

SUN MICROSYSTEMS, INC.

Form 10-Q

May 05, 2006

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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 March 26, 2006

or

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

Commission file number: 0-15086

SUN MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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)

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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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act) (Check one);

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). 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 May 1, 2006</u>
Common Stock \$0.00067 par value	3,497,720,742

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(unaudited)

(in millions, except per share amounts)

	Three Months Ended		Nine Months Ended	
	March 26, 2006	March 27, 2005	March 26, 2006	March 27, 2005
Net revenues:				
Products	\$ 2,035	\$ 1,683	\$ 5,847	\$ 5,199
Services	1,142	944	3,393	2,897
Total net revenues	3,177	2,627	9,240	8,096
Cost of sales:				
Cost of sales-products (including stock-based compensation expense of \$3 and \$8) ⁽¹⁾	1,152	975	3,341	3,044
Cost of sales-services (including stock-based compensation expense of \$7 and \$21) ⁽¹⁾	658	565	1,909	1,694
Total cost of sales	1,810	1,540	5,250	4,738
Gross margin	1,367	1,087	3,990	3,358
Operating expenses:				
Research and development (including stock-based compensation expense of \$19 and \$54) ⁽¹⁾	523	450	1,503	1,313
Selling, general and administrative (including stock-based compensation expense of \$28 and \$79) ⁽¹⁾	1,020	735	2,904	2,131
Restructuring charges	36	44	58	176
Purchased in-process research and development			60	
Total operating expenses	1,579	1,229	4,525	3,620
Operating loss	(212)	(142)	(535)	(262)
Gain on equity investments, net	4	2	31	7
Interest and other income, net	26	91	95	155
Loss before income taxes	(182)	(49)	(409)	(100)
Provision for (benefit from) income taxes	35	(21)	154	57

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Net loss	\$ (217)	\$ (28)	\$ (563)	\$ (157)
Net loss per common share-basic and diluted	\$ (0.06)	\$ (0.01)	\$ (0.16)	\$ (0.05)
Shares used in the calculation of net loss per common share basic and diluted	3,443	3,376	3,425	3,358

(1) For the three and nine months ended March 26, 2006, respectively.

See accompanying notes.

Table of Contents**SUN MICROSYSTEMS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in millions)

	March 26, 2006	June 30, 2005
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,641	\$ 2,051
Short-term marketable debt securities	1,231	1,345
Accounts receivable, net	2,301	2,231
Inventories	574	431
Deferred and prepaid tax assets	279	255
Prepaid expenses and other current assets	687	878
	<u>6,713</u>	<u>7,191</u>
Total current assets	6,713	7,191
Property, plant and equipment, net	1,880	1,769
Long-term marketable debt securities	1,557	4,128
Goodwill	2,487	441
Other acquisition-related intangible assets, net	1,083	113
Other non-current assets, net	650	548
	<u>\$ 14,370</u>	<u>\$ 14,190</u>
	<u>\$ 14,370</u>	<u>\$ 14,190</u>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and short-term borrowings	\$ 505	\$
Accounts payable	1,315	1,167
Accrued payroll-related liabilities	744	713
Accrued liabilities and other	930	1,014
Deferred revenues	1,684	1,648
Warranty reserve	244	224
	<u>5,422</u>	<u>4,766</u>
Total current liabilities	5,422	4,766
Long-term debt	585	1,123
Long-term deferred revenues	472	544
Other non-current obligations	1,504	1,083
Total stockholders equity	6,387	6,674
	<u>\$ 14,370</u>	<u>\$ 14,190</u>
	<u>\$ 14,370</u>	<u>\$ 14,190</u>

See accompanying notes.

Table of Contents**SUN MICROSYSTEMS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited, in millions)**

	Nine Months Ended	
	March 26,	March 27
	2006	2005
Cash flows from operating activities:		
Net loss	\$ (563)	\$ (157)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	440	497
Amortization of other acquisition-related intangible assets	242	57
Stock-based compensation expense	162	15
Purchased in-process research and development	60	
Gain on equity investments, net	(31)	(7)
Deferred taxes	(9)	(107)
Changes in operating assets and liabilities:		
Accounts receivable, net	229	338
Inventories	30	79
Prepaid and other assets	264	(265)
Accounts payable	(6)	16
Other liabilities	(588)	(292)
Net cash provided by operating activities	230	174
Cash flows from investing activities:		
Increase in restricted cash	(63)	
Purchases of marketable debt securities	(1,652)	(5,115)
Proceeds from sales of marketable debt securities	4,038	4,066
Proceeds from maturities of marketable debt securities	289	651
Proceeds from sales of equity investments, net	17	47
Acquisition of property, plant and equipment, net	(193)	(199)
Acquisition of spare parts and other assets	(53)	(68)
Payments for acquisitions, net of cash acquired	(3,150)	(45)
Net cash used in investing activities	(767)	(663)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	127	134
Principal payments on borrowings		(252)
Net cash provided by (used in) financing activities	127	(118)
Net decrease in cash and cash equivalents	(410)	(607)
Cash and cash equivalents, beginning of period	2,051	2,141

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Cash and cash equivalents, end of period	\$ 1,641	\$ 1,534
	<u> </u>	<u> </u>
Supplemental disclosure of cash flow information:		
Interest paid (net of interest received from swap agreements of \$80 and \$89, respectively)	\$ 46	\$ 27
	<u> </u>	<u> </u>
Income taxes paid (net of refunds of \$159 and \$19, respectively)	\$ 36	\$ 310
	<u> </u>	<u> </u>
Supplemental schedule of noncash investing activities:		
Stock and options issued in connection with acquisitions	\$ 89	\$ 1
	<u> </u>	<u> </u>
Net issuance of nonvested stock awards	\$ 162	\$
	<u> </u>	<u> </u>

See accompanying notes.

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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 network computing products and services. Network computing has been at the core of our offerings for the 24 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), Data Management (formerly known as Network Storage) (hardware and software), Support Services and Client solutions and Educational services. Our customers use our products and services to build mission-critical network computing environments to 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.

In addition, with the recent acquisition of Storage Technology Corporation (StorageTek), we have broadened our system strategy by offering our customers a complete range of storage products, services and solutions including StorageTek's Information Lifecycle Management (ILM) products, where we enable businesses to align the cost of storage with the value of information. StorageTek helps customers gain control of their storage environments by reducing the time, cost and complexity of their storage infrastructures.

2. Summary of Significant Accounting Policies

Fiscal Year

Sun's first three quarters in fiscal year 2006 ended on September 25, 2005, December 25, 2005 and March 26, 2006. In fiscal year 2005, the quarters ended on September 26, 2004, December 26, 2004 and March 27, 2005. 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. We completed our acquisitions of StorageTek and SeeBeyond Technology Corporation (SeeBeyond) as of August 31, 2005 and August 25, 2005, respectively. As a result, our condensed consolidated financial statements for the nine months ended March 26, 2006 included the results for StorageTek and SeeBeyond from the date of each acquisition.

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These Interim Financial Statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP) for interim financial information and the rules and regulations of the Securities and Exchange Commission (SEC) 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, 2005, filed with the SEC on September 13, 2005 (2005 Form 10-K). These Interim Financial Statements are unaudited but reflect all adjustments, including 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, 2005 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 2005 Form 10-K.

As described in our 2005 Form 10-K, we restated certain financial statements and other information for each of the first three quarters of fiscal 2005, with respect to our accounting for taxes and certain pre-tax accounting adjustments recorded throughout fiscal 2005.

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.

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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. Due to our net loss for all periods presented, all of our outstanding options were excluded from the diluted loss per share calculation because their inclusion would have been anti-dilutive.

If we had earned a profit during the three and nine months ended March 26, 2006, we would have added 37 million and 21 million, respectively, 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 nine months ended March 27, 2005, we would have added 25 million and 27 million common equivalent shares, respectively, to our basic weighted-average shares outstanding to compute the diluted weighted-average shares outstanding.

Recent Pronouncements

In October 2004, The American Jobs Creation Act of 2004 (the Jobs Act) was signed into law. The Jobs Act creates a temporary incentive for U.S. multinationals to repatriate accumulated income earned outside the U.S. at a favorable effective tax rate of 5.25%. On December 21, 2004, the Financial Accounting Standards Board (FASB) issued their staff position, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP 109-2). FSP 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. See Note 12 for further details.

In December 2004, the FASB issued Statement of Financial Accounting Standards (SFAS) 123 (revised 2004), Share-Based Payment (SFAS 123R). 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 requires additional accounting related to the income tax effects and disclosure regarding the cash flow effects resulting from share-based payment arrangements. In January 2005, the SEC issued Staff Accounting Bulletin No. 107, which provides supplemental implementation guidance for SFAS 123R. We selected the Black-Scholes option-pricing model as the most appropriate fair-value method for our awards and will recognize compensation cost on a straight-line basis over our awards vesting periods. We adopted SFAS 123R in the first quarter of fiscal 2006. See Note 9 for further details.

The adoption of the following accounting pronouncements in the first nine months of fiscal 2006 did not have a material impact on our results of operations and financial condition:

SFAS 151, Inventory Costs An Amendment of ARB No. 43, Chapter 4 ;

SFAS 153, Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29 ; and

Emerging Issues Task Force (EITF) Issue 05-06, Determining the Amortization Period for Leasehold Improvements.

In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections (SFAS 154), which replaces Accounting Principles Board Opinions (APB) 20 Accounting Changes and SFAS 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the earliest practicable date, as the required method for reporting a change in accounting principle and restatement

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with respect to the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by Sun in the first quarter of fiscal 2007.

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (FSP 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005. FSP 115-1 was adopted by Sun in the third quarter of fiscal 2006 and did not have a material impact on our results of operations and financial condition.

Table of Contents**3. Business Combinations**

During the nine months ended March 26, 2006, we acquired Tarantella, Inc. (Tarantella), SeeBeyond and StorageTek as described below. Each acquisition has been accounted for as a purchase business combination. Certain aspects of the purchase price allocations for SeeBeyond and StorageTek are preliminary and have been made using initial estimates of value. Adjustments due to the finalization of these estimates will be included in the allocation of the purchase price if the adjustment is determined within the purchase price allocation period of up to twelve months from the date of acquisition. The operating results of each business purchased are included in Sun's consolidated statement of operations from the date of each acquisition. Pro forma results of operations have not been presented for Tarantella and SeeBeyond because the effect of these acquisitions was not material to Sun on either an individual or an aggregated basis.

Tarantella

On July 13, 2005, we acquired all of the outstanding shares of Tarantella, a publicly held company based in Los Gatos, California, (OTC: TTLA.OB) by means of a merger pursuant to which we paid cash for all of the outstanding shares of capital stock of Tarantella. In addition, all outstanding options to purchase Tarantella common stock were converted into options to purchase shares of our stock. Tarantella is a leading provider of software that enables organizations to access and manage information, data and applications across virtually all platforms, networks and devices. We acquired Tarantella to enhance our thin-client product offerings and strengthen our utility computing strategy.

We purchased Tarantella for approximately \$25 million in cash and \$1 million in assumed options and transaction costs. The total purchase price of \$26 million was allocated as follows (in millions):

Goodwill	\$ 19
Other intangible assets	12
Tangible assets acquired and net liabilities assumed	(5)
	—
Total	\$ 26

SeeBeyond

On August 25, 2005, we acquired all of the outstanding shares of SeeBeyond, a publicly held company based in Monrovia, California (NASDAQ: SBYN). Under the terms of the agreement, SeeBeyond stockholders received \$4.25 per share in cash for each SeeBeyond share and certain SeeBeyond stock option holders received cash equal to the difference between \$4.25 per share and the exercise price of such stock options. In addition, certain other outstanding options to purchase SeeBeyond common stock were converted into options to purchase shares of our stock. SeeBeyond provides business integration software via its Integrated Composite Application Network (ICAN) suite, which enables the real-time flow of information within the enterprise and among customers, suppliers, and partners. This acquisition strengthened our software portfolio and created a complete offering for the development, deployment and management of enterprise applications and Service Oriented Architectures.

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We purchased SeeBeyond for approximately \$362 million in cash, \$9 million in assumed options, and approximately \$5 million in transaction costs. As of March 26, 2006, the total purchase price of \$376 million was allocated on a preliminary basis as follows (in millions):

Goodwill	\$ 255
Other intangible assets:	
Customer base and other	53
Developed technology	34
Tangible assets acquired and net liabilities assumed	23
In-process research and development	11
	<hr/>
Total	\$ 376
	<hr/>

The net liabilities assumed included approximately \$12 million of preliminary acquisition-related restructuring costs associated with the integration of facilities and activities of SeeBeyond.

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On August 31, 2005, we acquired all of the outstanding shares of StorageTek, a publicly held company based in Louisville, Colorado (NYSE: STK). Under the terms of the agreement, StorageTek stockholders received \$37 per share in cash for each StorageTek share and certain holders of StorageTek stock options received cash equal to the difference between \$37 per share and the exercise price of such options. In addition, certain other outstanding options to purchase StorageTek common stock were converted into options to purchase shares of our stock. StorageTek engages in the design, manufacture, sale and maintenance of data storage hardware and software, as well as the provisioning of support services worldwide. StorageTek helps customers gain control of their storage environments by reducing the time, cost and complexity of their storage infrastructures. We acquired StorageTek in order to offer customers a complete range of products, services and solutions for securely managing mission-critical data assets. The total purchase price of \$4,082 million was comprised of (in millions):

Cash paid to acquire the outstanding common stock of StorageTek	\$ 3,987
Fair value of StorageTek options assumed	80
Acquisition-related transaction costs	15
	<hr/>
Total purchase price	\$ 4,082
	<hr/>

The fair value of options assumed was determined using a price of \$3.76, which represented the average closing price of our common stock from two trading days before to two trading days after the June 2, 2005 announcement date and was calculated using a Black-Scholes valuation model with the following assumptions: weighted average remaining expected life of 2.7 years, average risk-free interest rate of 3.8%, average expected volatility of 44.8% and no dividend yield.

Acquisition-related transaction costs include investment banking, legal and accounting fees and other third-party costs directly related to the acquisition.

Preliminary Purchase Price Allocation

The preliminary allocation of the total purchase price of StorageTek's net tangible and identifiable intangible assets was based on their estimated fair values as of August 31, 2005. Adjustments to these estimates will be included in the allocation of the purchase price of StorageTek, if the adjustment is determined within the purchase price allocation period of up to twelve months. The excess of the purchase price over the identifiable intangible and net tangible assets was allocated to goodwill. As of March 26, 2006, the total purchase price of \$4,082 million has been allocated as follows (in millions):

Goodwill	\$ 1,772
Other intangible assets	1,113
Tangible assets acquired and liabilities assumed:	
Cash and marketable debt securities	1,204
Other current assets	522
Non-current assets	335
Accounts payable and accrued liabilities	(587)
Other liabilities	(326)

In-process research and development	49
	<hr/>
Total purchase price	\$ 4,082
	<hr/>

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We have estimated the fair value of other intangible assets through the use of an independent third-party valuation firm that used the income approach to value these identifiable intangible assets which are subject to amortization. These estimates are based on a preliminary valuation and are subject to change upon management's review of the final valuation. The following table sets forth the components of these other intangible assets at March 26, 2006 (dollars in millions):

	Preliminary	Accumulated	Net Book Value as of	Weighted Average
	Fair Value	Amortization	March 26, 2006	Useful Life (in years)
Customer base	\$ 540	\$ (102)	\$ 438	4
Developed technology	507	(75)	432	4
Trademarks	55	(2)	53	16
Other	11	(2)	9	3
Total intangible assets	\$ 1,113	\$ (181)	\$ 932	

Customer base represents the expected future benefit to be derived from StorageTek's existing customer contracts, backlog and underlying customer relationships. Developed technology, which is comprised of products that have reached technological feasibility, includes products in all of StorageTek's product lines, principally their tape and network products. Trademarks represented trade names and trademarks developed through years of design and development.

Tangible assets acquired and net liabilities assumed

We have estimated the fair value of certain tangible assets acquired and liabilities assumed. Since the date of acquisition, certain estimates have been adjusted through the allocation of the purchase price and continue to be subject to change. These estimates include those relating to deferred taxes and acquisition-related restructuring costs. We currently have provided a full valuation allowance on the acquired deferred tax assets. Adjustments to these acquired deferred taxes may be required upon the merger of the acquired foreign legal entities into a combined legal entity structure. Our acquisition-related restructuring liabilities were estimated based on an integration plan which focuses principally on the elimination of duplicative activities and facilities as discussed in Note 6.

In-process research and development

Of the total purchase price, approximately \$49 million has been allocated to in-process research and development (IPRD) and was expensed in the first quarter of fiscal 2006. Projects that qualify as IPRD represent those that have not yet reached technological feasibility and have no alternative use. Technological feasibility is defined as being equivalent to a beta-phase working prototype in which there is no remaining risk relating to the development.

The value assigned to IPRD was determined by considering the importance of each project to the overall development plan, estimating costs to develop the purchased IPRD into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present value. The revenue estimates used to value the purchased IPRD were based on estimates of the relevant market sizes and growth factors, expected trends in technology and the nature and expected timing of new product introductions by StorageTek and its competitors.

The rates utilized to discount the net cash flows to their present values are based on StorageTek's weighted-average cost of capital. The weighted-average cost of capital was adjusted to reflect the difficulties and uncertainties in completing each project and thereby achieving technological feasibility, the percentage of completion of each project, anticipated market acceptance and penetration, market growth rates and risks related to the impact of potential changes in future target markets. Based on these factors, discount rates that range from 13% - 15% were deemed appropriate for valuing the IPRD.

The estimates used in valuing IPRD were based upon assumptions believed to be reasonable but which are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur. Accordingly, actual results may differ from the projected results.

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The unaudited financial information in the table below summarizes the combined results of operations of Sun and StorageTek, on a pro forma basis, as though the companies had been combined as of the beginning of each of the periods presented. Sun's results of operations for the three and nine months ended March 26, 2006 included the results of StorageTek since August 31, 2005, the date of acquisition. The unaudited pro forma financial information for the nine months ended March 26, 2006 combines Sun's results for these periods with the results for StorageTek for the period from July 2, 2005 to August 30, 2005. The unaudited pro forma financial information for the three and nine months ended March 27, 2005 combines Sun's results for this period with StorageTek's results for the three and nine months ended April 1, 2005. The pro forma financial information presented below is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of each of the periods presented (in millions, except for per share amounts):

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>March 26,</u>	<u>March 27,</u>	<u>March 26,</u>	<u>March 27,</u>
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues	\$ 3,177	\$ 3,101	\$ 9,437	\$ 9,696
Net loss	\$ (210)	\$ (104)	\$ (620)	\$ (342)
Net loss per share - basic and diluted	\$ (0.06)	\$ (0.03)	\$ (0.18)	\$ (0.10)

4. Goodwill and Other Acquisition-related Intangible Assets

Information regarding our goodwill is as follows (in millions):

Balance as of June 30, 2005	\$ 441
Goodwill acquired during the period	2,046
Balance as of March 26, 2006	<u>\$ 2,487</u>

We are currently assessing the allocation of goodwill acquired through our acquisitions of StorageTek and SeeBeyond to our operating segments and expect to complete our assessment by the end of the fiscal year.

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

<u>Gross Carrying Amount</u>			<u>Accumulated Amortization</u>			<u>Net</u>
<u>June 30,</u>	<u>Additions</u>	<u>March 26,</u>	<u>June 30,</u>	<u>Additions</u>	<u>March 26,</u>	<u>March 26,</u>

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	<u>2005</u>		<u>2006</u>		<u>2005</u>		<u>2006</u>	
Developed technology	\$ 437	\$ 550	\$ 987	\$ (339)	\$ (117)	\$ (456)	\$ 531	
Customer base	55	593	648	(48)	(116)	(164)	484	
Trademark	6	57	63	(6)	(3)	(9)	54	
Acquired workforce and other	82	12	94	(74)	(6)	(80)	14	
	<u>\$ 580</u>	<u>\$ 1,212</u>	<u>\$ 1,792</u>	<u>\$ (467)</u>	<u>\$ (242)</u>	<u>\$ (709)</u>	<u>\$ 1,083</u>	

Amortization expense of other acquisition-related intangible assets was \$89 million and \$242 million for the three and nine months ended March 26, 2006, respectively, and \$19 million and \$57 million for the three and nine months ended March 27, 2005, respectively. Our acquisition-related intangible assets are primarily amortized over periods ranging from one to five years on a straight-line basis.

Estimated amortization expense for other acquisition-related intangible assets on our March 26, 2006 balance sheet for the fiscal years ending June 30, is as follows (in millions):

Remainder of 2006	\$ 88
2007	331
2008	313
2009	261
2010	52
Thereafter	38
	<u>\$ 1,083</u>

Table of Contents**5. Balance Sheet Details****Inventories**

Inventories consisted of the following (in millions):

	March 26, 2006	June 30, 2005
Raw materials	\$ 49	\$ 48
Work in process	125	121
Finished goods	400	262
	<u>\$ 574</u>	<u>\$ 431</u>

Deferred Revenues

The following table sets forth an analysis of our deferred revenue activity (in millions):

	Deferred services revenues	Other deferred revenues	Total
Balance at June 30, 2005	\$ 1,652	\$ 540	\$ 2,192
Deferred revenue acquired through acquisitions	117	12	129
Revenue deferred	2,383	869	3,252
Revenue recognized	(2,501)	(916)	(3,417)
	<u>1,651</u>	<u>505</u>	<u>2,156</u>
Balance at March 26, 2006	1,651	505	2,156
Less short-term portion	(1,210)	(474)	(1,684)
	<u>\$ 441</u>	<u>\$ 31</u>	<u>\$ 472</u>
Total long-term deferred revenues	<u>\$ 441</u>	<u>\$ 31</u>	<u>\$ 472</u>

Warranty Reserve

We accrue for our product warranty costs at the time of shipment. These product warranty costs are estimated based upon our historical experience and specific identification of product requirements, which may fluctuate based on product mix.

The following table sets forth an analysis of the warranty reserve activity (in millions):

Balance at June 30, 2005	\$ 224
Warranty reserve acquired through acquisitions	35
Charged to costs and expenses	250
Utilized	(265)
	<hr/>
Balance at March 26, 2006	\$ 244
	<hr/>

6. Restructuring Costs

In accordance with SFAS 112, Employers Accounting for Post Employment Benefits (SFAS 112) and SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), we recognized a total of \$36 million and \$58 million in restructuring charges in the three and nine months ended March 26, 2006, respectively, and \$44 million and \$176 million for the three and nine months ended March 27, 2005, respectively. In addition, we incurred restructuring related costs associated with acquisitions that are not included as expenses within our consolidated results of operations. This is because U.S. GAAP requires these costs to be recorded as assumed liabilities in our Consolidated Balance Sheets as of the date of acquisition. Our material restructuring related assumed liabilities are disclosed below in the section entitled Acquisition-related Restructuring Costs.

We estimated the cost of exiting and terminating our facility leases or acquired leases by referring to the contractual terms of the agreements and by evaluating the current real estate market conditions. In addition, we have estimated

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sublease income by evaluating the current real estate market conditions or, where applicable, by referring to amounts being negotiated. As of March 26, 2006, our estimated sublease income to be generated from sublease contracts not yet negotiated approximated \$63 million. 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 commercial real estate market conditions in certain geographies at the time we perform our evaluations or 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 and could be subject to adjustment as market conditions change.

Restructuring Plan V

In June 2005, we implemented a workforce reduction and in July 2005, we committed to a facility exit plan (Restructuring Plan V). In a continuing effort to improve our cost structure and improve operating efficiencies, we planned to reduce our workforce by approximately 1,000 employees across all employee levels, business functions, operating units and geographic regions. Through the nine months ended March 26, 2006, we reduced our workforce by approximately 700 employees under this plan. In the three and nine months ended March 26, 2006, we recognized a total of \$27 million and \$49 million, respectively, in charges associated with Restructuring Plan V, consisting solely of workforce reduction charges. In addition, we plan to eliminate excess facility capacity in light of revised facility requirements.

We anticipate recording 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 employees leaving Sun as determined by local employment laws and as we exit facilities. 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.

Restructuring Plans Prior to Phase V

In March 2004, we implemented 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 (Restructuring Plan IV). 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 fiscal 2005, we reduced our workforce by approximately 4,150 employees under this plan. As of March 26, 2006, all employees to be terminated as a result of Restructuring Plan IV had been notified. While most of the severance and related fringe benefits have been paid, in accordance with local employment laws, we expect to pay the remaining restructuring accrual related to severance over the next few quarters.

We committed to restructuring plans in fiscal 2004, 2003 and 2002 (Restructuring Plans IV, III and II, respectively) and a facility exit plan in fiscal 2001 (Facility Exit Plan I). These plans included eliminating excess facility capacity in light of revised facility requirements and other actions. We recorded initial restructuring charges in fiscal 2004, 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 markets in certain geographies, and the final settlement of certain lease obligations, we have made appropriate adjustments to the initial restructuring charges. These changes to the previous estimates have been reflected as Provision adjustments in the period the changes in estimates were made. Accrued lease costs during fiscal 2006 primarily relate to accretion expense.

All facilities relating to the amounts accrued under these restructuring plans were exited by June 30, 2005.

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The following table sets forth an analysis of our restructuring accrual activity for the nine months ended March 26, 2006 (in millions):

	Restructuring Plan V	Restructuring Plan IV		Restructuring Plan III	Restructuring Plan II	Facility Exit Plan I	
	Severance and Benefits	Severance and Benefits	Facilities Related and Other	Facilities Related	Facilities Related	Facilities Related	Total
Balance as of June 30, 2005	\$ 44	\$ 37	\$ 157	\$ 77	\$ 129	\$ 26	\$ 470
Severance and benefits	49	5					47
Accrued lease costs			8				8
Provision adjustments			(1)	(2)	2	(3)	3
Total restructuring charges	49	5	7	(2)	2	(3)	58
Cash paid	(61)	(31)	(35)	(14)	(15)	(11)	(167)
Balance as of March 26, 2006	\$ 32	\$ 11	\$ 129	\$ 61	\$ 116	\$ 12	\$ 361

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of March 26, 2006 for facility-related leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2023. As of March 26, 2006, \$114 million of the total \$361 million accrual for workforce reductions and facility-related leases was classified as current accrued liabilities and other and the remaining \$247 million was classified as other non-current obligations.

Acquisition-related Restructuring Costs

As a result of our acquisition of StorageTek, we recorded preliminary acquisition-related restructuring costs associated with the costs of integrating operating locations and activities of StorageTek with those of Sun. As noted above, U.S. GAAP requires that these acquisition-related restructuring costs, which are not associated with the generation of future revenues and have no future economic benefit, be recorded as assumed liabilities in the allocation of the purchase price. As a result, during the nine months ended March 26, 2006, we recorded approximately \$70 million of restructuring costs in connection with the StorageTek acquisition, which are based upon plans committed to by management. These costs were accounted for under EITF 95-3, Recognition of Liabilities in Connection with Purchase Business Combinations, and accordingly were recognized as restructuring liabilities assumed in the business combination. The following table sets forth an analysis of the components of the preliminary acquisition-related restructuring liabilities included in the purchase price allocation for StorageTek for the nine months ended March 26, 2006 (in millions):

Severance and Benefits	Facilities Related	Total
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Balance as of June 30, 2005	\$	\$	\$
Acquisition-related restructuring liabilities	26	44	70
Cash paid	(12)	(2)	(14)
	<u> </u>	<u> </u>	<u> </u>
Balance as of March 26, 2006	\$ 14	\$ 42	\$ 56
	<u> </u>	<u> </u>	<u> </u>

As of March 26, 2006, our estimated sublease income to be generated from sublease contracts not yet negotiated approximated \$8 million.

The acquisition-related restructuring costs are based on our integration plan which focuses principally on the elimination of duplicative activities. The balance of the StorageTek workforce reduction at March 26, 2006 is expected to be utilized during the remainder of fiscal 2006 and fiscal 2007 and is expected to be funded through cash flows from the combined operations. Certain aspects of the integration plan are still being finalized, including the evaluation of acquired facilities and workforce. Any changes resulting from the finalization of the integration plan could result in adjustments to our current estimates. As permitted under U.S. GAAP, these adjustments would be reflected in the allocation of the purchase price if made within twelve months from the date of acquisition.

Table of Contents**7. Comprehensive Income (loss)**

The components of comprehensive loss were as follows (in millions):

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>March 26,</u>	<u>March 27,</u>	<u>March 26,</u>	<u>March 27,</u>
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net loss	\$ (217)	\$ (28)	\$ (563)	\$ (157)
Change in unrealized value on investments, net	5	(26)	(27)	(17)
Change in unrealized fair value of derivative instruments and other, net	(12)	7	(15)	(1)
Translation adjustments, net	27	13	(61)	99
	<u>\$ (197)</u>	<u>\$ (34)</u>	<u>\$ (666)</u>	<u>\$ (76)</u>

The components of accumulated other comprehensive income were as follows (in millions):

	<u>March 26,</u>	<u>June 30,</u>
	<u>2006</u>	<u>2005</u>
Unrealized gains (losses) on investments, net	\$ (16)	\$ 11
Unrealized gains (losses) on derivative instruments and other, net	(13)	2
Cumulative translation adjustments, net	134	195
	<u>\$ 105</u>	<u>\$ 208</u>

8. Income Taxes

For the third quarter and first nine months of fiscal 2006, we recorded an income tax provision of \$35 million and \$154 million, respectively, compared with a tax benefit of \$21 million and tax provision of \$57 million for the corresponding periods of fiscal 2005. These tax provisions were primarily recorded for taxes due on income generated in certain state and foreign tax jurisdictions.

Our income tax provision during the first nine months of fiscal 2006, included a charge recorded in the second quarter associated with corrections of previously filed tax returns. This charge was partially offset by a benefit recorded in the third quarter associated with adjusting estimated amounts to actual liabilities resulting from the filing of prior years' tax returns. These adjustments are immaterial to our results of operations and financial condition for the current period as well as the prior affected periods.

We currently have provided a full valuation allowance on our U.S. deferred tax assets and a full or partial valuation allowance on certain overseas 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.

During the third quarter of fiscal 2006, we received a revenue agent report from the Internal Revenue Service relating to their examination of our tax returns filed for fiscal years 2001 and 2002. Pursuant to the report, the Internal Revenue Service has proposed various adjustments resulting in additional tax of approximately \$27 million. On April 17, 2006, we filed a protest with the Internal Revenue Service to contest several items. Although the ultimate outcome is unknown, we believe that we have adequately reserved for these potential adjustments and the final outcome will not have a material adverse affect on our results of operations.

We have also provided adequate amounts for other anticipated tax audit adjustments in the U.S., state and foreign tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes and interest may be due. In addition, although specific foreign country transfer pricing exposures have not been identified, the risk of potential adjustment exists. If our estimate of the federal, state and foreign income tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result. 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.

Table of Contents**9. Stock-Based Compensation**

We have a stock-based compensation program that provides our Board of Directors broad discretion in creating employee equity incentives. This program includes incentive and non-statutory stock options, nonvested stock awards (also known as restricted stock and restricted stock units that are settled in stock). These awards are granted under various plans, the majority of which are stockholder approved. Stock options are generally time-based, vesting 20% on each annual anniversary of the grant date over five years and expire eight years from the grant date. Nonvested stock awards are generally time-based and vest 50% in two tranches within a five year period from the grant date. Additionally, we have an Employee Stock Purchase Plan (ESPP) that allows employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. Effective May 2006, our ESPP plan was modified to allow employees to purchase shares of common stock at 85% of the fair market value at the date of purchase. Shares issued as a result of stock option exercises, nonvested stock and our ESPP are generally first issued out of treasury stock. As of March 26, 2006, we had approximately 374 million shares of common stock reserved for future issuance under our stock option plans and ESPP.

On July 1, 2005, we adopted the provisions of SFAS 123R, requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected to use the modified prospective transition method as permitted by SFAS 123R and therefore have not restated our financial results for prior periods. Under this transition method, stock-based compensation expense for the three and nine months ended March 26, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. Stock-based compensation expense for all stock-based compensation awards granted subsequent to July 1, 2005 was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. We recognize compensation expense for stock option awards on a straight-line basis over the requisite service period of the award.

The following table sets forth the total stock-based compensation expense resulting from stock options, nonvested stock awards, ESPP and options assumed as a result of our acquisitions included in our Condensed Consolidated Statements of Operations (in millions):

	Three Months	Nine Months
	Ended	Ended
	March 26,	March 26,
	2006	2006
	<u> </u>	<u> </u>
Cost of sales – products	\$ 3	\$ 8
Cost of sales – services	7	21
Research and development	19	54
Selling, general and administrative	28	79
	<u> </u>	<u> </u>
Stock-based compensation expense before income taxes	57	162
Income tax benefit		
	<u> </u>	<u> </u>
Total stock-based compensation expense after income taxes	\$ 57	\$ 162
	<u> </u>	<u> </u>

Net cash proceeds from the exercise of stock options were \$34 million and \$74 million for the three and nine months ended March 26, 2006, respectively, and \$20 million and \$73 million for the three and nine months ended March 27, 2005, respectively. No income tax benefit was

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realized from stock option exercises during the three and nine months ended March 26, 2006 and March 25, 2005. In accordance with SFAS 123R, we present excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

Prior to the adoption of SFAS 123R, we applied SFAS 123, amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS 148), which allowed companies to apply the existing accounting rules under APB 25, *Accounting for Stock Issued to Employees*, and related Interpretations. In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in our net income (loss) for periods prior to the adoption of SFAS 123R. As required by SFAS 148 prior to the adoption of SFAS 123R, we provided 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.

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The following table illustrates the effect on net income (loss) after tax and net income (loss) per common share as if we had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three and nine months ended March 27, 2005 (in millions, except per share amounts):

	Three Months Ended		Nine Months Ended	
	March 27,		March 27,	
	2005		2005	
Pro forma net loss:				
Net loss after tax	\$	(28)	\$	(157)
Add: stock-based compensation costs included in reported net loss (net of tax effects of none in all periods)		5		15
Deduct: stock-based compensation costs (net of tax effects of none in all periods) under SFAS 123		(58)		(424)
Pro forma net loss after tax	\$	(81)	\$	(566)
Pro forma basic and diluted net loss per common share:				
Pro forma shares used in the calculation of pro forma net loss per common share basic and diluted		3,376		3,358
Pro forma net loss per common share basic and diluted	\$	(0.02)	\$	(0.17)
Reported net loss per common share basic and diluted	\$	(0.01)	\$	(0.05)

The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the three and nine months ended March 26, 2006 and March 27, 2005, respectively:

Options	Three Months Ended		Nine Months Ended	
	March 26,	March 27,	March 26,	March 27,
	2006	2005	2006	2005
Expected life (in years)	4.8	5.7	4.8	5.9
Interest rate	4.43%	3.84%	4.19%	3.65%
Volatility	41.60%	67.27%	42.58%	68.22%
Dividend yield				
Weighted-average fair value at grant date	\$ 1.85	\$ 2.58	\$ 1.62	\$ 2.53
Employee Stock Purchase Plan	Three Months Ended		Nine Months Ended	
	March 26,	March 27,	March 26,	March 27,
	2006	2005	2006	2005
Expected life (in years)	0.5	0.5	0.5	0.5
Interest rate	4.25%	2.18%	3.76%	1.51%
Volatility	31.40%	41.13%	36.45%	41.67%
Dividend yield				

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Weighted-average fair value at grant date	\$ 0.93	\$ 1.11	\$ 0.96	\$ 1.04
-------------------------------------------	---------	---------	---------	---------

Our computation of expected volatility for the three and nine months ended March 26, 2006 is based on a combination of historical and market-based implied volatility. Our computation of expected life is based on historical exercise patterns. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

Prior to the adoption of SFAS 123R, our Board of Directors approved the acceleration of vesting of certain unvested and out-of-the-money stock options with exercise prices equal to or greater than \$6.00 per share previously awarded to our employees, including our executive officers and our directors, under our equity compensation plans. The acceleration of vesting was effective for stock options outstanding as of May 30, 2005. Options to purchase approximately 45 million shares of common stock or 18% of our outstanding unvested options were subject to the acceleration. The weighted average exercise price of the options that were accelerated was \$14.85. The purpose of the acceleration was to enable us to avoid recognizing compensation expense associated with these options in our Consolidated Statements of Operations upon the adoption of SFAS 123R in July 2005. We also believe that because

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the options that were accelerated had exercise prices in excess of the current market value of our common stock, the options had limited economic value and were not fully achieving their original objective of incentive compensation and employee retention.

Stock option activity for the nine months ended March 26, 2006, is as follows (in millions, except per share and term amounts):

	Shares	Weighted-Average Exercise Price	Weighted-Average	
			Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at June 30, 2005	557	\$ 11.94		
Grants and acquisition-related assumed options	91	3.26		
Exercises	(27)	2.72		
Forfeitures or expirations	(57)	11.79		
Outstanding at March 26, 2006	564	\$ 11.00	4.4	\$ 385
Exercisable at March 26, 2006	380	\$ 14.47	3.4	\$ 164

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between Sun's closing stock price on the last trading day of our third quarter of fiscal 2006 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 March 26, 2006. This amount changes based on the fair market value of Sun's stock. Total intrinsic value of options exercised is \$21 million and \$41 million for the three and nine months ended March 26, 2006, respectively. Total fair value of options vested is \$18 million and \$109 million for the three and nine months ended March 26, 2006, respectively.

As of March 26, 2006, \$369 million of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted-average period of 3 years.

In July 2005, our Board of Directors approved a one-time targeted recognition and retention program, which included the issuance of approximately 18 million shares of restricted stock to certain employees and executive officers with a purchase price of no greater than \$0.01 per share. These shares of restricted stock generally vest 50% on the first anniversary of the grant date and 50% six months thereafter.

The following table summarizes our restricted stock and restricted stock unit activity for the nine months ended March 26, 2006 (in millions, except per share amounts):

Number of	Weighted-Average Grant Date Fair
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	<u>Shares</u>	<u>Value</u>
Nonvested stock at June 30, 2005	2	\$ 4.80
Granted	42	4.07
Vested		
Forfeited	(1)	3.86
	<u> </u>	
Nonvested stock at March 26, 2006	43	\$ 4.10
	<u> </u>	

As of March 26, 2006, we retained purchase rights to 19 million shares of restricted stock issued pursuant to stock purchase agreements and other stock plans at a weighted-average price of approximately \$0.01.

As of March 26, 2006, \$129 million of total unrecognized compensation costs related to nonvested stock is expected to be recognized over a weighted-average period of two years.

10. Operating Segments

We design, manufacture, market and service network computing infrastructure solutions that consist of Computer Systems (hardware and software), Data Management (hardware and software), Support services, Client solutions and Educational services. Our President and Chief Executive Officer has been identified as the Chief Operating Decision

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Maker (CODM) as defined by SFAS 131, Disclosures About Segments of an Enterprise and Related Information (SFAS 131). 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.

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

We are currently reviewing the impact of our acquisition of StorageTek to our operating segment disclosure and anticipate that it may result in a change in our operating segments. Currently, the storage segment and services segment of StorageTek have been included in Product Group and Services segments, respectively.

We have a Global Sales and Services Organization (GSS) (formerly known as our Global Sales Organization) that is responsible for selling all of our products and managing the majority of our accounts receivable. Our CODM holds this organization accountable for overall products and services revenue and margins at a consolidated level. 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. Our 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 GSS, the WMO and StorageTek's comparable functions 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 GSS and WMO and other miscellaneous functions such as Corporate (in millions):

	Product			
	Group	Services	Other	Total
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Three Months Ended:				
March 26, 2006				
Revenues	\$ 2,035	\$ 1,142	\$	\$ 3,177
Interdivision revenues	58	84	(142)	
Operating income (loss)	379	391	(982)	(212)
March 27, 2005				
Revenues	\$ 1,683	\$ 944	\$	\$ 2,627
Interdivision revenues	141	96	(237)	
Operating income (loss)	258	339	(739)	(142)
Nine Months Ended:				
March 26, 2006				

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Revenues	\$ 5,847	\$ 3,393	\$	\$ 9,240
Interdivision revenues	174	265	(439)	
Operating income (loss)	1,066	1,257	(2,858)	(535)
March 27, 2005				
Revenues	\$ 5,199	\$ 2,897	\$	\$ 8,096
Interdivision revenues	479	300	(779)	
Operating income (loss)	833	1,091	(2,186)	(262)

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11. Legal Proceedings

On April 20, 2004, we were served with a complaint in a case in the United States District Court for the Eastern District of Texas entitled Gobeli Research (Gobeli) v. Sun Microsystems, Inc. and Apple Computer, Inc. (Apple). The complaint alleged that Sun products, including our Solaris Operating System, infringed on a Gobeli patent related to a system and method for controlling interrupt processing. We settled all outstanding claims against us in this case during our third fiscal quarter for an amount that was immaterial to our results of operations and financial condition.

12. Subsequent Events

On April 27, 2006, our Chief Executive Officer and Board of Directors approved our domestic reinvestment plan. As a result, we intend to repatriate up to \$2 billion in unremitted foreign earnings by June 30, 2006, of which \$1.6 billion is eligible to be taxed at a reduced effective tax rate under the Foreign Earnings Repatriation Provision of the American Jobs Creation Act. Upon repatriation, we will incur a tax charge in the range of \$60 million to \$80 million and expect to realize a loss of approximately \$15 million associated with the liquidation of a portion of our marketable debt securities portfolio.

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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 March 26, 2006, and the related condensed consolidated statements of operations for the three-month and nine-month periods ended March 26, 2006 and March 27, 2005, and the condensed consolidated statements of cash flows for the nine-month periods ended March 26, 2006 and March 27, 2005. 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, 2005, 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 12, 2005, 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, 2005, 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

April 21, 2006

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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), Data Management (formerly known as Network Storage) (hardware and software), Support services and Client solutions and Educational services. Sun's solutions are based on major Sun technology innovations such as the Java technology platform, the Solaris operating system (Solaris OS), Sun Java products, the N1 Grid architecture and the UltraSPARC® microprocessor technology, as well as other widely deployed technologies such as the Linux operating system and AMD Opteron® 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 first quarter of fiscal 2006, we leveraged our financial strength to make a strategic acquisition of Storage Technology Corporation (StorageTek). With this acquisition, we broadened our system strategy by offering our customers a complete range of storage products, services and solutions including StorageTek's Information Lifecycle Management (ILM) products, where we enable businesses to align the cost of storage with the value of information. We completed our acquisition of StorageTek on August 31, 2005. As a result, the results of operations for the nine months ended March 26, 2006 included the results for StorageTek from the date of acquisition. StorageTek has historically experienced a disproportionately high product revenue volume in the last month of each fiscal quarter. Therefore, the results of operations included for the nine months ended March 26, 2006 are not indicative of the results for a full nine months. StorageTek's products revenues are included in Data Management products and StorageTek's services revenues are included in Support services. Our discussion of our results of operations currently separately identifies the impact of the acquisition of StorageTek, however, as our integration activities proceed, it is likely that we will no longer be able to accurately provide such information in the future.

During the third quarter of fiscal 2006, we experienced a year over year increase in total net revenues of approximately 21%, which included an unfavorable foreign currency impact of approximately 4%. Excluding the revenues from StorageTek, we saw a year over year increase of 4% primarily due to the increase in our Products net revenue. Our Products net revenue of \$2,035 million was favorably impacted by \$244 million of storage revenue related to the operations of StorageTek and increased sales of our entry level servers due to the introduction of certain UltraSPARC IV+ and Opteron-based systems as well as an increase in the sales of other UltraSPARC IV systems. These increases were partially offset by reduced sales of our enterprise servers resulting from intense competition and a continuing shift in overall computer system demand towards our lower-priced entry-level systems. Our Services net revenue of \$1,142 million was favorably impacted by \$210 million of services revenue related to the operations of StorageTek. Excluding the revenues from StorageTek, Services net revenue was relatively flat and was impacted by a continued change in the mix towards maintenance contracts sold or renewed with lower levels of services and a shift in product sales mix to a greater proportion of low-end products, which are typically sold with reduced levels of services, offset by an increase in our on-site support and managed services revenue. Sequentially, we also experienced a decrease in total net revenues of approximately 5%, which reflects the normal seasonal decrease we experience between the second and third quarter.

During the third quarter of fiscal 2006, our year over year total gross margin increased by approximately 1.6 percentage points. Our year over year Products gross margin increased by approximately 1.3 percentage points as manufacturing and component cost reductions were partially

offset by the unfavorable impact of discounting and pricing actions and an increase in amortization of our other acquisition-related intangible assets. Our year over year Services gross margin increased by 2.3 percentage points primarily due to the favorable impact of delivery efficiencies, offset by sales discounting actions and inefficiencies realized from decreased sales volume over a fixed cost base. Our sequential quarterly Products gross margin increased 1.4 percentage points as cost reductions were partially offset by

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changes in product mix to a greater proportion of lower-margin products. Sequentially, Services gross margin decreased by 1.2 percentage points primarily due to continued change in sales mix towards maintenance contracts sold or renewed with lower services levels and a shift in product sales mix to a greater proportion of low-end products, which are typically sold with reduced levels of services.

During the third quarter of fiscal 2006, as compared with the corresponding period of fiscal 2005, our research and development expenses increased \$73 million and our sales, general and administrative expenses increased \$285 million. These increases were primarily due to the inclusion of operating expenses related to StorageTek, an increase in amortization of other acquisition-related intangible assets and stock-based compensation expense. Sequentially, our quarterly research and development expenses decreased \$18 million and our sales, general and administrative expenses decreased \$36 million primarily due to a reduction in other acquisition-related intangible asset amortization.

Our results of operations for the third quarter and first nine months of fiscal 2006 were significantly impacted by the adoption of Statement of Financial Accounting Standards (SFAS) 123R (revised 2004), Share-Based Payments (SFAS 123R) in the first quarter of fiscal 2006, which required us to recognize a non-cash expense related to the fair value of our stock-based compensation awards. We elected to use the modified prospective transition method of adoption requiring us to include this stock-based compensation charge in our results beginning in the first quarter of 2006 without restating prior periods to include stock-based compensation expense. Of the \$57 million in stock-based compensation expense recognized in the third quarter of fiscal 2006, \$3 million is included in cost of goods sold-products, \$7 million is included in cost of goods sold-services, \$19 million is included in research and development expense and \$28 million is included in sales, general and administrative expense. Of the \$162 million in stock-based compensation expense recognized in the first nine months of fiscal 2006, \$8 million is included in cost of goods sold-products, \$21 million is included in cost of goods sold-services, \$54 million is included in research and development expense and \$79 million is included in sales, general and administrative expense.

During the first nine months of fiscal 2006, our operating activities provided cash flows of \$230 million. Our focus on cash management remains a top priority and we plan to continue to drive improvement in our cash conversion cycle. At March 26, 2006 we had total cash, cash equivalents and marketable debt securities of approximately \$4.4 billion, which decreased from \$7.5 billion as of June 30, 2005, primarily due to cash paid for our acquisitions of StorageTek and SeeBeyond during the first quarter of fiscal 2006.

Critical Accounting Policies and Estimates

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 (U.S. GAAP). 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 cannot be forecast with certainty 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. Except as noted below for equity investments in privately-held companies, 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.

We believe there have been no significant changes during the first nine months of fiscal 2006 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 2005 Form 10-K, except as noted below.

In the first quarter of fiscal 2006, we determined that our equity investments in privately held companies accounting policy was no longer critical, as the remaining balance related to investments in privately held companies was no longer material.

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We are required to allocate the purchase price of acquired companies to the tangible and intangible assets acquired, liabilities assumed, as well as IPRD based on their estimated fair values. We engage independent third-party appraisal firms to assist us in determining the fair values of assets acquired and liabilities assumed. This valuation requires management to make significant estimates and assumptions, especially with respect to long-lived and intangible assets.

Critical estimates in valuing certain of the intangible assets include but are not limited to: future expected cash flows from customer contracts, customer lists, distribution agreements, and acquired developed technologies and patents; expected costs to develop the IPRD into commercially viable products and estimating cash flows from the projects when completed; the acquired company's brand awareness and market position, as well as assumptions about the period of time the brand will continue to be used in the combined company's product portfolio; and discount rates. Management's estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur.

Other estimates associated with the accounting for these acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed. In particular, liabilities to restructure the pre-acquisition organization, including workforce reductions, are subject to change as management completes its assessment of the pre-merger operations and begins to execute the approved plan.

Stock-Based Compensation Expense

We account for stock-based compensation in accordance with the provisions of SFAS 123R. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the award and is recognized as expense ratably over the requisite service period of the award. Determining the appropriate fair value model and calculating the fair value of stock-based awards requires judgment, including estimating stock price volatility, forfeiture rates and expected lives.

RESULTS OF OPERATIONS**Net Revenues**

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

<u>Three Months Ended</u>			<u>Nine Months Ended</u>		
March 26,	March 27,	<u>Change</u>	March 26,	March 27,	<u>Change</u>
2006	2005		2006	2005	

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Computer Systems products	\$ 1,474	\$ 1,391	6.0%	\$ 4,186	\$ 4,250	(1.5)%
Data Management products	561	292	92.1%	1,661	949	75.0%
Products net revenue	\$ 2,035	\$ 1,683	20.9%	\$ 5,847	\$ 5,199	12.5%
Percentage of total net revenues	64.1%	64.1%	pts	63.3%	64.2%	(0.9) pts
Support services	\$ 904	\$ 734	23.2%	\$ 2,692	\$ 2,253	19.5%
Client solutions and Educational services	238	210	13.3%	701	644	8.9%
Services net revenue	\$ 1,142	\$ 944	21.0%	\$ 3,393	\$ 2,897	17.1%
Percentage of total net revenues	35.9%	35.9%	pts	36.7%	35.8%	0.9 pts
Total net revenues	\$ 3,177	\$ 2,627	20.9%	\$ 9,240	\$ 8,096	14.1%
Revenue per employee ⁽¹⁾	\$ 83	\$ 82	1.2%	\$ 241	\$ 248	(2.8)%

- (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.

In recent periods, our services business has evolved as we have increased our emphasis on our solutions-based selling model and offerings, such as Managed services, that are not easily measured using prior disclosed metrics. As a result of these changes, we believe the importance of the services contract penetration rate to understanding of the performance of our services business has diminished. Accordingly, beginning in the first quarter of fiscal 2006, we are

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no longer including our service contract penetration rate as a key performance indicator. In addition, as a result of our acquisition of StorageTek, we are conducting an evaluation of the key performance indicators used to manage our business and anticipate changes.

Due to the generally strengthened U.S. dollar during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, our total net revenues were unfavorably impacted by foreign currency exchange rates. The net foreign currency impact to our total net revenues is difficult to precisely measure. However, our best estimate of the foreign exchange rate impact during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, approximated 4% and 2%, respectively, of Products net revenue and approximated 4% and 2%, respectively, of Services net revenue.

Products Net Revenue

Products net revenue consists of revenue generated from the sale of Computer Systems and Data Management products.

During the third quarter of fiscal 2006, as compared with the corresponding period in fiscal 2005, Computer Systems revenue increased primarily due to increased sales of our entry level servers due to the introduction of certain UltraSPARC IV+ and Opteron-based systems as well as an increase in sales for other UltraSPARC IV systems. This increase was partially offset by reduced sales of our enterprise servers resulting from intense competition and a continuing shift in overall computer system demand towards the usage of our lower-priced entry-level systems. However, during the first nine months of fiscal 2006, as compared with the corresponding period in fiscal 2005, Computer Systems revenue decreased as reduced sales of our enterprise and data center servers were only partially offset by increased sales of our entry level servers.

During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods in fiscal 2005, Data Management Products revenue included \$244 million and \$739 million, respectively, related to the operations of StorageTek, primarily the sales of their tape and network storage products. Excluding the revenues from StorageTek, Data Management products revenue increased by \$25 million and decreased by \$27 million during the third quarter and first nine months of fiscal 2006, respectively. The increase during the third quarter of fiscal 2006 was primarily due to increased sales of our data center storage systems, partially offset by reduced sales of our entry level storage systems. The decrease during the first nine months of fiscal 2006 was primarily due to reduced sales of our entry level storage systems, only partially offset by increased sales of our data center storage systems.

Services Net Revenue

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

Support services revenue consists primarily of maintenance contract revenue, which is recognized ratably over the contractual period. During the third quarter and first nine months of fiscal 2006, Support services net revenue included \$185 million and \$465 million, respectively, related to the operations of StorageTek. Excluding the revenues from StorageTek, Support services revenues decreased by \$15 million and \$26 million during the third quarter and first nine months of fiscal 2006, respectively, as compared with the corresponding periods in fiscal 2005. These decreases were primarily due to the unfavorable impact of foreign exchange, a continued change in the mix towards maintenance contracts sold or renewed with lower service levels and a shift in product sales mix to a greater proportion of low-end products, which are typically sold with reduced levels of services. These decreases were partially offset by increases in our site support and managed services revenues.

Client solutions and Educational services revenue consist primarily of revenue generated from professional services, such as technical consulting that helps our customers plan, implement, and manage distributed network computing environments. During the third quarter and first nine months of fiscal 2006, Client solutions and Educational services revenue included \$25 million and \$60 million, respectively, related to the operations of StorageTek. Excluding the revenues from StorageTek, Client solutions and Educational services revenue was relatively flat during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods in fiscal 2005. During the first nine months of fiscal 2006, as compared with the first nine months of fiscal 2005, revenue decreased due to solution-based sales to a health care services provider and an educational institution recognized in the first quarter of fiscal 2005 which did not recur in fiscal 2006. However, this decrease was offset by an increase in revenues from employee development and web-learning initiatives adopted by our customers during the first nine months of fiscal 2006.

Table of Contents**Net Revenues by Geographic Area**

(dollars in millions)

	<u>Three Months Ended</u>			<u>Nine Months Ended</u>		
	<u>March 26,</u>	<u>March 27,</u>	<u>Change</u>	<u>March 26,</u>	<u>March 27,</u>	<u>Change</u>
	<u>2006</u>	<u>2005</u>		<u>2006</u>	<u>2005</u>	
United States (U.S.)	\$ 1,325	\$ 982	34.9%	\$ 3,857	\$ 3,217	19.9%
Percentage of total net revenues	41.7%	37.4%	4.3 pts	41.7%	39.7%	2.0pts
International Americas (Canada and Latin America)	\$ 207	\$ 144	43.8%	\$ 542	\$ 418	29.7%
Percentage of total net revenues	6.5%	5.5%	1.0 pts	5.9%	5.2%	0.7pts
EMEA (Europe, Middle East and Africa)	\$ 1,119	\$ 1,009	10.9%	\$ 3,328	\$ 3,019	10.2%
Percentage of total net revenues	35.2%	38.4%	(3.2) pts	36.0%	37.3%	(1.3) pts
APAC (Asia, Australia and New Zealand)	\$ 526	\$ 492	6.9%	\$ 1,513	\$ 1,442	4.9%
Percentage of total net revenues	16.6%	18.7%	(2.1) pts	16.4%	17.8%	(1.4) pts
Total International revenues	\$ 1,852	\$ 1,645	12.6%	\$ 5,383	\$ 4,879	10.3%
Percentage of total net revenues	58.3%	62.6%	(4.3) pts	58.3%	60.3%	(2.0) pts
Total net revenues	\$ 3,177	\$ 2,627	20.9%	\$ 9,240	\$ 8,096	14.1%

United States (U.S.)

During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, net revenues in the U.S. included \$222 million and \$618 million, respectively, related to the operations of StorageTek and \$9 million and \$26 million, respectively, related to the operations of SeeBeyond. Excluding revenues from StorageTek and SeeBeyond, net revenues in the U.S. increased \$112 million and decreased by \$4 million during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, respectively. We experienced increased sales of our entry level servers due to the introduction of certain UltraSPARC IV+ and Opteron-based systems in the second quarter of fiscal 2006 as well as increased sales of other UltraSPARC IV systems primarily as a result of increased demand in the telecommunications sector.

The following table sets forth net revenues in those geographic markets that contributed significantly to international net revenues during the third quarter and first nine months of fiscal 2006:

(dollars in millions)

<u>Three Months Ended</u>		<u>Change</u>	<u>Nine Months Ended</u>		<u>Change</u>
<u>March 26,</u>	<u>March 27,</u>		<u>March 26,</u>	<u>March 27,</u>	

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	<u>2006</u>	<u>2005</u>		<u>2006</u>	<u>2005</u>	
United Kingdom (UK)	\$ 276	\$ 237	16.5%	\$ 792	\$ 752	5.3%
Germany	\$ 209	\$ 213	(1.9)%	\$ 682	\$ 632	7.9%
Central and Northern Europe	\$ 207	\$ 199	4.0%	\$ 576	\$ 572	0.7%
Japan	\$ 198	\$ 184	7.6%	\$ 557	\$ 517	7.7%

United Kingdom (UK)

During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, net revenues in the UK included \$34 million and \$98 million, respectively, related to the operations of StorageTek. Excluding the revenues from StorageTek, net revenues in the UK increased by \$5 million and decreased by \$58 million during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, respectively. The increase in the third quarter of fiscal 2006 was primarily due to moderate growth in Products and Client Solutions revenue and improvements in the financial services and government sectors, partially offset by the unfavorable impact of foreign currency. The decrease in the first nine months of fiscal 2006 was primarily due to revenue related to two large solution-based sales recognized in the first quarter of fiscal 2005 which did not recur in the first quarter of fiscal 2006.

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During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, net revenues in Germany included \$31 million and \$82 million, respectively, related to the operations of StorageTek. Excluding the revenues from StorageTek, net revenues in Germany decreased by \$35 million and \$32 million during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, respectively. Net revenues in Germany were impacted by intense competition, continuing weak demand for our data center servers in certain industry sectors and the unfavorable impact of foreign currency exchange, partially offset by an increase in sales of our entry-level products.

Central and Northern Europe (CNE)

During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, net revenues in CNE included \$25 million and \$86 million, respectively, related to the operations of StorageTek. Excluding the revenues from StorageTek, net revenues in CNE decreased by \$17 million and \$82 million during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, respectively, primarily due to the weak demand for our data center servers, a challenging macroeconomic environment and the unfavorable impact of foreign currency.

Japan

During the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, net revenues in Japan included \$23 million and \$65 million related to the operations of StorageTek. Excluding the revenues from StorageTek, net revenues in Japan decreased by \$9 million and \$25 million during the third quarter and first nine months of fiscal 2006, as compared with the corresponding periods of fiscal 2005, respectively, primarily due to a decrease in Products net revenue. The decrease in Products net revenue in Japan was due to the unfavorable impact of foreign currency exchange and continued intense competition in the telecommunication sector.

Gross Margin

(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 26, 2006	March 27, 2005	Change	March 26, 2006	March 27, 2005	Change
Products gross margin	\$ 883	\$ 708	24.7%	\$ 2,506	\$ 2,155	16.3%
Percentage of products net revenue	43.4%	42.1%	1.3 pts	42.9%	41.5%	1.4pts
Services gross margin	\$ 484	\$ 379	27.7%	\$ 1,484	\$ 1,203	23.4%

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Percentage of services net revenue	42.4%	40.1%	2.3pts	43.7%	41.5%	2.2pts
Total gross margin	\$ 1,367	\$ 1,087	25.8%	\$ 3,990	\$ 3,358	18.8%
Percentage of total net revenues	43.0%	41.4%	1.6pts	43.2%	41.5%	1.7pts

Products Gross Margin

Products gross margin percentage is influenced by numerous factors including product volume and mix, pricing, geographic mix, foreign currency exchange rates, the mix between sales to resellers and end-users, third-party costs (including both raw material and manufacturing costs), 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 third quarter of fiscal 2006, as compared with the corresponding period of fiscal 2005, our Products gross margin increased by 1.3 percentage points. This increase is primarily related to cost reductions resulting from supply

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chain restructuring and product cost engineering which collectively benefited gross margin by approximately 7 percentage points and a reduction in channel program and other reserves of approximately 1 percentage point. These increases were partially offset by planned list price reductions and sales discounting actions of approximately 4 percentage points, changes in product mix to a greater proportion of lower-margin products of approximately 3 percentage points and an increase in amortization of acquisition-related intangible assets of approximately 2 percentage points.

During the first nine months of fiscal 2006, as compared with the corresponding period of fiscal 2005, our Products gross margin increased 1.4 percentage points due to cost reductions resulting from supply chain restructuring and product cost engineering which collectively benefited gross margin by approximately 3 percentage points. Offsetting this increase was changes in product mix to a greater proportion of lower-margin products of approximately 2 percentage points and an increase in amortization of acquisition-related intangible assets of approximately 1 percentage point.

Services Gross Margin

Services gross margin percentage is influenced by numerous factors including services mix, pricing, geographic mix, foreign 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 third quarter of fiscal 2006, as compared with the corresponding period of fiscal 2005, our Services gross margin increased by 2.3 percentage points due to cost savings associated with delivery efficiencies of approximately 7 percentage points. Offsetting this increase was sales discounting actions of approximately 2 percentage points and inefficiencies realized from decreased sales volume over a fixed cost base of approximately 2 percentage points.

During the first nine months of fiscal 2006, as compared with the corresponding period of fiscal 2005, our Services gross margin increased by 2.2 percentage points due to cost savings associated with delivery efficiencies of approximately 5 percentage points. Offsetting this increase was sales discounting actions of approximately 1 percentage point and inefficiencies realized from decreased sales volume over a fixed cost base of approximately 1 percentage point.

Operating Expenses

(dollars in millions)

<u>Three Months Ended</u>			<u>Nine Months Ended</u>		
<u>March 26,</u>	<u>March 27,</u>		<u>March 26,</u>	<u>March 27,</u>	
<u>2006</u>	<u>2005</u>	<u>Change</u>	<u>2006</u>	<u>2005</u>	<u>Change</u>

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Research and development	\$ 523	\$ 450	16.2%	\$ 1,503	\$ 1,313	14.5%
Percentage of total net revenues	16.5%	17.1%		16.3%	16.2%	
Selling, general and administrative	\$ 1,020	\$ 735	38.8%	\$ 2,904	\$ 2,131	36.3%
Percentage of total net revenues	32.1%	28.0%		31.4%	26.3%	
Restructuring charges	\$ 36	\$ 44	(18.2)%	\$ 58	\$ 176	(67.0)%
Percentage of total net revenues	1.1%	1.7%		0.6%	2.2%	
Purchased in-process research and development	\$	\$	N/M*	\$ 60	\$	N/M*
Percentage of total net revenues	%	%		0.6%	%	
Total operating expenses	\$ 1,579	\$ 1,229	28.5%	\$ 4,525	\$ 3,620	25.0%

* N/M Not meaningful

Research and Development (R&D) Expenses

R&D expenses increased by \$73 million during the third quarter of fiscal 2006, as compared with the corresponding period of fiscal 2005, primarily due to \$62 million associated with the R&D expenses of StorageTek and SeeBeyond,

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\$19 million in stock-based compensation expense and a \$15 million increase in prototype expenses associated with new product introductions. These increases were partially offset by a \$14 million decrease in depreciation and amortization.

R&D expenses increased by \$190 million during the first nine months of fiscal 2006, as compared with the corresponding period of fiscal 2005, primarily due to \$148 million associated with the R&D expenses of StorageTek and SeeBeyond, \$54 million of stock-based compensation expense and a \$32 million increase in prototype expenses associated with new product introductions. These increases were partially offset by a \$39 million decrease in depreciation and amortization.

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 increased by \$285 million during the third quarter of fiscal 2006, as compared with the corresponding period of fiscal 2005, primarily due to \$178 million associated with the SG&A expenses of StorageTek and SeeBeyond and \$40 million in other acquisition-related intangible asset amortization resulting from these acquisitions. The remainder of the increase is due to a \$62 million increase in outside services costs and \$28 million of stock-based compensation expense, partially offset by \$21 million decrease in variable compensation.

SG&A expenses increased by \$773 million during the first nine months of fiscal 2006, as compared with the corresponding period of fiscal 2005, primarily due to \$453 million associated with the SG&A expenses of StorageTek and SeeBeyond and \$117 million in other acquisition-related intangible asset amortization resulting from these acquisitions. The remainder of the increase is due to a \$125 million increase in outside services costs and \$79 million of stock-based compensation expense. These increases were partially offset by \$39 million in cost savings resulting from workforce reductions and \$25 million decrease in depreciation and amortization.

We are continuing to focus our efforts on achieving additional operating efficiencies by reviewing and improving upon our existing business processes and cost structure.

Restructuring Costs

In accordance with SFAS 112, *Employers' Accounting for Post Employment Benefits* (SFAS 112) and SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146), we recognized a total of \$36 million and \$58 million in restructuring charges in the three and nine months ended March 26, 2006, respectively, and \$44 million and \$176 million for the three and nine months ended March 27, 2005, respectively. In addition, we incurred restructuring related costs associated with acquisitions that are not included as expenses within our consolidated results of operations. This is because U.S. GAAP requires these costs to be recorded as assumed liabilities in our Consolidated Balance Sheets as of the date of acquisition. Our material restructuring related assumed liabilities are disclosed below in the section entitled *Acquisition-related Restructuring Costs*.

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We estimated the cost of exiting and terminating our facility leases or acquired leases by referring to the contractual terms of the agreements and by evaluating the current real estate market conditions. In addition, we have estimated sublease income by evaluating the current real estate market conditions or, where applicable, by referring to amounts being negotiated. As of March 26, 2006, our estimated sublease income to be generated from sublease contracts not yet negotiated approximated \$63 million. 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 commercial real estate market conditions in certain geographies at the time we perform our evaluations or 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 and could be subject to adjustment as market conditions change.

Restructuring Plan V

In June 2005, we implemented a workforce reduction and in July 2005, we committed to a facility exit plan (Restructuring Plan V). In a continuing effort to improve our cost structure and improve operating efficiencies, we

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planned to reduce our workforce by approximately 1,000 employees across all employee levels, business functions, operating units and geographic regions. Through the nine months ended March 26, 2006, we reduced our workforce by approximately 700 employees under this plan. In the three and nine months ended March 26, 2006, we recognized a total of \$27 million and \$49 million, respectively, in charges associated with Restructuring Plan V, consisting solely of workforce reduction charges. In addition, we plan to eliminate excess facility capacity in light of revised facility requirements.

During the fourth quarter of fiscal 2006, we will be conducting a detailed operational, organizational, product and facility review of the entire company.

We anticipate recording 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 employees leaving Sun as determined by local employment laws and as we exit facilities. 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.

Restructuring Plans Prior to Phase V

In March 2004, we implemented 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 (Restructuring Plan IV). 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 fiscal 2005, we reduced our workforce by approximately 4,150 employees under this plan. As of March 26, 2006, all employees to be terminated as a result of Restructuring Plan IV had been notified. While most of the severance and related fringe benefits have been paid, in accordance with local employment laws, we expect to pay the remaining restructuring accrual related to severance over the next few quarters.

We committed to restructuring plans in fiscal 2004, 2003 and 2002 (Restructuring Plans IV, III and II, respectively) and a facility exit plan in fiscal 2001 (Facility Exit Plan I). These plans included eliminating excess facility capacity in light of revised facility requirements and other actions. We recorded initial restructuring charges in fiscal 2004, 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 markets in certain geographies, and the final settlement of certain lease obligations, we have made appropriate adjustments to the initial restructuring charges. These changes to the previous estimates have been reflected as Provision adjustments in the period the changes in estimates were made. Accrued lease costs during fiscal 2006 primarily relate to accretion expense.

All facilities relating to the amounts accrued under these restructuring plans were exited by June 30, 2005.

The following table sets forth an analysis of our restructuring accrual activity for the nine months ended March 26, 2006 (in millions):

Restructuring Plan V	Restructuring Plan IV	Restructuring Plan III	Restructuring Plan II	Facility Exit Plan I
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	Severance and Benefits	Severance and Benefits	Facilities Related and Other	Facilities Related	Facilities Related	Facilities Related	
Balance as of June 30, 2005	\$ 44	\$ 37	\$ 157	\$ 77	\$ 129	\$ 26	\$ 470
Severance and benefits	49	5					47
Accrued lease costs			8				8
Provision adjustments			(1)	(2)	2	(3)	3
Total restructuring charges	49	5	7	(2)	2	(3)	58
Cash paid	(61)	(31)	(35)	(14)	(15)	(11)	(167)
Balance as of March 26, 2006	\$ 32	\$ 11	\$ 129	\$ 61	\$ 116	\$ 12	\$ 361

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The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of March 26, 2006 for facility-related leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2023. As of March 26, 2006, \$114 million of the total \$361 million accrual for workforce reductions and facility-related leases was classified as current accrued liabilities and other and the remaining \$247 million was classified as other non-current obligations.

Acquisition-related restructuring costs

As a result of our acquisition of StorageTek, we recorded preliminary acquisition-related restructuring costs associated with the costs of integrating operating locations and activities of StorageTek with those of Sun. As noted above, U.S. GAAP requires that these acquisition-related restructuring costs, which are not associated with the generation of future revenues and have no future economic benefit, be recorded as assumed liabilities in the allocation of the purchase price. As a result, during the nine months ended March 26, 2006, we recorded approximately \$70 million of restructuring costs in connection with the StorageTek acquisition, which are based upon plans committed to by management. These costs were accounted for under EITF 95-3, Recognition of Liabilities in Connection with Purchase Business Combinations, and accordingly were recognized as restructuring liabilities assumed in the business combination. The following table sets forth an analysis of the components of the preliminary acquisition-related restructuring liabilities included in the purchase price allocation for StorageTek for the nine months ended March 26, 2006 (in millions):

	Severance and Benefits	Facilities Related	Total
	<u> </u>	<u> </u>	<u> </u>
Balance as of June 30, 2005	\$	\$	\$
Acquisition-related restructuring liabilities	26	44	70
Cash paid	(12)	(2)	(14)
	<u> </u>	<u> </u>	<u> </u>
Balance as of March 26, 2006	<u>\$ 14</u>	<u>\$ 42</u>	<u>\$ 56</u>

As of March 26, 2006, our estimated sublease income to be generated from sublease contracts not yet negotiated approximated \$8 million.

The acquisition-related restructuring costs are based on our integration plan which focuses principally on the elimination of duplicative activities. The balance of the StorageTek workforce reduction at March 26, 2006 is expected to be utilized during the remainder of fiscal 2006 and fiscal 2007 and is expected to be funded through cash flows from the combined operations. Certain aspects of the integration plan are still being finalized, including the evaluation of acquired facilities and workforce. Any changes resulting from the finalization of the integration plan could result in adjustments to our current estimates. As permitted under U.S. GAAP, these adjustments would be reflected in the allocation of the purchase price if made within twelve months from the date of acquisition.

Purchased In-Process Research and Development (IPRD)

Overview

In the first nine months of fiscal 2006, we recorded total IPRD expense of \$60 million related to our acquisitions of StorageTek and SeeBeyond. At the date of each acquisition, the projects associated with the IPRD efforts had not yet reached technological feasibility and the IPRD had no alternative future uses. Accordingly, these amounts were expensed on the respective acquisition dates of each of the Acquired Companies.

Also see Note 3 to the Condensed Consolidated Financial Statements for further discussion.

Preliminary valuation

Through the use of an independent third party, we have estimated the fair value of IPRD using the income approach. These calculations gave consideration to relevant market sizes and growth factors, expected industry trends, the anticipated nature and timing of new product introductions by us and our competitors, individual product sales cycles, and the estimated lives of each of the products underlying technology. The value of the IPRD reflects the relative

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value and contribution of the acquired research and development. In determining the value assigned to IPRD, we considered the R&D's stage of completion, the complexity of the work completed to date, the difficulty of completing the remaining development, costs already incurred and the projected cost to complete the project.

The values assigned to developed technologies related to each acquisition were based upon discounted cash flows related to the existing products projected income stream. Elements of the projected income stream included revenues, cost of sales (COS), R&D expenses and SG&A expenses. The discount rates used in the present value calculations were generally derived from a weighted average cost of capital, adjusted upward to reflect the additional risks inherent in the development life cycle, including the useful life of the technology, profitability levels of the technology, and the uncertainty of technology advances that are known at the date of each acquisition. Because each acquired entity's IPRD is unique, the discount rate, revenue, COS, R&D and SG&A assumptions used varied on a case-by-case basis.

Preliminary valuation assumptions

The following bullets summarize the significant assumptions underlying the preliminary valuation related to IPRD as of the relevant acquisition dates:

Acquisition of StorageTek We acquired \$49 million in IPRD related to nine projects within StorageTek's tape, disk and network product lines. At the date of acquisition, we estimated that development efforts were generally 50% - 60% complete and that approximately \$56 million in additional cost were required to complete development. Release dates range from the third quarter of fiscal 2006 to the second quarter of fiscal 2007.

Acquisition of SeeBeyond We acquired \$11 million in IPRD related to the development of ICAN version 5.1. At the date of acquisition, we estimated that development efforts were 75% complete and that approximately \$3 million in additional costs were required to complete development. The completion date for Java Composite Application Platform Suite (formerly known as ICAN 5.1) was the third quarter of fiscal 2006.

Given the uncertainties of the commercialization process, no assurances can be given that deviations from our estimates will not occur. At the time of the acquisitions, we believed there was a reasonable chance of realizing the economic return expected from the acquired in-process technology. However, as there is risk associated with the realization of benefits related to commercialization of an in-process project due to rapidly changing customer needs, the complexity of technology, and growing competitive pressures, there can be no assurance that any project will meet commercial success. Failure to successfully commercialize an in-process project would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of our intangible assets may become impaired.

Gain on Equity Investments, net

(dollars in millions)

Three Months Ended	Change	Nine Months Ended	Change
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	March 26,		100%	March 26,		N/M*
	March 27,			March 27,		
	2006	2005		2006	2005	
Gain on equity investments, net	\$ 4	\$ 2		\$ 31	\$ 7	N/M*

* N/M Not meaningful

In the third quarter of fiscal 2006, our gain on equity investments, net, was favorably impacted by \$6 million in gains on the sale of certain marketable equity investments in privately held companies. In the first nine months of fiscal 2006, our gain on equity investment, net, was favorable impacted by \$11 million in gains on the sale of certain marketable equity investments held in publicly traded companies, \$11 million in gains on warrants and \$9 million in gains on the sale of certain equity investments in privately held companies.

As of March 26, 2006, our equity investment portfolio of \$72 million consisted of \$23 million in marketable equity securities, \$30 million in equity investments in privately held companies and \$19 million in investments in venture capital funds and joint ventures. The ongoing valuation of our investment portfolio remains uncertain and may be subject to fluctuations based on whether we participate in additional investment activity or as a result of the occurrence of events outside of our control.

Table of Contents**Interest and Other Income, net**

(dollars in millions)

	<u>Three Months Ended</u>			<u>Nine Months Ended</u>		
	<u>March 26,</u>	<u>March 27,</u>	<u>Change</u>	<u>March 26,</u>	<u>March 27,</u>	<u>Change</u>
	<u>2006</u>	<u>2005</u>		<u>2006</u>	<u>2005</u>	
Interest and other income, net	\$ 26	\$ 91	(71.4)%	\$ 95	\$ 155	(38.7)%
Percentage of total net revenues	0.8%	3.5%		1.0%	1.9%	

In the third quarter and first nine months of fiscal 2006, as compared with the corresponding period of fiscal 2005, interest and other income, net, decreased \$65 million and \$60 million, respectively. These decreases were primarily due to \$54 million received from Microsoft in the third quarter of fiscal 2005 associated with a limited patent covenant and standstill agreement which will not reoccur until the fourth quarter of fiscal 2006. These decreases were also attributable to the reduction in cash equivalents and marketable debt securities following the acquisitions of StorageTek and SeeBeyond.

As of March 26, 2006, the average duration of our portfolio of marketable debt securities decreased to 0.55 years from 0.81 years at March 27, 2005. The decrease of 0.26 years is primarily related to a repositioning of the portfolio due to a rising interest rate environment. In general, we would expect the volatility of this portfolio to decrease as its duration decreases.

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.

On April 27, 2006, our Chief Executive Officer and Board of Directors approved our domestic reinvestment plan. As a result, we will repatriate up to \$2 billion in unremitted foreign earnings by June 30, 2006, and expect to realize a loss of approximately \$15 million associated with the liquidation of a portion of our marketable debt securities portfolio.

Income Taxes

(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 26,	March 27,	Change	March 26,	March 27,	Change
	2006	2005		2006	2005	
Provision for (benefit from) income taxes	\$ 35	\$ (21)	N/M*	\$ 154	\$ 57	N/M*

* N/M Not meaningful

For the third quarter and first nine months of fiscal 2006, we recorded an income tax provision of \$35 million and \$154 million, respectively, compared with a tax benefit of \$21 million and tax provision of \$57 million for the corresponding periods of fiscal 2005. These tax provisions were primarily recorded for taxes due on income generated in certain state and foreign tax jurisdictions.

Our income tax provision during the first nine months of fiscal 2006, included a charge recorded in the second quarter associated with corrections of previously filed tax returns. This charge was partially offset by a benefit recorded in the third quarter associated with adjusting estimated amounts to actual liabilities resulting from the filing of prior years' tax returns. These adjustments are immaterial to our results of operations and financial condition for the current period as well as the prior affected periods.

On April 27, 2006, our Chief Executive Officer and Board of Directors approved our domestic reinvestment plan. As a result, we will repatriate up to \$2 billion in unremitted foreign earnings by June 30, 2006, of which \$1.6 billion is eligible to be taxed at a reduced effective tax rate under the Foreign Earnings Repatriation Provision of the American Jobs Creation Act. Upon repatriation, we will incur a tax charge in the range of \$60 million to \$80 million.

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We currently have provided a full valuation allowance on our U.S. deferred tax assets and a full or partial valuation allowance on certain overseas 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.

During the third quarter of fiscal 2006, we received a revenue agent report from the Internal Revenue Service relating to their examination of our tax returns filed for fiscal years 2001 and 2002. Pursuant to the report, the Internal Revenue Service has proposed various adjustments resulting in additional tax of approximately \$27 million. On April 17, 2006, we filed a protest with the Internal Revenue Service to contest several items. Although the ultimate outcome is unknown, we believe that we have adequately reserved for these potential adjustments and the final outcome will not have a material adverse affect on our results of operations.

We have also provided adequate amounts for other anticipated tax audit adjustments in the U.S., state and foreign tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes and interest may be due. In addition, although specific foreign country transfer pricing exposures have not been identified, the risk of potential adjustment exists. If our estimate of the federal, state and foreign income tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result. 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.

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 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. On July 1, 2005, we adopted the provisions of SFAS 123R, requiring us to recognize expense related to the fair value of our stock-based compensation awards. We elected the modified prospective transition method as permitted by SFAS 123R. Under this transition method, stock-based compensation expense for the three and nine months ended March 26, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and compensation expense for all stock-based compensation awards granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. See Note 9 to our Consolidated Financial Statements for further detail, including the impact of the adoption to our Consolidated Statements of Operations.

Table of Contents**Equity Compensation Plan Information**

A summary of our stockholder approved and non-approved equity compensation plans as of March 26, 2006 is as follows (in millions, except exercise price amounts):

<u>Plan Category</u>	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (in dollars)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans
Equity compensation plans approved by security holders (excluding ESPP)	517	\$ 11.44	230