TRIAD HOSPITALS INC
Form 10-K
March 01, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from ______ to ______

Commission file number 0-29816

Triad Hospitals, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-2816101**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
5800 Tennyson Parkway Plano, Texas	**75024**

(Address of principal executive offices)	(Zip Code)

(214) 473-7000

(Registrant s telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
Common Stock, $.01 Par Value	**New York Stock Exchange**
Preferred Stock Purchase Rights	**New York Stock Exchange**

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES x NO ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. YES ¨ NO x

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

At June 30, 2006, which was the last business day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the registrant s common stock held by non-affiliates was approximately $3.3 billion based on the closing sale price of $39.58 per share of common stock as reported on the New York Stock Exchange. For purposes of the foregoing calculation, the Registrant s directors, executive officers, and the Triad Hospitals, Inc. Retirement Savings Plan have been deemed to be affiliates.

Indicate the number of shares outstanding of each of the issuer s classes of common stock of the latest practical date.

As of February 15, 2007, 88,355,551 shares of common stock $0.01 par value per share were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the 2007 Annual Meeting of Stockholders of Triad Hospitals, Inc. are incorporated by reference into Part III of this Form 10-K.

Table of Contents

TRIAD HOSPITALS, INC.

INDEX TO FORM 10-K

Part I

Item 1. Business

General

Triad Hospitals, Inc. is one of the largest publicly owned hospital companies in the United States and provides healthcare services through hospitals and ambulatory surgery centers that we own and operate in small cities and selected urban markets primarily in the southern, midwestern and western United States. Our domestic hospital facilities include 53 general acute care hospitals and 13 ambulatory surgery centers located in the states of Alabama, Alaska, Arizona, Arkansas, Georgia, Indiana, Louisiana, Mississippi, Nevada, New Mexico, Ohio, Oklahoma, Oregon, South Carolina, Tennessee, Texas and West Virginia. We also operate one general acute care hospital located in Dublin, Ireland. Included among our domestic hospital facilities is one hospital operated through a 50/50 joint venture that is not consolidated for financial reporting purposes and one hospital that is under construction. We are also a minority investor in three joint ventures that own seven general acute care hospitals in Georgia and Nevada. Through our wholly-owned subsidiary, Quorum Health Resources, LLC (QHR), we also provide management and consulting services to independent general acute care hospitals located throughout the United States. The terms we , our , the Company , us , and Triad refer to the business of Triad Hospitals, Inc. and our subsidiaries as a consolidated entity, except where it is clear from the context that such terms mean only Triad Hospitals, Inc.

Our general acute care hospitals typically provide a full range of services commonly available in hospitals, such as internal medicine, general surgery, cardiology, oncology, neurosurgery, orthopedics, obstetrics, diagnostic and emergency services. These hospitals also generally provide outpatient and ancillary healthcare services such as outpatient surgery, laboratory, radiology, respiratory therapy, cardiology and physical therapy. Outpatient services also are provided by ambulatory surgery centers that we operate. In addition, some of our general acute care hospitals have a limited number of licensed psychiatric beds and provide psychiatric skilled nursing services.

In addition to providing capital resources and general management, we make available a variety of management services to our healthcare facilities. These services include ethics and compliance programs, national supply and equipment purchasing, national leasing contracts, accounting, insurance placement, financial and clinical systems, governmental reimbursement assistance, information systems, legal support, personnel management, internal audit, access to regional managed care networks, resource management, and strategic and business planning.

Proposed Merger

On February 4, 2007, we entered into an Agreement and Plan of Merger (the Merger Agreement) with Panthera Partners, LLC, a Delaware limited liability company (Panthera Partners), Panthera Holdco Corp., a Delaware corporation and a wholly-owned subsidiary of Panthera Partners (Panthera Holdco, and together with Panthera Partners, Parent), and Panthera Acquisition Corporation, a Delaware corporation and a wholly-owned subsidiary of Panthera Holdco (Merger Sub). Under the terms of the Merger Agreement, Merger Sub will be merged with and into the Company, with the Company continuing as the surviving corporation and a wholly-owned subsidiary of Parent (the Merger). Parent is owned by private investment funds affiliated with CCMP Capital Advisors, LLC and Goldman Sachs & Co. Our Board of Directors approved the Merger Agreement on the unanimous recommendation of a Special Committee comprised entirely of disinterested directors (the Special Committee).

At the effective time of the Merger, each outstanding share of our common stock, other than shares owned by us, Parent, any stockholders who are entitled to and who properly exercise appraisal rights under Delaware law or any stockholders who enter into agreements with Parent to have their shares convert into equity of the surviving corporation, will be cancelled and converted into the right to receive $50.25 in cash, without interest.

We have made customary representations, warranties and covenants in the Merger Agreement. The Merger Agreement contains a go shop provision pursuant to which we have the right to solicit and engage in discussions and negotiations with respect to competing acquisition proposals through March 16, 2007. In accordance with the

Table of Contents

Merger Agreement, our Board of Directors, through the Special Committee and with the assistance of its independent advisors, intends to solicit superior proposals during this period. There can be no assurance that the solicitation of superior proposals will result in an alternative transaction. During the go shop period, Parent does not have a contractual right to be advised of or match the terms of any superior proposal. After March 16, 2007, we may continue discussions with any Excluded Party , defined as a party that submits a bona fide acquisition proposal during the go shop period or with whom we are having ongoing discussions or negotiations as of the end of the go shop period regarding a bona fide acquisition proposal. No later than March 19, 2007, we are required to provide the identity of the Excluded Parties to Parent s outside counsel that have entered into a customary non-disclosure agreement with the Company not to disclose such identity to Parent or its affiliates.

Except with respect to Excluded Parties, after March 16, 2007, we are subject to a no shop restriction on our ability to solicit third party proposals, provide information and engage in discussions and negotiations with third parties. The no shop provision is subject to a fiduciary out provision that allows us to provide information and participate in discussions and negotiations with respect to third party acquisition proposals submitted after March 16, 2007 that the Board of Directors (following the recommendation of the Special Committee) believes in good faith to be bona fide and determines in good faith, after consultation with its financial advisors and outside counsel, constitute or could reasonably be expected to result in a superior proposal, as defined in the Merger Agreement.

We may terminate the Merger Agreement under certain circumstances, including if our Board of Directors (following the recommendation of the Special Committee) determines in good faith that it has received a superior proposal and that failure to terminate the Merger Agreement could violate its fiduciary duties, and otherwise complies with certain terms of the Merger Agreement. In connection with such termination, we must pay a fee of $120 million to Parent, unless such termination is in connection with a superior proposal submitted by an Excluded Party, in which case we must pay a fee of $20 million to Parent and reimburse Parent for up to $20 million in out-of-pocket expenses. In certain other circumstances, the Merger Agreement provides for Parent or us to pay to the other party a fee of $120 million upon termination of the Merger Agreement.

Parent has obtained equity and debt financing commitments for the transactions contemplated by the Merger Agreement, the aggregate proceeds of which will be sufficient for Parent to pay the aggregate Merger consideration, including any contemplated refinancing of debt and all related fees and expenses. Consummation of the Merger is not subject to a financing condition, but is subject to various other conditions, including approval of the Merger by our stockholders, expiration or termination of applicable waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, the receipt of other required regulatory approvals and other customary closing conditions. The parties currently expect to close the transaction during the second quarter of 2007. Where this Annual Report on Form 10-K discusses our future plans, strategies or activities, such discussion does not give effect to the proposed Merger.

Our Formation

Our healthcare service business previously comprised the Pacific Group business of HCA, Inc. (HCA). On May 11, 1999, HCA divested its Pacific Group business to us through a spin-off to its stockholders. The spin-off was accomplished by a pro rata distribution of all outstanding shares of our common stock to the stockholders of HCA. We were incorporated under the laws of the State of Delaware in 1999. Information about certain indemnification and other arrangements entered into by HCA and us in connection with the distribution is included in the consolidated financial statements.

On April 27, 2001, we completed our merger with Quorum Health Group, Inc. (Quorum) for approximately $2.4 billion in cash, stock and assumption of debt. Pursuant to the terms of the merger agreement, each former Quorum shareholder was entitled to receive $3.50 in cash and 0.4107 shares of our common stock for each outstanding share of Quorum stock, plus cash in lieu of fractional shares of our common stock.

Table of Contents

Our Markets

Most of our domestically owned facilities are located in two distinct types of markets that are located primarily in the southern, midwestern and western United States. Approximately seventy percent of our owned facilities are located in small cities, generally with populations of less than 150,000 residents and located more than 60 miles from a major urban center. These facilities are usually either the only facility or one of two or three facilities in the community. The remainder of our owned facilities are located in selected larger urban areas. Currently, we own and operate facilities in 17 states. Over half of our facilities are located in the states of Alabama, Arkansas, Indiana, and Texas. In addition, we operate one general acute care hospital in Dublin, Ireland.

Through QHR, our separate contract management services and consulting subsidiary, we also provide consulting, education, intensive resource and management services to independent hospitals and hospital systems located primarily in non-urban areas throughout the United States.

Small City Markets

We believe that the small cities of the southern, midwestern and western United States are attractive to healthcare service providers as a result of favorable demographic, economic and competitive conditions. 37 of the 53 general acute care hospitals that we own and operate domestically are located in these small city markets. Of these, 20 hospitals are located in communities where they are the sole hospital and 17 hospitals are located in communities where they are one of only two or three hospitals. We believe that small city markets can support specialty services that generally produce higher revenues than other healthcare services. In addition, in small city markets, managed care penetration is generally lower than in urban areas, and we believe that we are in a good position to negotiate favorable managed care contracts in these markets. We also believe that small city markets are more conducive to our operating strategy.

Our direct competition in these small cities often is limited to a single competitor. We believe that the smaller populations and relative strength of the one or two acute care hospitals in these markets also limit the entry of specialty hospitals and alternate non-hospital providers, such as outpatient surgery centers or rehabilitation or diagnostic imaging centers, as well as managed care plans, compared to urban markets.

Selected Larger Urban Markets

Sixteen of the 53 general acute care hospitals that we own and operate domestically are located in selected larger urban markets of the southern, midwestern and western United States. In a majority of these urban markets, we believe we have a strong market position on our own or with our non-profit partner. As a result, we believe we are in a more favorable position to negotiate with managed care providers.

In addition to the direct competition we face from other healthcare providers in these markets, there are higher levels of managed care penetration in the larger urban markets. In other words, a higher relative proportion of the market population is enrolled in managed care programs such as health maintenance organizations, or HMOs, and preferred provider organizations, or PPOs.

Our Mission

Our mission is to continuously improve the quality of healthcare services provided to the communities we serve by creating an environment that fosters physician participation, recognizes the value and contributions of our employees and strives to meet the unique healthcare needs of the local communities. Our objective is to provide quality healthcare services to our communities, while simultaneously generating strong financial performance and appropriate returns to our investors, through disciplined and balanced execution of a comprehensive business strategy that reinforces both quality of care and financial strength.

Table of Contents

Business Strategy

Our business strategy combines an operating strategy devoted to working with providers, employees and communities and a capital strategy devoted to investing capital in a disciplined manner into internal and external development projects that enhance patient care and provide appropriate returns to investors. We believe our business strategy differentiates us from many peers and competitors.

Operating Strategy

The foundation of our operating strategy is to work cooperatively and collaboratively with physicians, communities and employees in a manner that benefits all constituents. We actively involve local providers, local community leaders and employees in critical decision making in order to enhance the quality of physicians practices, the quality of the healthcare environment in each community and the professional satisfaction of employees. We believe this strategy results in increased volumes, rates and operating margins, and in external development opportunities with not-for-profit hospitals attracted to our operating strategy. Our collaborative operating strategy has several components:

Actively involve healthcare providers in decision making. We believe that working cooperatively and collaboratively with physicians to develop and maintain strong, mutually beneficial relationships with them leads to improved physician satisfaction, resource management and quality of care. We believe that this results in higher volumes, rates and operating margins and in external development opportunities. To reinforce the collaboration, we have established in each market a Physician Leadership Group, or PLG, consisting of leading physicians who practice at our local hospitals. Each PLG meets monthly with corporate and hospital management to establish local priorities and address physician concerns. A national PLG, consisting of representatives from the local PLGs, meets regularly with members of our corporate management to address broader corporate and national objectives. Our corporate management includes a team of experienced physicians who focus entirely on maintaining physician relations. We also believe the PLGs generate and facilitate external development opportunities as more physicians and not-for-profit hospitals are able to learn through physician word-of-mouth about our operating strategy of working collaboratively with providers.

Similarly, we believe that working cooperatively and collaboratively with our nurses and other employees to develop and maintain strong, mutually beneficial relationships with them leads to improved satisfaction, morale and retention of our employees, as well as better quality of care for our patients. We believe that this leads to higher patient satisfaction, volumes, rates and operating margins. In each of our markets, we have a Nursing Leadership Group, or NLG, chaired by the facility Chief Nursing Officer and comprising facility nurses who work with corporate and hospital management to establish local priorities and company-wide best practices for nursing care. A national NLG, consisting of representatives from the local NLGs, addresses broader corporate and national objectives with members of our corporate management team. We have also created Departmental Operations Committees that address key clinical and support functions represented by specific hospital departments, including radiology, dietary and plant operations. Members, chosen for their leadership qualities demonstrated at our facilities, meet regularly to share best practices and other initiatives, both locally and nationally.

Actively involve communities in decision making. Our community philosophy is a simple one: our stockholders own the bricks and mortar, but the hospitals effectively belong to the communities we serve. We seek to have each community embrace its hospital as an important local asset in order to make the facility successful. To that end, we have created for each of our facilities local Boards of Trustees consisting solely of local physicians and community leaders. We empower each local Board of Trustees with responsibilities related to strategic and capital planning and overall supervision of the quality of care provided to the community. By involving local communities in key decisions affecting their hospitals, we believe we can achieve higher volumes, rates and operating margins.

Table of Contents

Actively partner with not-for-profit hospitals. An integral part of our operating strategy is to be a preferred partner for the not-for-profit hospitals that comprise approximately 85% of the nation s acute care hospitals. For not-for-profit hospitals, we offer three alternatives for potentially improving their performance: capital partnership, contract management and consulting services. We believe that these relationships can result in attractive growth opportunities that are consistent with, and that reinforce, the other components of our business strategy.

We provide an attractive alternative to not-for-profit hospitals that need capital. We can either buy the hospital or partner with the not-for-profit in a joint venture, often for the purpose of developing a new or replacement hospital for the community. We believe we often have a competitive advantage over some of our peers and competitors in buying or partnering with not-for-profit hospitals as a result of:

- our operating strategy of working cooperatively and collaboratively with physicians, employees and communities, which appeals to many not-for-profits;
- our flexibility regarding shared governance and ownership with not-for-profits through joint ventures with those who prefer to retain some ownership rather than sell; and
- our QHR management subsidiary s relationship and reputation with leading not-for-profits nationwide.

We also provide management and consulting services through our QHR subsidiary to approximately 170 not-for-profit hospitals in the United States. These are typically independent hospitals in rural communities that we believe benefit from the management infrastructure QHR provides, infrastructure that they might not otherwise afford on their own.

Capital Strategy

Our capital strategy consists of the disciplined investment of capital for routine maintenance projects as well as internal and external development projects intended to grow volumes, rates and operating margins. Except for routine maintenance projects, our capital projects are typically projected to generate a return greater than the hurdle rate used by us for that project, which is higher than our weighted average cost of capital. We are, however, willing to trade short-term returns for longer-term returns that we believe will be superior.

For existing facilities, we typically expect to spend approximately $150 to $160 million annually on routine maintenance capital expenditures for structural and cosmetic repairs at our facilities. We also identify and invest in expansion opportunities where we perceive that demand is not being adequately met due to population growth or insufficient existing healthcare services. Expansion opportunities may include adding beds, adding operating rooms or introducing specialty services in order to meet demand and decrease outmigration.

For external development, we pursue potential acquisitions, but only selectively and opportunistically. In situations where sellers are concerned solely with obtaining the highest price, especially in an auction, we generally do not have a competitive advantage over others and thus generally do not prevail. However, in situations where sellers also place value on our collaborative culture and strategy, we believe we often have a competitive advantage and sometimes can prevail, even in an auction, and even when we may not submit the highest financial offer. We also build new hospitals, either on our own or in partnership with not-for-profit hospitals, especially in small city markets and in other markets that tend to be most receptive to our strategy of working collaboratively with providers and communities. We also build replacement facilities for existing facilities, usually by becoming a capital partner with a not-for-profit hospital that lacks capital to rebuild an old or aging facility but has a favorable clinical reputation and market position.

Table of Contents

Hospital Operations

Our general acute care hospitals typically provide a full range of services commonly available in hospitals, such as internal medicine, general surgery, cardiology, oncology, neurosurgery, orthopedics and obstetrics, as well as diagnostic and emergency services. Our hospitals also generally provide outpatient and ancillary healthcare services such as outpatient surgery, laboratory, radiology, respiratory therapy, cardiology and physical therapy. Outpatient services also are provided by ambulatory surgery centers that we operate. In addition, certain of our general acute care hospitals have a limited number of licensed psychiatric beds. Financial information for each of the last three years relating to our owned operations, including our acute care hospitals and related healthcare entities, is provided in NOTE 17 - SEGMENT INFORMATION to the consolidated financial statements.

Each of our hospitals is governed by a local Board of Trustees, which includes local community leaders and members of the hospital s medical staff. The Board of Trustees establishes policies concerning the medical, professional and ethical practices at each hospital, monitors such practices, and is responsible for ensuring that these practices conform to established standards. We maintain quality assurance programs to support and monitor quality of care standards and to meet accreditation and regulatory requirements. Patient care evaluations and other quality of care assessment activities are monitored on a continuing basis.

Hospital Services and Utilization

Hospital revenues depend upon inpatient occupancy levels, the volume of outpatient procedures and the charges or negotiated payment rates for such services. Charges and reimbursement rates for inpatient routine services vary significantly depending on the type of service, such as medical/surgical, intensive care or psychiatric, the payer and the geographic location of the hospital.

We believe that important factors relating to the overall utilization of a hospital include the quality and market position of the hospital and the number, quality and specialties of physicians providing patient care within the facility. Generally, we believe that the ability of a hospital to meet the healthcare needs of its community is determined by its breadth of services, level of technology, emphasis on quality of care and convenience for patients and physicians. Other factors which impact utilization include the growth in local population, local economic conditions, market penetration of managed care programs and the availability of reimbursement programs such as Medicare and Medicaid. Utilization across the industry also is being affected by improved treatment protocols as a result of advances in medical technology and pharmacology.

The following table sets forth certain statistics for hospitals we owned for each of the past five years. The comparability of the statistics has been affected by acquisitions in 2002, 2003, 2005, and 2006. Medical/surgical hospital operations are subject to certain seasonal fluctuations, including decreases in patient utilization during holiday periods and increases in patient utilization during the cold weather months.

	Years ended December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
Number of hospitals at end of period (a)	53	49	46	44	38
Number of licensed beds at end of period (b)	9,614	8,674	7,475	7,390	6,856
Weighted average licensed beds (c)	9,276	8,111	7,420	6,972	6,713
Admissions (d)	349,491	316,963	296,542	265,820	252,903
Adjusted admissions (e)	596,061	538,635	506,334	449,376	424,877
Average length of stay (days) (f)	4.7	4.7	4.7	4.9	4.9
Average daily census (g)	4,503	4,066	3,771	3,557	3,377
Occupancy rate (h)	54%	52%	56%	53%	49%

(a) Number of hospitals excludes discontinued operations and facilities under construction at December 31st of each year. This table does not include any operating statistics for discontinued operations and non-consolidating joint ventures.
(b) Licensed beds are those beds for which a facility has been granted approval to operate from the applicable state licensing agency.
(c) Weighted average licensed beds represent the average number of licensed beds weighted based on periods owned.
(d) Admissions represent the total number of patients admitted (in the facility for a period in excess of 23 hours) to our hospitals and are used by management and certain investors as a general measure of inpatient volume.

Table of Contents

(e) Adjusted admissions are used by management and certain investors as a general measure of combined inpatient and outpatient volume. Adjusted admissions are computed by multiplying admissions (inpatient volume) by the sum of gross inpatient revenue and gross outpatient revenue and then dividing the resulting amount by gross inpatient revenue. The adjusted admissions computation adjusts outpatient revenue to the volume measure (admissions) used to measure inpatient volume resulting in a general measure of combined inpatient and outpatient volume.

(f) Average length of stay represents the average number of days admitted patients stay in our hospitals.

(g) Average daily census represents the average number of patients in our hospital beds each day.

(h) Occupancy rate represents the percentage of hospital available beds occupied by patients. Both average daily census and occupancy rate provide measures of the utilization of inpatient rooms.

Our hospitals have been affected by the trend toward performing certain services more frequently on an outpatient basis as procedures performed on an inpatient basis are converted to outpatient procedures through continuing advances in pharmaceutical and medical technologies. The redirection of certain procedures to an outpatient basis is also influenced by pressures from payers and patients to perform certain procedures as outpatient care rather than inpatient care. We have responded to the outpatient trend by enhancing our hospitals outpatient service capabilities, including:

(1) dedicating resources to our freestanding ambulatory surgery centers at or near certain of our hospital facilities,

(2) reconfiguring certain hospitals to more effectively accommodate outpatient treatment by, among other things, providing more convenient registration procedures and separate entrances, and

(3) restructuring existing surgical capacity to allow a greater number and range of procedures to be performed on an outpatient basis.

We expect the growth in outpatient services to continue, although possibly at a slower rate, in the future. Our facilities will continue to emphasize those outpatient services that can be provided on a quality, cost-effective basis and that we believe will experience increased demand.

Sources of Revenue for Healthcare Services

We receive payment for patient healthcare services from (i) the U.S. government primarily under the Medicare program, (ii) state governments under their respective Medicaid programs, (iii) managed care plans and other private insurers and (iv) directly from patients. The approximate percentages of our facilities patient revenues from such sources during the periods specified below were as follows:

	Years Ended December 31,		
	2006	**2005**	**2004**
Medicare	29.5%	31.2%	30.6%
Medicaid	5.2	5.0	5.0
Managed care plans	46.3	44.6	43.9
Uninsured	9.7	9.3	9.6
Other sources	9.3	9.9	10.9
Total	100.0%	100.0%	100.0%

Medicare is a Federal program that provides certain hospital and medical insurance benefits to persons age 65 and over, some disabled persons and persons with end-stage renal disease. Medicaid is a Federal-state program administered by the states which provides hospital benefits to qualifying individuals who are unable to afford care. All of our hospitals are certified as providers of Medicare and Medicaid services. Amounts received under the Medicare and Medicaid programs are generally significantly less than the hospital s customary charges for the services provided. We have seen a shift from Medicare revenue to managed care revenue due, in part, to higher patient utilization of Medicare managed care plans. For more detailed information, see Reimbursement.

To attract additional volume, most of our hospitals offer various discounts from established charges to certain large group purchasers of healthcare services, including private insurance companies, employers, and managed care plans. These discount programs limit our ability to increase charges in response to increasing costs. For more detailed information, see Competition.

Table of Contents

Patients are generally not responsible for any difference between customary hospital charges and amounts reimbursed for such services under Medicare, Medicaid, some private insurance plans, and managed care plans, but are responsible for services not covered by such plans, exclusions, deductibles or co-insurance features of their coverage. The amount of such exclusions, deductibles and co-insurance has generally been increasing each year. Collection of amounts due from individuals is typically more difficult than from governmental or business payers. Over the last several years and particularly in the last six months of 2006, we experienced significant growth in uninsured receivables and deterioration in the collectibility of these receivables. Beginning in the fourth quarter of 2004, we implemented a self-pay discount program that offers discounts to uninsured patients based on personal financial criteria and means testing. The amount of the discount varies based on each patient s financial condition. We implemented an additional component to our self-pay discount program in the second quarter of 2005. This additional component offers a discount for all uninsured patients, regardless of personal financial criteria, based on the lowest managed care discount in each hospital location. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations for a more detailed discussion of the impact of these trends on our results of operations and financial position.

For more information on the reimbursement programs on which our revenues are dependent, see Reimbursement.

Hospital Management Services

QHR is a leading provider of management and consulting services to acute care hospitals, providing management services to approximately 170 hospitals as of December 31, 2006. QHR provides management services to independent hospitals and hospital systems under management contracts and also provides selected consulting, educational and related services. QHR assists hospitals in improving their financial performance and the scope of their services. Most of the hospitals for which QHR performs management, consulting or support services are independent not-for-profit hospitals. These hospitals are generally located in non-urban areas. Approximately 73% of these hospitals have fewer than 100 beds. Upon entering into a management contract, QHR first assesses the operations of the hospital, including the hospital s financial management, the economic and population-related factors affecting the hospital s market, physician relationships and staffing requirements. Based on the results of its assessment, QHR develops and recommends a management plan to the hospital s governing board.

To implement the management plan adopted for each hospital, QHR typically provides the hospital with personnel to serve as the hospital s chief executive officer and chief financial officer. These QHR employees operate under the direction and control of the hospital s governing body, and the balance of the hospital staff remain employees of the hospital under the control and supervision of the hospital. QHR s hospital-based team is supported by its regional and corporate management staff. QHR currently has five regional offices located throughout the United States. QHR s regional office staff is experienced in providing management services to hospitals of all sizes in diverse markets throughout the United States. Each regional office is responsible for the management services provided within its geographic area.

QHR s hospital management contracts generally have a term of three to five years and had a renewal rate of approximately 95% in 2006. QHR s management contract fees are based on amounts agreed upon by QHR and the hospital s governing body, and generally are not related to the hospital s revenues or other variables. Under QHR s hospital management contracts, QHR is not responsible for hospital licensure, certificates of need, liability coverage, capital expenditures or other functions that are normally the responsibility of a hospital s governing body.

QHR offers consulting and related educational and management services to hospitals that are not part of its contract management program. QHR s consulting services are directed at many of the operational needs of hospitals, including accounts receivable management, health information management, human resources, facility design and various operational services. QHR also provides consulting services to large, sophisticated medical institutions that need hospital management advice for specific issues. Financial information for each of the last three years relating to our hospital management services is provided in NOTE 17 - SEGMENT INFORMATION to the consolidated financial statements.

Table of Contents

Competition

The hospital industry is highly competitive. We compete with other hospitals and healthcare providers for patients, and this competition has intensified in recent years. In some cases, competing hospitals are more established than our hospitals. Certain of these competing facilities, particularly in urban markets, offer services, including extensive medical research and medical education programs, which are not offered by our facilities. In addition, in certain of the markets where we operate, there are large teaching hospitals that provide highly specialized facilities, equipment and services that may not be available at our hospitals. Although some of our hospitals are located in geographic areas where they are currently the sole provider of general, acute care hospital services in their communities, these hospitals also face competition from other hospitals, including larger tertiary care centers. Despite the fact that these competing hospitals may be as far as 30 to 50 miles away, patients in these markets may migrate to these competing facilities as a result of local physician referrals, managed care incentives or personal choice.

In addition, some of the hospitals that compete with us are owned by tax-supported governmental agencies or not-for-profit entities supported by endowments and charitable contributions. These hospitals can make capital expenditures without paying sales taxes, and are generally exempt from property and income taxes. We also face competition from other specialized care providers, including specialty hospitals, outpatient surgery, orthopedic, oncology and diagnostic centers.

State certificate of need laws, or CON laws, place limitations on a hospital s ability to expand hospital services and add new equipment, and may have the effect of restricting competition. Nine states in which we operate, Alabama, Alaska, Georgia, Mississippi, Ohio, Oregon, South Carolina, Tennessee and West Virginia, have CON laws. The application process for approval of covered services, facilities, changes in operations and capital expenditures (including certain acquisitions of facilities) in these states is, therefore, highly competitive. In those states which have no CON laws or which set relatively high thresholds before expenditures become reviewable by state authorities, competition in the form of new services, facilities and capital spending is more prevalent.

The number and quality of the physicians on a hospital s staff are important factors in a hospital s competitive advantage. Physicians decide whether a patient is admitted to the hospital and the procedures to be performed. We believe that physicians refer patients to a hospital primarily on the basis of the quality of services it renders to patients and physicians, the quality of other physicians on the medical staff, the location of the hospital and the quality of the hospital s facilities, equipment and employees. Admitting physicians may be on the medical staff of other hospitals in addition to those of our hospitals.

One element of our business strategy is expansion through the acquisition of acute care hospitals in select markets. The competition to acquire hospitals is significant. We may acquire or develop, on a selective basis, hospitals that are similar to those currently owned and operated. However, suitable acquisitions may not be accomplished due to unfavorable terms. We may also seek to expand through the formation of joint ventures with other providers, including not-for-profit healthcare providers.

Another major factor in the competitive position of a hospital is management s ability to negotiate service contracts with purchasers of group healthcare services, such as managed care plans, which attempt to direct and control the use of hospital services and to obtain discounts from hospitals established charges. Employers and traditional health insurers are also interested in containing costs through negotiations with hospitals for managed care programs and discounts from established charges. Generally, hospitals compete for service contracts with group healthcare service purchasers on the basis of price, market reputation, geographic location, quality and range of services, quality of the medical staff and convenience. The importance of obtaining contracts with managed care organizations varies from market to market depending on the market strength of such organizations.

QHR also faces competitive challenges in the area of management services. In seeking management services, hospitals have a variety of alternatives. Hospitals managed by hospital management companies represent less than 10% of the total acute care hospitals in the United States. Most hospitals have their own management staff. Some hospitals choose to obtain management services from large, tertiary care facilities that create referral networks with smaller surrounding hospitals.

We, and the healthcare industry as a whole, face the challenge of continuing to provide quality patient care while dealing with rising costs, strong competition for patients and pressures by both private and government payers to control reimbursement rates. As both private and government payers reduce the scope of what may be reimbursed and control reimbursement levels for what is covered, Federal and state efforts to reform the healthcare system may further impact reimbursement rates. Changes in medical technology, existing and future legislation, regulations and interpretations and competitive contracting for provider services by private and government payers may require changes in our facilities, equipment, personnel, rates and/or services in the future.

The hospital industry and our hospitals continue to have significant unused capacity. Inpatient utilization, average lengths of stay and average occupancy rates have historically been negatively affected by payer-required pre-admission authorization, utilization review, patient preference and payer pressure to maximize outpatient and alternative healthcare delivery services for less acutely ill patients. Admissions constraints, payer pressures and increased competition are expected to continue. We endeavor to meet these challenges by expanding many of our facilities to include outpatient centers, offering discounts to private payer groups, upgrading facilities and equipment and offering new programs and services.

Employees and Medical Staff

At December 31, 2006, we had approximately 42,000 employees, including approximately 4,300 part-time employees, as well as approximately 400 employees providing hospital management and consulting services. Employees at three hospitals are currently represented by labor unions. We consider our employee relations to be good. While our non-union hospitals experience union organizational activity from time to time, we do not expect such efforts to materially affect our future operations. Our hospitals, like most hospitals, have experienced labor costs rising faster than the general inflation rate, primarily in nursing. There can be no assurance as to future availability and cost of qualified medical personnel.

Our hospitals are staffed by licensed physicians, some of whom are employed by us, who have been admitted to the medical staff of individual hospitals. At December 31, 2006, we employed approximately 1,100 physicians. Some physicians provide services in our hospitals under contracts, which generally describe a term of service, provide and establish the duties and obligations of such physicians, require the maintenance of certain performance criteria and fix compensation for such services. Any licensed physician may apply to be admitted to the medical staff of any of our hospitals, but admission to the staff must be approved by the hospital s medical staff and the appropriate governing board of the hospital in accordance with established credentialing criteria. Members of the medical staffs of our hospitals located in areas where there are other hospitals often also serve on the medical staffs of other hospitals and may terminate their affiliation with a hospital at any time.

We periodically perform both employee and physician satisfaction surveys. The surveys are used by management to enhance the operating performance of each hospital.

Our Ethics and Compliance Program

It is our policy that our business be conducted with integrity and in compliance with applicable law. We have developed a corporate-wide ethics and compliance program, which focuses on all areas of policy and regulatory compliance, including physician recruitment, reimbursement and cost reporting practices, and laboratory operations.

This ethics and compliance program is intended to assure that high standards of conduct are maintained in the operation of our business and that employees act in full compliance with all applicable laws, regulations and company policies and procedures. Under the ethics and compliance program, we provide initial and periodic legal compliance and ethics training to every employee, review various areas of our operations, and develop and implement policies and procedures designed to foster compliance with the law. We regularly monitor our ongoing compliance efforts. The program also includes a mechanism for employees to report, without fear of retaliation, any suspected legal or ethical violations to their supervisors or designated compliance officers in our hospitals, as well as a national hotline to which employees and others can report, on an anonymous basis if preferred, any suspected violations.

Table of Contents

We have also established a separate committee of the Board of Directors to monitor the ethics and compliance program.

On November 1, 2001, we entered into a five-year corporate integrity agreement with the Office of the Inspector General of the Department of Health and Human Services, or OIG, and agreed to maintain our compliance program in accordance with the corporate integrity agreement. The corporate integrity agreement expired on October 31, 2006. Violations of the corporate integrity agreement that occurred prior to its expiration could subject our hospitals to substantial monetary penalties. The cost to maintain the compliance program was approximately $5.1 million, $4.3 million, and $3.1 million in 2006, 2005 and 2004, respectively. The compliance measures and reporting and auditing requirements for our hospitals contained in the integrity agreement included:

- Continuing the duties and activities of corporate and facility compliance officers and committees and maintaining a written code of conduct and written policies and procedures;
- Providing general training on the compliance program and the agreement and specific training for the appropriate personnel on billing, coding and cost report issues;
- Having an independent third party conduct periodic audits of inpatient hospital service coding and laboratory billing;
- Continuing a confidential disclosure program and compliance hotline and implementing enhanced screening to ensure ineligible employees and contractors are not hired;
- Reporting substantial overpayment by a Federal healthcare program and probable violations of certain laws, rules and regulations; and
- Submitting annual reports to the OIG describing the operations of the corporate compliance program for the past year.

Reimbursement

Medicare. Under the Medicare program, acute care hospitals generally receive reimbursement under a prospective payment system, or PPS, for inpatient hospital services. Specially designated children s hospitals and certain designated cancer research hospitals are currently exempt from PPS and are reimbursed on a cost-based system, subject to certain cost limits known as TEFRA limits.

Under PPS, fixed payment amounts per inpatient discharge are established based on the patient s assigned diagnosis related group, or DRG. DRGs classify treatments for illnesses according to the estimated intensity of hospital resources necessary to furnish care for each principal diagnosis. DRG rates have been established for each hospital participating in the Medicare program, are based upon a statistically normal distribution of severity and are adjusted for area wage differentials but do not consider a specific hospital s costs. DRG rates are updated and re-calibrated annually and have been affected by several recent Federal enactments. The index used to adjust the DRG rates, known as the market basket index, gives consideration to the inflation experienced by hospitals (and entities outside of the healthcare industry) in purchasing goods and services. For Federal fiscal years 2005 and 2006 the updates were the full market basket. For Federal fiscal year 2007, hospitals generally will receive the full market basket update which is 3.4%.

Outpatient services provided at general, acute care hospitals typically are reimbursed under a PPS system for outpatient hospital services, or APCs. APCs were updated by the full market basket for Federal fiscal years 2005 and 2006. For Federal fiscal year 2007, APCs will be updated by the full market basket index which is 3.4%. Therapy services rendered by hospitals to outpatients and inpatients not reimbursed under Medicare are reimbursed according to the Medicare physician fee schedule.

Payments to PPS-exempt hospitals and units such as inpatient psychiatric hospital services were based upon reasonable costs, subject to a cost per discharge target. These limits are updated annually by a market basket index. On November 15, 2004, final rules were issued to convert reimbursement for PPS-exempt psychiatric hospitals and units to a prospective payment system. Reimbursement is based on a prospectively determined per diem for cost reporting periods beginning on or after January 1, 2005. The per diem rules have four tiers, the highest for the first day of the stay, a lower rate for the second through fourth day, a third tier for the fifth through eighth day, and a final tier. The payment system is being phased in over a three-year period. Also, during this period there is a stop loss provision equal to at least 70% of the amount that would have been paid under the reasonable cost reimbursement system. For the year ended December 31, 2006, less than 1% of our patient revenues was derived from Medicare psychiatric services.

Payments for Medicare skilled nursing facility services, home health services, inpatient rehabilitation hospital services and psychiatric hospital services are made under a separate PPS system for each of these services. The update for 2005 was the full market basket. For Federal fiscal year 2006, the rates were updated by the full market basket index for skilled nursing facility services and inpatient rehabilitation hospital services. The 2006 rate update for home health services was the market basket minus 0.8%. The 2007 rate update for psychiatric hospital services was the full market basket and was effective July 1, 2006. For skilled nursing facility services, the updates for Federal fiscal year 2007 will be the full market basket of 3.1%. For inpatient rehabilitation hospital services, the updates for Federal fiscal year 2007 is the full market basket of 3.3%, less coding improvement adjustments of 2.6%. There is also consolidated billing for skilled nursing facility services, under which payments for most non-physician services for beneficiaries no longer eligible for skilled nursing facility care will be made to the facility, regardless of whether the item or service was furnished by the facility, by others under arrangement, or under any other contracting or consulting arrangement. Consolidated billing is being implemented on a transition basis. As of December 31, 2006, 20 of our hospitals operated skilled nursing facilities.

Home health services are reimbursed under a PPS system. For fiscal years 2004 through 2006, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or MMA, provided for a reduction in the annual payment update and added a 5% rural add-on for discharges between April 1, 2004 and March 31, 2005. For the year ended December 31, 2006, less than 1% of our revenues was derived from home health services.

On November 20, 2004, Congress passed the FY 2005 Omnibus Appropriations bill which included a provision delaying the enforcement of the inpatient rehabilitation facility, or IRF, 75% rule, or the IRF 75% Rule. The IRF 75% Rule, implemented in 1983, is one of the key eligibility criteria for IRFs. In May 2004, the Centers for Medicare and Medicaid Services, or CMS, issued a final rule that included restrictive changes to the conditions that qualify under the IRF 75% Rule. This rule requires that beginning July 1, 2004, at least 50% of Medicare patients be classified in one of the thirteen medical categories. The Deficit Reduction Act of 2005, or DRA, extended by one year the transition back to 75%. The threshold increased to 60% on July 1, 2006, and increases to 65% on July 1, 2007, and up to the original 75% on July 1, 2008. A hospital not meeting these thresholds will receive reduced payments based on Medicare DRGs instead of IRF payments. We have not had any payments reduced under the provisions of the final rule.

Currently, physicians are paid by Medicare according to the physician fee schedule. However, physicians working in rural health clinics, such as those maintained by us, are reimbursed for their professional and administrative services through the rural health clinic subject to per visit limits unless the rural health clinic is based at a rural hospital with less than 50 beds. We have 10 rural health clinics affiliated with our hospitals.

Medicare has special payment provisions for sole community hospitals. A sole community hospital is generally the only hospital in at least a 35-mile radius. Seven of our facilities qualify as sole community hospitals under Medicare regulations. Special payment provisions related to sole community hospitals may include a higher reimbursement rate, which is based on a blend of hospital-specific costs and a national reimbursement rate, and a 90% payment floor for capital costs which guarantees the sole community hospital capital reimbursement equal to 90% of capital cost. In addition, the TRICARE program that provides medical insurance benefits to government employees has special payment provisions for hospitals recognized as sole community hospitals for Medicare purposes.

Medicare provides, in the form of outlier payments, for additional payment, beyond standard DRG payments, for covered hospital services furnished to a Medicare beneficiary if the operating costs of furnishing those services exceed a certain threshold. During 2002, CMS initiated an outlier reimbursement review process to assess nationally whether or not the amount of outlier payments being made to selected hospitals was appropriate. CMS issued proposed regulations in March 2003 that became effective October 1, 2003 that modified certain elements of the outlier reimbursement calculation. We derive less than 1% of patient revenues from outlier payments and the modifications did not have a material impact on our financial condition or results of operations.

On December 20, 2006, the Tax Relief and Health Care Act was signed into law, which includes a number of provisions related to Medicare and Medicaid spending. The Medicare provisions include a zero percent update for Federal fiscal year 2007 physician payments, which negated an expected 5% reduction, initiation of a short-term and long-term physician quality reporting program, implementation no sooner than 2009 of a voluntary quality reporting program for outpatient departments and ambulatory surgery centers and the extension of certain MMA provisions including certain hospital wage index reclassifications. The Medicaid provisions included a reduction in the Federal limit on the allowable Medicaid provider tax rate to 5.5% from 6.0%. We do not anticipate any material impact from the provisions of this act.

On April 12, 2006, CMS issued a notice of proposed rulemaking for Federal fiscal year 2007. The proposed rule affects Medicare s hospital inpatient PPS rates and policies for both inpatient acute as well as inpatient PPS exempt providers. Most of the proposed changes became effective October 1, 2006. The final rule includes updates to the base operating and capital reimbursement rates, DRG classifications, outlier payment threshold, reporting of hospital quality data for the annual hospital payment update and changes to the area wage index, among other changes. In addition, the rule calls for the recalibration of the DRG weights using a cost weighting methodology, which is a departure from prior years recalibration methodology that was based primarily on hospital charges. This change will be phased in over three years beginning in Federal fiscal year 2007. Also, the rule outlines a plan to further modify the inpatient PPS by incorporating severity of illness adjustors into the system. The severity adjustment component will begin in Federal fiscal year 2007 with 20 specific DRG changes and continue in 2008 after further analysis is completed. The cost-based weight recalibration methodology and the severity adjustment are expected to result in a redistribution of payments among hospitals across the country. Currently, we do not believe that these proposed changes will have a material adverse impact on our results of operations or cash flows.

The DRA was signed into law February 8, 2006 and includes provisions that will reduce Medicare and Medicaid spending by $6 billion and $5 billion, respectively, over five years. The Medicare provisions include a one-year extension of the phase-in period related to the IRF 75% Rule, an increase in the reduction in the market basket index for hospitals that do not report required quality information in Federal fiscal year 2007 to 2% from 0.4%, an extension of the APC hold-harmless payments for small rural hospitals, a freeze in physician payments for Federal fiscal year 2006 at current levels and a freeze in payments to home health agencies. The Medicaid provisions include expansion of recipient cost share amounts, extension of the look-back period for asset transfers applicable to long-term care coverage, redistribution of State Children s Health Insurance Program allotment surpluses and authorization for several demonstration projects to encourage community-based services and provide alternative benefits through health opportunity accounts. We do not expect any material impact from the provisions of DRA.

MMA was signed into law on December 8, 2003. In addition to creating a new Medicare prescription drug benefit, MMA provides for a number of other significant changes in the Medicare program. These changes include a reduction in the annual update for ambulatory surgery center payments from April 2004 through the third quarter of 2005 and no payment update for the fourth quarter of 2005 through 2009. MMA also provides for reductions in the annual update in home health agency payments for 2004 through 2006, and for a reduction in the annual update for inpatient hospital payments from 2005 through 2007 for hospitals that do not submit to the Medicare program quality reporting data specified under the National Voluntary Hospital Reporting Initiative. MMA also includes a number of provisions designed to increase Medicare payments to small urban and rural hospitals, increasing the limit on disproportionate share payments that rural hospitals may receive, permitting an adjustment to the calculation of the standardized payment to benefit hospitals in low-wage areas, such as rural hospitals, and equalizing the DRG base payment rate among hospitals.

On February 5, 2007, the President released the proposed Federal fiscal year 2008 budget, which calls for cuts in Medicare spending of $76 billion and Medicaid spending of $26 billion over five years. Some of the provisions related to Medicare spending include a reduction in the annual payment update factor for inpatient and outpatient services of 0.65%, a zero percent update in 2008 for skilled nursing and inpatient rehabilitation facilities and a 0.65% reduction in the update thereafter, a zero percent update for home health services through 2012, elimination of bad debt reimbursement for unpaid beneficiary cost-sharing, a reduction of 0.4% for all Medicare payments when

Table of Contents

general fund contributions exceed 45%, elimination of certain medical education payments for Medicare Advantage Beneficiaries and setting base payments for five post-acute conditions treated in skilled nursing and inpatient rehabilitation facilities. Key provisions related to Medicaid include creating consistency in the levels of reimbursement of administrative costs at 50%, recoupment of certain administrative costs included in block grants, reimbursement of targeted case management services at 50%, elimination of Medicaid graduate medical education payments and revised payments for government providers. If these provisions are enacted, it could have a material negative impact on our results of operations, financial position and cash flow.

Future legislation may decrease the rate of increase for the Medicare program, which could make it more difficult to grow revenue and to maintain or improve operating margins.

Medicaid. Most state Medicaid payments are made under a PPS, or under programs which negotiate payment levels with individual hospitals. Medicaid reimbursement is often less than a hospital s cost of services. Medicaid is currently funded jointly by the state and the Federal governments. The DRA includes provisions that reduce Medicaid spending by $5 billion over five years. The Federal government and many states may consider further reductions in the level of Medicaid funding while at the same time expanding Medicaid benefits, which could adversely affect future levels of Medicaid reimbursement received by our hospALIGN="top">

Pro forma net loss per common share basic and diluted

$(0.10) $(0.15)

Reported net loss per common share basic and diluted

$(0.04) $(0.09)

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 effective date of the recognition and measurement provisions of EITF 03-01 has been delayed by the Financial Accounting Standards Board. We do not expect the adoption of EITF 03-01 to have a material impact on our results of operations and financial condition.

3. GOODWILL AND OTHER ACQUISITION-RELATED INTANGIBLE ASSETS

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

Table of Contents

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

	Gross Carrying Amount			Accumulated Amortization			Net
	June 30, 2004	Additions	September 26, 2004	June 30, 2004	Additions	September 26, 2004	September 26, 2004
Developed technology	$ 383	$	$ 383	$ (295)	$ (10)	$ (305)	$ 78
Customer base and other	50		50	(45)	(1)	(46)	4
Acquired workforce and other	86		86	(52)	(7)	(59)	27
	$ 519	$	$ 519	$ (392)	$ (18)	$ (410)	$ 109

Amortization expense of other acquisition-related intangible assets was $18 million and $15 million for the three months ended September 26, 2004 and September 28, 2003, respectively.

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

2005 (including $18 million of amortization expense for the first three months of fiscal 2005)	$ 72
2006	39
2007	16
	$ 127

4. BALANCE SHEET DETAILS

Inventories

Inventories consisted of the following at (in millions):

	September 26, 2004	June 30, 2004
Raw materials	$ 66	$ 78
Work in process	155	131
Finished goods	195	255

	$ 416	$ 464

Deferred Revenues

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

	Deferred service revenues	**Other deferred revenues**	**Total**
Balance at June 30, 2004	$ 1,612	$ 562	$ 2,174
Revenue deferred	979	482	1,461
Revenue recognized	(1,133)	(632)	(1,765)
Balance at September 26, 2004	$ 1,458	$ 412	$ 1,870
Less short-term portion	(1,008)	(338)	(1,346)
Total long-term deferred revenues	$ 450	$ 74	$ 524

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 three months ended September 26, 2004 (in millions):

Balance at June 30, 2004	$ 252
Charged to costs and expenses	74
Utilization	(86)
Balance at September 26, 2004	$ 240

Table of Contents

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 includes reducing our workforce by at least 3,300 employees across all levels, business functions, operating units, and geographic regions, 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 first quarter of fiscal 2005 we recognized a total of $110 million in charges associated with the Fiscal 2004 Restructuring Plan, consisting of a $20 million workforce reduction charge and a $90 million excess facility charge.

We expect to record additional charges related to our workforce and facilities reductions primarily over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving the company 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 Statement of Operations.

In addition, as part of the Fiscal 2004 Restructuring Plan, 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 three months ended September 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	Severance and Benefits	Facilities Related	Facilities Related	Facilities Related	Total

		Other					
Balance as of June 30, 2004	$ 166	$ 88	$ 1	$ 90	$ 153	$ 45	$ 543
Severance and benefits	20						20
Accrued lease costs		80					80
Property and equipment impairment		12					12
Provision adjustments		(2)		1	(2)	(1)	(4)
Total restructuring charges	20	90		1	(2)	(1)	108
Cash paid	(87)	(11)	(1)	(8)	(7)	(5)	(119)
Non-cash		(12)		(2)			(14)
Balance as of September 26, 2004	$ 99	$ 155	$	$ 81	$ 144	$ 39	$ 518

Our accrued liability for all four plans was net of approximately $123 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 September 26, 2004 for facility related leases (net of anticipated sublease proceeds) will be paid over their respective lease

Table of Contents

terms through fiscal 2018. As of September 26, 2004, $204 million of the $518 million accrual was classified as current and the remaining $314 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 quarter of fiscal 2005, we paid $54 million and $1 million, respectively.

6. COMPREHENSIVE LOSS

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

	Three Months Ended	
	September 26, 2004	**September 28, 2003**
Net loss	$ (147)	$ (286)
Change in unrealized value on investments, net	8	(2)
Change in unrealized fair value of derivative instruments, net	1	1
Translation adjustments, net	(22)	(59)
	$ (160)	$ (346)

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

	September 26, 2004	**June 30, 2004**
Unrealized losses on investments, net	$ (9)	$ (17)
Unrealized losses on derivative instruments, net	(5)	(6)
Cumulative translation adjustments, net	174	196

	$ 160	$ 173

7. INCOME TAXES

For the first quarter of fiscal 2005, we recorded an income tax provision of $39 million as compared with an income tax provision of $31 million for the first quarter of fiscal 2004. These tax provisions were recorded for taxes due on income generated in certain state and foreign tax jurisdictions and reflect adjustments for the difference between estimated amounts recorded and actual liabilities resulting from the filing of prior years tax returns.

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

In addition, Sun has 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 could result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

8. OPERATING SEGMENTS

We design, manufacture, market and service network computing infrastructure solutions that consist of Computer Systems (hardware and software), Network Storage systems (hardware and software), Support services, Client solutions and Knowledge services. Effective July 1, 2004, our President and Chief Operating Officer was identified as the Chief Operating Decision Maker (CODM) as defined by SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information (SFAS 131). Following his appointment, we reorganized Sun and the effects of these changes to our business organization did not result in a change to our operating segment disclosure. The CODM continues to manage our company based primarily on broad functional

Table of Contents

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 manages the majority of our accounts receivable and inventory, respectively. In addition, we have a Worldwide Marketing Organization (WMO) that is responsible for developing and executing Sun s overall corporate, strategic and product marketing and advertising strategies. The CODM looks to this functional organization for advertising, pricing and other marketing strategies for the products and services delivered to market. Operating expenses (primarily sales, marketing and administrative) related to the GSO and the WMO are not allocated to the reportable segments and, accordingly, are included under the Other segment reported below.

Segment information

The following table presents revenues, interdivision revenues and operating income (loss) for our segments. The Other segment consisted 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:				
September 26, 2004				
Revenues	$ 1,676	$ 952	$	$ 2,628
Interdivision revenues	175	104	(279)	
Operating income (loss)	245	364	(744)	(135)
September 26, 2003				
Revenues	$ 1,634	$ 902	$	$ 2,536
Interdivision revenues	148	110	(258)	
Operating income (loss)	153	258	(662)	(251)

9. LEGAL PROCEEDINGS

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

Table of Contents

export control laws during the one year suspension period, the BIS order denying us worldwide export privileges could take effect and have a material affect on the results of operations and financial condition.

10. RELATED PARTIES

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

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

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

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

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

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

/s/ Ernst & Young LLP

San Jose, California

November 3, 2004

Table of Contents

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

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

Executive Overview

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

During the first quarter of fiscal 2005, we experienced a year over year increase in total net revenues of approximately 4% and a sequential quarterly decline in total net revenues of approximately 15%. The increase in total net revenues on a year over year basis included a favorable foreign currency impact of approximately 3% and the sequential impact of foreign currency on total net revenues was not material. Year over year, total net revenues were impacted by increased sales of our UltraSPARC® IV processor-based systems, especially in the enterprise server area, improved shipment linearity and efficiency improvements and increases in Support services and Client solutions revenues, which were offset by a decrease in our Network Storage products revenue. The sequential decrease in total net revenues reflects the normal seasonal decline we experience between the fourth quarter of the previous year and the first quarter of the next fiscal year.

Sequentially, our products gross margin percentage remained unchanged and was impacted primarily due to a $55 million charge related to the litigation settlement with Kodak and an unfavorable products mix, offset by the favorable impact of manufacturing and component cost reductions and pricing. Sequentially, our services gross margin increased approximately 4 percentage points primarily due to the favorable impact of cost reductions, productivity measures and changes in services mix, which were partially offset by the unfavorable impact of pricing.

Sequentially, our research and development expenses decreased by $102 million and sales, general and administrative expenses decreased by $165 million primarily due to on-going cost structure actions that included reducing our global workforce and property portfolio and implementing productivity improvement initiatives and expense reduction measures. The ongoing reductions in our global workforce and property portfolio resulted in a net restructuring charge of $108 million in the first quarter of fiscal 2005 .

During the quarter our operating activities provided cash flows of $124 million and we ended the quarter with a cash conversion cycle of 37 days, an improvement of 3 days from June 30, 2004. At September 26, 2004 we had a total cash, cash equivalents and marketable debt securities position of approximately $7.4 billion.

Changes to Previously Announced Fiscal 2005 First Quarter Results

On October 14, 2004, we announced our fiscal 2005 first quarter results which included the preliminary accounting for the settlement with Kodak. Subsequent to that date, we finalized our accounting for the settlement with Kodak as discussed in Note 9 to the Condensed Consolidated Financial Statements. As a result, we adjusted our previously announced first quarter of fiscal 2005 results by reducing our net loss by $27 million and basic and diluted net loss per common share by $0.01.

Critical Accounting Policies

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

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

RESULTS OF OPERATIONS

Net Revenues

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

	Three Months Ended		
	September 26, 2004	September 28, 2003	Change
Computer Systems products	$ 1,354	$ 1,282	5.6%
Network Storage products	322	352	(8.5)%
Products net revenue	$ 1,676	$ 1,634	2.6%
Percentage of total net revenues	63.8%	64.4%	
Support services	$ 745	$ 731	1.9%
Client solutions and Knowledge services	207	171	21.1%
Services net revenue	$ 952	$ 902	5.5%
Percentage of total net revenues	36.2%	35.6%	
Total net revenues	$ 2,628	$ 2,536	3.6%
Services contract penetration rate(1)	49.0%	42.3%	6.7pts
Revenue per employee(2)	$ 78	$ 70	11.4%

(1) 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.

(2) 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.

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

Products Net Revenue

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

During the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004, Products net revenues were favorably impacted by foreign currency exchange rates, increased Computer Systems sales of enterprise servers and UltraSPARC IV processor boards and improved shipment linearity. These increases were partially offset by decreased sales of data center and SPARC entry servers and desktops. Network Storage revenue was negatively impacted by reduced sales of storage products associated with decreased sales of data center servers and the technological transition in our high-end storage systems.

Table of Contents

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 and represents approximately 78% and 81% of services net revenue in the first quarter of fiscal 2005 and 2004, respectively. During the first quarter of fiscal 2005 as compared with the corresponding period in fiscal 2004, Support services net revenue was favorably impacted by foreign exchange, an increase in total contract value and the number of systems under a Support services contract as support services are increasingly being integrated as essential elements of a solution sale. The 6.7 percentage point increase in the services contract penetration rate was due to a unit increase in the systems under contract and a unit decrease in the number of active systems that comprise the installed base. The increase in the number of systems under an active Support service contract was partially offset by: (1) a change in contract mix towards maintenance contracts sold or renewed with reduced service levels; and (2) a change in product sales mix towards a greater proportion of low-end products, which are typically sold with reduced levels of services.

Client solutions and Knowledge services revenue consists primarily of professional services such as technical consulting that helps our customers plan, implement, and manage distributed network computing environments and, to a lesser extent, Knowledge services such as development and delivery of integrated learning solutions for enterprises, IT organizations, and individual IT professionals. The overall increase in Client solutions and Knowledge services revenue during the first quarter of fiscal 2005 as compared with the corresponding period in fiscal 2004 was due to increased Client solutions revenues resulting from the success of our solution-based selling strategy internationally, particularly in EMEA. These increases were partially offset by a reduction in customers spending related to Knowledge services.

Net Revenues by Geographic Area

(dollars in millions)

	Three Months Ended		
	September 26, 2004	**September 28, 2003**	**Change**
U.S.	$ 1,105	$ 1,162	(4.9)%
Percentage of net revenues	42.0%	45.8%	
Americas-Other (Canada and Latin America)	$ 110	$ 116	(5.2)%
Percentage of net revenues	4.2%	4.6%	
EMEA (Europe, Middle East and Africa)	$ 973	$ 822	18.4%
Percentage of net revenues	37.0%	32.4%	
APAC (Asia, Australia and New Zealand)	$ 440	$ 436	0.9%
Percentage of net revenues	16.8%	17.2%	
Total International revenues	$ 1,523	$ 1,374	10.8%
Percentage of net revenues	58.0%	54.2%	
Total net revenues	$ 2,628	$ 2,536	3.6%

Net revenues in the U.S. declined during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to an intense competitive environment and reduced spending in certain key sectors. We experienced a decline in government spending primarily in national security and defense, which negatively impacted our U.S. revenues during the first quarter of fiscal 2005. The telecommunications sector in the U.S. showed a trend of improvement in fiscal 2004 offsetting weakness in other sectors. This trend in the telecommunications sector did not continue in the first quarter of fiscal 2005 due in part to the spending patterns of certain customers.

Table of Contents

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

(dollars in millions)

	Three Months Ended		
	September 26, 2004	September 28, 2003	Change
United Kingdom (UK)	$ 292	$ 198	47.5%
Germany[(1)]	$ 200	$ 191	4.7%
Japan	$ 183	$ 185	(1.1)%
Central and Northern Europe (CNE)[(2)]	$ 152	$ 145	4.8%

(1) The Germany geographic market consists of Germany and Austria.

(2) The CNE geographic market consists primarily of Finland, Norway, Sweden, the Netherlands, Belgium, Luxembourg and Switzerland. In prior quarterly reports we included an international area called Northern Europe which consisted of Finland, Norway, Sweden, the Netherlands, Belgium, Luxembourg, Eastern European countries and Russia.

Net revenues in the UK grew across the majority of products and services categories during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004. Sales were especially strong in the telecommunications and government sectors and included $62 million related to the first phase of a multi-year solution-based sale to a health care services provider.

Net revenues in Germany slightly increased during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to an increase in Client solutions revenue. Growth in product revenue remained flat due to intense competition in a challenging economic environment.

Net revenues in Japan declined during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to decreases in Product revenue partially offset by increases in Support services and Client solutions revenue. We have taken actions in Japan, including a change in management and implementation of a plan to reduce our future costs in order to adjust to the current intense competitive business environment and these actions have slowed the rate of decline in this market s revenue.

Net revenues in CNE increased during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to increases in Product and Support services revenue associated with improving sales in the telecommunications and financial services sectors.

Gross Margin

(dollars in millions)

	Three Months Ended		
	September 26, 2004	September 28, 2003	Change
Products gross margin	$ 672	$ 669	0.4%
Percentage of products net revenue	40.1%	40.9%	(0.8)pts
Services gross margin	$ 401	$ 347	15.6%
Percentage of services net revenue	42.1%	38.5%	3.6pts
Total gross margin	$ 1,073	$ 1,016	5.6%
Percentage of net revenues	40.8%	40.1%	0.7pts

Products Gross Margin

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

Our products gross margin percentage was essentially unchanged as compared with the corresponding period of fiscal 2004 and was unfavorably impacted by approximately 3 percentage points as a result of the Kodak litigation settlement, planned list price reductions and sales discounting actions of greater than 2 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 benefited products gross margin by approximately 5 percentage points.

Table of Contents

We experienced significant component cost reductions over the last several years that benefited our products gross margin. These cost reductions generally offset, or were slightly less than, the pricing actions we took in those prior periods to respond to competitive pressure and the shift in our product mix towards sales of lower margin products. We expect pricing pressures associated with competition to continue to impact our products gross margin and we may not be able to achieve the same level of component cost reductions, which could adversely impact our operating results.

Services Gross Margin

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

The 3.6 percentage point increase in our services gross margin reflected the efficiencies realized from: (1) costs savings associated with our workforce reductions and facilities exit plans of nearly 4 percentage points; (2) lower on-going logistics costs, including spares, repair costs and warehousing of approximately 2 percentage points; and (3) on-going changes in our partner delivery model of approximately 2 percentage points. These increases were partially offset by the negative impact of competitive pricing pressures of approximately 3 percentage points and increased costs associated with a shift in product mix to solution-based sales of approximately 1 percentage point.

We expect pricing pressures associated with competition and the shift in product mix to solution-based sales, which have a greater proportion of Client solutions, to continue to impact our services gross margin and we may not be able to achieve our targeted levels of cost reductions and operational efficiencies, either of which could adversely impact our operating results.

Operating Expenses

(dollars in millions)

	Three Months Ended		
	September 26, 2004	**September 28, 2003**	**Change**
Research and development	$ 416	$ 467	(10.9)%
Percentage of net revenues	15.8%	18.4%	
Selling, general and administrative	$ 684	$ 798	(14.3)%
Percentage of net revenues	26.0%	31.5%	
Restructuring charges	$ 108	$ 1	N/M*
Percentage of net revenues	4.1%	0.0%	
Purchased in-process research and development	$	$ 1	N/M*
Percentage of net revenues	%	0.0%	

Total operating expenses	$ 1,208	$ 1,267	(4.7)%

* Not meaningful

Research and Development (R&D) Expenses

R&D expenses decreased by $51 million during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) $33 million in cost savings associated with workforce reductions; (2) $26 million in cost savings associated with discretionary and outside services spending; and (3) $11 million in payroll related savings due to fewer days in the current quarter and decreased depreciation due to reductions in capital expenditures. These decreases were partially offset by a $14 million increase in accrued bonus compensation and a $10 million increase in compensation and other costs associated with previous acquisitions.

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

Selling, General and Administrative (SG&A) Expenses

SG&A expenses decreased by $114 million during the first quarter of fiscal 2005 as compared with the corresponding period of fiscal 2004 primarily due to: (1) $61 million in cost savings associated with workforce reductions and rebalancing efforts; (2) $20 million in reductions in marketing related costs and other discretionary spending; (3) $21 million in occupancy cost savings associated with facilities exit actions; (4) $13 million in payroll related savings due to fewer days in the current quarter; and (5)

$12 million in decreased depreciation due to reductions in capital expenditures. These decreases were partially offset by a $17 million increase in variable compensation costs associated with bonuses and commissions.

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

Restructuring Charges and Workforce Rebalancing Efforts

Fiscal 2004 Restructuring Plan

In March 2004, our Board of Directors and management approved a plan to reduce our cost structure and improve operating efficiencies by reducing our workforce, exiting facilities, and implementing productivity improvement initiatives and expense reduction measures (Fiscal 2004 Restructuring Plan). This plan includes reducing our workforce by at least 3,300 employees across all levels, business functions, operating units, and geographic regions, 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 first quarter of fiscal 2005 we recognized a total of $110 million in charges associated with the Fiscal 2004 Restructuring Plan (consisting of a $20 million workforce reduction charge and a $90 million excess facility charge).

We expect to record additional charges related to our workforce and facilities reductions primarily over the next several quarters, the timing of which will depend upon the timing of notification of the remaining employees leaving the company 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 Statement of Operations.

In addition, as part of the Fiscal 2004 Restructuring Plan, 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 three months ended September 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	20						20
Accrued lease costs		80					80
Property and equipment impairment		12					12
Provision adjustments		(2)		1	(2)	(1)	(4)
Total restructuring charges	20	90		1	(2)	(1)	108
Cash paid	(87)	(11)	(1)	(8)	(7)	(5)	(119)
Non-cash		(12)		(2)			(14)
Balance as of September 26, 2004	$ 99	$ 155	$	$ 81	$ 144	$ 39	$ 518

Our accrued liability for all four plans was net of approximately $123 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

Table of Contents

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 September 26, 2004 for facility related leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of September 26, 2004, $204 million of the $518 million accrual was classified as current and the remaining $314 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 on 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 quarter of fiscal 2005, we paid $54 million and $1 million, respectively.

Loss on Equity Investments

(dollars in millions)

	Three Months Ended		
	September 26, 2004	**September 28, 2003**	**Change**
Loss on equity investments, net	$ (4)	$ (25)	84.0%
Percentage of net revenues	(0.2)%	(1.0)%	

Our equity investments portfolio, which primarily consists of investments in privately-held and publicly traded technology companies, has continued to be negatively impacted during the first quarter of fiscal 2005 by declining equity valuations in the technology sectors in which we have invested. The loss on equity investments of $4 million in the first quarter of fiscal 2005 was primarily related to decline in the valuation of warrants and a decline in value of our equity investments that was considered other than temporary. The loss on equity investments in the first quarter of fiscal 2004 was primarily related to decline in value of our equity investments portfolio that was considered other than temporary.

As of September 26, 2004, our equity investments portfolio of $100 million consisted of $31 million in marketable equity securities, $53 million in equity investments in privately-held companies and warrants and $16 million in investments in venture capital funds and other joint ventures. The ongoing valuation of our investment portfolio remains uncertain and may be subject to fluctuations based on whether we participate in additional financing activity or other events occurring outside of our control which impacts the valuation of our investee companies.

Interest Income, net

(dollars in millions)

	Three Months Ended		
	September 26, 2004	**September 28, 2003**	**Change**
Interest income, net	$ 31	$ 21	47.6%
Percentage of net revenues	1.2%	0.8%	

In the first quarter of fiscal 2005, interest income, net, increased $10 million as compared with the corresponding periods of fiscal 2004. This increase was primarily due to higher cash and marketable debt securities balances (an increase of $1.9 billion), partially offset by lower interest rates and lower realized gains on the sale of certain marketable debt securities.

The average duration of our portfolio of marketable debt securities decreased to 0.66 year at September 26, 2004 from 0.78 year at September 28, 2003. In general, we would expect the volatility of this portfolio to decrease as its duration decreases.

Table of Contents

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

Income Taxes

(dollars in millions)

	Three Months Ended		
	September 26, 2004	September 28, 2003	Change
Income tax provision	$ 39	$ 31	25.8%
Percentage of loss before taxes	N/A	N/A	

For the first quarter of fiscal 2005, we recorded an income tax provision of $39 million as compared with an income tax provision of $31 million for the first quarter of fiscal 2004. These tax provisions were recorded for taxes due on income generated in certain state and foreign tax jurisdictions and reflect adjustments for the difference between estimated amounts recorded and actual liabilities resulting from the filing of prior years tax returns.

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

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

Stock Options and Incentive Plans

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

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

	Shares Available for Grant	Outstanding Options	
		Number of Shares	Weighted Average Exercise Price
Balance at June 30, 2004	256	603	$ 12.85
Grants and assumptions	(61)	61	$ 3.81
Exercises		(8)	$ 1.82
Cancellations	24	(26)	$ 12.19
Balance at September 26, 2004	219	630	$ 12.15

21

Table of Contents

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

	Outstanding Options					Options Exercisable			
Range of Exercise Prices	Shares	Weighted Average Remaining Life in Years	Weighted Average Exercise Price	Aggregate Intrinsic Value	Potential Dilution Percentage	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Potential Dilution Percentage
$0.01 - $4.13	179	6.1	$ 3.51	$ 111	5.3%	61	$ 3.33	$ 49	1.8%
$4.13 - $5.00	111	6.7	4.24		3.3%	13	4.36		0.4%
$5.01 - $10.00	140	3.8	7.29		4.2%	92	6.79		2.8%
$10.01 - $15.00	40	3.6	12.62		1.2%	34	12.66		1.0%
$15.01 - $20.00	76	4.0	17.93		2.3%	55	17.78		1.6%
$20.01 - $40.00	44	3.4	37.92		1.3%	36	37.87		1.1%
$40.00 - $108.38	40	3.6	49.87		1.2%	30	49.78		0.9%
	630	4.9	$ 12.15	$ 111	18.8%	321	$ 16.09	$ 49	9.6%

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e., the difference between Sun s closing stock price of $4.13 on September 24, 2004 (last trading day of our first quarter of fiscal 2005), and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on September 26, 2004. This amount changes based on the fair market value of Sun s stock.

The potential dilution percentage is computed by dividing the options in the related range of exercise prices by the shares of common stock issued, adjusted for treasury stock, as of September 26, 2004 (3,344 million shares) and does not reflect the potential proceeds from the exercise price of the options.

The 630 million options outstanding will vest as follows (in millions):

	Q1 05 and prior	Remainder of 2005	2006	2007	2008	2009	2010	Total
Number of Options	321	70	81	67	49	30	12	630

Equity Compensation Plan Information

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

Plan Category	**Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights**	**Weighted Average Exercise Price of Outstanding Options, Warrants and Rights (in dollars)**	**Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans**
Equity compensation plans approved by security holders (excluding ESPP)	607	$ 12.38	190
Equity compensation plans not approved by security holders (excluding ESPP)	23	$ 6.16	29
Total (excluding ESPP)	630	$ 12.15	219
Equity compensation plans approved by security holders (ESPP only)	N/A	N/A	169
Equity compensation plans not approved by security holders (ESPP only)	N/A	N/A	N/A
Total (ESPP only)	N/A	N/A	169
All Plans	630	$ 12.15	388

Table of Contents

Options Granted during the Three Months Ended September 26, 2004 to the Most Highly Compensated Executive Officers Named in Our Most Recent Proxy Statement

Name	Number of Options Granted	Weighted Average Exercise Price
Scott G. McNealy	1,250,000	$ 3.79
Jonathan I. Schwartz	800,000	$ 3.79
Crawford W. Beveridge	400,000	$ 3.79
Stephen T. McGowan	400,000	$ 3.79
Gregory M. Papadopoulos	400,000	$ 3.79
Mark Tolliver[1]	N/A	N/A
David Yen[2]	400,000	$ 3.79

(1) Mr. Tolliver ceased being an Executive Officer of the Company effective April 14, 2004 and resigned from the Company effective September 30, 2004.

(2) Mr. Yen ceased being an Executive Officer of the Company effective June 29, 2004.

Table of Contents

LIQUIDITY, CAPITAL RESOURCES AND FINANCIAL CONDITION

(dollars in millions)

	September 26, 2004	June 30, 2004	Change
Cash and cash equivalents	$ 2,187	$ 2,141	$ 46
Marketable debt securities	5,246	5,467	(221)
Total cash, cash equivalents and marketable debt securities	$ 7,433	$ 7,608	$ (175)
Percentage of total assets	55.0%	52.5%	2.5pts

	Three Months Ended		
	September 26, 2004	September 26, 2003	Change
Cash provided by (used in) operating activities	$ 124	$ (49)	$ 173
Cash provided by (used in) investing activities	157	(492)	649
Cash provided by (used in) financing activities	(235)	7	(242)
Net increase (decrease) in cash and cash equivalents	$ 46	$ (534)	$ 580

Changes in Cash Flow

During the first quarter of fiscal 2005, our operating activities generated cash flows of $124 million, which is $173 million higher than the cash flows provided by operating activities during the first quarter of fiscal 2004. Cash provided by operating activities during the first quarter of fiscal 2005 was primarily the result of a $606 million decrease in accounts receivable primarily related to a reduction in days sales outstanding, partially offset by a decrease in accounts payable and other liabilities. In the first quarter of fiscal 2005, our cash provided by investing activities was primarily attributable to proceeds from maturities of marketable debt securities of $292 million and our cash used in financing activities was primarily attributable to a $250 million principal payment of our Senior Notes outstanding.

	September 26, 2004	June 30, 2004	Change
Days sales outstanding (DSO)[1]	59	68	9
Days of supply in inventory (DOS)[2]	24	22	(2)
Days payable outstanding (DPO)[3]	(46)	(50)	(4)

Cash conversion cycle	37	40	3
Inventory turns - products only	10.3	9.8	0.5

(1) DSO measures the number of days it takes, based on a 90 day average, to turn our receivables into cash.

(2) DOS measures the number of days it takes, based on a 90 day average, to sell our inventory.

(3) DPO measures the number of days it takes, based on a 90 day average, to pay the balances of our accounts payable.

We ended the first quarter of fiscal 2005 with a cash conversion cycle of 37 days, an improvement of 3 days from June 30, 2004. The cash conversion cycle is the duration between purchase of inventories and services and the collection of the cash for the sale of our products and services and is a metric on which we have focused as we continue to try to efficiently manage our assets. The cash conversion cycle results from the calculation of days sales outstanding (DSO) added to days of supply in inventories (DOS), reduced by days payable outstanding (DPO). DSO improved and net accounts receivable decreased from June 30, 2004 due to improved billings and collections throughout the quarter and a greater amount of deferred revenue recognized. DOS worsened 2 days due to a higher percentage of inventory to sales when compared to June 30, 2004. However, inventories decreased $48 million from June 30, 2004 and our products inventory turn rate increased to 10.3 turns at September 26, 2004 from 9.8 turns at June 30, 2004. Inventory turns is annualized and represents the number of times inventory is replenished during the year. Inventory management will continue to be an area of focus as we balance the need to maintain sufficient inventory levels to help ensure competitive lead times with the risk of inventory obsolescence due to rapidly changing technology and customer requirements. DPO improved 4 days and accounts payable decreased $250 million from June 30, 2004 due to timing differences in payments to our supply chain.

Acquisitions

We made no acquisitions during the first quarter of fiscal 2005.

Stock Repurchases

From time to time, our Board of Directors approves common stock repurchase programs allowing management to repurchase shares of our common stock in the open market pursuant to price-based formulas. In February 2001, we announced our intention to

Table of Contents

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

Borrowings

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

In addition, we have uncommitted lines of credit aggregating approximately $563 million. No amounts were drawn from these lines of credit as of September 26, 2004. Interest rates and other terms of borrowing under these lines of credit vary from country to country depending on local market conditions at the time of borrowing. There is no guarantee that the banks would approve our request for funds under these uncommitted lines of credit.

Contractual Obligations

Through the normal course of our business, we purchase or place orders for the necessary components of our products from various suppliers. We estimate that our contractual obligations at September 26, 2004 is between $430 million and $475 million. This range does not include contractual obligations recorded on the balance sheet as current liabilities. In addition, we have a contractual obligation under the terms of our strategic alliance with Fujitsu, whereby we have committed to buy Fujitsu products with a list price of $230 million and $265 million in fiscal years 2005 and 2006, respectively, at a predetermined discount from list price, depending upon the type of product purchased. Contractual obligations for the purchase of goods or services are comprised of agreements that are enforceable and legally binding on Sun and that specify all significant terms, including fixed or minimum quantities to be purchased, fixed, minimum or variable price provisions, and the appropriate timing of the transactions. Our purchase orders are based on our current manufacturing needs and are fulfilled by our vendors within a short time.

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

Capital Resources and Financial Condition

Our long-term strategy is to maintain a minimum amount of cash and cash equivalents in subsidiaries for operational purposes and to invest the remaining amount of our cash in interest bearing and highly liquid cash equivalents and marketable debt securities. Accordingly, in addition to the approximately $2.2 billion in cash and cash equivalents, we currently have approximately $5.2 billion in marketable debt securities that are available for shorter-term requirements, such as future operating, financing and investing activities, for a total cash and marketable debt securities position of approximately $7.4 billion. However, at June 30, 2004, approximately $1.1 billion of this balance represents earnings generated from operations domiciled in foreign tax jurisdictions that are designated as permanently invested in the respective tax jurisdictions. If these funds are required for our operations in the U.S., we could be required to accrue and pay additional taxes to repatriate these funds. Currently, we do not anticipate a need to repatriate these funds to our U.S. operations. Additionally, we are currently reviewing the provisions of the American Jobs Creation Act of 2004, and have not completed our evaluation of its impact to Sun.

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

Table of Contents

NON-AUDIT SERVICES OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

Table of Contents

RISK FACTORS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Joint development and marketing of a complex new product line is an inherently difficult undertaking and is subject to numerous risks. If Fujitsu and Sun are unable to agree upon aspects of the relationship, such as development objectives or product features, or if either Sun or Fujitsu fails to timely complete its development duties, the development project may be delayed, become more expensive or fail entirely, any of which could have a material adverse effect on our results of operations or financial condition. In addition, if we do not satisfy certain development or supply obligations under the agreements, or if we otherwise violate the terms of the agreements, we may be subject to significant contractual or legal penalties. Further, if Fujitsu encounters any of a number of potential problems in its business, such as intellectual property infringement claims, supply difficulties or financial challenges, these could impact our strategic relationship with them and could result in a material adverse effect on our business or results of operations.

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

Generally, the computer systems we sell to customers incorporate various hardware and software products that we sell, such as UltraSPARC microprocessors, various software elements, from the Solaris Operating System to the Java platform, Sun Java

System portfolio, N1 and Sun StorEdge array products. Any delay in the development, delivery or acceptance of key elements of the hardware or software included in our systems could delay our shipment of these systems. Delays in the development and introduction of our products may occur for various reasons.

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

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

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

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

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

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

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

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

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

We continuously seek to make our cost structure more efficient and focus on our core strengths. We recently announced our intent to develop and implement a global resourcing strategy and operating model which includes outsourcing activities and is focused on increasing workforce flexibility and scalability, and improving overall competitiveness by leveraging external talent and skills worldwide. To the extent we rely on partners or third party service providers for the provision of key business process functions, we may incur increased business continuity risks. If we are unable to effectively develop and implement our resourcing strategy, we may not realize cost structure efficiencies and our operating and financial results could be materially and adversely affected. In addition, if we are unable to effectively utilize or integrate and interoperate with external resources or if our partners or third party service providers experience business difficulties or are unable to provide business process services as anticipated, we may need to seek alternative service providers or resume providing such business processes internally which could be costly and time consuming and have a material adverse material effect on our operating and financial results.

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

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

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

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

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

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

In evaluating our ability to recover our deferred tax assets, in full or in part, we consider all available positive and negative evidence including our past operating results, the existence of cumulative losses in the most recent fiscal years and our forecast of future taxable income on a jurisdiction by jurisdiction basis. In determining future taxable income, we are responsible for assumptions utilized including the amount of state, federal and international pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we are using to manage the underlying businesses. Cumulative losses incurred in the U.S. and Japan in recent years represented sufficient negative evidence to require a full and partial valuation allowances in these jurisdictions, respectively. At June 30, 2004, we have established a valuation allowance against the deferred tax assets in these jurisdictions, which will remain until sufficient positive evidence exists to support reversal. Future reversals or increases to our valuation allowance could have a significant impact on our future earnings.

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

Table of Contents

we will continue to review our goodwill and other intangible assets for possible impairment. Any additional impairment charges could adversely affect our future earnings.

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

We are dependent on significant customers and specific industries.

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

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

We could lose our ability to export our products if we violate export control laws.

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 includes a one year suspended denial of our worldwide export privileges. In the event that we violate export control laws during the one year suspension period, the BIS order denying us worldwide export privileges could take effect. We are highly dependent upon the export of our products and services overseas. For example, our net revenues for fiscal 2004 for sales outside of the United States were approximately 57% of our total net revenues. Accordingly, in the event that the BIS imposed the extreme sanction of a denial of all export privileges, such penalty would have a material adverse effect on our financial condition and operating results.

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

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

Our acquisition and alliance activities could disrupt our ongoing business.

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

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

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

Our credit rating is subject to downgrade.

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

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

Sun has adopted a program of self-insurance with regard to certain risks such as California earthquakes and as supplemental coverage for certain potential liabilities including, but not limited to general liability, directors and officers liability, workers compensation, errors and omissions liability and property. We self-insure when the lack of availability and high cost of commercially available insurance products do not make the transfer of this risk a reasonable approach. In the event that the frequency of losses experienced by Sun increased unexpectedly, the aggregate of such losses could materially increase our liability and adversely affect our financial condition, liquidity, cash flows and results of operations. In addition, while the insurance market continues to limit the availability of certain insurance products while increasing the costs of such products, we will continue to evaluate the levels of claims we include in our self-insurance program. Any increases to this program increases our risk exposure and therefore increases the risk of a possible material adverse effect on our financial condition, liquidity, cash flows and results of operations. In addition, we have made certain judgments as to the limits on our existing insurance coverage that we believe are in line with industry standards, as well as in light of economic and availability considerations. Unforeseen catastrophic loss scenarios could prove our limits to be inadequate, and losses incurred in connection with the known claims we self-insure could be substantial. Either of these circumstances could materially adversely affect our financial and business condition.

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

Since our inception, we have used stock options and other long-term equity incentives as a fundamental component of our employee compensation packages. We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with Sun. The Financial Accounting Standards Board (FASB) has proposed changes to U.S. GAAP that, if implemented, would require us to record a charge to earnings for employee stock option grants. This pending regulation would negatively impact our earnings. For example, recording a charge for employee stock options under SFAS 123, Accounting for Stock-Based Compensation would have increased net loss by $818 million, $555 million and $647 million for fiscal 2004, 2003 and 2002, respectively. See also Note 2 to the Notes to Consolidated Financial Statements Summary of Significant Accounting Policies: Stock Options Plans. In addition, new regulations implemented by The Nasdaq National Market requiring shareholder approval for all stock option plans, as well as new regulations implemented by the New York Stock Exchange prohibiting NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions, could make it more difficult for us to grant options to employees in the future. To the extent that new regulations make it more difficult or expensive to grant stock options to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

Business interruptions could adversely affect our business.

Our operations and those of our suppliers are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, terrorist attacks and other events beyond our control. A substantial portion of our facilities, including our corporate

Table of Contents

headquarters and other critical business operations, are located near major earthquake faults. In addition, some of our facilities are located on filled land and, therefore, may be more susceptible to damage if an earthquake occurs. We do not carry earthquake insurance for direct earthquake-related losses. In addition, we do not carry business interruption insurance for, nor do we carry financial reserves against, business interruptions arising from earthquakes or certain other events. If a business interruption occurs, our business could be materially and adversely affected.

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

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

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

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

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

Some of our operations are subject to regulation under various federal, state and international laws governing the environment and hazardous substances. While we endeavor to be in compliance with environmental laws at all times, any failure to so comply can subject us to material liability. Also, particularly in Europe, we may be subject to compliance with developing product content requirements relating to recycling as well as product take back requirements that would make us responsible for recycling and/or disposing of products we have sold. These and other environmental laws may become stricter over time and require us to incur substantial costs for compliance. In addition, we could be subject to liability for investigation and remediation of hazardous substances if our operations have caused contamination or any of our owned or leased properties are found to be contaminated. Although costs relating to environmental matters have not resulted in a material adverse effect on us to date, there can be no assurance that we will not be required to incur such costs in the future.

Our stock price can be volatile.

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

FORWARD LOOKING STATEMENTS

This quarterly report, including the foregoing sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements related to our belief that support services are increasingly being integrated as essential elements of a solution sale; our expectation that pricing pressures associated with competition will continue to impact our products gross margin; our expectation that pricing pressures associated with competition and the shift in product mix to solution-based sales will continue to impact our services gross margin; our belief that we must continue to invest significant resources in new systems, software and microprocessor development and enhance existing products; our continued focus on achieving operating efficiencies; our expectations regarding SG&A expenditures on a dollar basis; our plan to reduce our workforce across all levels, business functions, operating units and geographic regions and eliminate excess facility capacity; our expectation to record additional charges related to our workforce and facilities reductions primarily over the next several quarters; our expectation to incur additional charges related to productivity improvement initiatives and expense reduction measures; our expectation that the volatility of our portfolio of marketable securities will decrease as its duration decreases; continuing to try to efficiently manage our assets; our continued focus on inventory management; our long-term strategy to maintain a minimum amount of cash and cash equivalents in subsidiaries for operational purposes and to invest the remaining amount of cash in interest bearing and highly liquid cash equivalents and marketable debt securities; our anticipation that we will not need to repatriate funds generated from operations domiciled in foreign tax jurisdictions to our U.S. operations; our belief that the liquidity provided by existing cash, cash equivalents, marketable debt securities and cash generated from operations will provide sufficient capital to meet our requirements for at least the next 12 months; our belief that our level of financial resources is a significant competitive factor in our industry; our business strategy to grow incremental revenue through recurring service models; our anticipation that the Advanced Product Line will ultimately

Table of Contents

replace a large proportion of our server product line; our intention to release our Solaris operating system to the open source development community as open source software; our intention to develop and implement a global resourcing strategy and operating model that includes outsourcing activities and is focused on increasing workforce flexibility and scalability and improving overall competitiveness; our intention to continue to make investments in companies, products, and technologies, either through acquisitions or investments or alliances; and our current plans not to discontinue our hedging programs.

These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth above and those contained in RISK FACTORS, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. Such factors include, but are not limited to, increased competition, increased pricing pressures, failure to design, develop and manufacture new products, lack of success in technological advancements, lack of acceptance of new products and services, unexpected changes in the demand for our products and services, delays in product introductions and projects, lack of success implementing new selling models, failure to further reduce costs or improve operating efficiencies including through our Fiscal 2004 Restructuring Plan, adverse business conditions, currency fluctuations, our failure to comply with export control laws and our ability to attract, hire and retain key and qualified employees.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Sensitivity

Our investment portfolio consists primarily of fixed income instruments with an average duration of 0.66 year as of September 26, 2004 as compared with 0.78 year as of September 28, 2003. The primary objective of our investments in debt securities is to preserve principal while maximizing yields, without significantly increasing risk. These available-for-sale securities are subject to interest rate risk. The fair market value of these securities may fluctuate with changes in interest rates. A sensitivity analysis was performed on this investment portfolio based on a modeling technique that measures the hypothetical fair market value changes (using a three month horizon) that would result from a parallel shift in the yield curve of plus 150 basis points (BPS). Based on this analysis, for example, a hypothetical 150 BPS increase in interest rates would result in an approximate $52 million decrease in the fair value of our investments in debt securities as of September 26, 2004.

We also entered into various interest-rate swap agreements to modify the interest characteristics of the Senior Notes so that the interest payable on the Senior Notes effectively becomes variable and thus matches the variable interest rate received from our cash and marketable debt securities. Accordingly, interest rate fluctuations impact the fair value of our Senior Notes outstanding, which will be offset by corresponding changes in the fair value of the swap agreements. However, by entering into these swap agreements, we have a cash flow exposure related to the risk that interest rates may increase. For example, at September 26, 2004, a hypothetical 150 BPS increase in interest rates would result in an approximate $19 million decrease in cash related to interest expense over a year.

Foreign Currency Exchange Risk

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

Based on our foreign currency exchange instruments outstanding at September 26, 2004, we estimate a maximum potential one-day loss in fair value of approximately $2 million, as compared with $4 million as of June 30, 2004, using a Value-at-Risk (VAR) model. The VAR model estimates were made assuming normal market conditions and a 95% confidence level. We used a Monte Carlo simulation type model that valued foreign currency instruments against three thousand randomly generated market price paths. Anticipated transactions, firm commitments, receivables, and accounts payable denominated in foreign currencies were excluded from the model. The VAR model is a risk estimation tool, and as such is not intended to represent actual losses in fair value that will be incurred by us. Additionally, as we utilize foreign currency instruments for hedging anticipated and firmly committed transactions, a loss in fair value for those instruments is generally offset by increases in the value of the underlying exposure. Foreign currency fluctuations did not have a material impact on our results of operations and financial position during the first quarter of fiscal 2005.

Equity Security Price Risk

We are exposed to price fluctuations on the marketable portion of equity securities included in our portfolio of equity investments. These investments are generally in companies in the high-technology industry sector, many of which are small capitalization stocks. We typically do not attempt to reduce or eliminate the market exposure on these securities. A 20% adverse change in equity prices would result in an approximate $8 million decrease in the fair value of our available-for-sale equity investments as of September 26, 2004, as compared with $4 million as of September 26, 2003. At September 26, 2004, three equity securities represented approximately $22 million of the $30 million total fair value of the marketable equity securities.

ITEM 4. CONTROLS AND PROCEDURES

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

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

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

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

Table of Contents

ITEM 6. EXHIBITS

See Index to Exhibits on Pages 46 to 47 hereof.

Table of Contents

SIGNATURES

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

SUN MICROSYSTEMS, INC.

BY /s/ STEPHEN T. MCGOWAN
Stephen T. McGowan

Chief Financial Officer and Executive

Vice President, Corporate Resources

(Principal Financial Officer)

/s/ ROBYN M. DENHOLM
Robyn M. Denholm

Vice President and Corporate Controller

(Principal Accounting Officer)

Dated: November 4, 2004

Table of Contents

INDEX TO EXHIBITS

Exhibit Number	Description
3.1(1)	Registrant s Restated Certificate of Incorporation.
3.2(2)	Certificate of Amendment of the Restated Certificate of Incorporation of Registrant dated November 8, 2000.
3.3(3)	Amended and Restated Certificate of Designations dated December 13, 2000.
3.4(4)	Bylaws of the Registrant, as amended June 24, 2004.
4.8(5)	Third Amended and Restated Shares Rights Agreement dated July 25, 2002.
4.10(6)	Indenture, dated August 1, 1999 (the Indenture) between Registrant and The Bank of New York, as Trustee.
4.11(6)	Form of Subordinated Indenture.
4.12(6)	Officers Certificate Pursuant to Section 301 of the Indenture, without exhibits, establishing the terms of Registrant s Senior Notes.
4.13(6)	Form of Senior Note.
15.1	Letter re: Unaudited Interim Financial Information.
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certificate of Chief Executive Officer.
32.2	Section 1350 Certificate of Chief Financial Officer.

(1) Incorporated by reference to Registrant s Quarterly Report on Form 10-Q for fiscal quarter ended March 29, 1998.
(2) Incorporated by reference as Exhibit 3.5 to Registrant s Quarterly Report on Form 10-Q for fiscal quarter ended December 31, 2000.
(3) Incorporated by reference as Exhibit 2.2 to Registrant s Form 8-A/ A filed December 20, 2000.
(4) Incorporated by reference to Exhibit 3.4 of Registrant s Annual Report on Form 10-K for the fiscal year ended June 30, 2004.
(5) Incorporated by reference to Registrant s Form 8-A/ A filed September 26, 2002.
(6) Incorporated by reference to Registrant s Current Report on Form 8-K filed August 6, 1999.