SUN MICROSYSTEMS, INC.
Form 10-Q
May 06, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 27, 2005

or

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

For the transition period from ______ to ______

Commission file number: 0-15086

SUN MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-2805249**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

4150 Network Circle, Santa Clara, CA 95054

(Address of principal executive offices with zip code)

(650) 960-1300

(Registrant s telephone number, including area code)

N/A

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	**Outstanding at May 2, 2005**
Common Stock - $0.00067 par value	3,406,018,623

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in millions, except per share amounts)

	Three Months Ended		Nine Months Ended	
	March 27, 2005	March 28, 2004	March 27, 2005	March 28, 2004
Net revenues:				
Products	$ 1,683	$ 1,711	$ 5,199	$ 5,289
Services	944	940	2,897	2,786
Total net revenues	2,627	2,651	8,096	8,075
Cost of sales:				
Cost of sales-products	975	980	3,044	3,052
Cost of sales-services	565	603	1,694	1,731
Total cost of sales	1,540	1,583	4,738	4,783
Gross margin	1,087	1,068	3,358	3,292
Operating expenses:				
Research and development	450	470	1,313	1,408
Selling, general and administrative	732	842	2,128	2,468
Restructuring charges	44	203	176	194
Purchased in-process research and development				1
Total operating expenses	1,226	1,515	3,617	4,071
Operating loss	(139)	(447)	(259)	(779)
Gain (loss) on equity investments, net	2	3	7	(58)
Interest and other income, net	91	23	155	64
Loss before income taxes	(46)	(421)	(97)	(773)
Provision (benefit) for income taxes	(43)	339	35	398
Net loss	$ (3)	$ (760)	$ (132)	$ (1,171)

Net loss per common share-basic and diluted	$ (0.00)	$ (0.23)	$ (0.04)	$ (0.36)
Shares used in the calculation of net loss per common share basic and diluted	3,376	3,286	3,358	3,261

See accompanying notes.

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SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions)

	March 27, 2005	June 30, 2004
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,534	$ 2,141
Short-term marketable debt securities	1,601	1,460
Accounts receivable, net	2,020	2,339
Inventories	388	464
Deferred and prepaid tax assets	112	62
Prepaid expenses and other current assets	1,063	837
Total current assets	6,718	7,303
Property, plant and equipment, net	1,851	1,996
Long-term marketable debt securities	4,222	4,007
Goodwill	441	406
Other acquisition-related intangible assets, net	79	127
Other non-current assets, net	606	664
	$ 13,917	$ 14,503
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and short-term borrowings	$	$ 257
Accounts payable	1,071	1,057
Accrued payroll-related liabilities	699	622
Accrued liabilities and other	1,163	1,308
Deferred revenues	1,399	1,617
Warranty reserve	225	252
Total current liabilities	4,557	5,113
Long-term debt	1,116	1,175
Long-term deferred revenues	519	557
Other non-current obligations	1,189	1,220
Total stockholders equity	6,536	6,438
	$ 13,917	$ 14,503

See accompanying notes.

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SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in millions)

	Nine Months Ended	
	March 27, 2005	March 28, 2004
Cash flows from operating activities:		
Net loss	$ (132)	$ (1,171)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	496	517
Amortization of other intangible assets and unearned equity compensation	73	65
Deferred taxes	(107)	300
Loss (gain) on equity investments, net	(7)	58
Purchased in-process research and development		1
Changes in operating assets and liabilities:		
Accounts receivable, net	338	202
Inventories	79	(77)
Prepaid and other assets	(265)	(18)
Accounts payable	16	113
Other liabilities	(317)	64
Net cash provided by operating activities	174	54
Cash flows from investing activities:		
Purchases of marketable debt securities	(5,115)	(6,649)
Proceeds from sales and maturities of marketable debt securities	4,717	6,374
Proceeds from sales of equity investments, net	47	14
Acquisition of property, plant and equipment, net	(199)	(189)
Acquisition of spare parts and other assets	(68)	(56)
Payments for acquisitions, net of cash acquired	(45)	(201)
Net cash used in investing activities	(663)	(707)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	134	151
Principal payments on borrowings	(252)	(7)
Net cash provided by (used in) financing activities	(118)	144
Net decrease in cash and cash equivalents	(607)	(509)
Cash and cash equivalents, beginning of period	2,141	2,015
Cash and cash equivalents, end of period	$ 1,534	$ 1,506
Supplemental disclosures of cash flow information:		
Interest paid (net of interest received from swap agreements of $62 and $72, respectively)	$ 27	$ 26

Income taxes paid (net of refunds of $19 and $125, respectively)	$ 310	$ 48
Supplemental schedule of noncash investing activities:		
Stock and options issued in connection with acquisitions	$ 1	$ 16

See accompanying notes.

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SUN MICROSYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

Sun Microsystems, Inc. s (Sun) business is singularly focused on providing products and services for network computing. Network computing has been at the core of the company s offerings for the 23 years of our existence and is based on the premise that the power of a single computer can be increased dramatically when interconnected with other computer systems for the purposes of communication and sharing of computing power. Together with our partners, we provide network computing infrastructure solutions that comprise Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions (formerly known as Professional services) and Knowledge services. Our customers use our products and services to build mission-critical network computing environments on which they operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

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

Basis of Presentation

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

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

Computation of Net Income (Loss) per Common Share

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

Diluted net income (loss) per common share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist primarily of stock options. Due to our net loss for all periods presented, all of our outstanding options were excluded from the diluted loss per share calculation because their inclusion would have been anti-dilutive.

If we had earned a profit during the three and nine months ended March 27, 2005, we would have added 25 million and 27 million common equivalent shares, respectively, to our basic weighted-average shares outstanding to compute the diluted weighted-average shares outstanding. If we had earned a profit during the three and nine months ended March 28, 2004, we would have added 47 million and 33 million common equivalent shares, respectively, to our basic weighted-average shares outstanding to compute the diluted weighted-average shares outstanding.

Stock Option Plans

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

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

The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the three and nine months ended March 27, 2005 and March 28, 2004, respectively:

Options	**Three Months Ended**		**Nine Months Ended**	
	March 27, 2005	**March 28, 2004**	**March 27, 2005**	**March 28, 2004**
Expected life (in years)	5.7	6.3	5.9	6.4
Interest rate	3.84%	3.03%	3.65%	3.39%
Volatility	67.27%	67.50%	68.22%	67.44%
Dividend yield				
Weighted-average fair value at grant date	$ 2.58	$ 3.20	$ 2.53	$ 2.74

Employee Stock Purchase Plan	**Three Months Ended**		**Nine Months Ended**	
	March 27, 2005	**March 28, 2004**	**March 27, 2005**	**March 28, 2004**
Expected life (in years)	0.5	0.5	0.5	0.5
Interest rate	2.18%	1.04%	1.51%	1.09%
Volatility	41.13%	45.06%	41.67%	54.97%
Dividend yield				
Weighted-average fair value at grant date	$ 1.11	$ 1.08	$ 1.04	$ 1.00

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

	Three Months Ended		**Nine Months Ended**	
	March 27, 2005	**March 28, 2004**	**March 27, 2005**	**March 28, 2004**
Pro forma net loss:				
Net loss after tax	$ (3)	$ (760)	$ (132)	$ (1,171)

Add: stock-based compensation costs included in reported net loss (net of tax effects of none in all periods)	5	5	15	20
Deduct: stock-based compensation costs (net of tax effects of none in all periods) under SFAS 123	(58)	(203)	(424)	(644)
Pro forma net loss after tax	$ (56)	$ (958)	$ (541)	$ (1,795)
Pro forma basic and diluted net loss per common share:				
Pro forma shares used in the calculation of pro forma net loss per common share - basic and diluted	3,376	3,286	3,358	3,261
Pro forma net loss per common share - basic and diluted	$ (0.02)	$ (0.29)	$ (0.16)	$ (0.55)
Reported net loss per common share - basic and diluted	$ (0.00)	$ (0.23)	$ (0.04)	$ (0.36)

Recent Pronouncements

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

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

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

In December 2004, the FASB issued SFAS 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R requires measurement of all employee stock-based compensation awards using a fair-value method and the recording of such expense in the consolidated financial statements. In addition, the adoption of SFAS 123R will require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. In January 2005, the SEC issued Staff Accounting Bulletin No. 107, providing supplemental implementation guidance for SFAS 123R. SFAS 123R is effective beginning in our first quarter of fiscal 2006. We are evaluating the requirements of SFAS 123R and we expect that the adoption of SFAS 123R will have a material impact on our results of operations and financial condition. We have not yet determined whether the adoption of SFAS 123R will result in stock-based compensation charges that are similar to the current pro forma disclosures under SFAS 123. However, the acceleration of certain unvested and out-of-money stock options as of May 30, 2005 will favorably impact our future results of operations. See Note 12, Subsequent Event.

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

3. BUSINESS COMBINATIONS

We completed one acquisition during the nine months ended March 27, 2005. The acquisition of SevenSpace Inc. (SevenSpace) is described below. Our consolidated financial statements include the operating results of the business acquired from the date of acquisition. Pro forma results of operations have not been presented because the effect of the acquisition was not material. In accordance with SFAS No. 141, Business Combinations, this transaction was accounted for as a purchase business combination.

SevenSpace

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

We purchased SevenSpace for approximately $46 million in cash, $1 million in assumed options, and approximately $1 million in transaction costs. The total purchase price of $48 million was allocated as follows (in millions):

Goodwill	$ 37
Other intangible assets	9
Tangible assets acquired and net liabilities assumed	2
Total	$ 48

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4. GOODWILL AND OTHER ACQUISITION-RELATED INTANGIBLE ASSETS

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

	Product Group	Sun Services	Total
Balance as of June 30, 2004	$ 326	$ 80	$ 406
Goodwill acquired during the period		37	37
Utilization of acquired deferred tax assets	(2)		(2)
Balance as of March 27, 2005	$ 324	$ 117	$ 441

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

	Gross Carrying Amount			Accumulated Amortization			Net
	June 30, 2004	Additions	March 27, 2005	June 30, 2004	Additions	March 27, 2005	March 27, 2005
Developed technology	$ 383	$ 4	$ 387	$ (295)	$ (33)	$ (328)	$ 59
Customer base	50	5	55	(45)	(2)	(47)	8
Acquired workforce and other	86		86	(52)	(22)	(74)	12
	$ 519	$ 9	$ 528	$ (392)	$ (57)	$ (449)	$ 79

Amortization expense of other acquisition-related intangible assets was $19 million and $57 million for the three and nine months ended March 27, 2005, respectively, and $17 million and $47 million for the three and nine months ended March 28, 2004, respectively.

The developed technology is being amortized on a straight-line basis over a three-year period and is included in cost of sales. Customer base is being amortized on a straight-line basis over a three-year period and is included in selling, general and administrative expenses. Acquired workforce and other are being amortized on a straight-line basis over a three-year period and is included in research and development.

For the fiscal years ending June 30, estimated amortization expense of other acquisition-related intangible assets for acquisitions completed prior to March 27, 2005 is as follows (in millions):

Remainder of 2005	$ 17

2006	42
2007	19
2008	1
	$ 79

5. BALANCE SHEET DETAILS

Inventories

Inventories consisted of the following (in millions):

	March 27, 2005	June 30, 2004
Raw materials	$ 70	$ 78
Work in process	117	131
Finished goods	201	255
	$ 388	$ 464

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Deferred Revenues

The following table sets forth an analysis of the deferred revenue activity for the nine months ended March 27, 2005 (in millions):

	Deferred services revenues	Other deferred revenues	Total
Balance at June 30, 2004	$ 1,612	$ 562	$ 2,174
Revenue deferred	839	627	1,466
Revenue recognized	(938)	(784)	(1,722)
Balance at March 27, 2005	1,513	405	1,918
Less short-term portion	(1,075)	(324)	(1,399)
Total long-term deferred revenues	$ 438	$ 81	$ 519

Warranty Reserve

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

The following table sets forth an analysis of the warranty reserve activity for the nine months ended March 27, 2005 (in millions):

Balance at June 30, 2004	$ 252
Charged to costs and expenses	224
Utilization	(251)
Balance at March 27, 2005	$ 225

6. RESTRUCTURING CHARGES AND WORKFORCE REBALANCING EFFORTS

Fiscal 2004 Restructuring Plan

In March 2004, our Board of Directors and management approved a plan to reduce our cost structure and improve operating efficiencies by reducing our workforce, exiting facilities, and implementing productivity improvement initiatives and expense reduction measures (Fiscal 2004

Restructuring Plan). This plan included reducing our workforce by at least 3,300 employees across all levels, business functions, operating units, and geographic regions. Through the end of the third quarter of fiscal 2005, we reduced our workforce by approximately 3,700 employees under this plan. This plan also included eliminating excess facility capacity in light of revised facility requirements and other actions. In accordance with SFAS No. 112, Employers Accounting for Post Employment Benefits and SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), in the third quarter and first nine months of fiscal 2005 we recognized a total of $40 million and $175 million, respectively, in charges associated with the Fiscal 2004 Restructuring Plan, consisting of $29 million and $68 million, respectively, in workforce reduction charges and $11 million and $107 million, respectively, in excess facility charges.

While we have substantially completed our Fiscal 2004 Restructuring Plan, we may record additional charges related to our workforce and facilities reductions over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving Sun as determined by local employment laws and as we continue to exit facilities. Certain costs related to the facilities reductions that do not meet the initial recognition criteria of SFAS 146 will be expensed as they are incurred and will be reflected as restructuring charges in our Consolidated Statements of Operations.

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

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

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

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The following table sets forth an analysis of the restructuring accrual activity for the nine months ended March 27, 2005 (in millions):

	Fiscal 2004 Restructuring Plan		Fiscal 2003 Restructuring Plan		Fiscal 2002 Restructuring Plan	Fiscal 2001 Facility Exit Plan	
	Severance and Benefits	Facilities Related and Other	Severance and Benefits	Facilities Related	Facilities Related	Facilities Related	Total
Balance as of June 30, 2004	$ 166	$ 88	$ 1	$ 90	$ 153	$ 45	$ 543
Severance and benefits	61						61
Lease costs		94					94
Property and equipment impairment		13					13
Provision adjustments	7			1	1	(1)	8
Total restructuring charges	68	107		1	1	(1)	176
Cash paid	(174)	(35)	(1)	(16)	(23)	(13)	(262)
Non-cash		(12)					(12)
Balance as of March 27, 2005	$ 60	$ 148	$	$ 75	$ 131	$ 31	$ 445

Our accrued liability for all four plans was net of approximately $105 million of estimated sublease income to be generated from sublease contracts not yet negotiated. Our ability to generate this amount of sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated, is highly dependent upon the economic conditions, particularly commercial real estate market conditions in certain geographies, at the time we negotiate the lease termination and sublease arrangements with third parties. The amounts we have accrued represent our best estimate of the obligations we expect to incur in connection with these plans, and could be subject to change. Adjustments may be required as conditions and facts change throughout the implementation period.

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of March 27, 2005 for facility related lease obligations (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of March 27, 2005, $158 million of the $445 million accrual was classified as current and the remaining $287 million was classified as non-current.

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

Workforce Rebalancing Efforts

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

During fiscal 2004 and the first nine months of fiscal 2005, we paid $54 million and $1 million, respectively.

7. COMPREHENSIVE LOSS

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

	Three Months Ended		Nine Months Ended	
	March 27, 2005	**March 28, 2004**	**March 27, 2005**	**March 28, 2004**
Net loss	$ (3)	$ (760)	$ (132)	$ (1,171)
Change in unrealized value of investments, net	(26)	2	(17)	(5)
Change in unrealized fair value of derivative instruments, net	7	13	(1)	14
Translation adjustments, net	13	16	99	47
	$ (9)	$ (729)	$ (51)	$ (1,115)

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

	March 27, 2005	**June 30, 2004**
Unrealized losses on investments, net	$ (34)	$ (17)
Unrealized losses on derivative instruments, net	(7)	(6)
Cumulative translation adjustments, net	295	196
	$ 254	$ 173

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8. INCOME TAXES

For the third quarter and first nine months of fiscal 2005, we recorded an income tax benefit of $43 million and an income tax provision of $35 million, respectively, as compared with an income tax provision of $339 million and $398 million for the corresponding periods of fiscal 2004. These tax provisions (benefit) were recorded for taxes due on income generated in certain state and foreign tax jurisdictions and also include adjustments for the difference between estimated amounts recorded and actual liabilities resulting from the filing of prior years tax returns.

During the third quarter of fiscal 2005, we recorded a tax benefit of $69 million resulting from actions taken in response to the 2004 Protocol to the 1992 Income Tax Convention between the U.S. and the Netherlands, which became effective during the third quarter of fiscal 2005. These actions resulted in a reduction of Dutch withholding taxes previously provided on undistributed foreign earnings, which were not permanently invested outside of the United States.

Additionally, during the third quarter of fiscal 2005, we adjusted our foreign subsidiaries tax provisions in certain countries. As a result, we recorded a net beneficial correction of $22 million associated with certain tax adjustments related to prior periods. These adjustments included a tax provision of $12 million relating to the difference between estimated amounts recorded and actual liabilities resulting from the completion of tax filings for fiscal 2003 and 2004, and a tax benefit from a reduction in the deferred tax valuation allowance of $34 million relating to certain foreign deferred tax assets that were generated through June 30, 2003. These adjustments are immaterial both individually and in the aggregate to our results of operations and financial condition for the affected periods.

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

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

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

9. OPERATING SEGMENTS

We design, manufacture, market and service network computing infrastructure solutions that consist of Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions and Knowledge services. Effective July 1, 2004, our President and Chief Operating Officer was identified as the Chief Operating Decision Maker (CODM) as defined by SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information (SFAS 131). Following his appointment, we reorganized Sun and the effects of these changes to our business organization did not result in a change to our operating segment disclosure. The CODM continues to manage our company based primarily on broad functional categories of sales, services, manufacturing, product development and engineering and marketing and strategy. The CODM reviews financial information on revenues and gross margins for products and services. The CODM also reviews operating expenses certain of which have been allocated to our two segments described below.

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

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

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Segment information

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

	Product Group	Sun Services	Other	Total
Three Months Ended:				
March 27, 2005				
Revenues	$ 1,683	$ 944	$	$ 2,627
Interdivision revenues	141	81	(222)	
Operating income (loss)	258	339	(736)	(139)
March 28, 2004				
Revenues	$ 1,711	$ 940	$	$ 2,651
Interdivision revenues	154	106	(260)	
Operating income (loss)	234	248	(929)	(447)

	Product Group	Sun Services	Other	Total
Nine Months Ended:				
March 27, 2005				
Revenues	$ 5,199	$ 2,897	$	$ 8,096
Interdivision revenues	479	285	(764)	
Operating income (loss)	833	1,091	(2,183)	(259)
March 28, 2004				
Revenues	$ 5,289	$ 2,786	$	$ 8,075
Interdivision revenues	482	323	(805)	
Operating income (loss)	716	790	(2,285)	(779)

10. LEGAL PROCEEDINGS

On February 11, 2002, Eastman Kodak Company (Kodak) filed a patent infringement lawsuit against us (Civil Action No. 02-CV-6074) in the United States District Court for the Western District of New York. Kodak alleged that some of our products infringed or contributed to the infringement of one or more patent claims owned by Kodak. Effective October 7, 2004, we reached an agreement with Kodak to settle all claims in the lawsuit, which included a release and a perpetual, non-exclusive, worldwide irrevocable license to certain Kodak patents, including the patents at issue in the lawsuit. In return, we paid Kodak $92 million. Of this amount, $10 million was expensed in fiscal 2004 and $55 million was expensed to cost of sales-products in the first quarter of fiscal 2005. The remaining amount represents the estimated future benefit that we will obtain from the licenses granted under the settlement. This $27 million intangible asset was recorded in other non-current assets and is being amortized ratably to cost of sales-products over the remaining patent life through fiscal 2010.

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

We entered into settlement agreements with the United States Department of Commerce, Bureau of Industry and Security, Office of Export Enforcement (BIS) on December 15, 2003 addressing certain BIS charges that we had violated export control regulations. The settlement included a one year suspended denial of our worldwide export privileges, which expired on December 15, 2004 without incident.

11. RELATED PARTIES

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

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12. SUBSEQUENT EVENT

On April 28, 2005, our Board of Directors approved the acceleration of vesting of certain unvested and out-of-money stock options with exercise prices equal to or greater than $6.00 per share previously awarded to our employees, including our executive officers and directors, under our equity compensations plans. The acceleration of vesting will be effective for stock options outstanding as of May 30, 2005. Options to purchase approximately 45 million shares of common stock or 18% of our outstanding unvested options are subject to the acceleration. The weighted average exercise price of the options subject to the acceleration is $14.85. The purpose of the acceleration is to enable us to avoid recognizing compensation expense associated with these options in future periods in our Consolidated Statements of Operations upon adoption of SFAS 123R in July 2005. We also believe that because the options to be accelerated have exercise prices in excess of the current market value of our common stock, the options have limited economic value and are not fully achieving their original objective of incentive compensation and employee retention.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of Sun Microsystems, Inc. as of March 27, 2005, and the related condensed consolidated statements of operations for the three-month and nine-month periods ended March 27, 2005 and March 28, 2004, and the condensed consolidated statements of cash flows for the nine-month periods ended March 27, 2005 and March 28, 2004. These financial statements are the responsibility of the Company s management.

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

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

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

/s/ Ernst & Young LLP

San Jose, California

May 4, 2005

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

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

Executive Overview

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

During the third quarter of fiscal 2005, we experienced a year over year decrease in total net revenues of approximately 1%, which included a favorable foreign currency impact of approximately 2%. Our Products net revenue was unfavorably impacted by competition and a continuing market shift in overall computer system demand away from our data center servers towards the usage of enterprise and entry level servers. This decrease was partially offset by increases in both Support services and Client solutions revenue. We also experienced a sequential quarterly decrease in total net revenues of approximately 7.5%, which included a favorable foreign currency impact of approximately 1%. The sequential decrease in total net revenues reflects the seasonal decrease we generally experience between our second and third quarters and a competitive business environment, particularly in the U.S., where total net revenues declined to $982 million in the third quarter of fiscal 2005, principally as a result of the decline in revenue from the government sector. To address the competitive environment and continued decline in U.S. revenues, we have appointed a new head of sales to strengthen our solution-based selling strategy.

During the third quarter of fiscal 2005, our year over year gross margin increased by approximately 1.1 percentage points. Our Products gross margin decreased by 0.6 percentage point primarily due to the unfavorable impact of discounting and pricing actions, partially offset by manufacturing and component cost reductions. Our Services gross margin increased by 4.2 percentage points primarily due to the favorable impact of volume efficiencies, cost reductions and productivity measures. Our sequential quarterly Products gross margin percentage was essentially flat as planned list price reductions and sales discounting actions were offset by cost reductions. Sequentially, Services gross margin decreased by 2.2 percentage points primarily due to the decrease in revenue partially offset by cost reductions and productivity measures.

During the third quarter and first nine months of fiscal 2005, we adjusted our foreign subsidiaries tax provisions in certain countries. As a result, our consolidated results of operations were favorably impacted by a net beneficial correction of $22 million related to adjustments to the valuation allowance on certain deferred tax assets and foreign tax provisions (see Income Taxes). These adjustments are immaterial both individually and in the aggregate to our results of operations and financial condition for the affected periods. Our financial results for the third quarter and first nine months of fiscal year 2005 also included a favorable impact of $54 million in additional settlement income from Microsoft (included in Interest and Other Income, net), and a benefit of $69 million related to the impact of a change in the U.S.-Dutch withholding tax treaty.

During the first nine months of fiscal 2005, our operating activities provided cash flows of $174 million. At March 27, 2005 we had a total cash, cash equivalents and marketable debt securities position of approximately $7.4 billion.

Subsequent to the announcement of our preliminary third quarter and first nine months of fiscal 2005 results on April 14, 2005, we obtained additional information that required us to reduce our previously announced net loss by approximately $6 million as a result of certain adjustments that are reflected in our condensed consolidated financial statements.

Critical Accounting Policies

The accompanying discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other

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sources. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. We are required to make estimates and judgments in many areas, including those related to fair value of derivative financial instruments, recording of various accruals, bad debt and inventory reserves, the useful lives of long-lived assets such as property and equipment, warranty obligations and potential losses from contingencies and litigation. We believe the policies disclosed are the most critical to our financial statements because their application places the most significant demands on management s judgment. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the three and nine months ended March 27, 2005 to the items that we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004.

RESULTS OF OPERATIONS

Net Revenues

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

	Three Months Ended			Nine Months Ended		
	March 27, 2005	**March 28, 2004**	**Change**	**March 27, 2005**	**March 28, 2004**	**Change**
Computer Systems products	$ 1,391	$ 1,365	1.9%	$ 4,250	$ 4,215	0.8%
Network Storage products	292	346	(15.6)%	949	1,074	(11.6)%
Products net revenue	$ 1,683	$ 1,711	(1.6)%	$ 5,199	$ 5,289	(1.7)%
Percentage of total net revenues	64.1%	64.5%		64.2%	65.5%	
Support services	$ 734	$ 731	0.4%	$ 2,253	$ 2,207	2.1%
Client solutions and Knowledge services	210	209	0.5%	644	579	11.2%
Services net revenue	$ 944	$ 940	0.4%	$ 2,897	$ 2,786	4.0%
Percentage of total net revenues	35.9%	35.5%		35.8%	34.5%	
Total net revenues	$ 2,627	$ 2,651	(0.9)%	$ 8,096	$ 8,075	0.3%
Revenue per employee[(1)]	$ 82	$ 74	10.8%	$ 248	$ 225	10.2%

	March 27, 2005	**March 28, 2004**	
Services contract penetration rate[(2)]	49.5%	42.7%	6.8pts

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

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

Due to the generally weakened U.S. dollar during the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, our total net revenues were favorably impacted by foreign currency exchange rates. The net foreign currency impact to our total net revenues is difficult to precisely measure. However, our best estimate of the foreign exchange benefit during the first nine months of fiscal 2005 as compared with the corresponding period of fiscal 2004, approximated a benefit of 2% of Products net revenue and a benefit of 4% of Services net revenue. Our best estimate of the foreign exchange benefit during the third quarter of fiscal 2005 as compared with the third quarter of fiscal 2004, approximated a benefit of 2% of Products net revenue and a benefit of 3% of Services net revenue.

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Products Net Revenue

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

During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, Computer Systems revenue increased primarily due to increased unit sales of entry level servers, which included servers running on our SPARC and AMD s Opteron™ x86 processors, and Netra™ servers. The increases in Computer Systems revenue were partially offset by reduced sales of data center servers in the same periods, which were adversely affected by intense competition and a continuing market shift in overall computer system demand toward the use of enterprise and entry level servers. Additionally, during the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, Computer systems revenue was favorably impacted by increased unit sales of certain enterprise servers. During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, Network Storage revenue decreased due to reduced sales of mid-range and data center storage systems and low-end storage components, partially offset by increased unit sales of entry level storage systems.

Services Net Revenue

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

Support services revenue consists primarily of maintenance contract revenue, which is recognized ratably over the contractual period. During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods in fiscal 2004, Support services net revenue increased due to the benefit of foreign exchange and an increase in the number of systems under a Support services contract. These increases were substantially offset by competitive pricing pressures. We believe the increase in the number of systems under a Support services contract is primarily due to our continuing emphasis on our solution-based selling strategy, which includes Support services as an essential element of a sale. The 6.8 percentage point increase in the services contract penetration rate is due to a continued increase in the systems under contract and a decrease in the estimate of the number of active systems that comprise the installed base.

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

Net Revenues by Geographic Area

(dollars in millions)

	Three Months Ended	Change	Nine Months Ended	Change

	March 27, 2005	March 28, 2004		March 27, 2005	March 28, 2004	
United States (U.S.)	$ 982	$ 1,037	(5.3)%	$ 3,217	$ 3,413	(5.7)%
Percentage of total net revenues	37.4%	39.1%		39.7%	42.3%	
Americas-Other (Canada and Latin America)	$ 144	$ 136	5.9%	$ 418	$ 404	3.5%
Percentage of total net revenues	5.5%	5.1%		5.2%	5.0%	
EMEA (Europe, Middle East and Africa)	$ 1,009	$ 1,002	0.7%	$ 3,019	$ 2,856	5.7%
Percentage of total net revenues	38.4%	37.8%		37.3%	35.4%	
APAC (Asia, Australia and New Zealand)	$ 492	$ 476	3.4%	$ 1,442	$ 1,402	2.9%
Percentage of total net revenues	18.7%	18.0%		17.8%	17.3%	
Total International revenues	$ 1,645	$ 1,614	1.9%	$ 4,879	$ 4,662	4.7%
Percentage of total net revenues	62.6%	60.9%		60.3%	57.7%	
Total net revenues	$ 2,627	$ 2,651	(0.9)%	$ 8,096	$ 8,075	0.3%

United States (U.S.)

Net revenues in the U.S. declined during the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004 primarily due to a decrease in products net revenue. In the U.S., our sales mix has traditionally included a higher proportion of product sales, which has contributed to the challenge in growing revenue in this geographic market as we continue to experience intense competitive pressures, especially in selling our high-end server products in certain key sectors. In

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the government sector, we continue to experience intense competition and reduced spending in certain areas which have traditionally been sources of relative competitive strength. During the first nine months of fiscal 2005, increased merger and acquisition activity in the telecommunication sector was correlated to reduced customer spending patterns in key accounts. Partially offsetting the decline in net revenue from the government and telecommunications sectors during the first nine months of fiscal 2005, was year over year growth in purchases from our Wall Street customer base.

The following table sets forth net revenues in those geographic markets that contributed significantly to changes in international net revenues during the third quarter and first nine months of fiscal 2005 (dollars in millions):

	Three Months Ended			Nine Months Ended		
	March 27, 2005	March 28, 2004	Change	March 27, 2005	March 28, 2004	Change
United Kingdom (UK)	$ 237	$ 255	(7.1)%	$ 752	$ 668	12.6%
Germany[(1)]	$ 213	$ 198	7.6%	$ 632	$ 600	5.3%
Japan	$ 199	$ 207	(3.9)%	$ 572	$ 584	(2.1)%
Central and Northern Europe (CNE)	$ 184	$ 166	10.8%	$ 517	$ 499	3.6%

(1) Beginning in the second quarter of fiscal 2005, all periods presented have been adjusted to exclude Austria from the Germany geographic market.

United Kingdom (UK)

During the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, net revenues in the UK decreased due to a lengthening of the sales cycle and a continuing market shift in overall computer system demand towards the usage of enterprise and entry level servers. During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, Support services and Client solutions revenues increased due in part to solution-based selling. Our revenue mix in the UK has included a higher proportion of services revenues when compared to other geographic markets such as the U.S. and Japan, which has contributed to our overall revenue growth in this geographic market on a nine-month basis. The government sector primarily contributed to the increase in revenue during the first nine months of fiscal 2005, as compared with the corresponding period of fiscal 2004, including $62 million of revenue recognized in the first quarter of fiscal 2005, which was related to the first phase of a multi-year solution-based sale to a health care services provider.

Germany

During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, net revenues in Germany increased due to the benefit of foreign exchange and a moderate increase in third quarter Products net revenue associated with increased sales of entry level and enterprise servers. Total net revenues in Germany have been impacted by intense competition, the weak demand for our data center servers, and a challenging macroeconomic environment. Despite these challenges, the government sector remained a source of overall revenue strength during the third quarter and first nine months of fiscal 2005.

Japan

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

Central and Northern Europe (CNE)

During the third quarter and first nine months of fiscal 2005 as compared with the corresponding periods of fiscal 2004, net revenues in CNE increased primarily due to increases in both Products and Client solutions revenues. Year over year revenue growth occurred in a variety of sectors and across the majority of products and services categories and, we believe in part, can be attributed to the success of our solution sales approach.

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Gross Margin

(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 27, 2005	March 28, 2004	Change	March 27, 2005	March 28, 2004	Change
Products gross margin	$ 708	$ 731	(3.1)%	$ 2,155	$ 2,237	(3.7)%
Percentage of products net revenue	42.1%	42.7%	(0.6)pts	41.5%	42.3%	(0.8)pts
Services gross margin	$ 379	$ 337	12.5%	$ 1,203	$ 1,055	14.0%
Percentage of services net revenue	40.1%	35.9%	4.2pts	41.5%	37.9%	3.6pts
Total gross margin	$ 1,087	$ 1,068	1.8%	$ 3,358	$ 3,292	2.0%
Percentage of total net revenues	41.4%	40.3%	1.1pts	41.5%	40.8%	0.7pts

Products Gross Margin

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

During the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, our products gross margin percentage decreased by 0.6 percentage point due to planned list price reductions and sales discounting actions of approximately 4 percentage points and changes in product mix to a greater proportion of lower margin products of approximately 1 percentage point. Offsetting these decreases were cost reductions due to supply chain restructuring, product cost engineering and continued use of dynamic bidding events which collectively benefited gross margin by approximately 4 percentage points.

During the first nine months of fiscal 2005 as compared with the corresponding period of fiscal 2004, our products gross margin percentage decreased by 0.8 percentage points due to: (1) planned list price reductions and sales discounting actions of approximately 4 percentage points; (2) the adverse impact of the first quarter s classification of the Kodak litigation settlement as a cost of product sales of approximately 1 percentage point; and (3) changes in product mix to a greater proportion of lower margin products of approximately 1 percentage point. Offsetting these decreases were cost reductions due to supply chain restructuring, product cost engineering and continued use of dynamic bidding events which benefited gross margin by approximately 5 percentage points.

Services Gross Margin

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

During the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, our services gross margin increased by 4.2 percentage points due to: (1) costs savings associated with our workforce reductions of approximately 2 percentage points; and (2) cost savings associated with delivery efficiencies of approximately 2 percentage points.

During the first nine months of fiscal 2005 as compared with the corresponding period of fiscal 2004, our services gross margin increased by 3.6 percentage points due to: (1) revenue volume efficiencies of approximately 3 percentage points; and (2) costs savings associated with our workforce reductions of approximately 2 percentage points. These increases were partially offset by the negative impact of increased costs associated with a shift in product mix to solution-based sales of approximately 1 percentage point.

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Operating Expenses

(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 27, 2005	March 28, 2004	Change	March 27, 2005	March 28, 2004	Change
Research and development	$ 450	$ 470	(4.3)%	$ 1,313	$ 1,408	(6.7)%
Percentage of total net revenues	17.1%	17.7%		16.2%	17.4%	
Selling, general and administrative	$ 732	$ 842	(13.1)%	$ 2,128	$ 2,468	(13.8)%
Percentage of total net revenues	27.9%	31.8%		26.3%	30.6%	
Restructuring charges	$ 44	$ 203	(78.3)%	$ 176	$ 194	(9.3)%
Percentage of total net revenues	1.7%	7.7%		2.2%	2.4%	
Purchased in-process research and development	$	$	N/M*	$	$ 1	N/M*
Percentage of total net revenues	%	%		%	0.0%	
Total operating expenses	$ 1,226	$ 1,515	(19.1)%	$ 3,617	$ 4,071	(11.2)%

* Not meaningful

Research and Development (R&D) Expenses

R&D expenses decreased by $20 million during the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to $35 million in cost savings associated with workforce reductions. This decrease was partially offset by a $20 million increase in compensation costs associated with salaries and bonuses.

R&D expenses decreased by $95 million during the first nine months of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) $102 million in cost savings associated with workforce reductions; (2) $39 million in cost savings associated with discretionary and outside services spending; and (3) a $20 million reduction of depreciation and amortization and payroll related savings due to fewer days in the first nine months of fiscal 2005. These decreases were partially offset by a $54 million increase in compensation costs associated with salaries and bonuses and a $27 million increase in compensation and other costs associated with current and previous acquisitions.

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

Selling, General and Administrative (SG&A) Expenses

SG&A expenses decreased by $110 million during the third quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) $68 million in cost savings associated with workforce reductions; (2) $28 million in reductions in legal costs; (3) $17 million in occupancy cost savings associated with facilities exit actions; and (4) a $12 million reduction of depreciation, amortization and marketing related costs. These decreases were partially offset by a $28 million increase in compensation costs associated with salaries and bonuses.

SG&A expenses decreased by $340 million during the first nine months of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) $195 million in cost savings associated with workforce reductions and rebalancing efforts; (2) $71 million in occupancy cost savings associated with facilities exit actions; (3) $50 million in reductions in legal costs; (4) $29 million reduction of depreciation and amortization; (5) $24 million in reductions in marketing related costs; and (6) a $25 million in payroll related savings related to fewer payroll days in the first nine months of fiscal 2005 and commissions. These decreases were partially offset by a $70 million increase in compensation costs associated with salaries and bonuses.

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

Restructuring Charges and Workforce Rebalancing Efforts

Fiscal 2004 Restructuring Plan

In March 2004, our Board of Directors and management approved a plan to reduce our cost structure and improve operating efficiencies by reducing our workforce, exiting facilities, and implementing productivity improvement initiatives and expense reduction measures (Fiscal 2004 Restructuring Plan). This plan included reducing our workforce by at least 3,300 employees across all levels, business functions, operating units, and geographic regions. Through the end of the third quarter of fiscal 2005,

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we reduced our workforce by approximately 3,700 employees under this plan. This plan also included eliminating excess facility capacity in light of revised facility requirements and other actions. In accordance with SFAS No. 112, Employers Accounting for Post Employment Benefits and SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), in the third quarter and first nine months of fiscal 2005 we recognized a total of $40 million and $175 million, respectively, in charges associated with the Fiscal 2004 Restructuring Plan, consisting of $29 million and $68 million, respectively, in workforce reduction charges and $11 million and $107 million, respectively, in excess facility charges.

While we have substantially completed our Fiscal 2004 Restructuring Plan, we may record additional charges related to our workforce and facilities reductions over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving Sun as determined by local employment laws and as we continue to exit facilities. Certain costs related to the facilities reductions that do not meet the initial recognition criteria of SFAS 146 will be expensed as they are incurred and will be reflected as restructuring charges in our Consolidated Statements of Operations.

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

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

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

The following table sets forth an analysis of the restructuring accrual activity for the nine months ended March 27, 2005 (in millions):

	Fiscal 2004 Restructuring Plan		Fiscal 2003 Restructuring Plan		Fiscal 2002 Restructuring Plan	Fiscal 2001 Facility Exit Plan	
	Severance and Benefits	Facilities Related and Other	Severance and Benefits	Facilities Related	Facilities Related	Facilities Related	Total
Balance as of June 30, 2004	$ 166	$ 88	$ 1	$ 90	$ 153	$ 45	$ 543
Severance and benefits	61						61
Lease costs		94					94
Property and equipment impairment		13					13
Provision adjustments	7			1	1	(1)	8
Total restructuring charges	68	107		1	1	(1)	176

Cash paid	(174)	(35)	(1)	(16)	(23)	(13)	(262)
Non-cash		(12)					(12)
Balance as of March 27, 2005	$ 60	$ 148	$	$ 75	$ 131	$ 31	$ 445

Our accrued liability for all four plans was net of approximately $105 million of estimated sublease income to be generated from sublease contracts not yet negotiated. Our ability to generate this amount of sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated, is highly dependent upon the economic conditions, particularly commercial real estate market conditions in certain geographies, at the time we negotiate the lease termination and sublease arrangements with third parties. The amounts we have accrued represent our best estimate of the obligations we expect to incur in connection with these plans, and could be subject to change. Adjustments may be required as conditions and facts change throughout the implementation period.

The remaining cash expenditures relating to workforce reductions are expected to be paid over the next few quarters. Our accrual as of March 27, 2005 for facility related lease obligations (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of March 27, 2005, $158 million of the $445 million accrual was classified as current and the remaining $287 million was classified as non-current.

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

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Workforce Rebalancing Efforts

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

Gain (Loss) on Equity Investments

(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 27, 2005	March 28, 2004	Change	March 27, 2005	March 28, 2004	Change
Gain (loss) on equity investments, net	$ 2	$ 3	(33.3)%	$ 7	$ (58)	N/M*

* Not meaningful

In the third quarter of fiscal 2005 and first nine months of fiscal 2005 and 2004, our gain (loss) on equity investments, net was favorably impacted by gains on the sale of certain equity investments of $5 million, $17 million and $12 million, respectively. Our portfolio primarily consists of investments in publicly traded and privately-held technology companies. These gains were partially offset by declining equity and warrant valuations in the technology sectors in which we have invested. The loss on equity investments in the first nine months of fiscal 2004 was primarily related to a decline in the value of our portfolio that was considered other than temporary.

As of March 27, 2005, our equity investment portfolio of $69 million consisted of $13 million in marketable equity securities, $39 million in equity investments in privately-held companies and $17 million in investments in venture capital funds and joint ventures. The ongoing valuation of our investment portfolio remains uncertain and may be subject to fluctuations based on whether we participate in additional investment activity or as a result of the occurrence of events outside of our control.

Interest and Other Income, net

(dollars in millions)

	Three Months Ended			Nine Months Ended
	March 27, 2005	March 28, 2004	Change	