SUN MICROSYSTEMS INC
Form 10-Q
February 04, 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 December 26, 2004

or

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

For the transition period from ______ to ______

Commission file number: 0-15086

SUN MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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 February 1, 2005**
Common Stock - $0.00067 par value	3,377,860,900

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

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

See accompanying notes.

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SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions)

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

See accompanying notes.

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SUN MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in millions)

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

Interest paid (net of interest received from swap agreements of $36 and $36, respectively)	$ 13	$ 13
Income taxes paid (net of refunds of $11 and $67, respectively)	$ 100	$ 74
Supplemental schedule of noncash investing activities:		
Stock and options issued in connection with acquisitions	$	$ 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 22 years of our existence and is based on the premise that the power of a single computer can be increased dramatically when interconnected with other computer systems for the purposes of communication and sharing of computing power. Together with our partners, we provide network computing infrastructure solutions that comprise Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions (formerly known as Professional services) and Knowledge services. Our customers use our products and services to build mission-critical network computing environments on which they operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical/scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year

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

Basis of Presentation

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

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

Computation of Net Income (Loss) per Common Share

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

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

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

Stock Option Plans

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

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

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

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

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

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

	Three Months Ended		**Six Months Ended**	
	December 26, 2004	**December 28, 2003**	**December 26, 2004**	**December 28, 2003**
Pro forma net income (loss):				

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

Recent Pronouncements

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

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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 income tax effects of such repatriation cannot be reasonably estimated at this time.

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

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

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

3. GOODWILL AND OTHER ACQUISITION-RELATED INTANGIBLE ASSETS

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

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

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

	2004		2004	2004		2004	2004
Developed technology	$ 383	$	$ 383	$ (295)	$ (22)	$ (317)	$ 66
Customer base and other	50		50	(45)	(1)	(46)	4
Acquired workforce and other	86		86	(52)	(14)	(66)	20
	$ 519	$	$ 519	$ (392)	$ (37)	$ (429)	$ 90

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

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

2005 (including $37 million of amortization expense for the first half of fiscal 2005)	$ 72
2006	39
2007	16
	$ 127

4. BALANCE SHEET DETAILS

Inventories

Inventories consisted of the following (in millions):

	December 26, 2004	June 30, 2004
Raw materials	$ 60	$ 78
Work in process	154	131
Finished goods	215	255
	$ 429	$ 464

Deferred Revenues

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

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

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

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

Warranty Reserve

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

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

Balance at June 30, 2004	$ 252
Charged to costs and expenses	154
Utilization	(170)
Balance at December 26, 2004	$ 236

5. RESTRUCTURING CHARGES AND WORKFORCE REBALANCING EFFORTS

Fiscal 2004 Restructuring Plan

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

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

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

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

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

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

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

	Fiscal 2004 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	39						39
Lease costs		89					89
Property and equipment impairment		13					13
Provision adjustments		(6)		(1)	(1)	(1)	(9)

Total restructuring charges	39	96		(1)	(1)	(1)	132
Cash paid	(144)	(25)	(1)	(10)	(16)	(9)	(205)
Non-cash		(12)		1			