587 |

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Equity Compensation Plan Information

A summary of our stockholder approved and non-approved equity compensation plans as of December 26, 2004 is as follows (in millions, except exercise price amounts):

| <u>Plan Category</u> | <u>Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights</u> | <u>Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (in dollars)</u> | <u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans</u> |
|--------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|
| Equity compensation plans approved by security holders (excluding ESPP) | 566 | \$ 12.29 | 220 |
| Equity compensation plans not approved by security holders (excluding ESPP) ⁽¹⁾ | 21 | \$ 6.04 | 30 |
| Total (excluding ESPP) | 587 | \$ 12.07 | 250 |
| Equity compensation plans approved by security holders (ESPP only) | N/A | N/A | 150 |
| Equity compensation plans not approved by security holders (ESPP only) | N/A | N/A | N/A |
| Total (ESPP only) | N/A | N/A | 150 |
| All Plans | 587 | \$ 12.07 | 400 |

(1) Includes assumed plans from acquisitions as well as our Equity Compensation Acquisition Plan for initial options, granted to employees, acquired through acquisitions.

Options Granted during the Six Months Ended December 26, 2004 to the Most Highly Compensated Executive Officers Named in Our Most Recent Proxy Statement⁽²⁾

Table of Contents

| <u>Name</u> | <u>Number of</u> <u>Options Granted</u> | <u>Weighted</u> <u>Average</u> <u>Exercise Price</u> |
|--------------------------|--------------------------------------------|------------------------------------------------------------|
| Scott G. McNealy | 1,250,000 | \$ 3.79 |
| Jonathan I. Schwartz | 800,000 | \$ 3.79 |
| Crawford W. Beveridge | 400,000 | \$ 3.79 |
| Stephen T. McGowan | 400,000 | \$ 3.79 |
| Gregory M. Papadopoulos | 400,000 | \$ 3.79 |
| David Yen ⁽¹⁾ | 400,000 | \$ 3.79 |

- (1) Mr. Yen ceased being an Executive Officer of the Company effective June 29, 2004.
- (2) Not included in the table above is Mr. Mark Tolliver who ceased being an Executive Officer of the Company effective April 15, 2004 and resigned from the Company effective September 30, 2004. Mr. Tolliver had no options granted during the six months ended December 26, 2004.

Table of Contents**LIQUIDITY, CAPITAL RESOURCES AND FINANCIAL CONDITION**

(dollars in millions)

| | December 26, 2004 | June 30, 2004 | Change |
|--------------------------------------------------------------------|----------------------|------------------|-----------------|
| Cash and cash equivalents | \$ 1,863 | \$ 2,141 | \$ (278) |
| Marketable debt securities | 5,601 | 5,467 | 134 |
| Total cash, cash equivalents and marketable debt securities | \$ 7,464 | \$ 7,608 | \$ (144) |
| Percentage of total assets | 54.3% | 52.5% | 1.8 pts |

| | Six Months Ended | | |
|-------------------------------------------------------------|-------------------------|----------------------|---------------|
| | December 26, 2004 | December 28, 2003 | Change |
| Cash provided by (used in) operating activities | \$ 176 | \$ (331) | \$ 507 |
| Cash used in investing activities | \$ (318) | \$ (369) | \$ 51 |
| Cash provided by (used in) financing activities | \$ (136) | \$ 113 | \$ (249) |
| Net increase (decrease) in cash and cash equivalents | \$ (278) | \$ (587) | \$ 309 |

Changes in Cash Flow

During the first half of fiscal 2005, our operating activities generated cash flows of \$176 million, which is \$507 million higher than the cash flows provided by operating activities during the first half of fiscal 2004. Cash provided by operating activities during the first half of fiscal 2005 was primarily the result of a \$499 million decrease in accounts receivable and a \$329 million non-cash add back of depreciation and amortization expense to our net loss of \$129 million. These increases in cash flow were partially offset by a \$342 million decrease in deferred revenue and a \$115 million decrease in accrued liabilities and other, which is due in part to \$203 million paid towards short-term severance and facilities restructuring liabilities. The reasons for certain changes in our working capital are discussed further in the cash conversion cycle section below. During the first half of fiscal 2005, our cash used in investing activities was primarily attributable to: (1) purchases of marketable debt securities, partially offset by proceeds and maturities of marketable debt securities of \$148 million and (2) cash used in capital purchases of \$183 million. Cash used in financing activities was primarily attributable to a \$250 million principal payment on our Senior Notes outstanding in the first quarter of fiscal 2005, partially offset by \$114 million of proceeds from the sale of common stock, net.

| December 26, 2004 | June 30, 2004 | Change |
|----------------------|------------------|--------|
|----------------------|------------------|--------|

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| | | | |
|--------------------------------------------------|------|------|-------|
| Days sales outstanding (DSO) ⁽¹⁾ | 58 | 68 | 10 |
| Days of supply in inventory (DOS) ⁽²⁾ | 23 | 22 | (1) |
| Days payable outstanding (DPO) ⁽³⁾ | (53) | (50) | 3 |
| | | | |
| Cash conversion cycle | 28 | 40 | 12 |
| | | | |
| Inventory turns - products only | 9.4 | 9.8 | (0.4) |

- (1) DSO measures the number of days it takes, based on a 90 day average, to turn our receivables into cash.
(2) DOS measures the number of days it takes, based on a 90 day average, to sell our inventory.
(3) DPO measures the number of days it takes, based on a 90 day average, to pay the balances of our accounts payable.

We ended the second quarter of fiscal 2005 with a cash conversion cycle of 28 days, an improvement of 12 days from June 30, 2004. The cash conversion cycle is the duration between purchase of inventories and services and the collection of the cash for the sale of our products and services and is a metric on which we have focused as we continue to try to efficiently manage our assets. The cash conversion cycle results from the calculation of days sales outstanding (DSO) added to days of supply in inventories (DOS), reduced by days payable outstanding (DPO). DSO improved and net accounts receivable decreased \$499 million from June 30, 2004 due to improved billing linearity and collection efficiencies throughout the second quarter. DOS worsened 1 day from June 30, 2004 due to a higher percentage of inventory to lower cost of sales. However, inventories decreased \$35 million from June 30, 2004 and our products inventory turn rate remained relatively flat at 9.4 turns at December 26, 2004 from 9.8 turns at June 30, 2004. Inventory turns is annualized and represents the number of times product inventory is replenished during the year. Inventory management will continue to be an area of focus as we balance the need to maintain sufficient inventory levels to help ensure competitive lead times with the risk of inventory obsolescence due to rapidly changing technology and customer requirements. DPO improved 3 days and accounts payable decreased \$94 million from June 30, 2004 due to timing differences in payments to our supply chain.

Acquisitions

Our acquisition activities have historically addressed research and development, technology, and product development needs and opportunities with respect to our existing technology roadmap and product development plans. As a result, our past acquisitions have not typically been made to supplement revenue growth, and have not historically represented acquisitions of material revenue streams.

Table of Contents

We made no acquisitions during the first half of fiscal 2005. On January 10, 2005, we acquired SevenSpace, Inc. (SevenSpace), a privately-held company based in Ashburn, Virginia, by means of a merger pursuant to which we paid approximately \$49 million in cash for all of the outstanding shares of capital stock of SevenSpace. In addition, all outstanding options to purchase SevenSpace capital stock were exchanged for options to purchase our common stock. SevenSpace delivers remote system monitoring and management across heterogeneous environments, including enterprise applications, databases, operating systems, and network devices, and will enhance our managed services offerings by adding support for non-Sun platforms.

Stock Repurchases

From time to time, our Board of Directors approves common stock repurchase programs allowing management to repurchase shares of our common stock in the open market pursuant to price-based formulas. In February 2001, we announced our intention to acquire up to \$1.5 billion of our outstanding common stock under a stock repurchase program authorized by our Board of Directors. Under the February 2001 program, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, including our projected cash flow requirements, our return to sustained profitability and our share price. During the first half of fiscal 2005 and the fiscal year ended June 30, 2004, we did not repurchase common stock under our repurchase program. All prior repurchases were made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended. As of December 26, 2004, approximately \$230 million of the \$1.5 billion remains available for repurchase.

Borrowings

Our \$1.05 billion of unsecured senior debt securities (Senior Notes) outstanding are due at various times through August 2009. The Senior Notes are subject to compliance with certain covenants that do not contain financial ratios. We are currently in compliance with these covenants. If we failed to be in compliance with these covenants, the trustee of the Senior Notes or holders of not less than 25% in principal amount of the Senior Notes would have the ability to demand immediate payment of all amounts outstanding.

In addition, we have uncommitted lines of credit aggregating approximately \$561 million and no amounts were drawn from these lines of credit as of December 26, 2004. Interest rates and other terms of borrowing under these lines of credit vary from country to country depending on local market conditions at the time of borrowing. There is no guarantee that the banks would approve our request for funds under these uncommitted lines of credit.

Contractual Obligations

Through the normal course of our business, we purchase or place orders for the necessary components of our products from various suppliers and estimate that these contractual obligations at December 26, 2004 are between \$425 million and \$475 million. This range does not include contractual obligations recorded on the balance sheet as current liabilities. In addition, we have a contractual obligation under the terms of our strategic alliance with Fujitsu, whereby we have committed to buy Fujitsu products with a list price of \$230 million and \$265 million in fiscal years 2005 and 2006, respectively, at a predetermined discount from list price, depending upon the type of product purchased. Contractual obligations for the purchase of goods or services are comprised of agreements that are enforceable and legally binding on Sun and that specify all significant terms, including fixed or minimum quantities to be purchased, fixed, minimum or variable price provisions, and the appropriate timing of the transactions. Our purchase orders are based on our current manufacturing needs and are fulfilled by our vendors within a short time.

Sun is insured by nationally recognized insurers for certain potential liabilities, including worker's compensation, general liability, automotive liability, employer's liability, errors and omissions liability, employment practices liability, property, cargo and crime and directors and officers liability. We have self-insured between \$2 and \$25 million per occurrence on these lines of coverage. Sun performs an annual actuarial analysis to develop an estimate of amounts to be paid for both claims reported and potential losses on activities that have occurred but have not yet been reported. Loss accruals were \$28 million and \$27 million as of December 26, 2004 and June 30, 2004, respectively.

Capital Resources and Financial Condition

Our long-term strategy is to maintain a minimum amount of cash and cash equivalents in subsidiaries for operational purposes and to invest the remaining amount of our cash in interest bearing and highly liquid cash equivalents and marketable debt securities. Accordingly, in addition to the approximately \$1.9 billion in cash and cash equivalents, at December 26, 2004 we have

Table of Contents

approximately \$5.6 billion in marketable debt securities that are available for shorter-term requirements, such as future operating, financing and investing activities, for a total cash and marketable debt securities position of approximately \$7.5 billion. However, at June 30, 2004, approximately \$1.1 billion of this balance represents earnings generated from operations domiciled in foreign tax jurisdictions that are designated as permanently invested in the respective tax jurisdictions. Should we decide to repatriate these earnings, we would be required to accrue and pay additional taxes to repatriate these funds. Currently, we do not anticipate a need to repatriate these funds to our U.S. operations. Additionally, we are currently reviewing the provisions of the American Jobs Creation Act of 2004, and have not completed our evaluation of its impact to Sun.

For the third quarter of fiscal 2005, we expect that cash flow from operations will be adversely impacted by an approximately \$180 million prepayment to the Internal Revenue Service related to ongoing tax examinations and approximately \$70 million in payments associated with our ongoing restructuring activities. Additionally, we do not expect the level of improvement in our cash conversion cycle that we experienced in the first half of fiscal 2005 to be sustainable due to seasonal trends expected during the second half of the fiscal year.

For fiscal 2005, we expect our total expenditures for capital investments and spares to be approximately \$400 million.

We believe that the liquidity provided by existing cash, cash equivalents, marketable debt securities and cash generated from operations will provide sufficient capital to meet our requirements for at least the next 12 months. We believe our level of financial resources is a significant competitive factor in our industry and we may choose at any time to raise additional capital to strengthen our financial position, facilitate growth, and provide us with additional flexibility to take advantage of business opportunities that arise.

NON-AUDIT SERVICES OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Our auditors, Ernst & Young LLP, perform the following non-audit services that have been pre-approved by our Audit Committee of the Board of Directors: expatriate tax and relocation services, international and U.S. tax planning and compliance services, and tax due diligence for acquisitions. In fiscal 2005, we are in the process of transitioning expatriate tax and relocation services from Ernst & Young LLP.

Ernst & Young LLP has recently notified the audit committee of the Sun Board of Directors that certain non-audit work it performed in Japan has raised questions regarding Ernst & Young LLP's independence with respect to its performance of audit services.

During fiscal year 2001, Ernst & Young LLP's affiliated firm in Japan (Ernst & Young Japan) performed employee tax return services for certain employees in Japan as requested by Sun. Ernst & Young Japan made payment of the relevant employee taxes of approximately \$750,000 on behalf of Sun. The payment of those taxes involved the handling of Company tax related funds. These payment services were discontinued in 2001. The fees paid by the Company to Ernst & Young Japan for the payment services were approximately \$2,500 in 2001.

Sun and Ernst & Young LLP continue to evaluate and review processes relevant to the maintenance of Ernst & Young LLP's independence. The audit committee has discussed with Ernst & Young LLP its independence from the Company.

Table of Contents

RISK FACTORS

Because of the following factors, as well as other factors affecting our operating results and financial condition, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

If we are unable to compete effectively with existing or new competitors, the loss of our competitive position could result in price reductions, fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability and loss of market share.

We compete in the computer systems (hardware and software) and network storage (hardware and software) products and services markets. These markets are intensely competitive. If we fail to compete successfully in these markets, the demand for our products and services would decrease. Any reduction in demand could lead to fewer customer orders, reduced revenues, pricing pressures, reduced margins, reduced levels of profitability and loss of market share. These competitive pressures could materially and adversely affect our business and operating results.

Our competitors are some of the largest, most successful companies in the world. They include International Business Machines Corporation (IBM), Hewlett-Packard Company (HP), EMC Corporation (EMC), Fujitsu Limited (Fujitsu) and the Fujitsu-Siemens joint venture. We also compete with systems manufacturers and resellers of systems based on microprocessors from Intel Corporation (Intel) and the Windows family of operating systems software from Microsoft Corporation (Microsoft). These competitors include Dell Inc. (Dell) and HP, in addition to Intel and Microsoft. Certain of these competitors compete aggressively on price and seek to maintain very low cost structures. Some of these competitors are seeking to increase their market share in the enterprise server market which creates increased pressure, including pricing pressure, on our workstation and lower-end server product lines. In particular, we are seeing increased competition and pricing pressures from competitors offering systems running Linux software and other open source software. In addition, certain of our competitors, including IBM and HP, have financial and human resources scale that are substantially greater than ours, which increases the competitive pressures we face.

Customers make buying decisions based on many factors, including among other things, new product and service offerings and features; product performance and quality; availability and quality of support and other services; price; platform; interoperability with hardware and software of other vendors; quality; reliability, security features and availability of products; breadth of product line; ease of doing business; a vendor's ability to adapt to customers' changing requirements; responsiveness to shifts in the marketplace; business model (e.g., utility computing, subscription based software usage, consolidation versus outsourcing); contractual terms and conditions; vendor reputation and vendor viability. As competition increases, each factor on which we compete becomes more important and the lack of competitive advantage with respect to one or more of these factors could lead to a loss of competitive position resulting in fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability and loss of market share. We expect competitive pressure to remain intense.

Fujitsu and its subsidiaries have, for many years, been key strategic channel partners for Sun, distributing substantial quantities of our products throughout the world. In addition, on May 31, 2004, we entered into a number of agreements with Fujitsu intended to substantially increase the scope of our relationship with them, including through collaborative selling efforts and joint development and marketing of a future generation of server products. However, Fujitsu is also a competitor of Sun and, as a licensee of various technologies from Sun and others, it has developed products that currently compete directly with our products.

Over the last several years, we have invested significantly in our network storage products business with a view to increasing the sales of these products both on a stand-alone basis to customers using the systems of our competitors, and as part of the systems that we sell. The intelligent storage products business is intensely competitive. EMC is currently a leader in the network storage products market and our primary

competitor.

We are continuing the implementation of a solution-based selling approach. While our strategy is that this will enable us to increase our revenues and margins, there can be no assurance that we will be successful in this approach. In fact, our implementation of this selling model may result in reductions in our revenues and/or margins, particularly in the short term, as we compete to attract business. In addition, if our emphasis on solution-based sales increases, we face strong competition from systems integrators such as IBM, Fujitsu-Siemens and HP. Our inability to successfully implement this model in the long term would have a material adverse impact on our revenues and margins.

We maintain higher research and development costs, as a percentage of total net revenues, than many of our competitors and our earnings are dependent upon maintaining revenues and gross margins at a sufficient level to offset these costs.

One of our business strategies is to derive a competitive advantage and a resulting enhancement of our gross margins from our investment in innovative new technologies which customers value. As a result, as a percentage of total net revenues, we incur higher fixed R&D costs than many of our competitors. To the extent that we are unable to develop and sell products with attractive gross margins in sufficient volumes, our earnings may be materially and adversely affected by our cost structure. During fiscal 2003 and 2004, we added new products to our entry-level server product line that are offered at a lower price point and, accordingly, provide us with a lower gross margin percentage than our products as a whole. Although our strategy is to sell

Table of Contents

these products as part of overall systems which include other products with higher gross margin percentages, to the extent that the mix of our overall revenues represented by sales of lower gross margin products increases, as it did during much of fiscal 2004, our gross margins and earnings may be materially and adversely affected.

In addition, one of our business strategies is to grow incremental revenue through recurring service models, such as subscriptions, leasing and pay-per-use. Under these recurring service models, we would recognize revenue for the contract incrementally over time or based upon usage rather than all at once upon the initial sale of a hardware or software product. However, if we increase our recurring service model base either while (1) not maintaining or increasing our point product sales; or (2) not growing them sufficiently to cover the decline in point product sales, we will incur a near-term reduction in our revenues as revenues that ordinarily would have been recognized upon the initial sale of products will be deferred until future periods, which would have a material adverse effect on our revenues, gross margins and earnings.

The products we make are very complex. If we are unable to rapidly and successfully develop and introduce new products and manage our inventory, we will not be able to satisfy customer demand.

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop and introduce new products that our customers choose to buy. If we are unable to develop new products, our business and operating results could be adversely affected. We must quickly develop, introduce, and deliver in quantity new, complex systems, software, and hardware products and components. These include products which incorporate our UltraSPARC® III and UltraSPARC IV architectures and the Solaris Operating System, the Java platform, Sun Java System portfolio and N1 Grid architecture, among others. The development process for these complicated products is very uncertain. It requires high levels of innovation from both our product designers and the suppliers of the components used in our products. The development process is also lengthy and costly. If we fail to accurately anticipate our customers' needs and technological trends, or are otherwise unable to complete the development of a product on a timely basis, we will be unable to introduce new products into the market on a timely basis, if at all, and our business and operating results would be materially and adversely affected.

The manufacture and introduction of our new products is also a complicated process. Once we have developed a new product, we face several challenges in the manufacturing process. We must be able to manufacture new products in sufficient volumes so that we can have an adequate supply of new products to meet customer demand. We must also be able to manufacture the new products at acceptable costs. This requires us to be able to accurately forecast customer demand so that we can procure the appropriate components at optimal costs. Forecasting demand requires us to predict order volumes, the correct mix of our hardware and software products, and the correct configurations of these products. We must manage new product introductions and transitions, such as the product transition from UltraSPARC III to UltraSPARC IV microprocessors to minimize the impact of customer-delayed purchases of existing products in anticipation of new product releases. We must also try to reduce the levels of older product and component inventories to minimize inventory write-offs. If we have excess inventory, it may be necessary to reduce our prices and write down inventory, which could result in lower gross margins. Additionally, our customers may delay orders for existing products in anticipation of new product introductions. As a result, we may decide to adjust prices of our existing products during this process to try to increase customer demand for these products. Our future operating results would be materially and adversely affected if such pricing adjustments were to occur and we were unable to mitigate the resulting margin pressure by maintaining a favorable mix of systems, software, service and other products, or if we were unsuccessful in achieving component cost reductions, operating efficiencies and increasing sales volumes.

If we are unable to timely develop, manufacture, and introduce new products in sufficient quantity to meet customer demand at acceptable costs, or if we are unable to correctly anticipate customer demand for our new and existing products, our business and operating results could be materially adversely affected.

We face numerous risks associated with our strategic alliance with Fujitsu.

On May 31, 2004, we entered into a number of agreements with Fujitsu intended to substantially increase the scope of our relationship with them. These agreements contemplate collaborative sales and marketing efforts and the joint development and manufacturing of a future generation of server products known as the Advanced Product Line (APL). We anticipate that the APL will ultimately replace a large proportion of our server product line and have agreed not to sell certain products which may compete with the APL at certain times as well as to purchase certain components solely from Fujitsu at certain times. In addition, the agreements contemplate that we dedicate substantial financial and human resources to this new relationship. As such, our future performance and financial condition will be substantially impacted by the success or failure of this relationship.

Joint development and marketing of a complex new product line is an inherently difficult undertaking and is subject to numerous risks. If we do not satisfy certain development or supply obligations under the agreements, or if we otherwise violate the terms of the agreements, we may be subject to significant contractual or legal penalties. Further, if Fujitsu encounters any of a number of potential problems in its business, such as intellectual property infringement claims, supply difficulties, difficulties in meeting development milestones or financial challenges, these could impact our strategic relationship with them and could result in a material adverse effect on our business or results of operations.

Table of Contents

The contractual arrangements contain objectives and deliverables that are to be concluded in the near term, known in the agreements as the Interim Period. As the Interim Period commitments are foundational to the overall alliance, failure to achieve those commitments will place the overall alliance at risk.

There can be no assurance that our strategic relationship with Fujitsu will be successful or that the economic terms of the agreements establishing the relationship will ultimately prove to be favorable to us. If any of the risks described above come to pass, they may result in a material adverse effect on our business, results of operations or financial condition.

The competitive advantage we derive from controlling the development of our Solaris operating system may be reduced if and when we convert it to open source software.

We have announced our intention to release our Solaris operating system to the open source development community as open source software. Although open source licensing models vary, generally open source software licenses permit the liberal copying, modification and distribution of a software program allowing a diverse programming community to contribute to the software. Following any such release, there could be an impact on revenue related to our Solaris operating system and we may no longer be able to exercise control over some aspects of the future development of the Solaris operating system. As a result, following any release of the Solaris operating system to the open source community, the feature set and functionality of the Solaris operating system may diverge from those that best serve our strategic objectives, move in directions in which we do not have competitive expertise or fork into multiple, potentially incompatible variations. We currently derive a significant competitive advantage from our development and licensing of Solaris and any of these events could reduce our competitive advantage or impact market demand for our products, software and services.

Our reliance on single source suppliers could delay product shipments and increase our costs.

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we currently depend on Texas Instruments for the manufacture of our UltraSPARC microprocessors and several other companies for custom integrated circuits. If we were unable to purchase on acceptable terms or experienced significant delays or quality issues in the delivery of necessary parts and/or components from a particular vendor and we had to find a new supplier for such parts and/or components, our new and existing product shipments could be delayed which could have a material adverse effect on our business, results of operations and financial conditions.

Our future operating results depend on our ability to purchase a sufficient amount of components to meet the demands of our customers.

We depend heavily on our suppliers to design, manufacture, and deliver on a timely basis the necessary components for our products. While many of the components we purchase are standard, we do purchase some components, including color monitors, custom power supplies, application specific integrated circuits (ASICs) and custom memory and graphics devices, that require long lead times to manufacture and deliver. Long lead times make it difficult for us to plan component inventory levels in order to meet the customer demand for our products. In addition, in the past, we have experienced shortages in certain of our components (specifically, ASICs, dynamic random access memories (DRAMs) and static random access memories (SRAMs)). If a component delivery from a supplier is delayed, if we experience a shortage in one or more components, or if we are unable to provide for adequate levels of component inventory, our new and/or existing product shipments could be delayed and our business and operating results could be materially and adversely affected.

Since we may order components from suppliers in advance of receipt of customer orders for our products which include these components, we could face a material inventory risk.

As part of our component planning, we place orders with or pay certain suppliers for components in advance of receipt of customer orders. We occasionally enter into negotiated orders with vendors early in the manufacturing process of our microprocessors to make sure we have enough of these components for our new products to meet anticipated customer demand. Because the design and manufacturing process for these components is very complicated it is possible that we could experience a design or manufacturing flaw that could delay or even prevent the production of the components for which we have previously committed to pay. We also face the risk of ordering too many components, or conversely, not enough components, since supply orders are generally based on forecasts of customer orders rather than actual customer orders. In addition, in some cases, we make noncancelable order commitments to our suppliers for work-in-progress, supplier's finished goods, custom sub-assemblies and/or Sun unique raw materials that are necessary to meet our lead times for finished goods. If we cannot change or be released from supply orders, we could incur costs from the purchase of unusable components, either due to a delay in the production of the components or other supplies or as a result of inaccurately predicting supply orders in advance of customer orders. Our business and operating results could be materially and adversely affected as a result of these increased costs.

Table of Contents

Delays in product development or customer acceptance and implementation of new products and technologies could seriously harm our business.

Generally, the computer systems we sell to customers incorporate various hardware and software products that we sell, such as UltraSPARC microprocessors, various software elements, from the Solaris Operating System to the Java platform, Sun Java System portfolio, N1 Grid and Sun StorEdge array products. Any delay in the development, delivery or acceptance of key elements of the hardware or software included in our systems could delay our shipment of these systems. Delays in the development and introduction of our products may occur for various reasons.

In addition, if customers decided to delay the adoption and implementation of new releases of our Solaris Operating System this could also delay customer acceptance of new hardware products tied to that release. Implementing a new release of an operating environment requires a great deal of time and money for a customer to convert its systems to the new release. The customer must also work with software vendors who port their software applications to the new operating system and make sure these applications will run on the new operating system. As a result, customers may decide to delay their adoption of a new release of an operating system because of the cost of a new system and the effort involved to implement it. Such delays in product development and customer acceptance and implementation of new products could materially and adversely affect our business.

Our products may have quality issues that could adversely affect our sales and reputation.

In the course of conducting our business, we experience and address quality issues. Some of our hardware and software products contain defects, including defects in our engineering, design and manufacturing processes, as well as defects in third-party components included in our products, which may be beyond our control. Often defects are identified during our design, development and manufacturing processes and we are able to correct many of these. Sometimes defects are identified after introduction and shipment of new products or enhancements to existing products.

When a quality issue is identified, we work extensively with our customers to remedy such issues. We may test the affected product to determine the root cause of the problem and to determine appropriate solutions. We may find an appropriate solution (often called a patch) or offer a temporary fix while a permanent solution is being determined. If we are unable to determine the root cause, find an appropriate solution or offer a temporary fix, we may delay shipment to customers. We may, however, ship products while we continue to explore a suitable solution if we believe the defect is not significant to the product's functionality.

Finding solutions to quality issues for our customers can be expensive and may result in additional warranty and other costs to Sun, reducing our operating results. For example, we can reserve for proactive product remediation, such as diagnosing and replacing components within systems in our installed base. In recent periods we have implemented new quality control measures intended to make it more likely that any quality issues are identified prior to product shipment. As a result of these measures, we may delay more product shipments in future periods as a result of the identification of quality issues or potential quality issues. There can be no assurance that future stop shipments will not have a material adverse effect on our revenues, operating results, cash flows from operations and financial condition. Delays in product shipments to our customers will delay revenue recognition and could adversely affect our revenues and reported results. If we are unable to fix identified errors or adequately address quality issues, our relationships with customers can be impaired, our reputation can suffer and we can lose customers or sales which could have a material adverse effect on our revenues, operating results, cash flows from operations and financial condition.

Our international customers and operations subject us to a number of risks.

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Currently more than half of our revenues come from international sales. In addition, a portion of our operations consists of manufacturing and sales activities outside of the U.S. Our ability to sell our products and conduct our operations internationally is subject to a number of risks. Local economic, political and labor conditions in each country could adversely affect demand for our products and services or disrupt our operations in these markets. We may also experience reduced intellectual property protection or longer and more challenging collection cycles as a result of different customary business practices in certain countries where we do business which could have a material adverse effect on our business operations and financial results. Currency fluctuations could also materially and adversely affect our business in a number of ways. Although we take steps to reduce or eliminate certain foreign currency exposures that can be identified or quantified, we may incur currency translation losses as a result of our international operations. Further, in the event that currency fluctuations cause our products to become more expensive in overseas markets in local currencies, there could be a reduction in demand for our products or we could lower our pricing in some or all of these markets resulting in reduced revenue and margins. Alternatively, a weakening dollar could result in greater costs to us for our overseas operations. Changes to and compliance with a variety of foreign laws and regulations may increase our cost of doing business in these jurisdictions. Trade protection measures and import and export licensing requirements subject us to additional regulation and may prevent us from shipping products to a particular market, and increase our operating costs. In addition, we could be subject to regulations, fines and penalties for violations of import and export regulations such as our products being shipped directly or through a third-party to certain countries. Such violations could result in penalties, including prohibiting us from exporting our products to one or more countries, and could materially and adversely affect our business. We entered into settlement agreements with the United States Department of Commerce, Bureau of Industry

Table of Contents

and Security, Office of Export Enforcement (BIS) on December 15, 2003 addressing certain BIS charges that we had violated export control regulations. The settlement included a one year suspended denial of our worldwide export privileges. This suspension expired without incident on December 15, 2004.

Moreover, local laws and customs in many countries differ significantly from those in the United States. We incur additional legal compliance costs associated with our international operations and could become subject to legal penalties in foreign countries if we do not comply with local laws and regulations which may be substantially different from those in the United States. In many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by United States regulations applicable to us such as the Foreign Corrupt Practices Act. Although we implement policies and procedures designed to ensure compliance with these laws, there can be no assurance that all of our employees, contractors and agents, including those based in or from countries where practices which violate such United States laws may be customary, will not take actions in violation of our policies. Any violation of foreign or United States laws by our employees, contractors or agents, even if such violation is prohibited by our policies, could have a material adverse effect on our business.

Failure to successfully implement our global resourcing activities could adversely affect our results of operations

We continuously seek to make our cost structure more efficient and focus on our core strengths. We recently announced our intent to develop and implement a global resourcing strategy and operating model which includes outsourcing activities and is focused on increasing workforce flexibility and scalability, and improving overall competitiveness by leveraging external talent and skills worldwide. To the extent we rely on partners or third party service providers for the provision of key business process functions, we may incur increased business continuity risks. We may no longer be able to exercise control over some aspects of the future development, support or maintenance of key non-core operations and processes, including the internal controls associated with those non-core business operations and processes, which could adversely affect our business. If we are unable to effectively develop and implement our resourcing strategy due to, among other things, data Protection issues, we may not realize cost structure efficiencies and our operating and financial results could be materially and adversely affected. In addition, if we are unable to effectively utilize or integrate and interoperate with external resources or if our partners or third party service providers experience business difficulties or are unable to provide business process services as anticipated, we may need to seek alternative service providers or resume providing such business processes internally which could be costly and time consuming and have a material adverse material effect on our operating and financial results.

We expect our quarterly revenues, cash flows and operating results to fluctuate for a number of reasons.

Future operating results and cash flows will continue to be subject to quarterly fluctuations based on a wide variety of factors, including:

Seasonality. Although our sales and other operating results can be influenced by a number of factors and historical results are not necessarily indicative of future results, our sequential quarterly operating results generally fluctuate downward in the first and third quarters of each fiscal year when compared with the immediately preceding quarter.

Linearity. Our quarterly sales have historically reflected a pattern in which a disproportionate percentage of such quarter's total revenues occur in the last month and weeks and days of the quarter. This pattern makes prediction of revenues, earnings and working capital for each financial period especially difficult and uncertain and increases the risk of unanticipated variations in quarterly results and financial condition.

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Foreign Currency Fluctuations. As a large portion of our business takes place outside of the U.S., we enter into transactions in other currencies. Although we employ various hedging strategies, we are exposed to changes in exchange rates, which causes fluctuations in our quarterly operating results. See Part I, Item 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Currency Exchange Risk.

Deferred Tax Assets. Estimates and judgments are required in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from net operating losses, tax carryforwards and temporary differences between the tax and financial statement recognition of revenue and expense. SFAS No. 109, Accounting for Income Taxes, also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

In evaluating our ability to recover our deferred tax assets, in full or in part, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized including the amount of state, federal and international pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we are using to manage the

Table of Contents

underlying businesses. Cumulative losses incurred in the U.S. and Japan in recent years represented sufficient negative evidence to require full and partial valuation allowances in these jurisdictions. At June 30, 2004, we established a valuation allowance against the deferred tax assets in these jurisdictions, which will remain until sufficient positive evidence exists to support reversal. Future reversals or increases to our valuation allowance could have a significant impact on our future earnings.

Goodwill and Other Intangible Assets. We perform an analysis on our goodwill balances to test for impairment on an annual basis or whenever events occur that may indicate impairment possibly exists. Goodwill is deemed to be impaired if the net book value of the reporting unit exceeds the estimated fair value. The impairment of a long-lived intangible asset is only deemed to have occurred if the sum of the forecasted undiscounted future cash flows related to the asset are less than the carrying value of the intangible asset we are testing for impairment. If the forecasted cash flows are less than the carrying value, then we must write down the carrying value to its estimated fair value. We recognized an impairment charge of \$49 million related to our goodwill during the fourth quarter of fiscal 2004 and an impairment charge of \$2.1 billion related to our goodwill and other intangible assets during the second quarter of fiscal 2003. As of June 30, 2004, we had a goodwill balance of \$406 million. Going forward we will continue to review our goodwill and other intangible assets for possible impairment. Any additional impairment charges could adversely affect our future earnings.

Investments. We have an investment portfolio that includes minority equity and debt investments. In most cases, we do not attempt to reduce or eliminate our market exposure on these investments and may incur losses related to the impairment of these investments. Our risk exposure in our marketable securities investments is concentrated across a relatively small number of entities and could be subject to substantial volatility if any of these entities experiences material changes to its business or securities. In addition, we have made and continue to evaluate and make, strategic equity investments in privately-held technology companies. Because these companies are typically early-stage ventures with either unproven business models, products that are not yet fully developed or products that have not yet achieved market acceptance, these investments are inherently risky due to factors beyond our control.

We are dependent on significant customers and specific industries.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 14%, 11% and 12% of our fiscal 2004, 2003 and 2002 net revenues, respectively. More than 90% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. The vast majority of this revenue is from a single GE subsidiary, comprising 11%, 9% and 8% of net revenues in 2004, 2003 and 2002, respectively. This GE subsidiary acts as a distributor of our products to resellers who in turn sell those products to end users. No other customer accounted for more than 10% of net revenues. The revenues from GE are generated in the Product Group and Sun Services segments.

We also depend on the telecommunications, financial services and government sectors for a significant portion of our revenues. Our revenues are dependent on the level of technology capital spending in the U.S. and international economies. If the current uncertain economic conditions continue in some or all of these sectors and geographies, we would expect that the significant reduction and deferrals of capital spending could continue. If capital spending declines in these industries over an extended period of time, our business will continue to be materially and adversely affected. We continue to execute on our strategy to reduce our dependence on these industries by expanding our product reach into new industries, but no assurance can be given that this strategy will be successful.

We are dependent upon our channel partners for a significant portion of our revenues.

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Our channel partners include distributors, original equipment manufacturers (OEM), independent software vendors (ISVs), system integrators, service providers and resellers. We have recently seen an increase in revenues via our reseller channel. We face ongoing business risks due to our reliance on our channel partners to maintain customer relationships and create customer demand with customers where we have no direct relationships. Should the effectiveness of our channel partners decline, we face risk of declining demand which could affect our results of operations.

Our business may suffer if it is alleged or found that we have infringed the intellectual property rights of others.

From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Responding to such claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources and cause us to incur significant expenses. Several pending claims are in various stages of evaluation. From time to time, we consider the desirability of entering into licensing agreements in certain of these cases. No assurance can be given that licenses can be obtained on acceptable terms or that litigation will not occur. In the event there is a temporary or permanent injunction entered prohibiting us from marketing or selling certain of our products, or a successful claim of infringement against us requiring us to pay royalties to a third party, and we fail to license such technology on acceptable terms and conditions or to develop or license a substitute technology, our business, results of operations or financial condition could be materially adversely affected. See Part II, Item 1, Legal Proceedings for further discussion.

Table of Contents

Our acquisition and alliance activities could disrupt our ongoing business.

We intend to continue to make investments in companies, products, and technologies, either through acquisitions or investments or alliances. For example, we have purchased several companies in the past and have also formed alliances, such as our strategic relationship with Fujitsu for the development, manufacturing and marketing of server products and our OEM relationship with Hitachi Data Systems for the collaboration on, and delivery of, a broad range of storage products and services. We also rely on IT services partners and independent software developers to enhance the value to our customers of our products and services. Acquisitions and alliance activities often involve risks, including: (1) difficulty in assimilating the acquired operations and employees; (2) difficulty in managing product co-development activities with our alliance partners; (3) retaining the key employees of the acquired operation; (4) disruption of our ongoing business; (5) inability to successfully integrate the acquired technology and operations into our business and maintain uniform standards, controls, policies, and procedures; and (6) lacking the experience to enter into new product or technology markets. In addition, from time to time, our competitors acquire or enter into exclusive arrangements with companies with whom we do business or may do business in the future. Reductions in the number of partners with whom we may do business in a particular context may reduce our ability to enter into critical alliances on attractive terms or at all, and the termination of an existing alliance by a business partner may disrupt our operations.

We depend on key employees and face competition in hiring and retaining qualified employees.

Our employees are vital to our success, and our key management, engineering, and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. Because our compensation packages include equity-based incentives, pressure on our stock price could affect our ability to offer competitive compensation packages to current employees. In addition, we must continue to motivate employees and keep them focused on our strategies and goals, which may be difficult due to morale challenges posed by our workforce reductions, global resourcing strategies and related uncertainties. Should these conditions continue, we may not be able to retain highly qualified employees in the future which could adversely affect our business.

Our credit rating is subject to downgrade.

On March 5, 2004, Standard & Poors lowered its rating on Sun to non-investment grade from BBB to BB+ and removed us from CreditWatch. The two other rating agencies that follow us, continue to rate us as investment grade. Our rating from Fitch Ratings is BBB- and they have placed us on stable outlook. Moody's Investor Services has given us a Baa3 rating and placed us on negative outlook. These ratings reflect those credit agencies' expectations that the intense competitive environment facing Sun in its core markets will continue over at least the near-term to challenge Sun's revenue and profitability. If we were to be further downgraded by these ratings agencies, such downgrades could increase our costs of obtaining, or make it more difficult to obtain or issue, new debt financing. In addition, further downgrades could affect our interest rate swap agreements that we use to modify the interest characteristics of any new debt. Any of these events could materially and adversely affect our business and financial condition.

Our use of a self-insurance program to cover certain claims for losses suffered and costs or expenses incurred could negatively impact our business upon the occurrence of an uninsured event.

Sun has adopted a program of self-insurance with regard to certain risks such as California earthquakes and as supplemental coverage for certain potential liabilities including, but not limited to general liability, directors and officers liability, workers compensation, errors and omissions liability and property. We self-insure when the lack of availability and high cost of commercially available insurance products do not make the

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transfer of this risk a reasonable approach. In the event that the frequency of losses experienced by Sun increased unexpectedly, the aggregate of such losses could materially increase our liability and adversely affect our financial condition, liquidity, cash flows and results of operations. In addition, while the insurance market continues to limit the availability of certain insurance products while increasing the costs of such products, we will continue to evaluate the levels of claims we include in our self-insurance program. Any increases to this program increase our risk exposure and therefore increase the risk of a possible material adverse effect on our financial condition, liquidity, cash flows and results of operations. In addition, we have made certain judgments as to the limits on our existing insurance coverage that we believe are in line with industry standards, as well as in light of economic and availability considerations. Unforeseen catastrophic loss scenarios could prove our limits to be inadequate, and losses incurred in connection with the known claims we self-insure could be substantial. Either of these circumstances could materially adversely affect our financial and business condition.

Recent issued regulations related to equity compensation could adversely affect our ability to attract and retain key personnel.

Since our inception, we have used stock options and other long-term equity incentives as a fundamental component of our employee compensation packages. We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with Sun. The Financial Accounting Standards Board (FASB) has issued changes to U.S. GAAP that will require us to record a charge to

Table of Contents

earnings for employee stock option grants. This regulation will negatively impact our earnings. For example, recording a charge for employee stock options under SFAS 123, *Accounting for Stock-Based Compensation* would have increased net loss by \$818 million, \$555 million and \$647 million for fiscal 2004, 2003 and 2002, respectively. See also Note 2 to the Notes to Consolidated Financial Statements *Summary of Significant Accounting Policies: Stock Options Plans*. In addition, new regulations implemented by The Nasdaq National Market requiring shareholder approval for all stock option plans, as well as new regulations implemented by the New York Stock Exchange prohibiting NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions, could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult or expensive to grant stock options to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

We face costs and risks associated with compliance with Section 404 of the Sarbanes-Oxley Act.

We are evaluating our internal control systems in order to allow our management to report on, and our independent auditors to attest to, our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. As a result, we are incurring additional expenses and a diversion of management's time. While we currently anticipate completion of testing and evaluation of our internal controls over financial reporting with respect to the requirements of Section 404 of the Sarbanes-Oxley Act in a timely fashion, there can be no assurance that we will be able to accomplish this. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we might be subject to investigation by regulatory authorities. Any such action could adversely affect our financial results and/or the market price of our common stock.

Audits of our business records may result in significant penalties.

We offer terms to some of our distributors and other customers that, in some cases, include complex provisions for pricing, data protection and other terms. In connection with such contracts, we are in some cases required to allow the customer to audit certain of our records to verify compliance with these terms. In particular, government agency customers audit and investigate government contractors, including us. These agencies review our performance under the applicable contracts as well as compliance with applicable laws, regulations and standards. The government also may review the adequacy of, and our compliance with, our internal control systems and policies, including our purchasing, property, estimating, compensation and management information systems. If an audit uncovers improper or illegal activities, we may be subject to penalties and other sanctions. In addition, we could suffer serious harm to our reputation if allegations of impropriety were made against us. The General Services Administration is currently auditing the schedule contract it has with us.

Business interruptions could adversely affect our business.

Our operations and those of our suppliers are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, terrorist attacks and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters and other critical business operations, are located near major earthquake faults. In addition, some of our facilities are located on filled land and, therefore, may be more susceptible to damage if an earthquake occurs. We do not carry earthquake insurance for direct earthquake-related losses. In addition, we do not carry business interruption insurance for, nor do we carry financial reserves against, business interruptions arising from earthquakes or certain other events. If a business interruption occurs, our business could be materially and adversely affected.

Our Fiscal 2004 Restructuring Plan may not result in the anticipated cost saving and benefits.

In March 2004, our Board of Directors and management approved the Fiscal 2004 Restructuring Plan. Our ability to achieve the cost savings and operating efficiencies anticipated by the Fiscal 2004 Restructuring Plan is dependent on a number of factors, including the speed with which we are able to implement the workforce and excess capacity reductions contemplated and the effectiveness of these implementations. If we are unable to implement these initiatives quickly and effectively, we may not achieve the level of cost savings and efficiency benefits expected for fiscal year 2005 and beyond.

Uncertain economic conditions could affect our ability to sublease properties in our portfolio.

In response to the global economic slowdown, we implemented facility exit plans in each of the last four fiscal years as part of our ongoing efforts to consolidate excess facilities. The uncertain economic conditions in the United States and in many of the countries in which we have significant leased properties have resulted in a surplus of business facilities making it difficult to sublease properties. We may be unable to sublease our excess properties, or we may not meet our expected estimated levels of subleasing income, and accordingly our results of operations could be materially and adversely affected.

Environmental regulations and costs could result in significant liabilities for us.

Some of our operations are subject to regulation under various federal, state and international laws governing the environment and hazardous substances. While we endeavor to be in compliance with environmental laws at all times, any failure to so comply can subject us to material liability. Also, particularly in Europe, we may be subject to compliance with developing product

Table of Contents

content requirements relating to recycling as well as product take back requirements that would make us responsible for recycling and/or disposing of products we have sold. These and other environmental laws may become stricter over time and require us to incur substantial costs for compliance. In addition, we could be subject to liability for investigation and remediation of hazardous substances if our operations have caused contamination or any of our owned or leased properties are found to be contaminated. Although costs relating to environmental matters have not resulted in a material adverse effect on us to date, there can be no assurance that we will not be required to incur such costs in the future.

Our stock price can be volatile.

Our stock price, like that of other technology companies, continues to be volatile. For example, our stock price can be affected by many factors such as quarterly increases or decreases in our earnings, speculation in the investment community about our financial condition or results of operations and changes in revenue or earnings estimates, downgrades in our credit ratings, announcement of new products, technological developments, alliances, acquisitions or divestitures by us or one of our competitors or the loss of key management personnel. In addition, general macroeconomic and market conditions unrelated to our financial performance may also affect our stock price.

FORWARD LOOKING STATEMENTS

This quarterly report, including the foregoing sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements related to our belief that the increase in the number of systems under a Support services contract is primarily due to our continuing emphasis in recent periods on solutions sales, which include support services as an essential element of a solutions sale; our belief that, with the exception of the global alliance with Fujitsu, our actions to adjust to the intense competitive environment have contributed towards stabilization of the Japanese market's revenue; our expectation that pricing pressures associated with competition and the shift in product mix to sales of lower-margin products will continue to impact our Products gross margin; our expectation that pricing pressures associated with competition and the shift in product mix to solution-based sales, which have a greater proportion of Client solutions, will continue to impact our Services gross margin; our belief that to maintain our competitive position we must continue to invest significant resources in new systems, software and microprocessor development, and enhance existing products; our continued focus on achieving operating efficiencies; our expectation that we will record additional charges related to our workforce and facilities reductions primarily over the next few quarters; our expectation that we will incur additional charges related to productivity improvement initiatives and expense reduction measures; our expectation that remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters; our expectation that the volatility of our portfolio of marketable securities will decrease as its duration decreases; our belief that inventory management will continue to be an area of focus; our belief that our acquisition of SevenSpace will enhance our managed services offerings by adding support for non-Sun platforms; our long-term strategy to maintain a minimum amount of cash and cash equivalents in subsidiaries and to invest the remaining amount of cash in interest-bearing cash equivalents and highly liquid marketable debt securities; our anticipation that we will not need to repatriate funds generated from operations domiciled in foreign tax jurisdictions to our U.S. operations; our expectations regarding the impact on cash flow from operations of a potential payment to the I.R.S. related to ongoing tax examinations and cash payments associated with our ongoing restructuring activities; our expectations regarding the level of improvements of our cash conversion cycle; our estimate of total expenditures for capital investments and spares for fiscal 2005; our belief that the liquidity provided by existing cash, cash equivalents, marketable debt securities and cash generated from operations will provide sufficient capital to meet our requirements for at least the next 12 months; our belief that our level of financial resources is a significant competitive factor in our industry; our business strategy to implement a solutions-based selling approach; our belief that this strategy will enable us to increase our revenues and margins; our strategy to derive competitive advantage from our investment in innovative new technologies; our strategy to sell new products in our entry-level server line as part of overall systems; our business strategy to grow incremental revenue through recurring service models; our anticipation that the Advanced Product Line will ultimately replace a large proportion of our server product line; our intention to release our Solaris operating system to the open source development community as open source software; our strategy to reduce our dependence on the telecommunications, financial services and government sectors by expanding our product reach into new industries; our intention to develop and implement a global resourcing strategy and operating model that includes outsourcing activities and is focused on increasing workforce flexibility and scalability and improving overall competitiveness; our intention to continue to make investments in companies, products, and technologies, either through acquisitions or investments or alliances; our belief that we will complete testing and evaluation of our internal controls over financial reporting with respect to the requirements of Section 404 of the Sarbanes-Oxley Act in a timely fashion; and our current plans not to discontinue our

hedging programs.

These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth above and those contained in RISK FACTORS, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. Such factors include, but are not limited to, increased competition, increased pricing pressures, failure associated with the Fujitsu strategic alliance, failure to design, develop and manufacture new products, risks associated with releasing our Solaris operating system to the open source development community as open source software,

Table of Contents

lack of success in technological advancements, lack of acceptance of new products and services, unexpected changes in the demand for our products and services, delays in product introductions and projects, lack of success implementing new selling models, failure to further reduce costs or improve operating efficiencies including through our Fiscal 2004 Restructuring Plan, adverse business conditions, quality issues associated with our hardware or software products, our dependence on currency fluctuations, our failure to comply with export control laws and our ability to attract, hire and retain key and qualified employees.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk related to changes in interest rates, foreign currency exchange rates, and equity security prices. To mitigate some of these risks, we utilize derivative financial instruments to hedge these exposures. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at December 26, 2004. Actual results may differ materially.

Interest Rate Sensitivity

Our investment portfolio consists primarily of fixed income instruments with an average duration of 0.67 year as of December 26, 2004 as compared with 0.93 year as of December 28, 2003. The primary objective of our investments in debt securities is to preserve principal while maximizing yields, without significantly increasing risk. These available-for-sale securities are subject to interest rate risk. The fair market value of these securities may fluctuate with changes in interest rates. A sensitivity analysis was performed on this investment portfolio based on a modeling technique that measures the hypothetical fair market value changes (using a three month horizon) that would result from a parallel shift in the yield curve of plus 150 basis points (BPS). Based on this analysis, for example, a hypothetical 150 BPS increase in interest rates would result in an approximate \$62 million decrease in the fair value of our investments in debt securities as of December 26, 2004.

We also entered into various interest-rate swap agreements to modify the interest characteristics of the Senior Notes so that the interest payable on the Senior Notes effectively becomes variable and thus matches the variable interest rate received from our cash and marketable debt securities. Accordingly, interest rate fluctuations impact the fair value of our Senior Notes outstanding, which will be offset by corresponding changes in the fair value of the swap agreements. However, by entering into these swap agreements, we have a cash flow exposure related to the risk that interest rates may increase. For example, at December 26, 2004, a hypothetical 150 BPS increase in interest rates would result in an approximate \$18 million decrease in cash related to interest expense over a year.

Foreign Currency Exchange Risk

As a large portion of our business takes place outside of the U.S., we enter into transactions in other currencies. We are primarily exposed to changes in exchange rates for the Euro, Japanese yen, and British pound. We are a net receiver of currencies other than the U.S. dollar and, as such, can benefit from a weaker dollar, and can be adversely affected by a stronger dollar relative to major currencies worldwide. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may adversely affect our consolidated revenue and operating margins as expressed in U.S. dollars. To minimize currency exposure gains and losses, we may borrow funds in local currencies, and we often enter into forward exchange contracts, purchase foreign currency options and promote natural hedges by purchasing components and incurring expenses in local currencies. Currently, we have no plans to discontinue our hedging programs; however, we may evaluate the benefits of our hedging strategies and may choose to discontinue them in the future.

Based on our foreign currency exchange instruments outstanding at December 26, 2004, we estimate a maximum potential one-day loss in fair value of approximately \$2 million, as compared with \$4 million as of June 30, 2004, using a Value-at-Risk (VAR) model. The VAR model estimates were made assuming normal market conditions and a 95% confidence level. We used a Monte Carlo simulation type model that valued foreign currency instruments against three thousand randomly generated market price paths. Anticipated transactions, firm commitments, receivables, and accounts payable denominated in foreign currencies were excluded from the model. The VAR model is a risk estimation tool, and as such is not intended to represent actual losses in fair value that will be incurred by us. Additionally, as we utilize foreign currency instruments for hedging anticipated and firmly committed transactions, a loss in fair value for those instruments is generally offset by increases

in the value of the underlying exposure.

Equity Security Price Risk

We are exposed to price fluctuations on the marketable portion of equity securities included in our portfolio of equity investments. These investments are generally in companies in the high-technology industry sector, many of which are small capitalization stocks. We typically do not attempt to reduce or eliminate the market exposure on these securities. A 20% adverse change in equity prices would result in an approximate \$6 million decrease in the fair value of our available-for-sale equity investments as of December 26, 2004, as compared with \$4 million as of December 26, 2003. At December 26, 2004, three equity securities represented approximately \$18 million of the \$31 million total fair value of the marketable equity securities.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

On February 11, 2002, Eastman Kodak Company (Kodak) filed a lawsuit against us entitled, Eastman Kodak Company v. Sun Microsystems, Inc., Civil Action No. 02-CV-6074, in the United States District Court for the Western District of New York and filed an amended complaint in that same court on March 22, 2002. Kodak alleged that some of our products, including aspects of our Java technology, infringe one or more Kodak patent claims contained in the following Kodak patents: U.S. Patent No. 5,206,951, U.S. Patent No. 5,421,012 and U.S. Patent No. 5,226,161 (collectively, the Litigated Kodak Patents). Kodak further alleged that we contributed to and induced infringement of one or more claims of the Litigated Kodak Patents. Effective October 7, 2004, we reached an agreement with Kodak to settle all claims in the lawsuit. As a result of the settlement, we received a release for any past infringement by Sun's Java technology of any patent held by Kodak (collectively, the Kodak Patent Portfolio) and a release for any past infringement whatsoever of the Litigated Kodak Patents and other specified patents held by Kodak (collectively, the Broadly Released Kodak Patents). Furthermore, Sun received a perpetual, non-exclusive, worldwide irrevocable license to the Kodak Patent Portfolio for the benefit of the Java technology and to the Broadly Released Kodak Patents for any and all purposes. The settlement involves cash paid by Sun of \$92 million.

On April 20, 2004, we were served with a complaint in a case entitled Gobeli Research (Gobeli) v. Sun Microsystems, Inc. and Apple Computer, Inc. (Apple). The complaint alleges that Sun products, including our Solaris Operating System, infringe on a Gobeli patent related to a system and method for controlling interrupt processing. Gobeli claims that Apple's OS 9 and OS X operating systems violate that same patent. The case is pending in the United States District Court for the Eastern District of Texas. We have filed a response denying liability and stating various affirmative defenses, and we intend to present a vigorous defense.

We entered into settlement agreements with the United States Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS) on December 15, 2003 addressing certain BIS charges that we had violated export control regulations. The settlement included a one-year suspended denial of our worldwide export privileges, which expired on December 15, 2004 without incident. Had we violated export control laws during the one-year suspension period, the BIS order would have denied us worldwide export privileges, which would have had a material effect on the results of operations and financial condition.

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

We held our Annual Meeting of Stockholders on November 10, 2004. At that meeting, the following actions were voted upon:

(a) Election of Directors:

| | FOR | WITHHELD |
|--------------------|---------------|-----------------|
| Scott G. McNealy | 2,877,963,826 | 97,445,011 |
| James L. Barksdale | 2,844,586,544 | 130,822,293 |
| Stephen M. Bennett | 2,904,396,965 | 71,011,872 |
| L. John Doerr | 2,601,563,776 | 373,845,061 |
| Robert J. Fisher | 2,807,776,097 | 167,632,740 |

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| | | |
|-------------------|---------------|-------------|
| Michael E. Lehman | 2,877,702,186 | 97,706,651 |
| M. Kenneth Oshman | 2,808,116,409 | 167,292,428 |
| Naomi O. Seligman | 2,807,246,075 | 168,162,762 |
| Lynn E. Turner | 2,807,334,709 | 168,074,128 |

The nine nominees who received the highest number of votes (all of the above individuals) were elected to the Board of Directors, and will serve as directors until our next annual meeting and until his or her successor is elected and qualified.

- (b) Ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending June 30, 2005:

| <u>FOR</u> | <u>AGAINST</u> | <u>ABSTAIN</u> | <u>NON-VOTES</u> |
|---------------|----------------|----------------|------------------|
| 2,786,829,772 | 170,584,091 | 17,994,974 | 0 |

The appointment was ratified.

Table of Contents

ITEM 6. EXHIBITS

See Index to Exhibits on Page 44 hereof.

Table of Contents

SIGNATURES

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

SUN MICROSYSTEMS, INC.

BY /s/ Stephen T. McGowan

Stephen T. McGowan
*Chief Financial Officer and Executive
Vice President, Corporate Resources
(Principal Financial Officer)*

/s/ Robyn M. Denholm

Robyn M. Denholm
*Vice President and Corporate Controller
(Principal Accounting Officer)*

Dated: February 3, 2005

Table of Contents

INDEX TO EXHIBITS

| Exhibit | |
|----------------|-------------------------------------------------------------------------------------|
| Number | Description |
| 3.4 | Bylaws of the Registrant, as amended June 24, 2004 and effective November 10, 2004. |
| 10.111* | Employment Agreement, dated January 31, 2005, between the Registrant and David Yen. |
| 15.1 | Letter re: Unaudited Interim Financial Information. |
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer. |
| 32.1 | Section 1350 Certificate of Chief Executive Officer. |
| 32.2 | Section 1350 Certificate of Chief Financial Officer. |

* Indicates a management contract or compensatory plan or arrangement.