

SUN MICROSYSTEMS INC
Form 10-K
September 29, 2003
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

—————
FORM 10-K

(Mark One)

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

For the fiscal year ended June 30, 2003

**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 of incorporation)

**4150 Network Circle
Santa Clara, CA 95054**

(Address of principal executive offices,
including zip code)

94-2805249

(I.R.S. Employer Identification No.)

(650) 960-1300

(Registrant's telephone number, including area code)

<http://www.sun.com/aboutsun/investor>

(Registrant's url)

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

* **Common Stock**

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

* Share Purchase Rights

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant, as of December 27, 2002 (the last business day of registrant's second quarter of fiscal 2003), was approximately \$10.2 billion based upon the last sale price reported for such date on The Nasdaq National Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 5% of the outstanding shares of Common Stock and shares held by officers and directors of the Registrant have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive.

The number of shares of the registrant's Common Stock (par value \$0.00067) outstanding as of September 15, 2003 was 3,240,726,143.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the 2003 Annual Meeting of Stockholders are incorporated by reference into Items 10, 11, 12 and 13 hereof.

Table of Contents

INDEX

PART I

<u>Item 1.</u>	Business	3
<u>Item 2.</u>	Properties	12
<u>Item 3.</u>	Legal Proceedings	12
<u>Item 4.</u>	Submission of Matters to a Vote of Security Holders	

	Executive Officers of the Registrant	14
--	--------------------------------------	----

PART II

<u>Item 5.</u>	Market for Registrant's Common Equity and Related Stockholder Matters	17
<u>Item 6.</u>	Selected Financial Data	18
<u>Item 7.</u>	Management's Discussion and Analysis of Financial Condition and Results of Operations	19
<u>Item 7A.</u>	Quantitative and Qualitative Disclosures About Market Risk	49
<u>Item 8.</u>	Financial Statements and Supplementary Data	51
	<u>Consolidated Statements of Operations</u>	52
	<u>Consolidated Balance Sheets</u>	53
	<u>Consolidated Statements of Cash Flows</u>	54
	<u>Consolidated Statements of Stockholders' Equity</u>	55
	<u>Notes to Consolidated Financial Statements</u>	56

<u>Item 9.</u>	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	92
----------------	--	----

<u>Item 9A.</u>	Controls and Procedures	92
-----------------	-------------------------	----

PART III

<u>Item 10.</u>	Directors and Executive Officers of the Registrant	92
<u>Item 11.</u>	Executive Compensation	92
<u>Item 12.</u>	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	92
<u>Item 13.</u>	Certain Relationships and Related Transactions	92

PART IV

<u>Item 15.</u>	Exhibits, Financial Statement Schedules, and Reports on Form 8-K	93
-----------------	--	----

<u>SIGNATURES</u>		94
--------------------------	--	----

Table of Contents

PART I

ITEM 1. BUSINESS

GENERAL

Sun's business is singularly focused on providing products and services for network computing. Network computing has been at the core of the company's offerings for the 21 years of our existence and is based on the premise that the power of a single computer can be increased dramatically when interconnected with other computer systems for the purposes of communication and sharing of computing power. Together with our partners, we provide network computing infrastructure solutions that comprise computer systems (hardware and software), network storage systems (hardware and software), support services and professional and educational services. Our customers use our products and services to build mission-critical network computing environments on which they operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment and healthcare.

For the fiscal year ended June 30, 2003, we had revenues of \$11.4 billion, employed approximately 36,100 employees, and conducted business in over 100 countries. We were incorporated in California in February 1982 and reincorporated in Delaware in July 1987.

We can be reached on the Internet at <http://www.sun.com>. Our most recent annual report on Form 10-K and certain of our other filings with the Securities and Exchange Commission (SEC) are available in PDF format through our Investor Relations website at <http://www.sun.com/aboutsun/investors>. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are also available on the SEC website at <http://www.sec.gov> which can be reached from our Investor Relations website.

BUSINESS STRATEGY

Our business strategy is built around our singular focus on network computing, and the computer systems (hardware and software), network storage systems (hardware and software), and support services and professional and educational services that enable networking solutions for our customers which attack cost and complexity, accelerate service delivery and provide mobility with security. The core elements of our business strategy include:

An end-to-end architecture that extends our common Java technology-based programming environment and SPARC® (Scalable Processor Architecture) technology implementation from devices as small as smart cards and cell phones to large multi-million dollar systems.

On-going innovation in microprocessor architecture, systems design and software to help ensure continuing technology leadership and resulting price-performance advantage.

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

A commitment to open application programming interfaces.

A solution-based selling model with an emphasis on utilizing our end-to-end network computing architecture platform to integrate our products and services to address customers' strategic business challenges and information technology needs.

A robust partner community, including independent software vendors (ISV), system integrators, resellers and original equipment manufacturers (OEM), which adds value to Sun products and services and extends our reach and expertise.

A leading services organization that enables Sun and our partners to deliver open, innovative solutions and optimize availability and capabilities of our customers' IT environment.

End-to-End Architecture

Developing and deploying services over the network requires an infrastructure platform that is enterprise ready, developer rich and economically compelling. This means that rather than offering the customer just the cheapest server or storage array, we are focused on providing the optimal combination of software and hardware that will give the customer better

Table of Contents

value. With this strategy, we are focused on offering the customer a platform that entails lower annual administrative costs, developer training costs, and downtime costs, which decreases customers' total cost of ownership.

In fiscal 2003, we introduced a number of new products supporting our strategy as an end-to-end infrastructure platform company and we improved the performance of our UltraSPARC[®] III microprocessor across our low, mid and high-end server lines. The UltraSPARC III processor is fully binary compatible with our previous generation processor, so customers can run existing applications without the time and cost of rewriting applications. We also strengthened our Linux support by extending our x86 low-end server product line. We continued the deployment of our Solaris 9 Operating System, which creates significant benefits to customers by reducing system downtime and upgrade costs because it is designed to run existing applications currently running on previous Solaris Operating System releases.

In addition, we introduced a new line of highly dense, very manageable low-end servers, the Sun Fire blade platform. This line allows customers to mix, match and manage different systems in a heterogeneous environment such as SPARC and x86 architectures, Solaris and Linux operating systems, and specialty blades in the same physical system. These servers are part of our broader strategy to deliver highly dense racks of low cost and very manageable server groups that are based on open application programming interfaces.

Our Sun ONE platform consists of Sun's powerful and scalable software, including the Solaris Operating System, Sun ONE middleware products and the Sun ONE Studio development environment. It also builds upon our well-established Java technology to help enable the creation and deployment of Sun ONE Services on Demand (i.e., the ability to provide information, data and applications anywhere, anytime and on any device, using open application programming interfaces that will work with a wide array of operating systems and applications).

Innovation

We believe that in order to be a leading developer of enterprise and network computing products and technologies, we must continue to invest and innovate. As indicated by our research and development investments of approximately 11-16% of annual revenues during each of the last three fiscal years, we are continually focused on technological innovation. Over the past few years, we have made significant investments in several of our product and services technologies, including investments in:

the highly scalable UltraSPARC processor and systems architecture including our next generation processors that enable chip multithreading to drive throughput computing at the processor level;

our highly reliable and scalable Solaris Operating System;

mission critical clustering, messaging, directory and web services infrastructure software;

the cross-platform Java software development environment, spanning smart cards, cellular handsets, set top boxes, desktop computers, and servers used by our customers and independent software vendors;

virtualization, provisioning, and monitoring software architecture for network computing resource optimization and systems management simplification;

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

our highly scalable enterprise servers, from entry level to data center class; and

network-based storage systems and software, including Sun HighGround storage management software and Sun QFS and Sun SAM-FS software.

Many of these technologies provide us with a competitive advantage and differentiation in the marketplace. We believe by investing in research and development, we are able to develop and deliver more valuable systems technology to our customers, and therefore, are able to generate better long-term profit margins on our products. We intend to continue our investments into new computing technologies and are focused on continuing to develop and deliver leading-edge network computing products based upon our innovations.

Open Application Programming Interfaces (APIs)

From inception, we have focused on developing products and technologies based upon open APIs. We believe the real power in computing lies in the ability to freely access and share information over the network, while unconstrained by proprietary software and hardware standards.

Table of Contents

The need for open APIs is at the heart of the Internet's development. We believe that without them, too many proprietary software and hardware protocols cause both incompatibility and cost issues, making it too difficult and uneconomical for individuals and organizations to fully access and harness the network. Through open APIs, we believe application adoption and service deployments over the network will grow more quickly, which will increase the workload on the network, leading to increased demand for our computer systems. In addition, by adhering to open APIs, we are able to deliver more flexible and compatible systems products to our customers, reducing administrative costs and adding to the demand for our systems. For example, we have created technologies, such as the Network File System (NFS), UltraSPARC architecture and the Java technologies, providing customers with flexibility for their networking environments, and facilitating industry growth. In addition, through our Sun ONE software platform, we have extended our well-established Java technology platform and utilized Web industry standards including XML (Extensible Markup Language), SOAP (Simple Object Access Protocol), UDDI (Universal Description, Discovery and Integration) and WSDL (Web Services Description Language).

Solutions-Based Selling Model

Our sales force is focused on selling our products and services via a solutions-based selling model whereby we offer an integrated and consistent set of end-to-end networking architecture platform solutions to the marketplace. These solution sets currently encompass three core competencies: the Data Center (including Storage), Java Web Services, and Edge Computing. These competencies line up directly with the three key strategies we present to our customers as part of the Sun vision—attacking cost and complexity, accelerating service delivery and enabling mobility with security. We believe our solutions-based selling approach allows us to engage with our customers over the entire life cycle of their key infrastructure projects, which brings our expertise to bear in accelerating the delivery of sustainable value from the products and services we produce.

Partner Community

Our partner community is essential to our success. While our product and service offerings are very broad, we recognize that no single supplier of computing solutions can meet all of the needs of all of its customers. We have established relationships with leading independent software vendors (independent software vendors are a part of nearly all solutions our customers implement), value-added resellers, OEMs, channel development providers, independent distributors, computer systems integrators and service delivery partners to deliver solutions that our customers demand. Through these relationships, our goal is to optimize our ability to be the technology of choice, the platform of choice, the partner of choice and to provide the end-to-end solutions that customers require to compete.

Global Services

We provide expertise in network computing through a broad range of global services including support services to help ensure high satisfaction and availability of our customers' mission-critical systems. In addition, our professional and educational services enable our customers to architect, implement and deploy systems within their IT environments and provide system/network management, education consulting, skills migration and training.

BUSINESS ORGANIZATION

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Our organization is centered around the functional competencies needed to design, develop and deploy the major elements of our infrastructure solutions. Our Global Sales Operations organization manages and has primary responsibility for our field sales, relationships with our selling partners, technical sales support, and sales operations. Our Marketing and Strategy Organization is responsible for corporate strategy and strategic planning and development, product marketing strategy, pricing strategy and execution, public and analyst relations, advertising and branding, go-to-market activities and acquisitions and strategic investments activities. Our Worldwide Operations organization manages and oversees manufacturing operations of Sun and our partners and is responsible for logistics operations. Our research and development investments comprise organizations focused on the development of computer systems (specifically organizations responsible for the development of processors and network products, enterprise systems products, volume systems products, and software) and network storage systems products. Our Sun Services organization is responsible for services including design, implementation and operation of enterprise and Internet computing environments, systems integration and support, and professional and educational services.

Table of Contents

SALES, MARKETING AND DISTRIBUTION

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. We also offer component products such as CPU chips and embedded boards on an OEM basis to other hardware manufacturers, and supply after-market and peripheral products to their end-user installed base, both directly and through independent distributors and resellers.

Our sales force serves the telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment and healthcare industries. We organize our sales coverage resources within four Time Zone groups, which consist of U.S., International Americas, EMEA (Europe Middle East and Africa) and APAC (Asia, Australia and New Zealand) comprising 22 geographically-based selling units. We have approximately 100 sales and service offices in the United States and an additional 150 sales and service offices in 45 other countries. In addition, we use independent distributors in over 100 countries. In general, our sales coverage model calls for independent distributors to be deployed in partnership with our direct sales force. However, in some smaller markets, independent distributors may be our sole means of sales, marketing and distribution.

Our relationships with resellers and distributors (collectively our Channel Partners) are very important to our future revenues and profitability. Channel relationships accounted for more than 61% of our revenues during fiscal 2003 and more than 65% in fiscal 2002. Our sales force is compensated on a channel-neutral basis to reduce potential conflict between our sales force and channel partners. Our partners include:

systems integrators, both government and commercial, who serve the market for large commercial projects requiring substantial analysis, design, development, implementation and support of custom solutions;

channel development providers who supply our products and provide product marketing and technical support services to our smaller resellers;

ISVs and resellers who provide added value in the form of software packages, proprietary software development, high-end networking integration, vertical integration, vertical industry expertise, training, installation and support;

OEMs who integrate our products with their hardware and software; and

independent distributors who primarily serve foreign markets in which we do not have a direct presence.

We have a wide range of marketing activities. Our marketing and strategy organization oversees Sun's strategic planning, determines product and pricing strategy; coordinates advertising, demand creation and public relations activities; maintains strategic partnerships with major independent software vendors; performs competitive analyses; and negotiates and supports acquisition and investment transactions.

Revenues from outside the United States were approximately 56% of our total net revenues in fiscal 2003 and 53% and 52% in fiscal 2002 and 2001, respectively. Direct sales we make outside of the United States are generally priced in local currencies and can be subject to currency exchange fluctuations. The net foreign currency impact on net revenues and operating results cannot be precisely measured because of the various hedging strategies we employ, however because of the general weakening of the U.S. dollar our best estimate of the foreign exchange benefit approximated 4% on total net revenues for fiscal 2003.

Some of our sales to international customers are made under export licenses that must be obtained from the United States Department of Commerce. In addition, all of our export transactions are subject to U.S. export control laws, and certain transactions could require prior approval of the U.S. Department of Commerce. Protectionist trade legislation in either the United States or other countries, such as a change in the current tariff structures, export compliance laws or other trade policies, could adversely affect our ability to sell or to manufacture in international markets. Furthermore, revenues from outside the United States are subject to inherent risks, including the general economic and political conditions in each country. See Item 3. Legal Proceedings, for a description of certain matters currently pending before the U.S. Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS).

The countries primarily contributing to our international sales are Japan, Germany and the United Kingdom (UK). Japan represented approximately 8% of our total net revenues in fiscal 2003, 9% in fiscal 2002 and 10% in fiscal 2001. Germany represented approximately 8% of our total net revenues in fiscal 2003, 7% in fiscal 2002 and 6% in fiscal 2001. The UK represented approximately 7% of our total net revenues in fiscal 2003, 7% in fiscal 2002 and 8% in fiscal

Table of Contents

2001. Over the past three years, Japan's revenues have declined while sales in Germany increased from the previous fiscal year and revenues in the United Kingdom were stable as a percentage of total net revenues. Sales to telecommunication and information technology manufacturing industries, primarily through Channel Partners, together represent a significant portion of Sun's revenues in Japan.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 11%, 12% and 13% of our fiscal 2003, 2002 and 2001 total net revenues, respectively. More than 90% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. Sales through MRA Systems, Inc., a channel development partner and a GE subsidiary, consisted of 9%, 8% and 10% of total net revenues in 2003, 2002 and 2001, respectively. As a channel development partner, MRA Systems, Inc. acts as a distributor of our products to resellers who in turn sell those products to end-users. Our business could be adversely affected if GE or another significant customer terminated its business relationship with us or significantly reduced the amount of business it did with us. See Note 15 to the Consolidated Financial Statements for additional information concerning sales to international customers and business segments.

Our product order backlog at June 30, 2003 was \$705 million, as compared with \$841 million at June 30, 2002. Our backlog includes orders for which a delivery schedule within six months has been specified by the customer and shipped products for which revenue has not been recognized. Backlog levels vary with demand, product availability and our delivery lead times, and are subject to significant decreases as a result of, among other things, customer order delays, changes or cancellations. As such, backlog levels are not a reliable indicator of future operating results.

MANUFACTURING AND SUPPLY

Worldwide Operations manages company-wide purchasing of materials used in producing Sun products, assists in product design enhancements, oversees our own manufacturing operations and those of our manufacturing partners and coordinates logistics operations. Our manufacturing operations consist primarily of final assembly, test and quality control of mid to high-end systems. For all other systems, we rely on external manufacturing partners. We manufacture in California, Oregon and Scotland, and distribute from California, the Netherlands and Japan. We have continued efforts to simplify the manufacturing process by reducing the diversity of system configurations offered and increasing the standardization of components across product types. In addition, we have continued to increase our focus on quality through the appointment of a Chief Quality Officer in fiscal 2003 and the implementation of new quality control processes that are intended to proactively identify quality issues. The early-identification of products containing defects in engineering, design and manufacturing processes, as well as defects in third-party components included in our products could result in delays of product shipments.

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we depend on Texas Instruments for our SPARC® microprocessors and several other companies for custom integrated circuits. If we were unable to purchase the necessary parts and components on acceptable terms from a particular vendor and we had to find a new supplier for such parts and components, our new and existing product shipments could be delayed, adversely affecting our business and operating results. Similarly, our ability to purchase components in sufficient quantities to meet customer demand could impact our future operating results. Further, we also face the risk of ordering too many components, or conversely, not enough components, because orders are generally based on forecasts of customer orders rather than actual orders, which subjects us to inventory risk.

PRODUCT DEVELOPMENT

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Our research and product development programs are intended to sustain and enhance our competitive position by incorporating the latest worldwide advances in hardware, software, graphics, networking, data communications and storage technologies. In addition, we may extend our product offerings and intellectual property through acquisitions of businesses or technologies or other arrangements with our partners. Sun's product development continues to focus on enhancing the performance, scalability, reliability, availability, and serviceability of our existing systems and the development of new technology standards. Additionally, we remain focused on system software platforms for Internet and intranet applications, telecommunications and next-generation service provider networks, developing advanced workstation, server and storage architectures, as well as designing application-specific integrated circuits. We devote

Table of Contents

substantial resources to software development as we believe it provides and will continue to provide significant competitive differentiation.

We conduct research and development principally in the United States, United Kingdom, France, Ireland, Germany, Japan, Norway and India. Research and development (R&D) expenses were \$1,837 million, \$1,832 million and \$2,016 million in fiscal 2003, 2002 and 2001, respectively.

PRODUCTS

Our products consist of Computer Systems and Network Storage systems.

COMPUTER SYSTEMS

Our Computer Systems products and technologies, including our full line of scalable workgroup and enterprise servers, our UltraSPARC microprocessors and our software, are integrated systems, designed, developed and produced for network computing environments.

Servers. We offer a full range of servers from our data center/high-performance computing servers through our entry server systems and blade systems.

High-end servers. Our high-end servers, the Sun Fire 15K and the Sun Fire 12K, are designed to offer greater performance and lower total cost of ownership than mainframe products and are used for consolidations, application migrations, data mining and warehousing, custom applications, on-line transaction support, enterprise resource planning, high performance technical computing and databases. The Sun Fire 15K server is one of the most scalable UNIX[®] platform-based systems in the marketplace and incorporates our UltraSPARC III microprocessor, mainframe features such as dynamic partitioning (Dynamic System Domains) and a supercomputer-class Gigaplane-XB interconnect.

Mid-range servers. Our midrange servers, including our Sun Fire 3800, Sun Fire 4800 and Sun Fire 6800 servers, provide reliability, availability and scalability to address the needs of data centers and enterprise-scale network computing at a moderate cost. These servers utilize the UltraSPARC III processor and Solaris 9 Operating System and feature enhanced processing power. They are available with various options in processor and memory expandability, hardware redundancy and component accessibility. In fiscal 2003, we introduced the Sun Fire 1280 server which uses the UltraSPARC III processor and is built to deliver the most multiprocessing capability further down in our family of mid-range Sun Fire servers.

Entry server systems. We also offer entry server systems, including our Sun Fire V480 and Sun Fire V880 servers, that deliver network computing in a compact, low-cost package. Our entry server systems are differentiated by their size, their processor architecture (SPARC or x86), their form factor (rackable or stand-alone systems) and the environment for which they are targeted (general purpose or specialized systems). During fiscal 2003, we introduced two new general purpose entry systems, the Sun Fire V240 server and the Star Fire V210 server, and our first line of entry level x86 servers, including the Sun Fire V60 server, and the Sun Fire V65 server, which provide high density scalable solutions for both Solaris and Linux operating systems. We also introduced our first blade systems offering. Our blade systems combine high density hardware architecture and system management software. They allow for management of a pool of heterogeneous, modular, single board

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

servers, such as SPARC and x86 architectures, Solaris and Linux operating systems, and specialty blades, as one computing environment.

Processors and Network Products. The UltraSPARC microprocessors provide the computing power of most of Sun's systems. We have three series of processors that use the SPARC architecture: 1) The UltraSPARC s-Series processors power the high-end and midrange server products from Sun, as well as power desktops. These CPUs offer our highest level of performance, scalability and leading-edge RAS; 2) The UltraSPARC i-Series processors offer a higher level of integration on the central processing unit enabling the price and performance design points deployed in Sun's workgroup servers, rack mount servers, and high performance desktops; and 3) The UltraSPARC e-Series processors balance cost, power consumption and performance, enabling economical 64-bit server and desktop solutions while maintaining binary compatibility with all SPARC processors, past and present.

Software. Our software offerings consist primarily of enterprise infrastructure software systems, software desktop systems, developer software and infrastructure management software.

Table of Contents

Solaris Operating System (OS). The Solaris OS is a high performance, highly reliable, scalable and secure operating environment for SPARC and x86 platforms that is easy to install and use, is optimized for the Java platform and supports more than 12,000 applications. It is optimized for enterprise computing, Internet and intranet business requirements, powerful databases and high performance technical computing environments. The Solaris 9 OS, our latest release of the Solaris OS, creates a services platform by combining traditional operating systems functionality with application services and identity management (management of user identities over the Internet or complex corporate networks so that users can use a single sign-on to be authenticated and authorized to access multiple files). Solaris 9 OS integrates many Sun ONE middleware elements making it easier to build and deploy application and web services based on Java and XML technologies. Our Trusted Solaris OS provides a high level of privacy and reduces the risk of security violations on a commercial-grade OS. Trusted Solaris OS is available for both SPARC and x86 platforms.

Java. Our Java platform application environment allows development of application software independent of the underlying operating system or microprocessor. Java technology allows a developer to write applications once for a wide range of platforms and devices. Our Java platforms are based on a common core architecture and include the Java 2 Platform, Standard Edition (J2SE) technology used on personal computers and workstation clients and available on Solaris OS, Linux, HP-UX, AIX, Tru64 Unix, Windows, MacOS X and other platforms; Java 2 Platform, Enterprise Edition (J2EE) technology used to develop and deploy webservices which enable secure, robust and interoperable business applications; Java 2 Platform, Micro Edition (J2ME) technology, which extends Java technology to consumer and embedded devices such as mobile phones, personal digital assistants (PDAs), digital set top boxes, and residential gateways; and Java Card smart card technology.

Developer tools. We develop and market software development tools designed to aid in application development and integration. The Java 2 Software Development Kit enables developers to create and run both applets (miniature applications written in the Java programming language) that run inside a web browser and applications that run outside of a browser. Our Sun ONE Developer Platform provides a desktop-to-mainframe development and test environment for programming in C, C++ and Java programming languages.

Sun ONE middleware and Desktop. Our Sun ONE software enables enterprises to leverage their information and applications into services offered on intranets and the Internet. Our Sun ONE middleware software includes application, directory, identity, integration, calendar, messaging and portal services for multiple platforms, including the Solaris OS, Windows NT, HP-UX, AIX and Linux operating systems. Our desktop software includes our StarOffice office productivity suite which has a fully integrated set of applications including word processing, spreadsheet, graphic design, presentations, database access, HTML editor, mail/news reader, event planner and formula editor tools. It runs on most major operating environments and platforms, including the Solaris OS, Microsoft Windows, Linux, OS/2, and Java platform.

N1. N1 software is our vision and architectural blueprint for reducing the cost and complexity of managing enterprise data centers by allowing a data center to work like a single system by combining foundation resources (e.g. servers, storage and network devices) with virtualization, provisioning, policy and automation, and monitoring. During fiscal 2003, we introduced the N1 Provisioning Server 3.0 Blades Edition, a comprehensive management environment for the Sun Fire Blade Platform that automates configuration and deployment tasks.

Desktops and Workstations. Our desktops and workstations provide powerful solutions for a wide range of business and technical activities such as software development, mechanical design, financial analysis and education. Our product line includes 64-bit workstations, graphics accelerator boards and thin client SunRay products. In fiscal 2003, we introduced the Sun Fire V880z visualization system that combines the performance of the Sun Fire V880 server and the new high performance XVR-4000 graphics accelerator for demanding high-end visualization applications.

NETWORK STORAGE

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Our Network Storage systems integrate servers, storage and software to support heterogeneous environments.

Storage Systems. Our high-end data storage systems provide a platform for direct attach storage or storage area network (SAN) solutions. They are designed for extreme availability, performance, scalability, connectivity and manageability. Our high-end data storage systems combine Hitachi Data Systems' high-end storage products with our resource management and file management software under an OEM agreement with HDS first signed in fiscal 2002.

Table of Contents

We offer a wide range of flexible, scalable mid-range storage systems which support high-performance computing and enterprise SAN implementations, as well as storage virtualization technology. In fiscal 2003, we introduced the Sun StorEdge 6320 system, which delivers performance, flexibility and high availability for clustered environments such as high-performance computing and decision support systems, and the Sun StorEdge 6120 array, which combines modular platform design and intuitive SAN-wide manageability.

Our Sun StorEdge products for workgroup applications offer a flexible, compact, cost-effective approach for growing storage demands. Their building-block architecture is designed to allow users to expand and customize as needed, offering performance and flexibility at low cost for a variety of environments for increased return on investment. In fiscal 2003, we introduced the Sun StorEdge 3510 array, which combines advanced RAID technology with industry-standard fiber-channel technology in a scalable package, and the Sun StorEdge 3310 series.

Storage Software. Our Sun StorEdge software is an integral part of our complete storage solutions. Our Sun StorEdge software is based on the Sun ONE architecture and comprises an open, integrated and automated storage management software family. The Sun StorEdge software suites are focused on availability, utilization, performance and storage resource management.

SERVICES

Our services team provides expertise in helping our customers deploy network computing environments through a broad range of services, including Support services (support for hardware and software) and Professional and Educational services. Sun Services assists customers globally, provides support services to nearly a million units under contracts in more than 100 countries, training more than 400,000 students annually, and providing consulting, integration and operations assistance to IT organizations worldwide.

SUPPORT SERVICES

The SunSpectrumSM Support services product offerings allow customers the power and flexibility to customize their support services contracts. Customers can choose from four levels of support that range from mission critical to self-support. This service is sold separately or packaged with hardware, software and peripherals as a single-price support service. Each contract type is specifically designed to enable high availability and continuous operation for our customers. Our resources in the field for direct services are complemented by third-party service providers who primarily deliver hardware support services such as spares inventories and manpower. Investments by these third-party service providers help us expand our geographic coverage without additional fixed cost investments on our part. Software support is primarily delivered by our software support engineers.

PROFESSIONAL AND EDUCATIONAL SERVICES

Sun Professional services provides a suite of technical consulting and systems integration services to help customers architect, implement, and manage complex network computing environments. Our highly trained Professional services team specializes in providing customers with advanced systems, software, storage, and network architecture design consulting, platform integration, enterprise systems management and operation such as network security and identity management, wireless network-based systems, and advanced Sun ONE and Java software integration solutions. We provide people, processes and technology and we partner with third-party systems integrators, to deliver solutions tailored to meet our customers' needs. Our technical and project management experts help design IT architectures and plan migrations from legacy systems to network computing or help customers upgrade existing network computing environments. Additionally, to keep customer

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

computing environments operating at peak performance, operations experts help customers manage the complexity of heterogeneous systems and networks.

Our Educational services group develops and delivers integrated learning solutions for enterprises, IT organizations, and individual IT professionals. These solutions help ensure that the necessary talent is available and properly aligned to meet our clients' network computing needs, as well as business objectives. Sun learning solutions include education consulting services, learning management technologies, multi-mode learning content and professional certifications.

COMPETITION

We compete in the computer hardware, software and services markets. These markets are intensely competitive. Our competitors are some of the largest, most successful companies in the world. They include International Business

Table of Contents

Machines Corporation (IBM), Hewlett-Packard Company (HP), EMC Corporation (EMC), Fujitsu and the Fujitsu-Siemens joint venture company. We also compete with companies who distribute systems based on microprocessors manufactured by Intel Corporation (Intel) and the Windows family of operating systems software developed by Microsoft Corporation (Microsoft). These competitors include Dell Inc. and HP, in addition to Intel and Microsoft.

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

We have encouraged the use of SPARC technology as a standard in the computer marketplace by licensing much of the technology, and promoting open interfaces to the Solaris OS, as well as by offering microprocessors and enabling technologies to third party customers. As a result, several licensees, including Fujitsu and the Fujitsu-Siemens joint venture company, also offer products based on the Solaris OS and the SPARC architecture that compete directly with our products. We have also worked to make our Java programming language a standard for complex networks. We develop applications, tools and systems platforms, as well as work with third-parties to create products and technologies, in order to continue to enhance the Java platform's capabilities. As part of this effort, we license Java technology which widely encourages competitors of Sun to also develop products competing with these applications, tools and platforms. If we are unable to compete effectively, our business could be harmed.

PATENTS, TRADEMARKS AND INTELLECTUAL PROPERTY LICENSES

We have used, registered, and/or applied to register certain trademarks and service marks to distinguish genuine Sun products, technologies and services from those of our competitors in the U.S. and in foreign countries and jurisdictions. We enforce our trademark, service mark and trade name rights in the U.S. and abroad.

We hold a number of U.S. and foreign patents relating to various aspects of our products and technology. While we believe that patent protection is important, we also believe that patents are of less competitive significance than factors such as innovative skills and technological expertise. From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Several pending claims are in various stages of evaluation. With the exception of the matters further disclosed at Item 3. Legal Proceedings of this report, we believe no material litigation has arisen from these claims. We are evaluating the desirability of entering into licensing agreements in certain of these cases. Based on industry practice, we believe that any necessary licenses or other rights could be obtained on commercially reasonable terms. However, no assurance can be given that licenses can be obtained on acceptable terms or that litigation will not occur. The failure to obtain necessary licenses or other rights, or litigation arising out of such claims, could adversely affect our business.

EMPLOYEES

As of September 15, 2003, we had approximately 36,100 employees (at June 30, 2003 we had approximately the same number of employees). We depend on key employees and face competition in hiring and retaining qualified employees. Our employees are vital to our success, and our

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

key management, engineering and other employees are difficult to replace. Although we have entered into a limited number of employment contracts with certain current and former executive officers, we generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. As our stock price has decreased and because we offer equity-based incentive compensation, our ability to continue to offer competitive compensation packages to current employees has been negatively impacted. Consequently, these pressures have affected our ability to attract and retain highly qualified personnel. If these adverse conditions continue, we may not be able to retain highly qualified employees in the future and this could harm our business. In addition, new regulations implemented by The Nasdaq National Market requiring shareholder approval for all stock option plans as well as new regulations implemented by the New York Stock Exchange prohibiting NYSE member organizations from giving a proxy to vote on equity-

Table of Contents

compensation plans unless the beneficial owner of the shares has given voting instructions could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult to grant stock options or require us to expense options granted to employees, we may incur increased compensation costs or find it difficult to attract, retain and motivate employees, either of which could materially and adversely affect our business.

ITEM 2. PROPERTIES

At June 30, 2003, Sun's worldwide facilities represented aggregate floor space of 15.3 million square feet, of which 5.6 million square feet was owned and 9.7 million square feet was leased. We had an aggregate floor space of 10.6 million square feet in the United States, of which 4.9 million square feet was owned and 5.7 million square feet was leased. In the 45 other countries in which we occupy space we had an aggregate of 4.7 million square feet, of which 0.7 million square feet was owned and 4.0 million square feet was leased.

At June 30, 2003, our owned properties consisted of:

Location	Square Footage of Facility	Square Footage Under Construction
Bagshot, England	25,995	n/a
Broomfield, Colorado	916,045	n/a
Burlington, Massachusetts	699,723	62,500
Farnborough (Guillemount Park), England	270,088	n/a
Linlithgow, Scotland	420,148	n/a
Menlo Park, California	1,022,088	n/a
Newark, California	1,404,309	n/a
Santa Clara, California	816,240	n/a
Total	5,574,636	62,500

In addition to the above-noted Square Footage Under Construction, we have approximately 1.6 million square feet of facilities available for future construction. We continually evaluate our facility requirements in light of our business needs and stage the future construction accordingly. In addition, we own approximately 38 acres of undeveloped land in Austin, Texas.

Starting in fiscal 2001, we committed to vacate properties, in the U.S and internationally, according to our restructuring and facility exit plans (Plans). 135 properties were selected to be vacated under these Plans, representing an aggregate square footage of 3.3 million square feet. At June 30, 2003, on a worldwide basis related to our Plans, we had an aggregate of 1.6 million square feet that was vacant and 0.7 million square feet that was being subleased to non-Sun businesses. Of these amounts, in the U.S. 1.2 million square feet was vacant and 0.5 million square feet was being subleased to non-Sun businesses and internationally we had 0.4 million square feet that was vacant and 0.2 million square feet that was being subleased to non-Sun businesses.

Additionally, at June 30, 2003, 35 properties representing 0.4 million square feet remained to be exited under the Fiscal 2003 Restructuring Plan and will be vacated no later than December 28, 2003.

Substantially all of our facilities are used jointly by our Product group, Sun Services group, Global Sales Operations and other functions. Our manufacturing facilities are located in Linlithgow (Scotland), Beaverton (Oregon) and Newark (California).

ITEM 3. LEGAL PROCEEDINGS

On February 11, 2002, Eastman Kodak Company (Kodak) filed a civil lawsuit against us, Eastman Kodak Company v. Sun Microsystems, Inc., Civil Action No. 02-CV-6074, in the United States District Court for the Western District of New York. On March 22, 2002, Kodak filed a First Amended Complaint, which asserts that some of our products, including those relating to our Java technology, infringe one or more claims of U.S. Patent No. 5,206,951, U.S. Patent No. 5,421,012, and U.S. Patent No. 5,226,161 (collectively, the Kodak Patents). Kodak further alleges that we have

Table of Contents

contributed to and induced infringement of one or more claims of the Kodak Patents. Kodak seeks injunctive relief against future infringement, unspecified damages for past infringement, and attorney's fees and costs. We have filed an Answer with the court, denying infringement of any valid and enforceable claim of any of the Kodak Patents. We also filed counter-claims, seeking a declaratory judgment of noninfringement, invalidity and/or unenforceability of the Kodak Patents. We further allege that Kodak's claims are barred in whole or in part by the doctrines of estoppel, laches and patent exhaustion, and that we have license and/or sublicense rights to the Kodak Patents. Discovery is ongoing, and the parties recently submitted briefs regarding claim construction. Trial has not been scheduled. Based on our analysis of the Kodak patents, applicable law, and discussions over many months with Kodak, we believe this suit is without merit and, accordingly, we will defend ourselves and pursue our counterclaims vigorously. At this time, we cannot forecast with reasonable certainty the potential costs associated with an adverse outcome of this matter.

On March 8, 2002, we filed suit against Microsoft Corporation (Microsoft) in the United States District Court for the Northern District of California, pursuant to United States and State of California antitrust laws. In our lawsuit and in subsequent filings in that case, we allege that Microsoft has engaged in illegal conduct, including efforts to acquire, maintain and expand a number of illegal monopolies; illegal tying arrangements; illegal exclusive dealings; copyright infringement; unreasonable restraints of trade; and unfair competition. Our requested remedies include: (1) preliminary injunctions requiring Microsoft to distribute our binary implementation of the Java Runtime Environment as part of Windows XP and Internet Explorer ("must carry remedy") and to stop the unlicensed distribution of Microsoft's Virtual Machine for Java technology ("copyright infringement remedy"); (2) a permanent injunction to restore competition to the markets in which Microsoft is unlawfully attempting to acquire, maintain and expand a number of monopolies; and (3) compensation for losses we suffered as a result of Microsoft's unlawful actions. The case was transferred to the District of Maryland and combined with other cases pending against Microsoft for consolidated pretrial proceedings, in the case entitled Microsoft Corp. Windows Operating System Antitrust Litigation, MDL-1332. At the conclusion of the pretrial proceedings, the case will return for trial to the Northern District of California. On January 15, 2003, Judge Motz granted us two preliminary injunctions, ordering Microsoft to implement our requested "must carry remedy" for shipments of Windows XP and granting our requested "copyright infringement remedy." Judge Motz also reversed an earlier order dismissing two of our claims and denied Microsoft's remaining motions to dismiss. On June 26, 2003, a three-judge panel of the Court of Appeals reversed and remanded Judge Motz's ruling with respect to the "must carry" injunction and upheld Judge Motz's ruling with respect to the copyright infringement injunction. We are considering various alternatives related to the Court of Appeals rulings, including asking Judge Motz to modify his order to meet the concerns raised by the Court of Appeals. Microsoft has filed counterclaims against us, alleging unfair competition and breach of a settlement agreement between the parties related to Microsoft's use of our Java technology. Microsoft is also appealing an earlier ruling regarding whether and to what extent they are precluded from relitigating findings made in the United States antitrust case. We believe that Microsoft's counterclaims are without merit and intend to present a vigorous defense. At this time, we cannot forecast with reasonable certainty the potential costs associated with an adverse outcome with respect to Microsoft's counterclaims.

In early February 2002, Sun and two of its subsidiaries received several charging letters from the United States Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS) claiming that we had violated export control regulations. The letters relate to sales in 1998 in Egypt and in 1997 to a reseller in Hong Kong for subsequent resale in the People's Republic of China. On April 16, 2003, the BIS provided us with a charging letter documenting nineteen additional charges, which involved alleged violations of certain record keeping requirements. The relevant export statutes provide for monetary penalties and in some cases denial of export privileges and exclusion from practice before the BIS if a violation is found. The BIS has submitted a settlement proposal which would include a monetary penalty and a suspended one-year denial of export privileges. The proposed denial would not be enforced if there were no violations during the one year suspension period. BIS approval would be required for transactions involving export, re-export or transfer of items subject to the relevant export regulations and involving the specific entities involved in the Egyptian and People's Republic of China transactions which were the subject of the original 2002 charging letters. We would be entitled to an administrative hearing in the event the BIS should allege that a further violation has taken place. In August 2003, we received verbal notice from the BIS that they were considering filing two additional charges, both of which would address alleged violations related to certain recordkeeping requirements with respect to certain exports to Syria. In order to fully investigate and address the possible new charges, we requested and received an extension of time until October 31, 2003 to file a formal response to all the charging letters or otherwise resolve the matters through a negotiated resolution. We are involved in ongoing settlement

Table of Contents

discussions with the BIS and continue to believe it is reasonably likely that we will reach a negotiated resolution. However, absent a negotiated resolution, an administrative hearing would be set and, in such case, we would assert a vigorous defense. We believe that any monetary penalties would not have a material adverse effect on our financial position, results of operations or cash flows for any fiscal year or fiscal quarter. A denial of export privileges, including any revocation of the proposed suspended denial, would have a material adverse effect on our business.

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

No matters were submitted to a vote of stockholders of Sun during the fourth quarter of fiscal 2003.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following sets forth certain information regarding our Executive Officers as of September 15, 2003.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Scott G. McNealy	48	Chairman of the Board of Directors, President and Chief Executive Officer
Crawford W. Beveridge	57	Executive Vice President, People and Places, and Chief Human Resources Officer
Mark A. Canepa	48	Executive Vice President, Network Storage Products
John D. Croll	46	Senior Vice President, General Counsel and Secretary
Robyn M. Denholm	39	Vice President and Corporate Controller
H. William Howard	69	Senior Vice President, Chief Information Officer
Neil A. Knox	50	Executive Vice President, Volume Systems Products
Clark H. Masters	54	Executive Vice President, Enterprise Systems Products
Eugene G. McCabe	50	Senior Vice President, Worldwide Operations
Stephen T. McGowan	55	Chief Financial Officer and Executive Vice President, Corporate Resources
Michael H. Morris	55	Senior Vice President, Special Counsel
Gregory M. Papadopoulos	45	Executive Vice President and Chief Technology Officer
Marissa T. Peterson	41	Executive Vice President, Worldwide Operations and Chief Customer Advocate
Jonathan I. Schwartz	37	Executive Vice President, Software
Patricia C. Sultz	50	Executive Vice President, Sun Services
Mark E. Tolliver	51	Executive Vice President, Marketing and Strategy and Chief Strategy Officer
David W. Yen	51	Executive Vice President, Processor and Network Products
Robert H. Youngjohns	51	Executive Vice President, Global Sales Operations

Mr. McNealy is a Founder of Sun and has served as Chairman of the Board of Directors, President and Chief Executive Officer since July 2002, as Chairman of the Board and Chief Executive Officer from April 1999 to June 2002, as Chairman of the Board of Directors, President and Chief Executive Officer from December 1984 to April 1999, as President and Chief Operating Officer from February 1984 to December 1984 and as Vice President of Operations from February 1982 to February 1984. Mr. McNealy has served as a Director of the Company since the

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

incorporation of the Company in February 1982.

Mr. Beveridge has served as Executive Vice President, People and Places, and Chief Human Resources Officer of Sun since March 2000 and as Vice President, Corporate Resources from March 1985 to December 1990. From January 1991 to February 2000, Mr. Beveridge served as Chief Executive, Scottish Enterprise, a Scottish quasi-autonomous non-governmental organization involved in economic development in Scotland. Mr. Beveridge serves on the Board of Directors of Autodesk, Inc., a digital design and content company.

Table of Contents

Mr. Canepa has served as Executive Vice President, Network Storage Products of Sun since April 2001, as Vice President and General Manager, Internet Desktop and Server Products from June 2000 to April 2001 and as Vice President, Workgroup Server Products from October 1996 to June 2000.

Mr. Croll has served as Senior Vice President, General Counsel and Secretary of Sun since April 2002, as Vice President, Legal; General Counsel, Global Sales Organization from July 2001 to March 2002, as Vice President, Sales Operations, Global Sales Organization from July 2000 to March 2002, as Vice President and General Counsel of Sun Microsystems Computer Corporation, a wholly-owned subsidiary of Sun from August 1995 to June 2000, and as Vice President, Corporate Development and Strategy, and General Counsel, SunSoft, Inc., a wholly-owned subsidiary of Sun, from September 1994 to August 1995. Mr. Croll held various positions in the corporate development and legal organizations of SunSoft, Inc. from April 1991 to August 1994.

Ms. Denholm has served as Vice President and Corporate Controller since August 2003, as Vice President and Acting Corporate Controller from June 2003 through August 2003, as Vice President, Finance, Services and Finance Systems and Processes from August 2001 through June 2003, as Director, Asia Pacific Shared Financial Services from April 1998 through August 2001 and as Australasian Financial Controller, Computer Systems from January 1996 through April 1998.

Mr. Howard has served as Senior Vice President, Chief Information Officer of Sun since July 2000 and as Vice President, Chief Information Officer from September 1998 to July 2000.

Mr. Knox has served as Executive Vice President, Volume Systems Products of Sun since July 2002, as Vice President and General Manager, Volume Systems Products from July 2001 to July 2002, and as Vice President and General Manager, Network Systems of Sun from July 1995 to July 2001.

Mr. Masters has served as Executive Vice President, Enterprise Systems Products of Sun since July 2002, as Vice President, Enterprise Systems Products from June 2000 to July 2002, and as Vice President, Data Center and High Performance Computing from July 1996 to June 2000.

Mr. McCabe has served as Senior Vice President, Worldwide Operations since January 2003 and as Vice President, High-End Operations from September 1999 through January 2003. From July 1998 through September 1999, Mr. McCabe served as Vice President, High-End Operations for Compaq Computer Corporation.

Mr. McGowan has served as Chief Financial Officer and Executive Vice President, Corporate Resources of Sun since July 2002, as Vice President, Finance, Global Sales Operations from July 2001 to June 2002, as Vice President, Staff Operations, Global Sales Operations from June 2000 to June 2001, as Vice President, Finance, Computer Systems, Network Storage and Network Service Providers from February 1998 to June 2000, as Vice President, Finance, Worldwide Financial Operations of Sun Microsystems Computer Corporation (SMCC), a wholly-owned subsidiary of Sun, from July 1994 to February 1998 and as Vice President, Finance, North America and Australia Field Operations of SMCC from October 1992 to July 1994.

Mr. Morris has served as Senior Vice President, Special Counsel of Sun since April 2002, as Senior Vice President, General Counsel and Secretary from April 2000 to March 2002 and as Vice President, General Counsel and Secretary from October 1987 to April 2000.

Mr. Papadopoulos has served as Executive Vice President and Chief Technology Officer of Sun since December 2002, as Senior Vice President and Chief Technology Officer from July 2000 to December 2002 and as Vice President and Chief Technology Officer from April 1998 to July 2000. He served as Vice President and Chief Technology Officer of Sun Microsystems Computer Corporation (SMCC), a wholly-owned subsidiary of Sun from March 1996 to April 1998, as Chief Technology Officer of SMCC from December 1995 to March 1996 and as Chief Scientist, Server Systems Engineering from September 1994 to December 1995. Mr. Papadopoulos has a part-time, non-compensated appointment as a Visiting Professor of Electrical Engineering and Computer Science at the Massachusetts Institute of Technology.

Ms. Peterson has served as Executive Vice President, Worldwide Operations and Chief Customer Advocate of Sun since July 2002, as Executive Vice President, Worldwide Operations from January 2000 to July 2002, and as Vice President, Worldwide Operations from April 1998 to December 1999. She served as Vice President, Worldwide Operations, Logistics from December 1995 to April 1998 and as Director, U.S. Manufacturing from December 1993 to April 1995.

Table of Contents

Mr. Schwartz has served as Executive Vice President, Software of Sun since July 2002, as Senior Vice President, Corporate Strategy and Planning from July 2000 to July 2002, as Vice President, Ventures Fund from October 1999 to July 2000, as Vice President, Internet and Application Products from May 1999 to October 1999, as Vice President, Enterprise Products Group from July 1998 to May 1999 and as Director, Product Marketing, Javasoft, from July 1997 to July 1998.

Ms. Sueltz has served as Executive Vice President, Sun Services since July 2002, as Executive Vice President, Software Systems Group of Sun from July 2000 to June 2002 and as President, Software Products & Platforms from September 1999 to June 2000. Ms. Sueltz served in various management capacities at IBM Corporation, a diversified computer and information technology company, from 1979 to 1999. Ms. Sueltz is a Director of Delphi Corporation, a global supplier of automotive components, and Amgen Inc., a biotechnology company.

Mr. Tolliver has served as Executive Vice President, Marketing and Strategy and Chief Strategy Officer of Sun since July 2002, as Executive Vice President and President, iPlanet, Sun-Netscape Alliance from July 2000 to July 2002, as President and General Manager, Sun-Netscape Alliance from March 1999 to July 2000, as President, Consumer and Embedded Division from April 1998 to March 1999, as Vice President, Market Development from July 1996 to April 1998 and as Vice President, Strategy from December 1995 to July 1996.

Mr. Yen has served as Executive Vice President, Processor and Network Products of Sun since July 2002, as Vice President and General Manager, Processor Products Group from February 2001 to June 2002, as Vice President and General Manager, Integrated Products Group from July 2000 to January 2001, and as Vice President and General Manager, Enterprise Servers Products from September 1996 to June 2000. Mr. Yen held various positions in the Server Systems Engineering and Networked Resources Group organizations from October 1988 to August 1996.

Mr. Youngjohns has served as Executive Vice President, Global Sales Operations of Sun since July 2002, as Vice President, Europe Middle East and Africa from April 1998 to July 2002, and as Vice President, UK from November 1995 to April 1998.

Table of Contents**PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED****STOCKHOLDER MATTERS**

Our common stock trades on The Nasdaq National Market under the symbol SUNW. As of September 15, 2003, there were approximately 23,700 stockholders of record and the closing price of Sun's common stock was \$3.859 per share as reported by The Nasdaq National Market.

The following table sets forth for the fiscal periods indicated the high and low sale prices for our common stock as reported by The Nasdaq National Market:

	Fiscal 2003		Fiscal 2002	
	High	Low	High	Low
First Quarter	\$ 6.13	\$ 2.55	\$ 18.24	\$ 7.52
Second Quarter	4.58	2.34	14.72	7.81
Third Quarter	3.95	3.02	14.41	7.88
Fourth Quarter	5.64	3.13	9.55	4.55

No cash dividends were declared or paid in fiscal 2003 or fiscal 2002. We anticipate retaining available funds to finance future growth and have no present intention to pay cash dividends.

Equity Compensation Plan Information

The following table presents a summary of outstanding stock options and securities available for future grant under our stockholder approved and non-approved equity compensation plans as of June 30, 2003 (in millions, except per share amounts).

<u>Plan Category</u>	<u>Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights</u>	<u>Weighted Average Exercise Price of Outstanding Options, Warrants and Rights</u> (in dollars)	<u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans</u>

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Equity compensation plans approved by security holders (excluding ESPP)	569	\$	14.11	274
Equity compensation plans not approved by security holders (excluding ESPP)	18	\$	9.01	31
Total (excluding ESPP)	587	\$	13.95	305
Equity compensation plans approved by security holders (ESPP only)	N/A		N/A	43
Equity compensation plans not approved by security holders (ESPP only)	N/A		N/A	
Total (ESPP only)	N/A		N/A	43
All Plans	587	\$	13.95	348

For a description of material features of each equity compensation plan which has not been approved by security holders, see Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA⁽¹⁾**

The following selected financial data should be read in conjunction with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 8. Financial Statements and Supplementary Data.

Fiscal Years Ended June 30,

	2003		2002		2001		2000		1999	
	Dollars	%	Dollars	%	Dollars	%	Dollars	%	Dollars	%
(In millions, except per share amounts)										
Net revenues	\$ 11,434	100.0	\$ 12,496	100.0	\$ 18,250	100.0	\$ 15,721	100.0	\$ 11,806	100.0
Cost of sales	6,492	56.8	7,580	60.7	10,040	55.0	7,540	48.0	5,670	48.0
Gross margin	4,942	43.2	4,916	39.3	8,210	45.0	8,181	52.0	6,136	52.0
Operating expenses:										
Research and development	1,837	16.1	1,832	14.7	2,016	11.0	1,630	10.4	1,280	10.8
Selling, general and administrative	3,329	29.1	3,806	30.5	4,445	24.4	4,053	25.8	3,183	27.0
Restructuring charges	371	3.2	517	4.1	75	0.4				
Impairment of goodwill and other intangible assets	2,125	18.6	6		1		21	0.1	9	0.1
Goodwill amortization					285	1.6	72	0.4	23	0.2
Purchased in-process research and development	4		3		77	0.4	12	0.1	121	1.0
Total operating expenses	7,666	67.0	6,164	49.3	6,899	37.8	5,778	36.8	4,616	39.1
Operating income (loss)	(2,724)	(23.8)	(1,248)	(10.0)	1,311	7.2	2,393	15.2	1,520	12.9
Gain (loss) on equity investments, net	(84)	(0.7)	(99)	(0.8)	(90)	(0.5)	208	1.3		
Other income, net	155	1.3	299	2.4	363	2.0	170	1.1	85	0.7
Income (loss) before taxes	(2,653)	(23.2)	(1,048)	(8.4)	1,584	8.7	2,771	17.6	1,605	13.6
Provision (benefit) for income taxes	776	6.8	(461)	(3.7)	603	3.3	917	5.8	575	4.9
Cumulative effect of change in accounting principle, net					(54)	(0.3)				
Net income (loss)	\$ (3,429)	(30.0)	\$ (587)	(4.7)	\$ 927	5.1	\$ 1,854	11.8	\$ 1,030	8.7
Net income (loss) per common share-diluted ⁽²⁾	\$ (1.07)		\$ (0.18)		\$ (0.27)		\$ 0.55		\$ 0.31	
Shares used in the calculation of net income (loss) per common share-diluted ⁽²⁾	3,190		3,242		3,417		3,379		3,282	

As of June 30,

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
Cash, cash equivalents and marketable debt securities	\$ 5,741	\$ 5,864	\$ 6,171	\$ 6,436	\$ 2,692
Total assets	\$ 12,985	\$ 16,522	\$ 18,181	\$ 14,152	\$ 8,499
Long-term debt	\$ 1,531	\$ 1,653 ⁽³⁾	\$ 1,565	\$ 1,523	\$ 37
Deferred income taxes and other non-current obligations ⁽⁴⁾	\$ 384	\$ 202	\$ 884	\$ 774	\$ 347

- (1) Fiscal years ended June 30. All historical financial information has been restated to reflect the merger with Forte Software, Inc. on October 19, 1999.
- (2) Share and per share amounts for all periods presented have been adjusted to reflect stock splits through June 30, 2003.
- (3) Includes approximately \$204 million classified as current portion of long-term debt.
- (4) Excludes long-term deferred revenues.

Table of Contents

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

This annual report, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements regarding our intention to maintain our valuation allowance for deferred tax assets, our income tax expense in the future, our expectations regarding component cost reductions, our belief that we must continue to invest significant resources in new systems, software and microprocessor development and our intentions regarding R&D expenditure levels on a dollar basis, our continued focus on achieving operating efficiencies, our expectations regarding SG&A expenditures on a dollar basis, our expectation to pay remaining restructuring costs over the next few quarters, our workforce reduction resulting in termination of employees across all employee levels, business functions, operating units and geographic regions, our intention to sublease certain of our leased facilities, our expectations to exit certain facilities by December 28, 2003, our belief that projections used in performing valuations for our acquisitions are still valid in all material respects, our focus on inventory management, our expectation to generate positive cash flow from operations for the full fiscal year ending June 30, 2004, our long-term strategy to maintain a minimum amount of cash and cash equivalents in subsidiaries and to invest the remaining amount of cash in interest bearing and highly liquid cash equivalents and marketable debt securities, our belief that the liquidity provided by existing cash, cash equivalents, marketable debt securities and cash generated from operations will provide sufficient capital to meet our requirements for at least the next 12 months, our belief that our level of financial resources is a significant competitive factor in our industry, our current plans not to discontinue our hedging programs, our belief that the Kodak suit is without merit and our intent to defend ourselves and pursue counterclaims vigorously, our belief that the Microsoft counterclaims are without merit and our intent to present a vigorous defense, and our belief that we will be able to reach a negotiated resolution with the BIS and in the absence of a negotiated resolution, our assertion of a vigorous defense.

These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth below and those contained in RISK FACTORS, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. Such factors include, but are not limited to, increased competition, continued adverse economic conditions in the U.S. and internationally, including adverse economic conditions in the specific markets for our products, adverse business conditions, failure to design, develop and manufacture new products, lack of success in technological advancements, lack of acceptance of new products, unexpected changes in the demand for our products and services, the inability to successfully manage inventory pricing pressures, failure to reduce costs or improve operating efficiencies, changes to and compliance with international laws and regulations, currency fluctuations and our ability to attract, hire and retain key and qualified employees.

Changes to Previously Announced Fiscal 2003 Fourth Quarter and Annual Results

On July 22, 2003, we announced our fiscal 2003 fourth quarter and annual results. In connection with the preparation of our fiscal 2003 financial statements we performed an analysis of the likelihood of the realization of our net deferred tax assets. At that time, we considered all available evidence, as required, under Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109) and we concluded that we appropriately accounted for the estimated valuation allowance at that time and we would be able to realize all of our net deferred tax assets.

In conjunction with the filing of our annual report on Form 10-K for fiscal 2003, we were required to reassess all significant estimates and judgments made in our financial statements, including those made under SFAS 109, considering any additional information available. When we updated our SFAS 109 analysis, we considered continuing market uncertainties and our progress against the planned forecast of operating results for the not-yet-reported first quarter of fiscal 2004 including the impact of an anticipated loss in this quarter on the remaining planning period underlying the SFAS 109 analysis. This updated analysis therefore included the evaluation of information which was not available at the time when we performed our previous analysis when we announced our fiscal 2003 results on July 22, 2003. In light of this new information and after considering all available evidence, both positive and negative, we concluded that an increase to our valuation allowance for our deferred tax assets was required.

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Accordingly, based upon our best estimate, we have recorded a non-cash charge in the fourth quarter of fiscal 2003 of \$1,051 million to increase our valuation allowance for our deferred tax assets. Set forth below is a reconciliation of our

Table of Contents

reported results from our July 22, 2003 press release to amounts reported in this Annual Report on Form 10-K which reflects this increase to our valuation allowance (in millions, except per share amounts):

	Three Months Ended June 30, 2003			Year Ended June 30, 2003		
	Previously Announced	Increase (Decrease)	Reported in Annual Report 10-K	Previously Announced	Increase (Decrease)	Reported in Annual Report 10-K
Provision (benefit) for income taxes	\$ 9	\$ 1,051	\$ 1,060	\$ (275)	\$ 1,051	\$ 776
Net income (loss)	\$ 12	\$ (1,051)	\$ (1,039)	\$ (2,378)	\$ (1,051)	\$ (3,429)
Net income (loss) per common share-diluted and diluted	\$ 0.00	\$ (0.32)	\$ (0.32)	\$ (0.75)	\$ (0.32)	\$ (1.07)

Critical Accounting Policies

The accompanying discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States (US 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 are subject to change and the best estimates and judgments routinely require adjustment. We are required to make estimates and judgments in many areas, including those related to fair value of derivative financial instruments, recording of various accruals (including our accrual for restructuring charges), inventory reserves, the useful lives of long-lived assets such as property and equipment, warranty obligations and potential losses from contingencies and litigation. However, we believe the policies discussed below are the most critical to our financial statements because their application places the most significant demands on management's judgment. Our critical accounting policies are described in the following paragraphs.

Revenue Recognition

As discussed in Note 2 to our Consolidated Financial Statements, we enter into agreements to sell hardware, software, services and other arrangements (multiple element arrangements) that include combinations of products and/or services. While the vast majority of our sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, significant contract interpretation is sometimes required to determine the appropriate accounting including: (1) whether an arrangement exists; (2) how the price should be allocated among the deliverables if there are multiple deliverables; and (3) whether undelivered elements are essential to the functionality of delivered elements. In addition, our revenue recognition policy requires an assessment as to whether collectibility is probable, which inherently requires us to evaluate the creditworthiness of our customers.

Channel Partners selling our high volume products generally carry Sun products as inventory and we recognize revenue when we sell to the Channel Partners, if our revenue recognition criteria are met. Channel Partners selling our high-end products generally purchase our products at the time an end-user is identified. The revenue we recognize associated with channel sales transactions requires us to make estimates in several areas including: (1) creditworthiness; (2) the amount of credits we will give for subsequent changes in our price list (i.e., price protection); (3) the amount of stock rotation; and (4) customer returns.

Goodwill

We adopted Statement of Financial Accounting Standard No. 142 (SFAS 142), *Goodwill and Other Intangible Assets* on July 1, 2001. This standard requires that goodwill no longer be amortized, and instead, be tested for impairment on a periodic basis. At June 30, 2003, we had \$326 million in goodwill, as compared with \$2.2 billion at June 30, 2002.

In testing for a potential impairment of goodwill, SFAS 142 requires us to: (1) allocate goodwill to the various Sun businesses to which the acquired goodwill relates; (2) estimate the fair value of those Sun businesses to which goodwill

Table of Contents

relates; and (3) determine the carrying value (book value) of those businesses, as some assets and liabilities related to those businesses, such as inventory and accounts receivable, are not held by those businesses but by functional departments (for example, our Global Sales Operations and Worldwide Operations organizations). If the estimated fair value is less than the carrying value for a particular business, then we are required to estimate the fair value of all identifiable assets and liabilities of the business, in a manner similar to a purchase price allocation for an acquired business. This requires independent valuations of certain internally generated and unrecognized intangible assets such as in-process research and development and developed technology. Only after this process is completed, is the amount of any goodwill impairment determined.

The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgment at many points during the analysis. In estimating the fair value of the businesses with recognized goodwill for the purposes of our annual or periodic analyses, we make estimates and judgments about the future cash flows of these businesses. Although our cash flow forecasts are based on assumptions that are consistent with the plans and estimates we are using to manage the underlying businesses, there is significant judgment in determining the cash flows attributable to these businesses over their estimated remaining useful lives. In addition, we make certain judgments about allocating shared assets such as accounts receivable and inventory to the estimated balance sheet for those businesses. We also consider our market capitalization (adjusted for unallocated monetary assets such as cash, marketable debt securities and debt) on the date we perform the analysis.

When we conducted our fiscal 2002 annual analysis in the fourth quarter of fiscal 2002, we concluded at that time that we did not have any impairment of goodwill based on our then forecasted discounted cash flows as well as our market capitalization. In October 2002, based on a combination of factors, particularly: (1) our current and projected operating results; (2) our decision to reduce our workforce and eliminate excess facility space; and (3) our then current market capitalization, we concluded there were sufficient indicators to require us to perform an analysis to assess whether any portion of our recorded goodwill balance was impaired. When we performed the new analysis in October 2002, the estimated fair value of our reporting units decreased because our then current forecasted discounted cash flows and market capitalization were lower than at the time of our previous analysis. Based on this new analysis, we concluded that the goodwill in our Volume Systems and Network Storage reporting units was impaired. As required by SFAS 142, in measuring the amount of goodwill impairment, we made a hypothetical allocation of the estimated fair value of these reporting units to the tangible and intangible assets (other than goodwill) within these reporting units. Prior to this allocation of the assets to the reporting units, we assessed long-lived assets for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (SFAS 144). Based on this allocation, we concluded that all of the recorded goodwill in the Volume Systems reporting unit (\$1,566 million) and the Network Storage reporting unit (\$461 million) was impaired and needed to be expensed as a non-cash charge to continuing operations during the second quarter of fiscal 2003. Approximately \$1,560 million and \$360 million of the impairment related to goodwill acquired from our acquisitions of Cobalt Networks, Inc. and HighGround Systems, Inc., respectively.

We performed our fiscal 2003 annual analysis in the fourth quarter of fiscal 2003. Based on our estimates of forecasted discounted cash flows as well as our market capitalization, at that time, we concluded that there was no additional impairment of our goodwill. We may incur charges for impairment of goodwill in the future if the net book value of our reporting units exceeds the estimated fair value. Any additional future impairment charges could adversely affect our earnings.

Other Intangible Assets

SFAS 144 is the authoritative standard on the accounting for the impairment of other intangible assets. As required by SFAS 144, we perform tests for impairment of intangible assets other than goodwill (Other Intangible Assets) whenever events or circumstances suggest that Other Intangible Assets may be impaired. We recognized \$98 million, \$6 million and \$1 million in fiscal 2003, 2002 and 2001, respectively, as impairment charges against the carrying value of Other Intangible Assets. At June 30, 2003, we had Other Intangible Assets with a carrying value of approximately \$114 million. These consisted of Other Intangible Assets related to business combinations of approximately \$91 million and an intangible asset with a carrying value of \$23 million related to a revenue generating technology license, acquired as part of the Strategic Alliance with AOL (see Notes 4 and 5 to the Consolidated Financial Statements for further discussion). To evaluate potential impairment, SFAS 144 requires us to assess whether the future cash flows related to the asset will be greater than its carrying value at the time of the test. Accordingly, while our cash

Table of Contents

flow assumptions are consistent with the plans and estimates we are using to manage the underlying businesses, there is significant judgment in determining the cash flows attributable to our Other Intangible Assets over their respective estimated useful lives. For example, if we reduced the estimated useful life of all intangible assets as of June 30, 2003, by one year or reduced the projected cash flows by 20%, up to \$27 million of our Other Intangible Assets would be considered to be impaired and we would be required to recognize an impairment based on the difference between the fair value of these Other Intangible Assets and their carrying value.

Based on the considerations outlined in the preceding discussion on goodwill, in October 2002, we concluded there were sufficient indicators to require us to perform an analysis to assess whether a portion of our Other Intangible Assets balance was impaired. As a result of our analysis, we recognized an impairment charge of \$98 million to reduce our Other Intangible Assets balance to its estimated fair value. All impairments of Other Intangible Assets were recognized before we made a hypothetical allocation of the estimated fair value of the reporting units to the tangible and intangible assets (other than goodwill) within each reporting unit tested for goodwill impairment, as required by SFAS 142. The fair value of the other acquisition-related intangibles and a revenue generating technology license was determined based primarily on the income approach, which utilizes discounted cash flows to estimate the fair value of the asset. See Note 4 to our Consolidated Financial Statements for further discussion. We will be required to periodically evaluate our Other Intangible Assets balance for further impairments. Any additional impairments could have an adverse impact on future operating results.

Bad Debt Reserves

At June 30, 2003, our bad debt reserve was approximately \$112 million. We evaluate the collectibility of our accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations to us, we record a specific allowance against amounts due to us, and thereby reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, industry and geographic concentrations, the current business environment and our historical experience. If the financial condition of our customers deteriorates or if economic conditions worsen, additional allowances may be required in the future, which could have an adverse impact on our future operating results.

Equity Investments in Privately-Held Companies

Our investments in privately-held companies are made as part of Sun's strategic equity investment strategy. Our strategy is to invest up to certain authorized amounts in companies developing products, markets and services that are strategic to Sun's business and technology. These equity investments are generally made in connection with a round of financing with other third-party investors. At June 30, 2003, we had approximately \$170 million of equity investments in privately-held companies. As our equity investments generally do not permit us to exert significant influence or control over the entity in which we are investing, these amounts generally represent our cost of the investment, less any adjustments we make when we determine that an investment's net realizable value is less than its carrying cost.

The process of assessing whether a particular equity investment's net realizable value is less than its carrying cost requires a significant amount of judgment. In making this judgment, we carefully consider the investee's cash position, projected cash flows (both short and long-term), financing needs, recent financing rounds, most recent valuation data, the current investing environment, management/ownership changes, and competition. This valuation process is based primarily on information that we request from these privately-held companies. This information is not subject to the same disclosure and audit requirements as the reports required of U.S. public companies, and as such, the reliability and accuracy of the data may vary. Based on our evaluation, we recorded impairment charges related to our investments in privately-held companies of \$72 million, \$64 million and \$72 million in fiscal years ended 2003, 2002 and 2001, respectively.

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Estimating the net realizable value of investments in privately-held early-stage technology companies is inherently subjective and may contribute to significant volatility in our reported results of operations. For example, if the current weak investing environment continues throughout fiscal 2004, we may incur additional impairments to our equity investments in privately-held companies, which could have an adverse impact on our future earnings.

Table of Contents

Income Taxes

In determining income (loss) for financial statement purposes, we must make certain estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. SFAS 109 also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

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

In conjunction with the filing of our annual report on Form 10-K, we were required to reassess all significant estimates and judgments made in our financial statements, considering any additional information available. From the time we released our June 30, 2003 fourth quarter and annual results, on July 22, 2003, to the filing of this Form 10-K we determined that the underlying assumptions related to judgments made in connection with our SFAS 109 analysis had changed. In performing our updated analysis of the realizability of our deferred tax assets, we considered continuing market uncertainties and our progress against the planned forecast of operating results for the not-yet-reported first quarter of fiscal 2004 including the impact of an anticipated loss in this quarter on the remaining planning period underlying the SFAS 109 analysis. In light of this new information and after considering all available evidence, both positive and negative, we concluded that an increase to our valuation allowance for our deferred tax assets was required. Accordingly, based upon our best estimate, we have recorded a non-cash charge in the fourth quarter of fiscal 2003 of \$1,051 million to increase our valuation allowance for our deferred tax assets.

We intend to maintain this valuation allowance until sufficient positive evidence exists to support reversal of the valuation allowance. Our income tax expense recorded in the future will be reduced to the extent of offsetting decreases in our valuation allowance. The realization of our remaining deferred tax assets is primarily dependent on forecasted future taxable income. Any reduction in estimated forecasted future taxable income including but not limited to any future restructuring activities may require that we record an additional valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in such period and could have a significant impact on our future earnings.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

Table of Contents**RESULTS OF OPERATIONS****Net Revenues**

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Computer Systems products	\$ 6,243	(15.6)%	\$ 7,396	(40.3)%	\$ 12,389
Network Storage products	1,550	(8.7)%	1,697	(35.4)%	2,626
Products net revenue	\$ 7,793	(14.3)%	\$ 9,093	(39.4)%	\$ 15,015
Percentage of total net revenues	68.2%	(4.6) pts	72.8%	(9.5) pts	82.3%
Support services	\$ 2,844	12.1%	\$ 2,538	16.0 %	\$ 2,188
Professional and Educational services	797	(7.9)%	865	(17.4)%	1,047
Services net revenue	\$ 3,641	7.0%	\$ 3,403	5.2%	\$ 3,235
Percentage of total net revenues	31.8%	4.6 pts	27.2%	9.5 pts	17.7%
Total net revenues	\$ 11,434	(8.5)%	\$ 12,496	(31.5)%	\$ 18,250

Due to the general weakening of the U.S dollar during fiscal 2003, our total net revenues were favorably impacted by foreign exchange as compared with fiscal 2002. The net foreign currency impact to our total net revenues is difficult to precisely measure because of the various hedging strategies we employ, however our best estimate of the foreign exchange benefit in fiscal 2003 as compared with fiscal 2002 approximated 4% on total net revenues for fiscal 2003.

Products Net Revenue

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

During fiscal 2003, our Computer Systems and Network Storage products net revenue decreased, as compared with fiscal 2002, primarily as a result of an intense competitive environment as well as the continuing adverse macroeconomic conditions that began at the end of the second quarter of fiscal 2001. The adverse macroeconomic conditions affecting our business are specifically the adverse financial conditions brought on by the general recessionary downturns in the U.S. and other global economies during this time period. This economic recession has affected most of our customers and has caused reductions in technology capital spending by our customers, particularly those in the telecommunications, financial services and manufacturing industries. In addition, the recession has in some cases resulted in the loss of customers due to bankruptcies or the winding down of these companies, most notably in the so-called dot-com and telecommunications industries, which effects were most prevalent in the U.S. During fiscal 2003, we experienced continued lower sales volumes and competitive pricing pressure for both Computer Systems and Network Storage products. In addition to the factors noted above, we also believe that we are experiencing particularly intense competitive pressure at the lower end of our Computer Systems product line. Network Storage products revenue was impacted to a lesser degree than Computer Systems products revenue during fiscal 2003, as Network Storage products revenue benefited during fiscal 2003 from our introduction of new storage products, which expanded our total network storage offering.

In fiscal 2002, our products net revenue decreased as compared with fiscal 2001, primarily as a result of the adverse macroeconomic conditions that began at the end of the second quarter of fiscal 2001 and continued throughout fiscal 2002.

If the worldwide adverse economic conditions significantly worsen in a quarter or continue over an extended period of time, or if competition continues to adversely affect our business or intensifies, our results of operations and cash flows could be further adversely affected.

Services Net Revenue

Services net revenue consists of revenue generated from Sun Services (formerly Enterprise Services), which includes Support services, and Professional and Educational services.

Table of Contents

During fiscal 2003, the growth in services net revenue, as compared with fiscal 2002, was due to an increase in revenue from Support services (of approximately 12%), partially offset by decreases in revenue from Professional and Educational services (of approximately 8%). Support services revenue, which represents over 67% of services net revenue for all periods presented, consists primarily of maintenance contract revenue. Support services revenue growth was primarily a result of an increase in the number of systems under contracts as we renewed contracts with existing customers and entered into new contracts from the sale of new systems. Professional and Educational services revenue is generated from technical consulting to help customers plan, implement, and manage distributed network computing environments and from development and delivery of integrated learning solutions for enterprises, IT organizations, and individual IT professionals. The Professional and Educational services revenue decrease during fiscal 2003 was due primarily to reductions in customer IT spending, an intense competitive environment and, to a lesser extent, the reduction in new product sales.

In fiscal 2002, the 5.2% growth in services net revenue, as compared with fiscal 2001, was due to an increase in revenue from Support services, partially offset by decreases in revenue from Professional and Educational services. Support services revenue growth was primarily a result of: (1) an increase in our installed base of systems; and (2) a better mix of platinum, gold, silver and bronze service level contracts in our portfolio (i.e. more premium services with higher associated revenue). The Professional and Educational services revenue decrease was due to a combination of: (1) a reduction in customers discretionary spending, and (2) a decline in new product sales.

A significant portion of our services net revenue is generated by contracts related to new product sales; as a result, our services net revenue could be negatively impacted if macroeconomic conditions continue to negatively impact our products net revenue.

Net Revenues by Geographic Area

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
U.S. (United States)	\$ 5,048	(14.9)%	\$ 5,935	(32.4)%	\$ 8,779
Americas Other (Canada and Latin America)	543	(5.2)%	573	(28.9)%	806
Americas Total	\$ 5,591	(14.1)%	\$ 6,508	(32.1)%	\$ 9,585
Percentage of net revenues	48.9%	(3.2) pts	52.1%	(0.4) pts	52.5%
EMEA (Europe, Middle East and Africa)	\$ 3,783	(1.2)%	\$ 3,830	(30.7)%	\$ 5,526
Percentage of net revenues	33.1%	2.5 pts	30.6%	0.3 pts	30.3%
APAC (Asia, Australia and New Zealand)	\$ 2,060	(4.5)%	\$ 2,158	(31.3)%	\$ 3,139
Percentage of net revenues	18.0%	0.7 pts	17.3%	0.1 pts	17.2%
Total net revenues	\$ 11,434	(8.5)%	\$ 12,496	(31.5)%	\$ 18,250

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
U.S.	\$ 5,048	(14.9)%	\$ 5,935	(32.4)%	\$ 8,779
Percentage of net revenues	44.1%	(3.4) pts	47.5%	(0.6) pts	48.1%
International	\$ 6,386	(2.6)%	\$ 6,561	(30.7)%	\$ 9,471
Percentage of net revenues	55.9%	3.4 pts	52.5%	0.6 pts	51.9%
Total net revenues	\$ 11,434	(8.5)%	\$ 12,496	(31.5)%	\$ 18,250

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

In fiscal 2003, our total net revenues decreased by 8.5% as compared with fiscal 2002. The decrease in total net revenues in the U.S. and internationally is primarily the result of continued adverse macroeconomic conditions and an intense competitive environment. See [Products Net Revenue](#) for the description of adverse macroeconomic conditions.

Table of Contents

The following table sets forth net revenues in countries or regions contributing significantly to changes in international net revenues during the last three fiscal years:

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Germany	\$ 931	13.5%	\$ 820	(28.7)%	\$ 1,150
United Kingdom (UK)	\$ 849	(9.0)%	\$ 933	(36.6)%	\$ 1,471
Northern Europe *	\$ 568	(5.6)%	\$ 602	(30.1)%	\$ 870
Japan	\$ 936	(11.7)%	\$ 1,060	(38.0)%	\$ 1,711

* Northern Europe consists primarily of the Scandinavian countries, the Netherlands, Belgium, Luxembourg, Eastern European countries and Russia.

During fiscal 2003, we experienced lower sales volumes in the UK and Northern Europe, as compared with fiscal 2002 primarily due to adverse macroeconomic conditions similar to those experienced in the U.S. and an intense competitive environment. In Germany, we believe the increase in revenue, despite continued adverse economic conditions in this country, was primarily due to the increased success we have been experiencing as a result of our emphasis on an end-to-end networking architecture platform selling approach in that region. The net foreign currency impact is difficult to precisely measure because of the various hedging strategies we employ, however our best estimate of the foreign exchange benefit in fiscal 2003 as compared with fiscal 2002 approximated 12% on EMEA net revenues for fiscal 2003.

Economic conditions in Japan have declined substantially in recent years and, combined with an intense competitive environment in this country, have adversely impacted our sales. In particular, during fiscal 2003, we faced continued intense competitive pressure, together with our Channel Partners, when responding to the changing requirements of the Japanese market. If the adverse economic conditions in Japan continue or worsen and competition continues to intensify, our results of operations and cash flows could be further adversely affected.

In fiscal 2003, decreases in net revenues in Japan, the UK and Northern Europe partially offset by an increase in net revenues in Germany accounted for approximately 75% of the total decrease in international net revenues, as compared with fiscal 2002.

In fiscal 2002, within the EMEA region, net revenues decreased by 30.7% as compared with fiscal 2001, primarily because of decreases in net revenues in the UK, Germany and Northern Europe.

In fiscal 2002, within the APAC region, net revenues decreased by 31.3% as compared with fiscal 2001, primarily because of decreases in net revenues in Japan, China and Korea totaling \$841 million of the \$981 million overall APAC decrease.

In fiscal 2002, decreases in net revenues in Japan, the UK, Northern Europe, and Germany collectively accounted for approximately 61% of the total decrease in international net revenues, as compared with fiscal 2001.

Gross Margin

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Products gross margin	\$ 3,451	(3.8)%	\$ 3,587	(49.1)%	\$ 7,055
Percentage of products net revenue	44.3%	4.9 pts	39.4%	(7.6) pts	47.0%
Services gross margin	\$ 1,491	12.2%	\$ 1,329	15.1 %	\$ 1,155
Percentage of services net revenue	41.0%	1.9 pts	39.1%	3.4 pts	35.7%
Total gross margin	\$ 4,942	(8.6)%	\$ 4,916	(40.1)%	\$ 8,210
Percentage of net revenues	43.2%	3.9 pts	39.3%	(5.7) pts	45.0%

Products Gross Margin

In fiscal 2003, our products gross margin percentage increased by 4.9 percentage points, as compared with fiscal 2002.

Table of Contents

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

In fiscal 2003, as compared with fiscal 2002, the 4.9 percentage point increase in our products gross margin percentage was primarily the result of: (1) lower purchased component costs, benefiting products gross margin by approximately 6 percentage points; (2) lower platform transition costs associated with the conversion of a majority of our product lines to the UltraSPARC III microprocessor that were incurred in the first half of fiscal 2002, and lower fixed manufacturing costs benefiting products gross margin by approximately 3 points; and (3) lower amortization costs of certain of our intangible assets that were partially written-down during the second quarter of fiscal 2003, benefiting products gross margin by approximately 1 point. These favorable factors were partially offset by: (1) reductions in product pricing (normal price list reductions and competitive transaction pricing), negatively impacting products gross margin by approximately 5 points; and (2) changes in the sales products mix, negatively impacting products gross margin by approximately 1 point.

In fiscal 2002, products gross margin decreased by 7.6 percentage points, as compared with fiscal 2001. Substantially all of the 7.6 percentage point decline in products gross margin was due to reductions in product pricing (normal price list reductions and competitive transaction pricing), negatively impacting products gross margin by approximately 10 percentage points and higher platform transition costs associated with conversion of a majority of our product lines to the UltraSPARC III microprocessor, negatively impacting products gross margin by approximately 1 point. These transition costs primarily consisted of write-offs for excess and obsolete inventory and costs associated with rework. However, the resulting decline in products gross margin was partially offset by lower purchased component costs, benefiting products gross margin by approximately 5 points.

We have experienced significant component cost reductions over the last several years, which have benefited our products gross margin, but we do not expect these decreases to continue to the same degree in the future. In addition, should the current global macroeconomic conditions remain unfavorable or deteriorate further affecting the demand for our products, or the pricing pressures associated with competition worsen, products gross margin could be adversely impacted.

Services Gross Margin

In fiscal 2003, services gross margin percentage increased 1.9 percentage points as compared with fiscal 2002.

Services gross margin percentage is influenced by numerous factors including services mix, pricing, geography mix, currency 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 are our best estimates only.

During fiscal 2003, as compared with fiscal 2002, the 1.9 percentage points increase in our services gross margin percentage reflected the impact of: (1) overall cost reductions, primarily from decreases in discretionary spending, and improved operating efficiencies across all lines of our services business, helped, in part, by lower overall headcount, benefiting services gross margin by approximately 3 points; and (2) Support services revenue increasing as a percentage of total services net revenue (Support services generates a higher gross margin than Professional and Educational services), benefiting services gross margin by approximately 1 point. The impact of these favorable items on services gross margin

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

in fiscal 2003, as compared with fiscal 2002, was partially offset by competitive pricing pressures, which negatively impacted services gross margin by approximately 2 points.

In fiscal 2002, the 3.4 percentage point increase in services gross margin, as compared with fiscal 2001, reflected the impact of: (1) variable costs decreasing as a result of discretionary spending controls, benefiting gross margin by approximately 2 percentage points; (2) Support services revenue increasing as a percentage of total services net revenue, benefiting gross margin by approximately 1 point; and (3) infrastructure headcount-related costs decreasing due to the workforce reduction in the second quarter of fiscal 2002 (direct services headcount decreased by 2% or

Table of Contents

approximately 240 employees while services revenue continued to grow), benefiting gross margin by approximately 1 point. The impact of these favorable items on services gross margin in fiscal 2002, as compared with fiscal 2001, was partially offset by: (1) increased fixed infrastructure costs, negatively impacting services gross margin by approximately 1 point; and (2) increased third-party costs necessary to support global customer service expectations, negatively impacting services gross margin by approximately 1 point.

Operating Expenses

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Research and development	\$ 1,837	%	\$ 1,832	(9.1)%	\$ 2,016
Percentage of net revenues	16.1%	1.4 pts	14.7%	3.7 pts	11.0%
Selling, general and administrative	\$ 3,329	(12.5)%	\$ 3,806	(14.4)%	\$ 4,445
Percentage of net revenues	29.1%	(1.4) pts	30.5%	6.1 pts	24.4%
Restructuring charges	\$ 371	(28.2)%	\$ 517	589.3%	\$ 75
Percentage of net revenues	3.2%	(0.9) pts	4.1%	3.7 pts	0.4%
Impairment of goodwill and other intangible assets	\$ 2,125	N/M	\$ 6	N/M	\$ 1
Percentage of net revenues	18.6%	18.6 pts	%	pts	%
Goodwill amortization	\$	N/M	\$	N/M	\$ 285
Percentage of net revenues	%	pts	%	(1.6) pts	1.6%
Purchased in-process research and development	\$ 4	33.3%	\$ 3	(96.1)%	\$ 77
Percentage of net revenues	%	pts	%	(0.4) pts	0.4%
N/M Not meaningful					

Research and Development (R&D) Expenses

During fiscal 2003, R&D expenses in dollars remained relatively flat, as compared with the same period a year ago. However, the components of R&D expenses for fiscal 2003, differed from fiscal 2002. During fiscal 2003, as compared with fiscal 2002, an \$81 million net increase in compensation costs was substantially offset by a \$76 million decrease in: (1) costs incurred for prototype development of \$27 million; (2) depreciation costs of \$22 million; (3) infrastructure costs of \$21 million due to our restructuring plans; and (4) discretionary spending of \$6 million.

The \$184 million decrease in R&D expenses for fiscal 2002, as compared with fiscal 2001, was primarily a result of: (1) significant cost cutting measures in the areas of consulting, travel and other types of discretionary spending of approximately \$98 million; (2) lower costs incurred for prototype development of approximately \$47 million; and (3) a decrease in compensation costs of approximately \$74 million as a result of our annual one week mandatory shutdown in July 2001, lower incentive compensation costs and a reduction in headcount (during fiscal 2002, approximately 500 employees of Sun's workforce reduction were engineering employees). These reductions were partially offset by higher depreciation costs of approximately \$35 million.

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. In the short-term, on a dollar basis, we intend to slightly increase our levels of R&D expenditures.

Selling, General and Administrative (SG&A) Expenses

SG&A expenses decreased \$477 million to \$3,329 million in fiscal 2003, as compared with \$3,806 million in fiscal 2002. The \$477 million decrease was primarily the result of: (1) a \$196 million decrease in discretionary spending in areas such as advertising and consulting; (2) a \$179 million decrease in compensation costs (which is net of a \$33 million decreased benefit from our annual mandatory shutdown in July 2002, as compared with our mandatory July 2001 shutdown, resulting from fewer required vacation days in July 2002 as compared with July 2001, a \$20 million increase in benefits costs and a \$31 million increase due to annual salary adjustments during the third

Table of Contents

quarter of fiscal 2003) primarily as a result of headcount reductions; and (3) a \$102 million decrease in depreciation and occupancy costs as a result of reductions in capital expenditures and reductions from our facility exit plans.

In fiscal 2002, SG&A expenses decreased \$639 million to \$3,806 million as compared with \$4,445 million in fiscal 2001, primarily as a result of: (1) significant cost cutting measures in the areas of travel, advertising, marketing, facilities and other types of discretionary spending of approximately \$425 million; and (2) lower aggregate compensation costs of approximately \$250 million as a result of our workforce reduction that began in the second quarter of fiscal 2002, a benefit from our mandatory July shutdown, implemented in July 2001 and lower incentive compensation costs. These reductions were partially offset by higher depreciation costs of approximately \$60 million.

We are continuing to focus our efforts on achieving additional operating efficiencies by reviewing and improving upon existing business processes and evaluating our cost structure. In the short-term, on a dollar basis, we expect to slightly decrease our SG&A expenditures.

Restructuring Charges

The following discussion should be read in connection with Note 6 to the Consolidated Financial Statements.

We committed to restructuring plans in fiscal 2003 and 2002 (Fiscal 2003 Restructuring Plan and Fiscal 2002 Restructuring Plan, respectively) and a facility exit plan in fiscal 2001 (Fiscal 2001 Facility Exit Plan). We recorded initial restructuring charges in fiscal 2003, 2002 and 2001 based on assumptions and related estimates that we deemed appropriate for the economic environment that existed at the time these estimates were made. However, due to the continued deterioration of the commercial real estate market, primarily in the U.S., and the final settlement of certain lease obligations, we have made appropriate adjustments to the initial restructuring charges recorded in fiscal 2003, 2002 and 2001. During fiscal 2001, we recorded a charge of \$75 million for the Fiscal 2001 Facility Exit Plan. During fiscal 2002, we recorded net charges of \$517 million: \$26 million of additional charges related to our Fiscal 2001 Facility Exit Plan and the remaining net charges of \$491 million related to our Fiscal 2002 Restructuring Plan. During fiscal 2003, we recorded net charges of \$371 million: \$33 million of additional charges related to our Fiscal 2001 Facility Exit Plan, \$38 million of additional charges related to our Fiscal 2002 Restructuring Plan and \$300 million net charges related to our Fiscal 2003 Restructuring Plan. Details about each of these plans are discussed below.

Our accrued liability for all plans of \$375 million at June 30, 2003, was net of approximately \$156 million of estimated sublease income to be generated from sublease contracts not yet negotiated. Our ability to generate this amount of sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated, is highly dependent upon the economic conditions, particularly commercial real estate market conditions in certain geographies, at the time we negotiate the lease termination and sublease arrangements with third parties. While the amount we have accrued represents our best estimate of the remaining obligations we expect to incur in connection with these plans, estimates are subject to change and may have required routine adjustments as conditions and facts change through the implementation period. If adverse macroeconomic conditions continue, particularly as they pertain to the commercial real estate market, we may be required to reduce our estimated future sublease income and, accordingly, increase our estimated cost to exit certain facilities.

Fiscal 2003 Restructuring Plan

In October 2002, we committed to and began implementing a workforce reduction and facility exit plan (Fiscal 2003 Restructuring Plan). The goal of this plan was to reduce costs and improve operating efficiencies in order to adjust to the current business environment. We implemented

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

the plan by reducing headcount and eliminating excess facility capacity in light of revised facility requirements. In accordance with EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring), we recognized \$308 million in restructuring charges associated with the Fiscal 2003 Restructuring Plan (consisting of a \$176 million workforce reduction charge and a \$132 million excess facility charge).

During the second quarter of fiscal 2003, we recognized a workforce reduction charge of \$176 million relating to severance and related fringe benefits for approximately 3,200 employees. As of June 30, 2003, substantially all employees to be terminated as a result of the restructuring 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

Table of Contents

restructuring accrual related to severance over the next few quarters. The workforce reduction will result in the termination of employees across all employee levels, business functions, operating units, and geographic regions.

In addition, during the second quarter of fiscal 2003, we recorded a charge of \$132 million relating to the consolidation of excess facilities. The facility exit charges included:

\$114 million of estimated future obligations for non-cancelable lease payments (net of estimated sublease income of \$44 million) or termination fees generated by exiting excess rental facilities. We estimated the cost of exiting and terminating the facility leases by referring to the contractual terms of the agreements and by evaluating the current real estate market conditions. In addition, we intend to sublease certain leased facilities and estimated the sublease income by evaluating the current real estate market conditions or, where applicable, by referring to amounts being negotiated; and

\$18 million for the impairment of property and equipment (primarily leasehold improvements) for which there are insufficient cash flows to support the carrying cost. The property and equipment impairment was determined based on the difference between the assets' estimated fair value and their carrying value.

We expect to exit the facilities relating to the amounts accrued under the Fiscal 2003 Restructuring Plan by December 28, 2003. At June 30, 2003, we had an aggregate accrued liability of \$110 million with respect to the Fiscal 2003 Restructuring Plan.

During the second half of fiscal 2003, we reduced our estimate of the total cost associated with this restructuring activity to \$300 million and accordingly, recorded an adjustment of \$8 million.

Fiscal 2002 Restructuring Plan

In the second quarter of fiscal 2002, we implemented a workforce reduction and facility exit plan, which resulted in a charge of \$511 million (consisting of a \$146 million workforce reduction charge and a \$365 million excess facility charge). The goal of the restructuring was to reduce costs and improve operating efficiencies in order to adjust to the then current business environment. Specifically, we reduced our headcount by approximately 9% (or 3,400 employees and 500 contractors) and eliminated excess facilities in light of revised facility requirements.

As part of the restructuring, we recorded a workforce reduction charge of \$146 million related to severance and fringe benefits for terminated employees. The restructuring resulted in the termination of employees across all employee levels, business functions, operating units, and geographic regions. In addition, we recorded a charge of \$365 million related to the consolidation of excess facilities. The facility exit charges included:

\$282 million of estimated future obligations for non-cancelable lease payments or termination fees generated by exiting excess leased facilities. Our estimate of the cost of exiting and terminating the facility leases was based on the contractual terms of the agreements and then current commercial real estate market conditions. In addition, we intend to sublease certain leased facilities and estimated the sublease income based on then current real estate market conditions or, where applicable, amounts being negotiated;

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

\$66 million for the impairment of in-process construction costs related to the termination of certain building construction projects; and

\$17 million for the impairment of property and equipment (primarily leasehold improvements) that were no longer in use. The property and equipment impairment was determined based on the difference between the assets' estimated fair value and their carrying value.

All facilities relating to the amounts accrued under the restructuring were exited by December 31, 2002.

During the second half of fiscal 2002, we reduced our initial estimate, primarily to reflect the settlement of certain lease obligations associated with this restructuring activity and recorded an adjustment of \$20 million. During fiscal 2003, we increased our estimate and recorded an adjustment of \$38 million. This adjustment primarily reflects the decrease in estimated sublease income due to the deterioration of certain commercial real estate markets. As of June 30, 2003, the revised total estimated cost for the Fiscal 2002 Restructuring Plan of \$529 million was net of approximately \$121 million of estimated sublease income.

Table of Contents**Fiscal 2001 Facility Exit Plan**

In the fourth quarter of fiscal 2001, we elected to exit certain building leases and discontinue certain building projects. We incurred approximately \$75 million for facility exit costs associated with this decision. As a result of the continued deterioration of certain commercial real estate markets, we reduced our sublease income assumptions and, accordingly, recorded an additional \$26 million and \$33 million charge in fiscal 2002 and fiscal 2003, respectively, to reflect this change in our estimates. As of June 30, 2003, the revised total estimated facility exit cost of \$134 million was net of approximately \$31 million in estimated sublease income.

The following table sets forth an analysis of the restructuring accrual activity for the fiscal years ended June 30, 2003, 2002 and 2001 (in millions):

	Fiscal 2003		Fiscal 2002		Fiscal 2001	
	Restructuring Plan		Restructuring Plan		Facility Exit Plan	
	Severance and Benefits	Facilities Related	Severance and Benefits	Facilities Related	Facilities Related	Total
Restructuring provision in fiscal 2001:						
Accrued lease costs	\$	\$	\$	\$	\$ 46	\$ 46
Property and equipment impairment					29	29
Total restructuring charges in fiscal 2001					75	75
Non-cash charges					(29)	(29)
Balance as of June 30, 2001					46	46
Restructuring provision in fiscal 2002:						
Severance and benefits			146			146
Accrued lease costs				282		282
Property and equipment impairment				83		83
Provision adjustments				(20)	26	6
Total restructuring charges in fiscal 2002			146	345	26	517
Cash paid			(127)	(93)	(19)	(239)
Non-cash charges				(83)		(83)
Balance as of June 30, 2002			19	169	53	241
Restructuring provision in fiscal 2003:						
Severance and benefits	176					176
Accrued lease costs		114				114
Property and equipment impairment		18				18
Provision adjustments	(4)	(4)	(2)	40	33	63
Total restructuring charges in fiscal 2003	172	128	(2)	40	33	371
Cash paid	(148)	(5)	(17)	(31)	(26)	(227)

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Non-cash charges		(13)		3		(10)
Balance as of June 30, 2003	\$ 24	\$ 110	\$	\$ 181	\$ 60	\$ 375

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of June 30, 2003 for abandoned leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of June 30, 2003, \$123 million of the \$375 million accrual was classified as current and the remaining \$252 million was classified as non-current.

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

Table of Contents

Impairment of Goodwill and Other Intangible Assets

In October 2002, based on a combination of factors, particularly: (1) our current and projected operating results; (2) our decision to reduce our workforce and eliminate excess facility space; and (3) our then current market capitalization, we concluded there were sufficient indicators to require us to assess whether any portion of our recorded goodwill balance was impaired. As part of this analysis, SFAS 142 requires that we estimate the fair value of our reporting units as compared with their estimated book value. If the estimated fair value of a reporting unit is less than the estimated book value, then an impairment is deemed to have occurred. In estimating the fair value of our reporting units, we primarily used the income approach (which utilizes forecasted discounted cash flows to estimate the fair value of the reporting unit) and the market approach (which estimates fair value based on market prices for comparable companies). We also considered Sun's total market capitalization as of October 17, 2002 (the date we concluded an analysis was required), and our average market capitalization for the 30 days prior to and subsequent to October 17, 2002 to adequately consider the impact of volatility on our market capitalization on that day.

We conducted our fiscal 2002 annual analysis in the fourth quarter of fiscal 2002. We concluded at that time, that we did not have any impairment of goodwill based on our then forecasted discounted cash flows as well as our market capitalization. However, in October 2002, the estimated fair value of our reporting units decreased because our current forecasted discounted cash flows and market capitalization were lower than at the time of our previous analysis. Based on this analysis, we concluded that the goodwill in our Volume Systems and Network Storage reporting units was impaired. As required by SFAS 142, in measuring the amount of goodwill impairment, we made a hypothetical allocation of the estimated fair value of the reporting units to the tangible and intangible assets (other than goodwill) within these reporting units. Based on this allocation, we concluded that all of the recorded goodwill in the Volume Systems reporting unit (\$1,566 million) and the Network Storage reporting unit (\$461 million) was impaired and needed to be expensed as a non-cash charge to continuing operations during the second quarter of fiscal 2003.

We performed our fiscal 2003 annual analysis in the fourth quarter of fiscal 2003. Based on our estimates of forecasted discounted cash flows as well as our market capitalization at that time, we concluded that there was no additional impairment of our goodwill.

Based on the same considerations outlined in the above discussion on goodwill, in October 2002, we concluded there were sufficient indicators to require us to assess whether a portion of our other intangible assets was impaired. SFAS 144 is the authoritative standard on the accounting for the impairment of other intangible assets. As a result of our analysis we recognized an impairment expense of \$98 million in our Product Group reporting segment to reduce our Other Intangible Assets balance to its fair value during the second quarter of fiscal 2003. All impairments of non-goodwill intangible assets were recognized before we made a hypothetical allocation of the estimated fair value of the reporting units to the tangible and intangible assets (other than goodwill) within each reporting unit tested for goodwill impairment, as required by SFAS 142. The fair value of the other acquisition-related intangibles and a revenue generating technology license was determined based primarily on the income approach, which utilizes discounted cash flows to estimate the fair value of the asset.

Goodwill Amortization

Sun adopted Statement of Financial Accounting Standards 141, Business Combinations, and SFAS 142, effective July 1, 2001, and discontinued amortization of goodwill in fiscal 2002. The goodwill amortization expense was primarily attributable to the acquisition of Cobalt Networks, Inc. in December 2000.

Purchased In-Process Research and Development (IPRD)

Overview

IPRD expense of \$3.5 million, \$3.2 million, and \$77.4 million in fiscal 2003, 2002, and 2001, respectively, is a result of in-process technologies associated with our acquisitions of: Pirus Networks, Inc. (Pirus) and Terraspring, Inc. (Terraspring) in fiscal 2003; ISOPIA, Inc. (Isopia) in fiscal 2002; and LSC, Incorporated (LSC), HighGround Systems, Inc. (HighGround), InfraSearch, Inc. (InfraSearch), Cobalt Networks, Inc. (Cobalt) and grapeVINE Technologies, L.L.C. (grapeVINE) in fiscal 2001 (collectively the Acquired Companies). At the date of each acquisition noted above, the projects associated with the IPRD efforts had not yet reached technological feasibility and the IPRD had no

Table of Contents

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 Consolidated Financial Statements for further discussion.

Valuation of IPRD

General

Amounts allocated to IPRD are calculated using established valuation techniques accepted in the high-technology industry. These calculations give 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 value and contribution of the acquired research and development. We gave consideration to 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 expected cost to complete the project in determining the value assigned to IPRD.

Approach Used for Valuation of IPRD in the Purchase Acquisitions Presented

The values assigned to developed technologies related to each acquisition were based upon discounted cash flows related to the future products projected income stream. Elements of the projected income stream included revenues, cost of sales (COS), SG&A expenses, and R&D 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. As 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. In addition, we did not expect to achieve a material amount of expense reductions or synergies; therefore, the valuation assumptions did not include significant anticipated cost savings.

Valuation Assumptions

The following table summarizes the significant assumptions underlying the valuations related to the IPRD from each of the Acquired Companies in fiscal 2003, 2002, and 2001 (dollars in millions):

Acquired Company	IPRD	Estimated Cost to Complete Technology at Time of Acquisition	Percentage Completed at Time of Acquisition	Average Revenue Growth Rate	Percentage of Revenue			
					Average COS	Average SG&A	Average R&D	Discount Rate Used
Fiscal 2003								
Pirus	\$ 3.3	\$ 3.8	30%	15%	51%	31%	4%	22%

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Terraspring	\$ 0.2	\$ 1.0	25%	23%	12%	22%	2%	31%
Fiscal 2002								
Isopia	\$ 3.2	\$ 0.6	45%	58%	13%	35%	2%	26%
Fiscal 2001								
LSC	\$ 0.3	\$ 0.5	78%	70%	10%	40%	2%	24%
HighGround	\$ 4.8	\$ 5.0	58%	54%	2%	60%	2%	26%
InfraSearch	\$ 1.0	\$ 0.8	75%	247%	18%	50%	1%	30%
Cobalt	\$ 70.8	\$ 1.5	67%	50%	49%	28%	1%	22%
grapeVINE	\$ 0.5	\$ 0.3	83%	10%	18%	48%	1%	23%

Overview of IPRD in Fiscal 2003, 2002 and 2001

Included below are further details regarding the nature of the significant amounts of purchased technology acquired during fiscal 2003, 2002 and 2001.

Given the uncertainties of the commercialization process, no assurance 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

Table of Contents

related to commercialization of an in-process project due to rapidly changing customer needs, the complexity of the 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 acquired may become impaired.

Cobalt

On December 7, 2000, we acquired all of the outstanding capital stock of Cobalt, a Delaware corporation, by means of a merger transaction pursuant to which all of the outstanding capital stock and options of Cobalt were converted into the right to receive shares of and options to purchase our common stock.

At the acquisition date, Cobalt was engaged in development activity associated with development of its Cobalt RaQ XTR, Qube ML and CacheRaQ server appliance products as well as related software. These products perform critical Internet-related applications including file serving, web hosting, and providing software applications over the Internet, such as electronic mail and electronic commerce. These products also provide overflow file storage for network users, and network caching products, which enable more efficient bandwidth usage and improve speed of Internet content delivery. At the acquisition date, Cobalt had made substantial progress in the areas of product definition, architecture design and coding. Remaining efforts necessary to complete these server appliance products related primarily to additional coding, testing and implementation. We released certain general availability versions of these products in late January 2001 through April 2001, at which time we began to realize economic benefits associated with these server appliance products.

The following table provides information regarding the status of IPRD projects at the date of acquisition and as of June 30, 2003 (in millions):

<u>Acquired Company/Business</u>	<u>Estimated Cost to Complete at Time of Acquisition</u>	<u>Actual Costs Incurred as of June 30, 2003</u>	<u>Actual Product Release Date</u>
Pirus	\$ 3.8	\$	N/A ⁽¹⁾
Terraspring	\$ 1.0	\$	N/A ⁽¹⁾
Isopia	\$ 0.6	\$ 1.2	Q3FY2002
LSC	\$ 0.5	\$ 1.1	Q4FY2001
HighGround	\$ 5.0	\$ 5.5	Q4FY2001
InfraSearch	\$ 0.8	\$ 0.8	N/A ⁽²⁾
Cobalt	\$ 1.5	\$ 2.5	Q3FY2001
grapeVINE	\$ 0.3	\$ 1.1	Q4FY2001

- (1) Projects identified as IPRD when we acquired the company have been delayed since the acquisition and are not currently part of any specific projects roadmap.
- (2) The associated OpenSearch technology is being incorporated into Project JXTA, our incubation research effort addressing new styles of distributed computing.

Except for the acquisitions discussed under Note 4 to the Consolidated Financial Statements, we believe that the projections we used in performing our valuations for each acquisition, are still valid in all material respects; however, we cannot assure you that the projected results will be achieved. We continue to make substantial progress related to the development and commercialization of acquired technologies. Although we have experienced delays in the completion of certain of our development efforts and their related commercialization, the expected

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

total costs to complete such technologies have not materially increased, individually or in the aggregate, from our estimates at the time of the acquisitions. We periodically evaluate our product development timeline and modify our overall business plan in response to various factors. Modifications to our business plan include the reallocation of resources among various alternative development projects. As of June 30, 2003, and for each of the three fiscal years then ended, the impact of delays in the realization of economic benefits related to acquired technologies, individually or in the aggregate, has not been material to our overall consolidated financial position.

Table of Contents**Loss on Equity Investments**

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Loss on equity investments, net	\$ 84	(15.2)%	\$ 99	10.0%	\$ 90
Percentage of net revenues	0.7%	(0.1) pts	0.8%	0.3 pts	0.5%

Our equity investments portfolio, which primarily consists of investments in publicly traded and privately-held technology companies, has continued to be negatively impacted by the adverse macroeconomic conditions and declining equity valuations in the technology sector during fiscal 2003. The loss on equity investments in fiscal 2003 of \$97 million, as compared with \$102 million in fiscal 2002 and \$142 million in fiscal 2001, was primarily related to a decline in value of the portfolio that was considered other than temporary. This loss was partially offset by gains of \$13 million in fiscal 2003, as compared with \$3 million in fiscal 2002 and \$52 million in fiscal 2001, relating to the valuation of warrants and the sale of certain marketable equity securities. See Note 2 to the Consolidated Financial Statements for further discussion.

The privately-held technology companies in which we have invested are particularly vulnerable to the current adverse economic conditions and the related slow down of investing activity in the private equity market place. If the current negative economic conditions persist, we may incur additional losses on our investments.

Other Income, net

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Interest income	\$ 166	(31.7)%	\$ 243	(40.0)%	\$ 405
Interest expense	(43)	(25.9)%	(58)	(42.0)%	(100)
Gain on marketable debt securities	32	(71.9)%	114	96.6 %	58
Other income, net	\$ 155	(48.2)%	\$ 299	(17.6)%	\$ 363
Percentage of net revenues	1.4%	(1.0) pts	2.4%	0.4 pts	2.0%

In fiscal 2003, other income, net, decreased 48.2%, as compared with fiscal 2002. The decrease in fiscal 2003, as compared with fiscal 2002, is primarily due to fewer realized gains on the sale of certain marketable debt securities (a decrease of \$82 million) and a combination of lower interest rates and lower cash and marketable debt securities balances (a decrease of \$77 million). These unfavorable factors were partially offset by a decrease in our interest expense of \$15 million for fiscal 2003, as compared with fiscal 2002, as a result of lower interest rates and lower debt principal outstanding during fiscal 2003.

In fiscal 2002, the 17.6% decrease in other income, net as compared with fiscal 2001, was primarily due to a combination of lower interest rates and lower cash and marketable debt securities balances, partially offset by an increase in the amount of gain realized on the sale of certain fixed

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

income marketable debt securities during fiscal 2002. Our interest expense relates primarily to our issuance of \$1.5 billion of unsecured senior debt securities in August 1999.

The average duration of our portfolio of marketable securities decreased to 0.72 year as of June 30, 2003 from 0.89 year as of June 30, 2002. 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 securities which are predominantly variable interest rate instruments. To better match the interest rate characteristics of our fixed-rate unsecured senior debt securities with those in our investment portfolio, we entered into interest rate swap transactions so that the interest associated with these debt securities effectively becomes variable.

Table of Contents**Income Taxes**

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Provision (benefit) for income taxes	\$ 776	N/M	\$ (461)	N/M	\$ 603
Percentage of income (loss) before taxes and cumulative effect of change in accounting principle	N/A	N/A	44.0%	5.9 pts	38.1%

In fiscal 2003, we recorded an expense for income taxes of \$776 million on pretax losses of \$2,653 million. In fiscal 2002 and 2001, our effective income tax rates were 44.0% and 38.1% respectively.

The tax expense for fiscal 2003 is due primarily to the increase in our valuation allowance and the non-deductibility of goodwill impairment recognized in fiscal 2003.

In fiscal 2003, we recorded a total of \$1,082 million non-cash charge to our valuation allowance which reduced our net deferred tax assets to \$582 million.

In conjunction with the filing of our annual report on Form 10-K, we were required to reassess all significant estimates and judgments made in our financial statements, considering any additional information available. From the time we released our June 30, 2003 fourth quarter and annual results, on July 22, 2003, to the filing of this Form 10-K we determined that the underlying assumptions related to judgments made in connection with our SFAS 109 analysis had changed. In performing our updated analysis of the realizability of our deferred tax assets, we considered continuing market uncertainties and our progress against the planned forecast of operating results for the not-yet-reported first quarter of fiscal 2004 including the impact of an anticipated loss in this quarter on the remaining planning period underlying the SFAS 109 analysis. In light of this new information and after considering all available evidence, both positive and negative, we concluded that an increase to our valuation allowance for our deferred tax assets was required. Accordingly, based upon our best estimate we have recorded a non-cash charge in the fourth quarter of fiscal 2003 of \$1,051 million to increase our valuation allowance for our deferred tax assets.

We intend to maintain this valuation allowance until sufficient positive evidence exists to support reversal of the valuation allowance. Our income tax expense recorded in the future will be reduced to the extent of offsetting decreases in our valuation allowance. The realization of our remaining deferred tax assets is primarily dependent on forecasted future taxable income. Any reduction in estimated forecasted future taxable income, including but not limited to any future restructuring activities may require that we record an additional valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in such period and could have a significant impact on our future earnings.

The difference between our fiscal 2002 and 2001 tax rates is primarily attributable to: (1) the elimination of certain non-deductible accounting charges resulting from our adoption of SFAS 142; (2) increased statutory credits (both in dollars and as a percentage of income (loss) before income taxes) generated in fiscal 2002; and (3) a reduction in benefits resulting from decreased profitability in certain low-tax, non-U.S. jurisdictions.

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

(dollars in millions)

	<u>2003</u>	<u>Change</u>	<u>2002</u>	<u>Change</u>	<u>2001</u>
Cash and cash equivalents	\$ 2,015	\$ (9)	\$ 2,024	\$ 552	\$ 1,472
Marketable debt securities	3,726	(114)	3,840	(859)	4,699
Total cash, cash equivalents and marketable debt securities	\$ 5,741	\$ (123)	\$ 5,864	\$ (307)	\$ 6,171
Percentage of total assets	44.2%	8.7 pts	35.5%	1.6 pts	33.9%
Days sales outstanding (DSO)	72		72	(5)	67
Days of supply in inventory (DOS)	22	5	27	13	40
Days payable outstanding (DPO)	(48)	1	(47)	7	(40)
Cash conversion cycle	46	6	52	15	67
Inventory turns-products only	8.6	1.9	6.7	(3.2)	9.9
Cash provided by operating activities	\$ 1,037	\$ 157	\$ 880	\$ (1,209)	\$ 2,089
Cash provided by (used in) investing activities	\$ (528)	\$ (567)	\$ 39	\$ 1,593	\$ (1,554)
Cash used in financing activities	\$ (518)	\$ (151)	\$ (367)	\$ 545	\$ (912)
Net increase (decrease) in cash and cash equivalents	\$ (9)	\$ (561)	\$ 552	\$ 929	\$ (377)

Changes in Cash Flow

During fiscal 2003, our operating activities generated cash flows of \$1,037 million, which is \$157 million higher than the cash flows provided by operating activities during fiscal 2002. In fiscal 2003, our use of cash for non-operating activities was primarily attributable to the \$499 million repurchase of our common stock in the open market, the \$200 million principal payment on our issued fixed-rate unsecured senior debt securities (Senior Notes), the \$373 million of capital spending on equipment additions to support product development and the \$217 million we invested in spare parts and other assets. As a result, during the twelve months ended June 30, 2003, our cash, cash equivalents and marketable debt securities decreased by \$123 million.

Net accounts receivable decreased to \$2,381 million at June 30, 2003 from \$2,745 million at June 30, 2002. The decrease in net accounts receivable was primarily due to the lower volume of sales and improving collection efficiencies offset by decreasing linearity.

We ended the fourth quarter of fiscal 2003 with a cash conversion cycle of 46 days, an improvement of 6 days from June 30, 2002. The cash conversion cycle is the duration between purchase of inventories and services and the collection of the cash for the sale of our products and services and is a metric on which we have focused as we continue to try to efficiently manage our assets. The cash conversion cycle results from the calculation of days of sales outstanding (DSO) added to days of supply in inventories (DOS), reduced by days of payable outstanding (DPO). We decreased our days of supply in inventories by continuing reductions in inventory levels and increased our days of payables outstanding by negotiating more favorable terms with our vendors, while days of sales outstanding remained unchanged from June 30, 2002.

Inventories decreased to \$416 million at June 30, 2003 from \$591 million at June 30, 2002 and our inventory turn rate increased to 8.6 times at June 30, 2003 from 6.7 at June 30, 2002. Inventory turns is annualized and represents the number of times inventory is replenished during the year. The increase in the inventory turns rate is a result of the lower balance in inventory and our ability to efficiently manage our inventory to meet customer demands. Inventory management will continue to be an area of focus as we balance the need to maintain strategic inventory levels to help ensure competitive lead times with the risk of inventory obsolescence due to rapidly changing technology and customer requirements.

Prepaid expenses and other current assets decreased to \$787 million at June 30, 2003 from \$847 million at June 30, 2002 due to the receipt of income tax refunds of approximately \$351 million during fiscal 2003, partially offset by increases in value added tax receivables.

Table of Contents

Accounts payable decreased to \$903 million at June 30, 2003 from \$1,044 million at June 30, 2002. This decrease was primarily due to lower inventory purchases and decreases in related operating activities, partially offset by an increase in value added tax payables. Our accrued payroll-related liabilities decreased to \$479 million at June 30, 2003 from \$538 million at June 30, 2002, as a result of a decrease in incentive compensation. Accrued liabilities decreased to \$1,027 million at June 30, 2003 from \$1,201 million at June 30, 2002, as a result of the overall decrease in our sales and related operational costs. Other non-current obligations increased to \$834 million at June 30, 2003 from \$679 million at June 30, 2002 primarily due to increases in the long-term liability related to our restructuring plans, partially offset by a decrease in long-term deferred revenues.

Liquidity

Based on our current plan, we expect to generate positive cash flow from operations for the full fiscal year ending June 30, 2004, although there can be no assurance of this. From time to time, our Board of Directors approves systematic common stock repurchase programs allowing management to repurchase shares of our common stock in the open market pursuant to price-based formulas. These programs are largely intended to manage the dilutive effect generated by the exercise of stock options. In February 2001, we announced our intention to acquire up to \$1.5 billion of our outstanding common stock under a stock repurchase program authorized by our Board of Directors which was in addition to our ongoing systematic stock repurchase programs. Approval of the February 2001 program by our Board of Directors reflected Sun's strong belief in its future, our belief at the time that our then current market valuation did not reflect the underlying long term value of the company and our desire to enhance stockholder value. Under the February 2001 program, the timing and actual number of shares subject to repurchase are at the discretion of our management and are contingent on a number of factors, including our projected cash flow requirements, market conditions and our share price. During the fiscal year ended June 30, 2003, we repurchased common stock under all repurchase programs for an aggregate purchase price of \$499 million and during the fiscal year ended June 30, 2002 we repurchased common stock under all repurchase programs for an aggregate purchase price of \$591 million. All such repurchases were made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended.

Our \$1.3 billion Senior Notes outstanding are due at various times between August 2004 and August 2009. The Senior Notes are subject to compliance with certain covenants that do not contain financial ratios. Accordingly, the impairment charge on goodwill and other intangible assets taken during fiscal 2003 had no impact on our debt covenants. We are currently in compliance with these covenants. If we failed to be in compliance with these covenants, the trustee of the Senior Notes or holders of not less than 25% in principal amount of the Senior Notes would have the ability to demand immediate payment of all amounts outstanding.

The following table summarizes our contractual obligations at June 30, 2003 (in millions):

Contractual Obligations	Total	Payments Due	Payments	Payments	Payments
		in Less	Due in	Due in 4-5	Due After
		Than 1	1-3	Years	5 Years
		Year	Years		
Senior Notes	\$ 1,300	\$	\$ 250	\$ 500	\$ 550
Non-cancelable operating leases	\$ 1,361	\$ 273	\$ 402	\$ 248	\$ 438

Capital Resources and Financial Condition

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Our long-term strategy is to maintain a minimum amount of cash and cash equivalents in subsidiaries for operational purposes and to invest the remaining amount of our cash in interest bearing and highly liquid cash equivalents and marketable debt securities. Accordingly, in addition to the \$2,015 million in cash and cash equivalents, we currently have for shorter-term requirements approximately \$3,726 million in marketable debt securities that are available for future operating, financing and investing activities, for a total cash and marketable debt securities position of \$5,741 million. However, approximately \$1,365 million of this balance represents cash generated from operations domiciled in foreign tax jurisdictions that are designated as permanently invested in the respective tax jurisdictions. If these funds are required for our operations in the U.S., we would be required to accrue and pay additional taxes to repatriate these funds. Currently, we do not anticipate a need to repatriate these funds to our U.S. operations.

Sun is insured by nationally recognized insurers for certain potential liabilities, including worker s compensation, general liability, automotive liability, employer s liability, errors and omissions liability, employment practices

Table of Contents

liability, property, cargo and crime and directors and officers liability. Since July 1, 2003, we have self-insured between \$2 and \$25 million per occurrence on the lines of coverage noted above. In addition, beginning in fiscal 2004, we reduced the third-party insurance coverage of our directors and officers such that we now self-insure for all indemnification or defense payments we, as a company, may make to or on behalf of our directors and officers as a result of obligations under applicable agreements, Sun's charter documents and applicable law. As our indemnification obligations to directors and officers are substantial, the reduction in third-party coverage of our directors and officers liability insurance could adversely affect Sun's financial condition, liquidity, cash flows and results of operations if a material claim or loss occurred. Sun performs an annual actuarial analysis to develop an estimate of amounts to be paid for both claims reported and potential losses on activities that have occurred but have not yet been reported. Loss accruals were \$24 million as of June 30, 2003.

In addition, we have uncommitted lines of credit aggregating approximately \$647 million. No amounts were drawn from these lines of credit as of June 30, 2003. Interest rates and other terms of borrowing under these lines of credit vary from country to country depending on local market conditions at the time of borrowing. There is no guarantee that the banks would approve our request for funds under these uncommitted lines of credit.

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

DILUTIVE EFFECT OF STOCK OPTIONS ISSUED TO DIRECTORS AND EMPLOYEES

Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We primarily rely on three stock option plans that provide broad discretion to our Board of Directors to create appropriate equity incentives for members of our board of directors and our employees. Our 1990 Long-Term Equity Incentive Plan is the primary plan under which most of our options are granted. The 1996 Equity Compensation Acquisition Plan is the plan under which we grant options to employees hired in connection with the acquisition of another company, and the 1988 Directors' Stock Option Plan provides for the automatic grant of stock options to non-employee directors on the date each person initially becomes a director, and on the date of each annual meeting of stockholders to non-employee directors who are elected and who have served as a member of our board of directors for at least six months. Substantially all of our employees participate in our stock option program.

We also have stock repurchase programs in place to manage the dilutive effect generated by the exercise of stock options. In implementing our stock option program, we carefully monitor both the potential and actual dilution associated with our stock option program. However, during fiscal 2003, the shares we repurchased under our stock repurchase program negatively impacted our net loss per share amount by approximately four cents. We view dilution from stock option exercises as the difference between the number of options exercised reduced by the number of shares repurchased in a given fiscal year as a percentage of the number of shares outstanding at the beginning of the year (exercise dilution). We also monitor the potential dilution from net option grants in a given year by comparing the option grants reduced by cancellations in a given year with the number of shares outstanding at the beginning of the year (grant dilution). In addition, we monitor the net cash cost of our stock repurchase programs.

As of June 30, 2003, the total outstanding options held by the five most highly compensated executive officers identified in our 2003 Proxy Statement (the Named Executive Officers) amounted to approximately 37.6 million or 6.4% of the approximately 587 million outstanding options held by all employees. For a given year, the percentage of options granted to the Named Executive Officers is calculated by comparing the options granted to such executives to net options granted.

Table of Contents

The following table illustrates the grant dilution, exercise dilution and the net cash outlay for our stock repurchase programs associated with our stock option program (in millions, except percentages):

	2003	2002	2001	2000	1999
Shares outstanding at beginning of year	3,537	3,536	3,495	3,493	3,465
Less treasury stock outstanding at beginning of year	(303)	(288)	(301)	(359)	(432)
Net shares outstanding	3,234	3,248	3,194	3,134	3,033
Grants and assumptions	115	119	124	132	92
Less option cancellations	(58)	(35)	(18)	(22)	(26)
Net option grants	57	84	106	110	66
Grant dilution	1.8%	2.6%	3.3%	3.5%	2.2%
Options exercised	26	28	63	70	88
Less shares repurchased	(126)	(62)	(52)	(18)	(18)
Net shares issued (repurchased)	(100)	(34)	11	52	70
Exercise dilution	(3.1)%	(1.1)%	0.3%	1.7%	2.3%
Cost of shares repurchased	\$ 499	\$ 554	\$ 1,123	\$ 505	\$ 159
Less proceeds from options exercised	(46)	(78)	(202)	(174)	(143)
Less tax benefit from options exercised	(9)	(98)	(816)	(708)	(222)
Net cash (inflow) outflow	\$ 444	\$ 378	\$ 105	\$ (377)	\$ (206)
Options granted to the five most highly compensated executive officers	2.3	3.8	2.9	2.9	5.4
Options granted to the Named Executive Officers as a percentage of net options granted during the year	4.0%	4.5%	2.7%	2.6%	8.2%

Options Granted during Fiscal 2003 to the Most Highly Compensated Executive Officers Named in Our 2003 Proxy Statement

Name	Number of Options Granted	Exercise Price
Scott G. McNealy	1,000,000	\$ 3.70

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

William N. Joy ⁽¹⁾	300,000	\$	3.70
Gregory M. Papadopoulos	300,000	\$	3.70
Patricia C. Sultz	300,000	\$	3.70
Robert H. Youngjohns	400,000	\$	3.70

(1) Mr. William N. Joy retired on September 9, 2003.

NON-AUDIT SERVICES OF INDEPENDENT AUDITORS

Our auditors, Ernst & Young LLP, perform the following non-audit services that have been approved by our Audit Committee of the Board of Directors: expatriate tax and relocation services, international and U.S. tax planning and compliance services, and tax due diligence for acquisitions. Two officers, who are expatriates, utilize the tax services, which Ernst & Young LLP provides to all our employees under our expatriate program. Starting fiscal 2004, our expatriate officers will no longer receive tax services including personal tax return filing from Ernst & Young LLP. In addition, Scott McNealy, our Chairman of the Board of Directors, President and Chief Executive Officer, retains Ernst & Young LLP to advise him on his personal income taxes.

Table of Contents

RISK FACTORS

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

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

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

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

Our future competitive performance depends on a number of factors, including our ability to: (1) continually develop and introduce new products and services with better prices and performance than those offered by our competitors; (2) offer a wide range of solutions and products from small single processor systems to large complex enterprise level systems; (3) offer solutions to customers that operate effectively within a computing environment that includes hardware and software from multiple vendors; (4) offer products that are reliable and that ensure the security of data and information; (5) create products for which third party software vendors will develop a wide range of applications; and (6) offer high quality solutions, products and services with high performance and low incidence of defects.

Fujitsu and its subsidiaries have, for many years, been a key strategic channel partner for Sun, distributing substantial quantities of our products throughout the world. However, Fujitsu is also a competitor of Sun and, as a licensee of various technologies from Sun and others, it has developed products that compete directly with our products. While we currently believe that Fujitsu intends to continue as our strategic channel partner, there can be no assurance of this and it is likely that the level of competition between Fujitsu and Sun will further intensify. While we intend to compete vigorously with Fujitsu, our inability to compete successfully with Fujitsu would have an adverse impact on our revenues and margins.

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

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

Table of Contents

One of our business strategies is to derive a competitive advantage and a resulting enhancement of our gross margins from our investments in innovative new technologies which customers value. As a result, as a percentage of revenues, we incur higher fixed R&D costs than many of our competitors. In addition, as a result of investing in a significant direct sales force we incur higher fixed selling costs as a percentage of revenues as compared with some of our competitors. To the extent that we are unable to develop and sell products with attractive gross margins in sufficient volumes, our earnings may be materially adversely affected by our cost structure. During fiscal 2003, we added new products to our entry-level server product line that are offered at a lower price point and, accordingly, provide us with a lower gross margin percentage than our products as a whole. Although our strategy is to sell these products as part of overall systems which include other products with higher gross margin percentages, to the extent that the mix of our overall revenues represented by sales of lower gross margin products increases, our gross margins and earnings may be adversely affected.

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

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

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

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

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

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we depend on Texas Instruments for the manufacture of our UltraSPARC microprocessors and several other companies for custom integrated circuits. If we

Table of Contents

were unable to purchase on acceptable terms or experienced significant delays or quality issues in the delivery of necessary parts and components from a particular vendor and we had to find a new supplier for such parts and components, our new and existing product shipments could be delayed, adversely affecting our business and operating results.

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

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

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

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

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

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

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

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

involved to implement it. Such delays in product development and customer acceptance and implementation of new products could adversely affect our business.

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

In the course of conducting our business, we experience and address quality issues. Some of our hardware and software products contain defects, including defects in our engineering, design and manufacturing processes, as well as defects

Table of Contents

in third-party components included in our products, which may be beyond our control. Often defects are identified during our design, development and manufacturing processes and we are able to correct many of these. Sometimes defects are identified after introduction and shipment of new products or enhancements to existing products.

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

Finding solutions to quality issues for our customers can be expensive and may result in additional warranty and other costs to Sun, reducing our operating results. In recent periods we have implemented new quality control measures intended to make it more likely that any quality issues are identified prior to product shipment. As a result of these measures, we may delay more product shipments in future periods as a result of the identification of quality issues or potential quality issues. For example, in July and August 2003, we temporarily stopped shipment on a significant portion of our server product lines as a result of identification of quality issues. The products subject to these delays have resumed shipping. At this point, we are unable to quantify the financial impact, if any, of these stopped shipments on our first quarter of fiscal 2004. Delays in product shipments to our customers will delay revenue recognition and could adversely affect our revenues and reported results. If we are unable to fix identified errors or adequately address quality issues, our relationships with customers can be impaired, our reputation can suffer and we can lose customers or sales which could have a material adverse effect on our revenues, operating results, cash flows from operations and financial condition.

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

Currently more than half of our revenues come from international sales. In addition, a portion of our operations consists of manufacturing and sales activities outside of the U.S. Our ability to sell our products and conduct our operations internationally is subject to a number of risks. Local economic, political and labor conditions in each country could adversely affect demand for our products and services or disrupt our operations in these markets. We may also experience reduced intellectual property protection or longer and more challenging collection cycles as a result of different customary business practices in certain countries where we do business which could have an adverse effect on our business operations and financial results. Currency fluctuations could also adversely affect our business in a number of ways. Although we take steps to reduce or eliminate certain foreign currency exposures that can be identified or quantified, we may incur currency translation losses as a result of our international operations. Further, in the event that currency fluctuations cause our products to become more expensive in overseas markets in local currencies, there could be a reduction in demand for our products or we could lower our pricing in some or all of these markets resulting in reduced revenue and margins. Alternatively, a weakening dollar could result in greater costs to us for our overseas operations. Changes to and compliance with a variety of foreign laws and regulations may increase our cost of doing business in these jurisdictions. Trade protection measures and import and export licensing requirements subject us to additional regulation and may prevent us from shipping products to a particular market, and increase our operating costs. In addition, we could be subject to regulations, fines and penalties for violations of import and export regulations such as our products being shipped directly or through a third-party to certain countries. Such violations could result in penalties, including prohibiting us from exporting our products to one or more countries, and could adversely affect our business. See Item 3. Legal Proceedings for a description of certain matters currently pending before the U.S. Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS).

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

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

Seasonality. Our sequential quarterly operating results usually fluctuate downward in the first quarter of each fiscal year when compared with the immediately preceding fourth quarter.

Table of Contents

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

Deferred Tax Assets. In determining income (loss) for financial statement purposes, we must make certain estimates and judgments. These estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from temporary differences between the tax and financial statement recognition of revenue and expense. SFAS No. 109, Accounting for Income Taxes, also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

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

In conjunction with the filing of our annual report on Form 10-K, we were required to reassess all significant estimates and judgments made in our financial statements, considering any additional information available. From the time we released our June 30, 2003 fourth quarter and annual results, on July 22, 2003, to the filing of this Form 10-K we determined that the underlying assumptions related to judgments made in connection with our SFAS 109 analysis had changed. In performing our updated analysis of the realizability of our deferred tax assets, we considered continuing market uncertainties and our progress against the planned forecast of operating results for the not-yet-reported first quarter of fiscal 2004 including the impact of an anticipated loss in this quarter on the remaining planning period underlying the SFAS 109 analysis. In light of this new information and after considering all available evidence, both positive and negative, we concluded that an increase to our valuation allowance for our deferred tax assets was required. Accordingly, based upon our best estimate we have recorded a non-cash charge in the fourth quarter of fiscal 2003 of \$1,051 million to increase our valuation allowance for our deferred tax assets.

The realization of our remaining deferred tax assets is primarily dependent on forecasted future taxable income. Any reduction in estimated forecasted future taxable income including but not limited to any future restructuring activities may require that we record an additional valuation allowance against our deferred tax assets. An increase in the valuation allowance would result in additional income tax expense in such period and could have a significant impact on our future earnings.

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

Investments. We have an investment portfolio that includes minority equity and debt investments. In most cases, we do not attempt to reduce or eliminate our market exposure on these investments and may incur losses related to the impairment of these investments. Our risk exposure in our marketable securities investments is concentrated across a relatively small number of entities and could be subject to substantial volatility if

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

any of these entities experiences material changes to its business or securities. In addition, we have made and continue to evaluate and make, strategic equity investments in privately-held technology companies. Because these companies are typically early-stage ventures with either unproven business models, products that are not yet fully developed or products that have not yet achieved market acceptance, these investments are inherently risky due to factors beyond our control.

Table of Contents

We are dependent on significant customers and specific industries.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 11%, 12% and 13% of our fiscal 2003, 2002 and 2001 net revenues, respectively. Our Chairman of the Board of Directors, President and Chief Executive Officer, Scott G. McNealy, was a member of GE's Board of Directors in fiscal 2002 and part of fiscal 2003. Mr. McNealy resigned from the GE Board of Directors as of January 1, 2003. More than 90% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. Sales through MRA Systems, Inc., a channel development partner and a GE subsidiary, consisted of 9%, 8% and 10% of net revenues in 2003, 2002 and 2001, respectively. As a channel development partner, MRA Systems, Inc. acts as a distributor of our products to resellers who in turn sell those products to end-users. No other customer accounted for more than 10% of revenues. The revenues from GE are generated in the Product Group and Sun Services segments.

We also depend on the telecommunications, financial services and manufacturing industries for a significant portion of our revenues. Significant reduction in technology capital spending in these industries, such as we have experienced since the last half of fiscal 2001, may continue to result in decreased revenues and earnings. Our revenues are dependent on the level of technology capital spending in the U.S. and international economies. If the current adverse economic conditions continue, we would expect that the significant reduction and deferrals of capital spending would continue. If capital spending continues to decline in these industries over an extended period of time, our business will continue to be adversely affected. We continue to execute on our strategy to reduce our dependence on these industries by expanding our product reach into new industries, but no assurance can be given that this strategy will be successful.

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

From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Responding to such claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources and cause us to incur significant expenses. Several pending claims are in various stages of evaluation. From time to time, we consider the desirability of entering into licensing agreements in certain of these cases. No assurance can be given that licenses can be obtained on acceptable terms or that litigation will not occur. In the event there is a temporary or permanent injunction entered prohibiting us from marketing or selling certain of our products, or a successful claim of infringement against us requiring us to pay royalties to a third party, and we fail to license such technology on acceptable terms and conditions or to develop or license a substitute technology, our business, results of operations or financial condition could be materially adversely affected. See Item 3. Legal Proceedings for further discussion.

Our acquisition and alliance activities could disrupt our ongoing business.

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

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

Our employees are vital to our success, and our key management, engineering, and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key

Table of Contents

person life insurance on any of our employees. Because our compensation packages include equity-based incentives, pressure on our stock price could affect our ability to continue to offer competitive compensation packages to current employees. In addition, we must continue to motivate employees and keep them focused on our strategies and goals, which may be difficult due to morale challenges posed by our workforce reductions and general uncertainty about the economy. Should these conditions continue, we may not be able to retain highly qualified employees in the future which could adversely affect our business.

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

Since our inception, we have used stock options and other long-term equity incentives as a fundamental component of our employee compensation packages. We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with Sun. Several agencies and entities, are considering, and the Financial Accounting Standards Board (FASB) has announced that it will propose changes to US GAAP that, if implemented, would require us to record a charge to earnings for employee stock option grants. This pending regulation would negatively impact our earnings. For example, recording a charge for employee stock options under SFAS No. 123, Accounting for Stock-Based Compensation would have increased net loss by \$555 million and \$647 million for fiscal 2003 and 2002, respectively, and reduced net income by \$533 million for fiscal 2001. In addition, new regulations implemented by The Nasdaq National Market requiring shareholder approval for all stock option plans as well as new regulations implemented by the New York Stock Exchange prohibiting NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult or expensive to grant options to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

Business interruptions could adversely affect our business.

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

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

In response to the continuing global economic slowdown, we implemented facility exit plans during each of fiscal years 2003, 2002 and 2001, as part of our ongoing efforts to consolidate excess facilities. The continuing general adverse economic conditions in the United States and in many of the countries in which we have significant leased properties have resulted in a surplus of business facilities making it difficult to sublease properties. If the adverse economic conditions continue, we may be unable to sublease our excess properties, or we may not meet our expected estimated levels of subleasing income, and our results of operations could be negatively affected.

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

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Some of our operations are subject to regulation under various federal, state and international laws governing the environment and hazardous substances. While we endeavor to be in compliance with environmental laws at all times, any failure to so comply can subject us to material liability. Also, particularly in Europe, we may be subject to compliance with developing product content requirements relating to recycling as well as product take back requirements that would make us responsible for recycling and/or disposing of products we have sold. These and other environmental laws may become stricter over time and require us to incur substantial costs for compliance. In addition, we could be subject to liability for investigation and remediation of hazardous substances if our operations have caused

Table of Contents

contamination or any of our owned properties are found to be contaminated. Although costs relating to environmental matters have not resulted in a material adverse effect on us to date, there can be no assurance that we will not be required to incur such costs in the future.

Our equity securities are subject to equity price risk and their value may fluctuate.

From time to time, we make equity investments for the promotion of business and strategic objectives in publicly traded and privately-held companies. The market price and valuation of the securities that we hold in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control. Many of the companies in which we have invested have experienced significant volatility in their stock prices. We typically do not attempt to reduce or eliminate this equity price risk, through hedging or similar techniques, and market price and valuation fluctuations could impact our financial results. To the extent that the fair value of these securities was less than our cost over an extended period of time, our net income (loss) would be negatively impacted. See Item 7A. Quantitative and Qualitative Disclosures about Market Risk – Equity Security Price Risk for further discussion.

Our stock price can be volatile.

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

Our credit rating is subject to downgrade.

In fiscal 2003, Standard & Poor's, a credit agency that follows Sun, downgraded us from triple- B -plus to triple- B rating. In addition, Standard & Poor's and Moody's Investor Services, another credit agency, continued to place Sun on negative outlook. In August 2003, Moody's announced it had placed us under review for possible downgrade. This reflects those credit agencies' expectations that the intense competitive environment facing Sun in its core markets will continue over at least the near-term to challenge Sun's sales and profitability. The downgrade by Standard & Poor's and any potential downgrade by Moody's could increase our costs of obtaining, or make it more difficult to obtain, new debt financing or issue new debt, either of which could adversely affect our business and financial condition.

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

Sun has adopted a program of self-insurance with regard to certain risks such as California earthquakes and directors and officers liability and as supplemental coverage for certain potential liabilities including general liability, workers compensation, errors and omissions liability and property. We self-insure when the lack of availability and high cost of commercially available insurance products do not make the transfer of this risk a reasonable approach. In these instances, Sun assumes the liability to cover claims for losses suffered and from costs or expenses incurred by individuals or entities through the use of a self-insurance program. In the event that the frequency of losses experienced by Sun increased unexpectedly, the aggregate of such losses could materially increase Sun's liability and adversely affect Sun's financial condition, liquidity, cash flows and results of operations. In addition, while the insurance market continues to limit the availability of certain insurance

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

products while increasing the costs of such products, Sun will continue to evaluate the levels of claims Sun includes in its self-insurance program. Any increases to this program increases Sun's risk exposure and therefore increases the risk of a possible material adverse effect on Sun's financial condition, liquidity, cash flows and results of operations. In addition, Sun has made certain judgments as to the limits on its existing insurance coverage that Sun believes are in line with industry standards, as well as in light of economic and availability considerations. Unforeseen catastrophic loss scenarios could prove Sun's limits to be inadequate and could materially adversely affect Sun's financial and business condition. See Note 2 to our Consolidated Financial Statements regarding our self-insurance program and the changes to our self-insurance program for fiscal 2004.

Table of Contents**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk related to changes in interest rates, foreign currency exchange rates, and equity security prices. To mitigate some of these risks, we utilize derivative financial instruments to hedge these exposures. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at June 30, 2003. Actual results may differ materially.

Interest Rate Sensitivity

Our investment portfolio consists primarily of fixed income instruments with an average duration of 0.72 year as of June 30, 2003, as compared with 0.89 year as of June 30, 2002. The primary objective of our investments in debt securities is to preserve principal while maximizing yields, without significantly increasing risk. These available-for-sale securities are subject to interest rate risk. The fair market value of these securities may fluctuate with changes in interest rates. A sensitivity analysis was performed on this investment portfolio based on a modeling technique that measures the hypothetical fair market value changes (using a three month horizon) that would result from a parallel shift in the yield curve of plus 150 basis points (BPS). Based on this analysis, for example, a hypothetical 150 BPS increase in interest rates would result in an approximate \$50 million decrease in the fair value of our investments in debt securities as of June 30, 2003, as compared with a \$52 million decrease as of June 30, 2002.

We also entered into various interest-rate swap agreements to modify the interest characteristics of the Senior Notes so that the interest payable on the Senior Notes effectively becomes variable and thus matches the variable interest rate received from our cash and marketable securities. Accordingly, interest rate fluctuations impact the fair value of our Senior Notes outstanding, which will be offset by corresponding changes in the fair value of the swap agreements. However, by entering into these swap agreements, we have a cash flow exposure related to the risk that interest rates may increase. For example, at June 30, 2003, a hypothetical 150 BPS increase in interest rates would result in an approximate \$18 million decrease in cash over a year.

Foreign Currency Exchange Risk

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

Based on our foreign currency exchange instruments outstanding at June 30, 2003, we estimate a maximum potential one-day loss in fair value of approximately \$6 million, as compared with \$8 million as of June 30, 2002, using a Value-at-Risk (VAR) model. The VAR model estimates were made assuming normal market conditions and a 95% confidence level. We used a Monte Carlo simulation type model that valued foreign currency instruments against three thousand randomly generated market price paths. Anticipated transactions, firm commitments, receivables, and accounts payable denominated in foreign currencies were excluded from the model. The VAR model is a risk estimation tool, and as such is

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

not intended to represent actual losses in fair value that will be incurred by us. Additionally, as we utilize foreign currency instruments for hedging anticipated and firmly committed transactions, a loss in fair value for those instruments is generally offset by increases in the value of the underlying exposure. Foreign currency fluctuations did not have a material impact on our results of operations and financial position during fiscal 2003, 2002 and 2001.

Table of Contents

Equity Security Price Risk

We are exposed to price fluctuations on the marketable portion of equity securities included in our portfolio of equity investments. These investments are generally in companies in the high-technology industry sector, many of which are small capitalization stocks. We typically do not attempt to reduce or eliminate the market exposure on these securities. A 20% adverse change in equity prices would result in an approximate \$3 million decrease in the fair value of our available-for-sale equity investments as of June 30, 2003, as compared with \$4 million as of June 30, 2002. At June 30, 2003, three equity securities represented approximately \$12 million of the \$15 million total fair value of the marketable equity securities, as compared with June 30, 2002, at which time, three equity securities represented approximately \$14 million of the \$18 million total fair value of the marketable equity securities. Refer to Note 2 to the Consolidated Financial Statements for additional discussion on Sun's marketable equity securities.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Consolidated Financial Statements of Sun Microsystems, Inc.:	
Consolidated Statements of Operations for each of the three fiscal years ended June 30, 2003	52
Consolidated Balance Sheets at June 30, 2003 and June 30, 2002	53
Consolidated Statements of Cash Flows for each of the three fiscal years ended June 30, 2003	54
Consolidated Statements of Stockholders' Equity for each of the three fiscal years ended June 30, 2003	55
Notes to Consolidated Financial Statements	56
Report of Ernst & Young LLP, Independent Auditors	91
<i>Financial Statement Schedules:</i>	
The following consolidated financial statement schedule of Sun Microsystems, Inc. is filed as part of this Annual Report on Form 10-K and should be read in conjunction with the Consolidated Financial Statements of Sun Microsystems, Inc.:	
Schedule II Valuation and Qualifying Accounts	95

Schedules not listed above have been omitted since they are not applicable or are not required, or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

Table of Contents**SUN MICROSYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in millions, except per share amounts)

	Fiscal Years Ended June 30,		
	2003	2002	2001
Net revenues:			
Products	\$ 7,793	\$ 9,093	\$ 15,015
Services	3,641	3,403	3,235
Total net revenues	11,434	12,496	18,250
Cost of sales:			
Cost of sales-products	4,342	5,506	7,960
Cost of sales-services	2,150	2,074	2,080
Total cost of sales	6,492	7,580	10,040
Gross margin	4,942	4,916	8,210
Operating expenses:			
Research and development	1,837	1,832	2,016
Selling, general and administrative	3,329	3,806	4,445
Restructuring charges	371	517	75
Impairment of goodwill and other intangible assets	2,125	6	1
Goodwill amortization			285
Purchased in-process research and development	4	3	77
Total operating expenses	7,666	6,164	6,899
Operating income (loss)	(2,724)	(1,248)	1,311
Loss on equity investments, net	(84)	(99)	(90)
Interest income	166	243	405
Interest expense	(43)	(58)	(100)
Gain on marketable debt securities	32	114	58
Income (loss) before income taxes and cumulative effect of change in accounting principle	(2,653)	(1,048)	1,584
Provision (benefit) for income taxes	776	(461)	603
Income (loss) before cumulative effect of change in accounting principle	(3,429)	(587)	981
Cumulative effect of change in accounting principle, net			(54)
Net income (loss)	\$ (3,429)	\$ (587)	\$ 927

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Net income (loss) per common share-basic:			
Income (loss) before cumulative effect of change in accounting principle	\$ (1.07)	\$ (0.18)	\$ 0.30
Cumulative effect of change in accounting principle			(0.02)
	<u> </u>	<u> </u>	<u> </u>
Net income (loss) per common share-basic	\$ (1.07)	\$ (0.18)	\$ 0.28
	<u> </u>	<u> </u>	<u> </u>
Net income (loss) per common share-diluted:			
Income (loss) before cumulative effect of change in accounting principle	\$ (1.07)	\$ (0.18)	\$ 0.29
Cumulative effect of change in accounting principle			(0.02)
	<u> </u>	<u> </u>	<u> </u>
Net income (loss) per common share-diluted	\$ (1.07)	\$ (0.18)	\$ 0.27
	<u> </u>	<u> </u>	<u> </u>
Shares used in the calculation of net income (loss) per common share-basic	3,190	3,242	3,234
	<u> </u>	<u> </u>	<u> </u>
Shares used in the calculation of net income (loss) per common share-diluted	3,190	3,242	3,417
	<u> </u>	<u> </u>	<u> </u>

See accompanying notes.

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

(in millions, except par values)

	June 30,	
	2003	2002
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,015	\$ 2,024
Short-term marketable debt securities	1,047	861
Accounts receivable, net of bad debt reserves of \$112 in 2003 and \$114 in 2002	2,381	2,745
Inventories	416	591
Deferred and prepaid tax assets	133	709
Prepaid expenses and other current assets	787	847
Total current assets	6,779	7,777
Property, plant and equipment, net	2,267	2,453
Long-term marketable debt securities	2,679	2,979
Goodwill	326	2,182
Other acquisition-related intangible assets, net	91	104
Other non-current assets, net	843	1,027
	\$ 12,985	\$ 16,522
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and short-term borrowings	\$	\$ 205
Accounts payable	903	1,044
Accrued payroll-related liabilities	479	538
Accrued liabilities and other	1,027	1,201
Deferred revenues	1,453	1,321
Warranty reserve	267	284
Total current liabilities	4,129	4,593
Long-term debt	1,531	1,449
Other non-current obligations	834	679
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 10 shares authorized (1 share of which has been designated as Series A Preferred participating stock); no shares issued and outstanding		
Common stock and additional paid-in-capital, \$0.00067 par value, 7,200 shares authorized; issued and outstanding: 3,587 shares in 2003 and 3,537 shares in 2002	6,647	6,485
Treasury stock, at cost: 351 shares in 2003 and 303 shares in 2002	(3,169)	(2,905)

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Unearned equity compensation	(33)	(46)
Retained earnings	2,869	6,298
Accumulated other comprehensive income (loss)	177	(31)
	<u> </u>	<u> </u>
Total stockholders' equity	6,491	9,801
	<u> </u>	<u> </u>
	\$ 12,985	\$ 16,522
	<u> </u>	<u> </u>

See accompanying notes.

Table of Contents**SUN MICROSYSTEMS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in millions)

	Fiscal Years Ended June 30,		
	2003	2002	2001
Cash flows from operating activities:			
Net income (loss)	\$ (3,429)	\$ (587)	\$ 927
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	918	970	847
Amortization of other intangible assets and unearned equity compensation	110	122	382
Impairment of goodwill and other intangible assets	2,125	6	1
Tax benefits from employee stock plans	9	98	816
Deferred taxes	706	(673)	(186)
Loss on equity investments, net	84	99	90
Other	4	3	130
Changes in operating assets and liabilities:			
Accounts receivable, net	387	211	(253)
Inventories	181	458	(446)
Prepays and other assets	31	383	(438)
Accounts payable	(133)	(7)	123
Other liabilities	44	(203)	96
Net cash provided by operating activities	1,037	880	2,089
Cash flows from investing activities:			
Purchases of marketable debt securities	(6,958)	(14,921)	(14,068)
Proceeds from sales of marketable debt securities	6,476	15,377	14,069
Proceeds from maturities of marketable debt securities	578	377	38
Purchases of equity investments	(21)	(41)	(182)
Proceeds from sales of equity investments	17	7	76
Acquisition of property, plant and equipment, net	(373)	(559)	(1,292)
Acquisition of spare parts and other assets	(217)	(152)	(177)
Payments for acquisitions, net of cash acquired	(30)	(49)	(18)
Net cash provided by (used in) investing activities	(528)	39	(1,554)
Cash flows from financing activities:			
Acquisition of common stock	(499)	(591)	(1,321)
Proceeds from issuance of common stock, net	182	237	422
Principal payments on borrowings and other obligations	(201)	(13)	(13)

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Net cash used in financing activities	(518)	(367)	(912)
Net increase (decrease) in cash and cash equivalents	(9)	552	(377)
Cash and cash equivalents, beginning of year	2,024	1,472	1,849
Cash and cash equivalents, end of year	\$ 2,015	\$ 2,024	\$ 1,472

Supplemental disclosures of cash flow information:

Interest paid (net of interest received from swap agreements of \$70, \$44 and none in fiscal 2003, 2002 and 2001, respectively)	\$ 36	\$ 115	\$ 114
--	-------	--------	--------

Income taxes paid (received) (net of refunds of \$351, \$329 and \$113 in fiscal 2003, 2002 and 2001, respectively)	\$ (91)	\$ 93	\$ 434
---	---------	-------	--------

Supplemental schedule of noncash investing activities:

Stock and options issued in connection with acquisitions	\$ 193	\$ 29	\$ 2,563
--	--------	-------	----------

See accompanying notes.

Table of Contents**SUN MICROSYSTEMS, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in millions)

	Common Stock and Additional		Treasury Stock		Unearned Equity Compensation	Retained Earnings	Accumulated	Total
	Paid-in-Capital						Other	
	Shares	Amount	Shares	Amount			Comprehensive Income (Loss)	
Balances as of June 30, 2000	3,495	\$ 2,728	(301)	\$ (1,438)	\$ (15)	\$ 5,959	\$ 75	\$ 7,309
Net income						927		927
Change in unrealized gain (loss) on investments, net of taxes							(72)	(72)
Change in unrealized gain (loss) on derivative instruments							15	15
Translation adjustments							(47)	(47)
Total comprehensive income								823
Issuance of stock, net of repurchases		98	72	324				422
Treasury stock purchased			(59)	(1,321)				(1,321)
Tax benefit from employee stock transactions and other		839			(4)			835
Issuance of common stock and assumption of stock options in connection with acquisitions	41	2,572			(75)			2,497
Amortization of unearned equity compensation					21			21
Issuance of common stock dividends		1				(1)		
Balances as of June 30, 2001	3,536	6,238	(288)	(2,435)	(73)	6,885	(29)	10,586
Net loss						(587)		(587)
Change in unrealized gain (loss) on investments, net of taxes							(28)	(28)
Change in unrealized gain (loss) on derivative instruments, net of taxes							(46)	(46)
Translation adjustments							72	72
Total comprehensive loss								(589)
Issuance of stock, net of repurchases	(1)	116	49	121				237
Treasury stock purchased			(64)	(591)				(591)
Tax benefit from employee stock transactions and other		100						100
Issuance of common stock and assumption of stock options in connection with acquisitions	2	31			(27)			4
Amortization of unearned equity compensation					54			54
Balances as of June 30, 2002	3,537	6,485	(303)	(2,905)	(46)	6,298	(31)	9,801

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Net loss					(3,429)			(3,429)
Change in unrealized gain (loss) on investments, net of taxes						6		6
Change in unrealized gain (loss) on derivative instruments, net of taxes						11		11
Translation adjustments						191		191
Total comprehensive loss								(3,221)
Issuance of stock, net of repurchases	(51)	78	235					184
Treasury stock purchased		(126)	(499)					(499)
Tax benefit from employee stock transactions and other	20							20
Issuance of common stock and assumption of stock options in connection with acquisitions	50	193			(19)			174
Amortization of unearned equity compensation					32			32
Balances as of June 30, 2003	3,587	\$ 6,647	(351)	\$ (3,169)	\$ (33)	\$ 2,869	\$ 177	\$ 6,491

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

Sun's business is singularly focused on providing products and services for network computing. Network computing has been at the core of the company's offerings for the 21 years of our existence and is based on the premise that the power of a single computer can be increased dramatically as when interconnected with other computer systems for the purposes of communication and sharing of computing power. Together with our partners, we provide network computing infrastructure solutions that comprise computer systems (hardware and software), network storage systems (hardware and software), support services and professional and educational services. Our customers use our products and services to build mission-critical network computing environments on which they operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment and healthcare.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of Sun and its subsidiaries. Intercompany accounts and transactions have been eliminated. Certain amounts from prior years, primarily relating to deferred revenue presented on the balance sheets, have been reclassified to conform to the current year presentation.

In December 2000, Sun effected a two-for-one split of its common stock paid in the form of stock dividends. All share and per share data herein has been adjusted to reflect the split for all periods presented.

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (US GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts in the financial statements and accompanying notes. These estimates form the basis for judgments we make about the carrying values of assets and liabilities that are not readily apparent from other sources. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. US GAAP requires us to make estimates and judgments in several areas, including those related to impairment of intangible assets and equity investments, revenue recognition, recoverability of inventory and accounts receivable, the fair value of derivative financial instruments, the recording of various accruals (including our accrual for restructuring charges), the useful lives of long-lived assets such as property and equipment, income taxes, warranty obligations and potential losses from contingencies and litigation. Actual results in these particular areas could differ from those estimates.

Cash Equivalents

Cash equivalents consist primarily of highly liquid investments with insignificant interest rate risk and original maturities of three months or less at the date of purchase.

Bad Debt Reserves

We evaluate the collectibility of our accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations to us, we record a specific allowance against amounts due to us, and thereby reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, industry and geographic concentrations, the current business environment and our historical experience. At June 30, 2003 and 2002, our bad debt reserves were \$112 million and \$114 million, respectively. We expensed amounts related to doubtful accounts of \$37 million, \$46 million, and \$25 million for fiscal 2003, 2002 and 2001, respectively.

Table of Contents

Investments

Investments consist of marketable debt securities, marketable equity securities and other investments.

Marketable Debt Securities

Investments in marketable debt securities consist primarily of corporate notes and bonds, asset and mortgage backed securities and U.S. government notes and bonds with original maturities beyond three months. Short-term investments are marketable debt securities with maturities of less than one year from the balance sheet date (except cash equivalents), while long-term investments represent all other marketable debt securities. All marketable debt securities are held in Sun's name and deposited primarily with one major financial institution. Sun's policy is to protect the value of its investment portfolio and minimize principal risk by earning returns based on current interest rates. We only invest in marketable debt securities with a minimum rating of single A or above from a nationally recognized credit rating agency. At June 30, 2003 and 2002 all of Sun's marketable debt securities were classified as available-for-sale and were carried at fair market value.

Marketable Equity Securities

Investments in marketable equity securities consist of equity holdings in public companies. Marketable equity securities are initially recorded at cost upon acquisition and are classified as available-for-sale when there are no restrictions on Sun's ability to liquidate such securities within 12 months. Investments in marketable equity securities were \$15 million and \$18 million at June 30, 2003 and 2002, respectively. At June 30, 2003, all marketable equity investments were classified as available-for-sale and are included in Other non-current assets, net in the Consolidated Balance Sheet. Changes in the fair value of these securities are recognized in Accumulated other comprehensive income (loss), net of tax in the Consolidated Statements of Stockholders' Equity. Net unrealized gains, net of tax, on marketable equity investments were \$9 million, none, and \$10 million at June 30, 2003, 2002 and 2001, respectively. Realized gains on marketable equity securities totaled \$6 million, \$3 million and \$31 million in fiscal 2003, 2002 and 2001, respectively, and are recognized in Loss on equity investments, net in the Consolidated Statements of Operations. In addition, we review all marketable equity securities for other than temporary declines in fair value. We consider a marketable equity security to be other-than-temporarily impaired if, as of the end of any quarter, the carrying value of the investment has been greater than the market value for the last six consecutive months. This evaluation is performed on a quarterly basis. Based on our evaluation, if a security is considered to be other than temporarily impaired, an impairment charge is recognized in Loss on equity investments, net in the Consolidated Statements of Operations. For fiscal 2003, 2002 and 2001, \$8 million, \$23 million and \$70 million were recorded as impairment charges related to marketable equity securities, respectively.

Other Investments

Other investments include equity investments in privately-held companies that develop products, markets and services that are strategic to Sun, investments in venture capital funds and other joint ventures, securities lent under our securities lending program and the cash surrender value of life insurance policies.

Our equity investments are generally made in connection with a round of financing with other third-party investors. As the investments in privately-held companies do not permit us to exert significant influence or control over the entity in which we are investing, the recorded amounts generally represent our cost of the investment less any adjustments we make when we determine that an investment's carrying value is

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

other-than-temporarily impaired. At June 30, 2003, we had approximately 71 investments in various high technology companies. These investments totaled \$170 million and \$229 million at June 30, 2003 and 2002, respectively, and were included in Other non-current assets, net in the Consolidated Balance Sheets.

The process of assessing whether a particular equity investment's net realizable value is less than its carrying cost requires a significant amount of judgment due to the lack of a mature and stable public market for these securities. In making this judgment, we carefully consider the investee's most recent financial results, cash position, recent cash flow data, projected cash flows (both short and long-term), financing needs, recent financing rounds, most recent valuation data, the current investing environment, management or ownership changes, and competition. This valuation process is based primarily on information that we request and receive from these privately-held companies. In addition, we

Table of Contents

consider an equity investment to be other-than-temporarily impaired if, as of the end of any quarter, the carrying value of the investment has been greater than the estimated fair value for the last six consecutive months. This evaluation is performed on a quarterly basis. Based on our evaluations, we recorded impairment charges related to our investments in privately-held companies of \$72 million, \$64 million and \$72 million for fiscal 2003, 2002 and 2001, respectively.

Investments in venture capital funds and other joint ventures were \$22 million and \$34 million at June 30, 2003 and 2002, respectively, and were accounted for using the equity method of accounting. We recorded a net loss of \$10 million and \$15 million for fiscal 2003 and 2002, respectively, and a net gain of \$21 million for fiscal 2001, related to our investments in venture capital funds and were reflected in Loss on equity investments, net.

In fiscal 2003, we began to enter into securities lending agreements with financial institutions to enhance investment income. Selected securities are loaned and are secured by collateral equal to at least 102% of the fair market value of the securities. Collateral is in the form of cash or securities issued or guaranteed by the U.S. Government, and Sun's securities lending agent has provided us with counterparty indemnification in the event of borrower default. Loaned securities continue to be classified as investment assets with a corresponding liability. The maximum amount loaned under Sun's securities lending program in fiscal 2003 was \$551 million. As of June 30, 2003, there were no outstanding securities lending transactions and we did not maintain any related collateral that we were permitted to sell or repledge.

We maintain certain investments in life insurance contracts to generate returns that offset changes in certain liabilities related to deferred compensation arrangements. These assets consist of the cash surrender value of the life insurance policies and are stated at fair value. Both realized and unrealized gains and losses, which have not been material, are included in income and expense and generally offset the change in the deferred compensation liability.

Inventories

Inventories are stated at the lower of cost (first in, first out) or market (net realizable value). Inventory in-transit (included in finished goods) consists of products shipped but not recognized as revenue because they did not meet the revenue recognition criteria. We evaluate our ending inventories for estimated excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand within specific time horizons (generally six months or less). Inventories in excess of future demand are reserved. In addition, we assess the impact of changing technology on our inventory-on-hand and we write-off inventories that are considered obsolete.

Long-lived Assets

Intangible Assets Other than Goodwill

Sun reviews its long-lived assets (other than goodwill) for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We assess the recoverability of the long-lived assets (other than goodwill) by comparing the estimated undiscounted cash flows associated with the related asset or group of assets against their respective carrying amounts. The amount of an impairment, if any, is calculated based on the excess of the carrying amount over the fair value of those assets.

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

At June 30, 2003, we had Intangible Assets Other than Goodwill (Other Intangible Assets) with a net book value of approximately \$114 million, net of accumulated amortization of \$525 million, as compared with a net book value of \$215 million, net of accumulated amortization of \$429 million at June 30, 2002. These amounts include intangibles related to acquisitions with a net book value of \$91 million, net of accumulated amortization of \$326 million, as compared with a net book value of \$104 million, net of accumulated amortization of \$262 million at June 30, 2002. In addition, at June 30, 2003, Other Intangible Assets includes amounts related to a revenue generating technology license, acquired as part of the Strategic Alliance with AOL (see Note 5), with a net book value of \$23 million, net of accumulated amortization of \$199 million, as compared with a net book value of \$111 million, net of accumulated amortization of \$167 million at June 30, 2002.

During the fiscal year ended June 30, 2003, Sun recognized an impairment expense related to Other Intangible Assets totaling \$98 million, as compared with \$6 million in fiscal 2002 and \$1 million in fiscal 2001. The impairment charges in fiscal 2003, 2002 and 2001 pertained to the Product Group segment. These charges were based on a comparison of the fair value of the underlying intangible asset, calculated based on the discounted cash flows expected during its remaining useful life, to its carrying value. While our cash flow assumptions are consistent with the plans and estimates

Table of Contents

we are using to manage the underlying businesses, there is significant judgment in attributing cash flows to our Other Intangible Assets over their respective estimated useful lives. See Note 4.

Goodwill

We adopted Statement of Financial Accounting Standard No. 142 (SFAS 142), *Goodwill and Other Intangible Assets* on July 1, 2001. This standard requires that goodwill no longer be amortized, and instead, be tested for impairment on an annual basis (or whenever events occur which may indicate possible impairment). We perform the impairment analysis at one level below the operating segment level (see Note 15) as defined in SFAS 142. This analysis requires management to make a series of critical assumptions to: (1) evaluate whether any impairment exists, and (2) measure the amount of impairment.

In testing for a potential impairment of goodwill, SFAS 142 requires us to: (1) allocate goodwill to the various Sun businesses to which the acquired goodwill relates; (2) estimate the fair value of those Sun businesses to which goodwill relates; and (3) determine the carrying value (book value) of those businesses, as some assets and liabilities related to those businesses, such as inventory and accounts receivable, are not held by those businesses but by functional departments (for example, our Global Sales Operations and Worldwide Operations organizations). Furthermore, if the estimated fair value is less than the carrying value for a particular business, then we are required to estimate the fair value of all identifiable assets and liabilities of the business, in a manner similar to a purchase price allocation for an acquired business. This requires independent valuations of certain internally generated and unrecognized intangible assets such as in-process research and development and developed technology. Only after this process is completed, is the amount of goodwill impairment determined.

The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgment at many points during the analysis. In estimating the fair value of the businesses with recognized goodwill for the purposes of our annual or periodic analyses, we make estimates and judgments about the future cash flows of these businesses. Our cash flow forecasts are based on assumptions that are consistent with the plans and estimates we are using to manage the underlying businesses. In addition, we make certain judgments about allocating shared assets such as accounts receivable and inventory to the estimated balance sheet for those businesses. We also consider our market capitalization (adjusted for unallocated monetary assets such as cash, marketable debt securities and debt) on the date we perform the analysis.

Capitalized Software

Costs related to internally-developed software and software purchased for internal use, which are required to be capitalized pursuant to Statement of Position (SOP) No. 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*, are included in property, plant and equipment under machinery and equipment.

Concentration of Credit Risk

The majority of our cash is maintained with one major financial institution headquartered in the United States. Cash balances with this bank in the United States exceed the amount of insurance provided on such deposits. However, deposits in foreign countries are subject to local banking laws and may bear higher or lower risk than cash deposited in the United States.

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Financial instruments that potentially subject Sun to concentrations of credit risk consist principally of marketable securities, foreign exchange contracts, interest rate instruments and trade receivables. The counterparties to the agreements relating to Sun's investment securities, foreign exchange contracts, and interest rate instruments consist of various major corporations and financial institutions of high credit standing. We do not believe there is significant risk related to non-performance by these counterparties because the amount of credit exposure to any one financial institution and any one type of investment (excluding U.S. government and agency securities) is limited to 5%. The credit risk on receivables due from counterparties related to foreign exchange and currency option contracts was insignificant at June 30, 2003 and 2002. Our trade receivables are derived primarily from sales of computer systems and network storage products and services to end-user customers in diversified industries, as well as various resellers. We perform ongoing credit evaluations of our customers' financial condition and limit the amount of credit extended when deemed necessary, but generally require no collateral.

Table of Contents

Revenue Recognition

Sun enters into transactions to sell products (hardware and software), services and multiple element arrangements that may include any combination thereof. We evaluate revenue recognition for these transactions using the following basic criteria (collectively called the Revenue Recognition Criteria):

Evidence of an arrangement: Before revenue is recognized, we must have evidence of an agreement with the customer reflecting the terms and conditions to deliver products or services.

Delivery: For products, delivery is considered to occur when hardware or the media containing software products are shipped and title and risk of loss have been transferred or, in the case of electronic delivery of software, the customer is given access to the licensed software programs. For services, delivery is considered to occur when the contracted services are provided.

Fixed or determinable fee: We consider a fee to be fixed or determinable if the fee is not subject to refund or adjustment. If a portion of the arrangement fee is not fixed or determinable, we recognize that amount as revenue when the amount becomes fixed or determinable. We do not consider a fee to be fixed and determinable if any amount is due more than 180 days from the delivery date. Payments terms of less than 180 days are evaluated based upon the country in which the arrangement is entered into to assess whether the fee is fixed and determinable.

Collection is deemed probable: At the time of the transaction, we conduct a credit review of each customer involved in a significant transaction with Sun to determine the creditworthiness of the customer. Collection is deemed probable if we expect the customer to be able to pay amounts under the arrangement as those amounts become due. If we determine that collection is not probable, we recognize revenue when collection becomes probable (generally upon cash collection).

The following policies are applicable to Sun's major categories of revenue transactions:

Products Revenue

Products revenue is recognized when the Revenue Recognition Criteria are met. Our standard sales agreements generally do not include customer acceptance provisions. However, if there is a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until we have evidence of customer acceptance. End-user customers generally do not have the right of return. With regard to sales to resellers and distributors (Channel Partners), revenue is generally recognized upon delivery (assuming all other revenue recognition criteria are met) as the Channel Partner's obligation to pay us is generally not contingent upon resale of the product, and all other criteria of SFAS No. 48, "Revenue Recognition When Right of Return Exists" have been met. This is often referred to as recognition "on sell-in." If the Channel Partner's obligation to pay is contingent upon resale of the product, we defer revenue recognition until the product is sold by the Channel Partner. This is often referred to as recognition "on sell-through." Our program offerings to certain of our Channel Partners provide for the right to return our product for stock rotation. We defer revenue recognition for these stock rotation rights to return our product based upon our historical experience with the Channel Partner. In accordance with contractual provisions, we also offer co-operative marketing funds based on a fixed dollar percentage of sales and price protection for certain of our Channel Partners. For co-operative marketing funds, as the related revenue is recognized, we either record marketing expense when we have evidence of fair value of the advertising benefit received, or we record the amount as a reduction to revenue. For our price protection program, we reduce revenue based upon our historical experience.

In addition, we sell products to leasing companies that, in turn, lease these products to end-users. In transactions where the leasing companies have no recourse to Sun in the event of default by the end-user, we recognize revenue on the transaction when the Revenue Recognition Criteria are met. In arrangements where the leasing companies have full recourse to Sun in the event of default by the end-user (defined as recourse leasing), we recognize the product revenue (and the related cost of the product) as the payments are made to the leasing company by the end-user (generally ratably over the lease term). We had deferred revenue and related deferred costs of \$27 million and \$11 million at June 30, 2003 (\$45 million deferred revenue and \$12 million deferred costs at June 30, 2002), respectively, related to recourse leases which will be recognized in future periods.

Services Revenue

Services revenue is recognized when the Revenue Recognition Criteria are met. Specifically, maintenance contract revenue is recognized ratably over the contractual period; educational services revenue is recognized as the services are

Table of Contents

rendered; time and material, and fixed price professional services contract revenue is recognized as the services are rendered, or upon completion of the professional services contract. If we can reliably evaluate progress to completion (based on total projected hours to be incurred on the professional services contract as compared with hours already incurred), we recognize the revenue as the services are rendered and recognize the related costs as they are incurred. In instances where we cannot reliably estimate the total projected hours, we recognize revenue upon completion of the professional services contract and the related costs are deferred and recognized in the same period as the revenue. Losses on fixed price professional services contracts are recognized in the period in which the loss becomes known. Our service agreements generally do not include customer acceptance provisions. However, if there is a customer acceptance provision, or if there is uncertainty about customer acceptance of services rendered, revenue is deferred until we have evidence of customer acceptance.

Multiple Element Arrangements

In certain circumstances, Sun enters into revenue arrangements as a result of which we are obligated to deliver to our customers multiple products and/or services (multiple elements). In these transactions, we allocate the total revenue to be earned under the arrangement among the various elements based on their relative fair value; however, in the case of software transactions, the allocation is based on Sun-specific objective evidence of fair value. Sun-specific objective evidence of fair value is generally the price charged when that element is sold separately. We recognize revenue related to the delivered products or services only if: (1) the above Revenue Recognition Criteria are met; (2) any undelivered products or services are not essential to the functionality of the delivered products or services; (3) payment for the delivered products or services is not contingent upon delivery of the remaining products or services; (4) we have an enforceable claim to receive the amount due in the event we do not deliver the undelivered products or services; and (5) as discussed above, there is evidence of the fair value for each of the undelivered products or services. For example, in certain arrangements, installation services are considered essential to the functionality of the delivered product. Accordingly, revenue is not recognized in those arrangements until the installation is complete and all other revenue recognition criteria are met.

Change in Accounting

We changed our revenue recognition policy effective July 1, 2000, based on guidance provided in Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, as amended (SAB 101). Sun's adoption of SAB 101 resulted in a change in accounting for certain product shipments where installation services were other than perfunctory. The cumulative effect of the change on retained earnings as of June 30, 2000 resulted in a charge of \$54 million (net of income taxes of \$33 million) to fiscal 2001 income.

Research and Development Expenditures

Costs related to the research, design, and development of products are charged to research and development expenses as incurred. Software development costs are capitalized beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. Generally, Sun's products are released soon after technological feasibility has been established. As a result, costs subsequent to achieving technological feasibility have not been significant and all software development costs have been expensed as incurred.

Shipping Costs

Sun's shipping and handling costs for product sales are included under cost of sales for all periods presented.

Advertising Costs

Advertising costs consist of development and placement costs of our advertising campaigns and are charged to expense when incurred. Advertising expense was \$84 million, \$124 million, and \$170 million for fiscal 2003, 2002, and 2001, respectively.

Table of Contents**Self-Insurance**

Sun is insured by nationally recognized insurers for certain potential liabilities, including worker's compensation, general liability, automotive liability, employer's liability, errors and omissions liability, employment practices liability, property, cargo and crime and directors and officers liability. During fiscal 2003, we self-insured between \$2 and \$5 million per occurrence on the lines of coverage noted above except for directors and officers liability where we assumed up to \$25 million per occurrence. Since July 1, 2003, we increased certain per occurrence self-insurance levels and currently self-insure between \$2 and \$25 million per occurrence on the lines of coverage noted above. In addition, beginning in fiscal 2004, we reduced the third-party insurance coverage of our directors and officers such that we now self-insure for all indemnification or defense payments we, as a company, may make to or on behalf of our directors and officers as a result of obligations under applicable agreements, Sun's charter documents and applicable law. As our indemnification obligations to directors and officers are substantial, the reduction in third-party coverage of our directors and officers liability insurance could adversely affect Sun's financial condition, liquidity, cash flows and results of operations if a material claim or loss occurred. Sun performs an annual actuarial analysis to develop an estimate of amounts to be paid for both claims reported and potential losses on activities that have occurred but have not yet been reported. Loss accruals were \$24 million and \$27 million as of June 30, 2003 and June 30, 2002, respectively.

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

The following table sets forth the computation of basic and diluted earnings per share for each of the past three fiscal years (in millions, except per share amounts):

	Fiscal Years Ended June 30,		
	2003	2002	2001
Income (loss) before cumulative effect of change in accounting principle	\$ (3,429)	\$ (587)	\$ 981
Cumulative effect of change in accounting principle, net			(54)
Net income (loss)	<u>\$ (3,429)</u>	<u>\$ (587)</u>	<u>\$ 927</u>
Weighted average shares outstanding:			
Basic	3,190	3,242	3,234
Effect of dilutive securities (primarily stock options)			183
Diluted	<u>3,190</u>	<u>3,242</u>	<u>3,417</u>
Net income (loss) per common share-basic:			
Income (loss) before cumulative effect of change in accounting principle	\$ (1.07)	\$ (0.18)	\$ 0.30
Cumulative effect of change in accounting principle			(0.02)

Edgar Filing: SUN MICROSYSTEMS INC - Form 10-K

Net income (loss) per common share-basic	\$ (1.07)	\$ (0.18)	\$ 0.28
Net income (loss) per common share-diluted:			
Income (loss) before cumulative effect of change in accounting principle	\$ (1.07)	\$ (0.18)	\$ 0.29
Cumulative effect of change in accounting principle			(0.02)
Net income (loss) per common share-diluted	\$ (1.07)	\$ (0.18)	\$ 0.27

US GAAP requires all anti-dilutive securities, including stock options, to be excluded from the diluted earnings per share computation. For fiscal 2003 and 2002, due to our net loss, all of our outstanding options of 587 million and 556 million, respectively, were excluded from the diluted loss per share calculation because their inclusion would have been anti-dilutive. If we had earned a profit during fiscal 2003 and 2002, we would have added 28 million and 97 million equivalent shares to our basic weighted average shares outstanding to compute the diluted weighted average shares outstanding.

Table of Contents**Stock Option Plans**

SFAS 123, Accounting for Stock-Based Compensation, amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure permits companies to measure compensation cost of stock-based awards based on their estimated fair value at the date of grant and recognize that amount over the related service period. We believe the existing stock option valuation models do not necessarily provide a transparent measure of the fair value of stock-based awards. Therefore, as permitted by SFAS 148, we apply the existing accounting rules under APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. In general, as the exercise price of all options granted under these plans is equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost is recognized in net income (loss). In addition, under these plans, options to purchase shares of common stock may be granted at less than fair market value, which results in compensation expense equal to the difference between the market value on the date of grant and the purchase price. This expense is recognized over the vesting period of the shares in net income (loss). As required by SFAS 148, we provide pro forma net income (loss) and pro forma net income (loss) per common share disclosures for stock-based awards made during fiscal 2003, 2002 and 2001, as if the fair-value-based method defined in SFAS 123 had been applied.

The fair value of the following stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for fiscal years ended June 30:

	Options			Employee Stock Purchase Plan		
	2003	2002	2001	2003	2002	2001
Expected life (in years)	6.5	6.8	5.8	0.5	0.5	0.5