SUN MICROSYSTEMS INC
Form 10-Q
May 13, 2002

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2002

or

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

Commission file number: 0-15086

SUN MICROSYSTEMS, INC.
(Exact name of registrant as specified in its charter)

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

901 San Antonio Road, Palo Alto, CA 94303
(Address of principal executive offices with zip code)

(650) 960-1300
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES (X) NO ( )

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	Outstanding at April 25, 2002
Common Stock $0.00067 par value	3,246,270,224

TABLE OF CONTENTS

Table of Contents

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in millions, except per share amounts)

	Three Months Ended		Nine Months Ended	
	March 31, 2002	April 1, 2001	March 31, 2002	April 1, 2001
Net revenues:				
Products	$ 2,269	$ 3,262	$ 6,586	$ 11,922
Services	838	833	2,490	2,333
Total net revenues	3,107	4,095	9,076	14,255
Cost of sales:				
Cost of sales products	1,306	1,864	4,030	6,170
Cost of sales services	494	539	1,544	1,519
Total cost of sales	1,800	2,403	5,574	7,689
Gross margin	1,307	1,692	3,502	6,566
Operating expenses:				
Research and development	468	486	1,369	1,473
Selling, general and administrative	991	948	2,918	3,371
Restructuring charges	(4)		521	
Goodwill amortization		105		160
Purchased in-process research and development		1	3	72
Total operating expenses	1,455	1,540	4,811	5,076
Operating income (loss)	(148)	152	(1,309)	1,490
Loss on equity investments, net	(23)	(13)	(81)	(12)
Interest income, net	77	110	252	276
Income (loss) before income taxes and cumulative effect of change in accounting principle	(94)	249	(1,138)	1,754
Provision (benefit) for income taxes	(57)	113	(490)	685
Income (loss) before cumulative effect of change in accounting principle	(37)	136	(648)	1,069
Cumulative effect of change in accounting principle, net				(54)
Net income (loss)	$ (37)	$ 136	$ (648)	$ 1,015
Net income (loss) per common share basic:				
Income (loss) before cumulative effect of change in accounting principle	$ (0.01)	$ 0.04	$ (0.20)	$ 0.33
Cumulative effect of change in accounting principle				(0.02)

Net income (loss) per common share basic	$(0.01)	$ 0.04	$ (0.20)	$ 0.31
Net income (loss) per common share diluted:				
Income (loss) before cumulative effect of change in accounting principle	$(0.01)	$ 0.04	$ (0.20)	$ 0.31
Cumulative effect of change in accounting principle				(0.01)
Net income (loss) per common share diluted	$(0.01)	$ 0.04	$ (0.20)	$ 0.30
Shares used in the calculation of net income (loss) per common share basic	3,245	3,256	3,242	3,230
Shares used in the calculation of net income (loss) per common share diluted	3,245	3,417	3,242	3,428

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in millions)

	March 31, 2002 (unaudited)	June 30, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,672	$ 1,472
Short-term investments	712	387
Accounts receivable, net	2,407	2,955
Inventories	554	1,049
Deferred and prepaid tax assets	1,733	1,102
Prepaid expenses and other current assets	615	969
Total current assets	7,693	7,934
Property, plant and equipment, net	2,512	2,697
Long-term marketable debt securities	3,564	4,312
Goodwill	2,182	2,126
Other acquisition-related intangible assets, net	121	185
Other non-current assets, net	802	927
	$ 16,874	$ 18,181
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$ 207	$ 3
Accounts payable	935	1,050
Accrued payroll-related liabilities	520	488
Accrued liabilities and other	1,615	1,778
Deferred revenues and customer deposits	1,609	1,827
Total current liabilities	4,886	5,146
Long-term debt	1,384	1,565
Other non-current obligations	873	884
Total stockholders equity	9,731	10,586
	$ 16,874	$ 18,181

See accompanying notes.

Table of Contents

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

	Nine Months Ended March 31, 2002	April 1, 2001
Cash flows from operating activities:		
Net income (loss)	$ (648)	$ 1,015
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	717	610
Amortization of goodwill (fiscal 2001 only) and other acquisition-related charges	89	221
Tax benefits from employee stock plans	58	692
Loss on equity investments, net	81	12
Other	3	126
Changes in operating assets and liabilities:		
Accounts receivable, net	548	(215)
Inventories	495	(340)
Prepaids and other assets	407	(461)
Accounts payable	(115)	97
Other liabilities	(932)	266
Net cash provided by operating activities	703	2,023
Cash flows from investing activities:		
Net sales and maturities of (purchases of) marketable debt securities	360	(819)
Net purchases of equity investments	(31)	(96)
Acquisitions of property, plant and equipment	(461)	(942)
Acquisitions of spare parts and other assets	(67)	(164)
Payments for acquisitions, net of cash acquired	(49)	(23)
Net cash used in investing activities	(248)	(2,044)
Cash flows from financing activities:		
Principal payments on borrowings and other obligations	(10)	(15)
Proceeds from issuance of common stock, net	121	278
Acquisition of treasury stock	(366)	(804)
Net cash used in financing activities	(255)	(541)
Net increase (decrease) in cash and cash equivalents	200	(562)
Cash and cash equivalents, beginning of period	1,472	1,849
Cash and cash equivalents, end of period	$ 1,672	$ 1,287

See accompanying notes.

Table of Contents

SUN MICROSYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. DESCRIPTION OF BUSINESS

Sun Microsystems, Inc. (Sun or the Company) is a leading worldwide provider of products, services and support solutions for building and maintaining network computing environments. Sun sells scalable computer and storage systems, high-speed microprocessors, and a complete line of high-performance software for operating networks, computing equipment and storage products. Sun also provides a full range of services including support, professional services and education. The Company markets its products primarily to business, governmental and educational customers and operates in various product categories across geographically diverse markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal year

Sun s first three quarters in fiscal 2002 ended on September 30, December 30 and March 31 (in fiscal 2001 the quarters ended on October 1, December 31 and April 1). The fourth quarter in all fiscal years ends on June 30.

Basis of presentation

The consolidated financial statements include the accounts of Sun and its wholly owned subsidiaries. Intercompany accounts and transactions have been eliminated. Certain amounts from prior year financial statements have been reclassified to conform to the current year presentation.

While the quarterly financial information is unaudited, the financial statements included in this report reflect all adjustments (consisting of normal recurring adjustments) that the Company considers necessary for a fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for the interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated balance sheet as of June 30, 2001 has been derived from the audited consolidated balance sheet as of that date. The information included in this report should be read in conjunction with the Company s Annual Report on Form 10-K for fiscal 2001 and its quarterly reports on Form 10-Q for the fiscal quarters ended September 30, 2001 and December 30, 2001 filed with the Securities and Exchange Commission on September 20, 2001, November 14, 2001, and February 12, 2002, respectively.

Computation of net income (loss) per common share

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding (adjusted for treasury stock and common stock subject to repurchase activity) during the period. Diluted net income (loss) per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period; dilutive common equivalent shares consist primarily of stock options. For the three and nine months ended March 31, 2002, 97 million and 107 million common equivalent shares, respectively, were excluded from the computation of diluted net income (loss) per common share because they were anti-dilutive. For the three and nine months ended April 1, 2001, 161 million and 198 million dilutive common equivalent shares, respectively, were included in the computation of diluted net income.

Table of Contents

Change in accounting

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

Recent pronouncements

On June 29, 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (SFAS 141), Business Combinations, which eliminates the pooling of interests method of accounting for all business combinations initiated after June 30, 2001, and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. As of July 1, 2001, the Company adopted this accounting standard.

In addition, as of July 1, 2001, the Company early adopted SFAS 142, Goodwill and Other Intangible Assets, which addresses the financial accounting and reporting standards for goodwill and other intangible assets subsequent to their acquisition. This accounting standard requires that goodwill no longer be amortized, and instead, be tested for impairment on a periodic basis.

In accordance with SFAS 142, the Company discontinued the amortization of goodwill effective July 1, 2001. In addition, the Company recharacterized acquired workforce (and its related deferred tax liabilities) as goodwill because it is no longer defined as an acquired intangible asset under SFAS 141. Accordingly, no acquired workforce amortization was recognized during the three months and the nine months ended March 31, 2002.

The provisions of SFAS 142 also require the completion of a transitional impairment test within six months of adoption, with any impairments treated as a cumulative effect of change in accounting principle. During the quarter ended December 30, 2001, the Company completed the transitional impairment test, which did not result in an impairment of recorded goodwill.

For further discussion, see Note 5, Goodwill and Other Acquisition-Related Intangible Assets.

Table of Contents

A reconciliation of previously reported net income and earnings per share, to the amounts adjusted for the exclusion of goodwill and workforce amortization, net of the related income tax effect, follows (in millions, except per share amounts):

	Three Months Ended		Nine Months Ended	
	March 31, 2002	April 1, 2001	March 31, 2002	April 1, 2001
Reported net income (loss)	$ (37)	$ 136	$ (648)	$ 1,015
Add: Goodwill amortization		105		160
Workforce amortization		3		4
Tax impact		(14)		10
Adjusted net income (loss)	$ (37)	$ 230	$ (648)	$ 1,189
Basic earnings per share:				
Reported earnings per share basic	$ (0.01)	$ 0.04	$ (0.20)	$ 0.31
Add: Goodwill amortization		0.03		0.05
Workforce amortization				
Tax impact				0.01
Adjusted earnings per share basic	$ (0.01)	$ 0.07	$ (0.20)	$ 0.37
Diluted earnings per share:				
Reported earnings per share diluted	$ (0.01)	$ 0.04	$ (0.20)	$ 0.30
Add: Goodwill amortization		0.03		0.04
Workforce amortization				
Tax impact				0.01
Adjusted earnings per share diluted	$ (0.01)	$ 0.07	$ (0.20)	$ 0.35

On October 3, 2001, the FASB issued SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS 144 supersedes SFAS 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be disposed of. The primary objectives of SFAS 144 are to develop one accounting model based on the framework established in SFAS 121 for long-lived assets to be disposed of by sale, and to address significant implementation issues. The Company will adopt SFAS 144 for its fiscal year beginning July 1, 2002. At this time, management does not expect the adoption of SFAS 144 to have a material effect on the Company s financial position or results of operations.

3. BUSINESS COMBINATIONS

The Company completed three acquisitions in the first nine months of fiscal 2002. Sun s acquisition of ISOPIA, Inc. (Isopia) on July 26, 2001 is described below (the aggregate purchase price of the other two acquisitions was less than $15 million and, accordingly, are not considered significant to Sun s financial statements). The consolidated financial statements include the operating results of each business from the date of acquisition. Pro forma results of operations have not been presented because the effects of these acquisitions were not material on either an individual or an aggregate basis.

The Company calculates amounts allocated to in-process research and development (IPRD) using established valuation techniques in the high-technology industry and expenses such amounts in the quarter that the related acquisition is consummated if technological feasibility of the in-process technology has not been achieved and no alternate future uses have been established. Research and development costs to bring the products from the acquired companies to technological feasibility are not expected to have a material impact on the Company s future results of operations or cash flows. Intangible assets subject to amortization are being amortized on a straight line basis over periods not exceeding five years.

Table of Contents

On July 26, 2001, Sun acquired Isopia, a corporation located in Toronto, Canada, by means of a plan of arrangement. Isopia develops on-line software that enables the delivery of on-line training and end-to-end management of training products via the Internet. Sun acquired Isopia to enhance its position in the corporate education market. A subsidiary of Sun, organized for the purpose of the acquisition, issued approximately 1.84 million exchangeable shares (which Isopia stockholders may exchange for shares of Sun common stock) at a fair value of $15.235 per share, or $28.0 million in the aggregate, and Sun paid $36.2 million in cash, in exchange for all of Isopia s outstanding stock. Sun also assumed all of Isopia s 1.4 million outstanding options at an estimated fair value of $1.3 million, and incurred $1.3 million in acquisition costs, resulting in an aggregate purchase price of approximately $66.8 million. This transaction was accounted for as a purchase, with the excess of the purchase price over the estimated fair value of the net tangible assets ($0.6 million) being allocated to developed technology ($3.7 million), IPRD ($3.2 million), goodwill ($39.0 million), and related deferred tax liabilities ($4.8 million). In addition, $25.1 million of the purchase price was allocated to deferred compensation, which primarily represents the pro-rata portion of the intrinsic value of unvested exchangeable shares held by certain key Isopia shareholders at the date of the acquisition.

4. BALANCE SHEET AND STATEMENT OF CASH FLOW INFORMATION

Inventories consist of the following (in millions):

	March 31, 2002	June 30, 2001
Raw materials	$ 206	$ 600
Work in process	118	137
Finished goods	230	312
	$ 554	$1,049

Long-term marketable debt securities of $3,564 million and $4,312 million as of March 31, 2002 and April 1, 2001, respectively, consist primarily of corporate bonds, floating-rate notes, and asset-backed securities with maturities greater than one year from the balance sheet date. All marketable debt securities are held in the Company s name and are held in custody with primarily one major financial institution. The Company s policy is to protect the value of its investment portfolio and minimize principal risk by earning returns based on current interest rates. Earnings related to marketable debt securities, including any realized gains and losses resulting from the sale of these securities, are classified under interest income, net.

Other non-current assets, net, includes $303 million and $365 million of equity investments as of March 31, 2002 and April 1, 2001, respectively. Equity investments consist of marketable equity securities, which represent equity holdings in publicly traded companies, and other equity holdings, which represent equity holdings in non-publicly traded companies and investments in third-party venture capital funds. Equity investments are contained within our internally-managed venture capital fund. The Company monitors for potential impairment of its equity investments and makes appropriate reductions in carrying values when such impairments are determined to be other-than-temporary. Loss on equity investments, net consists of gains and losses realized on the disposal of equity investments and impairment charges recognized on equity investments.

Net sales and maturities of (purchases of) marketable debt securities consist of the following for the nine months ended (in millions):

	March 31, 2002	April 1, 2001
Purchases of marketable debt securities	$ (11,020)	$ (9,610)
Proceeds from sales and maturities of marketable debt securities	11,380	8,791
	$ 360	$ (819)

Table of Contents

Net purchases of equity investments consist of the following for the nine months ended (in millions):

	March 31, 2002	April 1, 2001
Purchases of equity investments	$ (38)	$ (139)
Proceeds from sales of equity investments	7	43
	$ (31)	$ (96)

Cash paid for interest and income taxes for the nine months ended was (in millions):

	March 31, 2002	April 1, 2001
Interest	$ 113	$ 114
Income taxes	$ 142	$ 385

Supplemental schedule of noncash investing activities for the nine months ended (in millions):

	March 31, 2002	April 1, 2001
Stock and options issued in connection with acquisitions	$ 29	$ 2,029

5. GOODWILL AND OTHER ACQUISITION-RELATED INTANGIBLE ASSETS

Changes in the carrying amount of goodwill for the nine months ended March 31, 2002, are as follows (in millions):

	Computer Systems and Network Storage	Enterprise Services	Other	Total
Balance as of July 1, 2001	$ 2,071	$ 9	$ 46	$ 2,126
Workforce reclassified as goodwill	10	1	1	12
Goodwill acquired during the period	3	39	2	44
Balance as of March 31, 2002	$ 2,084	$ 49	$ 49	$ 2,182

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

March 31, 2002			June 30, 2001		
Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net

Developed technology	$ 308	$ (210)	$ 98	$ 290	$ (169)	$ 121
Customer base	57	(37)	20	57	(19)	38
Other	7	(4)	3	53	(27)	26
	$ 372	$ (251)	$ 121	$ 400	$ (215)	$ 185

Amortization expense of other acquisition-related intangible assets was $24 million and $60 million for the three months and nine months ended March 31, 2002, respectively, and $16 million and $28 million for the three months and nine months ended April 1, 2001, respectively. Amortization expense for fiscal 2002 includes a $6 million charge for impairment of certain intangible assets. This amortization expense is included in Selling, general and administrative.

Estimated amortization expense for the fiscal years ending June 30, is as follows (in millions):

2002	$ 79
2003	68
2004	32
2005	3
	$182

6. EXPIRATION OF THE STRATEGIC DEVELOPMENT AND MARKETING AGREEMENT WITH AOL-TIME WARNER, INC.

Pursuant to the Strategic Development and Marketing Agreement and related agreements (collectively the SDMA) signed in November 1998, as amended, the Sun and AOL-Time Warner (AOL) strategic alliance expired on March 17, 2002. Following such expiration, Sun retained rights equivalent to ownership of intellectual property developed by the strategic alliance, subject to AOL s license rights; Sun retained broad licensing rights to intellectual property that existed prior to formation of the strategic alliance; and Sun retained limited licensing rights to certain third-party intellectual property. Sun has no on-going obligations to AOL under the SDMA.

7. RESTRUCTURING CHARGES

Fiscal 2002 restructuring plan

In response to the continuing global economic slowdown, the Company began implementing a workforce reduction and facility exit plan in the second quarter of fiscal 2002. This restructuring resulted in a charge of $511 million (consisting of a $146 million workforce reduction charge and a $365 million excess facility charge) in the second quarter of fiscal 2002. The goal of the restructuring is to reduce costs and improve operating efficiencies in order to adjust to the current business environment. Specifically, it is the Company s intent under this plan to reduce its headcount by approximately 9% (or 3,400 employees and 500 contractors) and to eliminate excess facility capacity in light of revised facility requirements.

The Company recorded a workforce reduction charge of $146 million related to severance and fringe benefits for terminated employees. The restructuring will result in the termination of approximately 3,400 employees across all employee levels, business functions, operating units, and geographic regions. As of March 31, 2002, approximately 3,250 employees had been terminated as a result of the restructuring. The majority of the remaining identified employees reside outside of the United States, and the timing of their termination is dependent upon the local employment laws that govern such employees. All remaining employees are expected to be terminated by the fourth quarter of fiscal 2002.

In addition, the Company recorded a charge of $365 million related to the consolidation of excess facilities. The facility exit charges include:

$282 million of estimated future obligations for non-cancelable lease payments (net of $80 million of estimated sublease income) or termination fees generated by exiting excess rental facilities. The Company estimated the cost of exiting and terminating the facility leases based on the contractual terms of the agreements and then current real estate market conditions. In addition, the Company intends to sublease certain leased facilities and estimated the sublease income based on then current real estate market conditions or, where applicable, amounts being negotiated;

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

Table of Contents

$17 million for the impairment of property and equipment (primarily leasehold improvements) for which there are insufficient cash flows to support the carrying cost. The property and equipment impairment was determined based on the difference between the assets estimated fair value and their carrying value as of December 30, 2001.

The Company expects to exit the facilities relating to the amounts accrued under the restructuring by no later than December 31, 2002.

During the third quarter of fiscal 2002, the Company reduced its estimate of the total costs associated with the above restructuring activities and recorded an adjustment of $15 million. The adjustment reflects the settlement of one particular lease obligation.

Fiscal 2001 facility exit plan

In the fourth quarter of fiscal 2001, Sun elected to exit certain building leases and building projects. The Company charged approximately $75 million for facility exit costs associated with this decision, of which $46 million was reflected as an accrual as of June 30, 2001. As a result of the continued deterioration of certain commercial real estate markets, Sun reduced its sublease income assumptions and, accordingly, recorded an additional $25 million charge ($14 million and $11 million in the first and third quarters of fiscal 2002, respectively) to reflect this change in estimates. As of March 31, 2002, the revised estimated facility exit cost of $100 million is net of approximately $30 million in estimated sublease income.

The following table sets forth an analysis of the restructuring accrual activity for the nine months ending March 31, 2002 (in millions):

	FY'02 Restructuring Plan		FY'01 Facility Exit Plan	Total
	Severance and Benefits	Facilities-related	Facilities-related	
Balance of accrual as of June 30, 2001	$	$	$ 46	$ 46
Restructuring provision in fiscal 2002:				
Severance and benefits	146			146
Accrued lease costs		282		282
Property and equipment impairment		83		83
Provision adjustments		(15)	25	10
Total restructuring charges in fiscal 2002	146	350	25	521
Cash paid	(116)	(5)	(9)	(130)
Non-cash charges		(83)		(83)
Balance of accrual as of March 31, 2002	$ 30	$ 262	$ 62	$ 354

The remaining cash expenditures relating to workforce reductions and the termination of lease agreements are expected to be paid by the second quarter of fiscal 2003. The current estimates accrued for abandoned leases (net of anticipated sublease proceeds) will be paid over their respective lease terms through fiscal 2018. As of March 31, 2002, $165 million of the $354 million accrual was classified as current and the remaining $189 million was classified as non-current.

The above restructuring charges are based on certain estimates which are subject to change. Changes to the estimates will be reflected as Provision adjustments on the above table in the period the changes in estimates are made.

Table of Contents

8. INCOME TAX RATE

The Company s effective income tax benefit rate was 60.8% and 43.1% for the third quarter and first nine months of fiscal 2002, respectively, as compared with effective income tax expense rates of 45.4% and 39.1% for the corresponding periods of fiscal 2001.

The difference between the Company s current and prior quarter tax rates is primarily due to a change in the Company s estimate in projected statutory credits to be recognized in the current fiscal year.

The primary difference between the Company s current and prior nine-month tax rates can be explained by: (1) the elimination of certain non-recurring, non-deductible accounting charges resulting from the Company s adoption of SFAS No. 142; (2) increased projected statutory credits to be recognized in the current fiscal year; and (3) a reduction in benefits associated with decreased profitability in certain low-tax, non-U.S. jurisdictions.

The Company currently expects the fourth quarter fiscal 2002 tax benefit rate to be 46.0%. This expected rate, based on current tax law and current estimates of earnings, is subject to change.

9. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended		Nine Months Ended	
	March 31, 2002	April 1, 2001	March 31, 2002	April 1, 2001
Net income (loss)	$ (37)	$ 136	$ (648)	$ 1,015
Change in unrealized value of investments, net	(50)	(11)	(56)	(87)
Change in unrealized fair value of foreign exchange hedging contracts	(8)	37	(25)	44
Translation adjustments, net	(18)	23	18	4
	$ (113)	$ 185	$ (711)	$ 976

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

	March 31, 2002	June 30, 2001
Unrealized gains (losses) on investments, net	$ (3)	$ 53
Unrealized gains (losses) on foreign exchange hedging contracts	(10)	15
Cumulative translation adjustments	(79)	(97)
	$ (92)	$ (29)

10. OPERATING SEGMENTS

The following table presents revenues, interdivisional revenues and operating income (loss) for the Company s segments. The Other segment consists of certain operating product groups that did not meet the requirements for a reportable segment, such as Sun s Software Systems Group and iPlanet, and other miscellaneous functions, such as Corporate and Global Sales Operations. It is not unusual for the Company to have minor reorganizations from time-to-time during the year; under such circumstances, the historical information is updated to reflect the changes in business.

Table of Contents

Three Months Ended (in millions)	Computer Systems and Network Storage	Enterprise Services	Other	Total
March 31, 2002				
Revenues	$ 2,157	$ 838	$ 113	$ 3,107
Interdivisional revenues		113	(113)	
Operating income (loss)	360	233	(741)	(148)
April 1, 2001				
Revenues	3,088	833	173	4,095
Interdivisional revenues	1	117	(118)	
Operating income (loss)	$ 728	$ 179	$ (755)	$ 152

Nine Months Ended (in millions)	Computer Systems and Network Storage	Enterprise Services	Other	Total
March 31, 2002				
Revenues	$ 6,176	$ 2,490	$ 410	$ 9,076
Interdivisional revenues		363	(363)	
Operating income (loss)	826	621	(2,756)	(1,309)
April 1, 2001				
Revenues	11,421	2,333	501	14,255
Interdivisional revenues	2	343	(345)	
Operating income (loss)	$ 3,757	$ 473	$ (2,740)	$ 1,490

11. LEGAL PROCEEDINGS

On February 11, 2002, Eastman Kodak Company (Kodak) filed a lawsuit in the US District Court for the Western District of New York, making various patent infringement claims against the Company with respect to aspects of the Company s Java technologies. The lawsuit was subsequently amended and served on the Company on April 3, 2002. The Lawsuit seeks injunctive relief against future infringement, unspecified damages for past infringement together with costs and attorney s fees. Based on discussions over many months with Kodak, the Company believes that this suit is without merit, and, accordingly, will defend itself vigorously. Sun cannot forecast at this time with reasonable certainty the potential costs associated with an adverse outcome of this matter.

On March 8, 2002, Sun filed suit against Microsoft Corporation (Microsoft) in the United States District Court for the Northern District of California pursuant to United States and State of California antitrust laws alleging illegal efforts to acquire, maintain and expand a number of monopolies; illegal tying arrangements; exclusive dealings; copyright infringement; unreasonable restraint of trade; and unfair competition. Sun is seeking remedies that include (1) preliminary injunctions that require Microsoft to distribute Sun s binary implementation of the Java Run-time Environment as part of Windows XP and Internet Explorer and to stop the unlicensed distribution of Microsoft s Virtual Machine for Java in violation of the January 23, 2001 settlement agreement; (2) a permanent injunction to restore competition to the markets in which Microsoft is unlawfully attempting to acquire, maintain and expand a number of monopolies; and (3) compensation for losses suffered by Sun as a result of Microsoft s unlawful actions.

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

This quarterly report, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, particularly statements relating to our expectations as to product demand and products net revenue, our expectations regarding product mix trends, our expectations regarding services net revenue, revenues, results of operations, cash flows and products and services gross margin, our expectations regarding further product cost reductions, our belief that to maintain our competitive position we must continue to invest significant resources in new systems, software and microprocessor development as well as enhancing existing products, our expectations regarding the dollar amount of R&D expenses, and management s long-term objectives to invest 10-11% of our net revenues in R&D, our expectations with regard to selling, general and administrative expenses, our continual focus on efforts to achieve additional operating efficiencies and to review and improve our business processes, our goal with regard to restructuring, our intent to reduce headcount by approximately 9%, statements regarding the timing for termination of the remaining employees to be terminated under our restructuring plan, and expectations about the timing of our exit from certain facilities under our restructuring plan, our intent to sublease certain leased facilities, our expectations regarding the volatility of our marketable debt securities portfolio and interest income, our expected tax benefit rate, our liquidity strategy, our belief that we have sufficient capital to meet our requirements for at least the next twelve months, our expectations regarding the timing of payments to be made related to workforce and facility reductions, our intent to focus on inventory management, our belief that the level of financial reserves is a competitive factor and our belief that the Kodak litigation is without merit, and as set forth in the section entitled Purchased in-process research and development expenses : statements regarding our belief about the realization of expected economic return from acquired in-processed technology and resulting or related products, our expected expense reductions or synergies, our ability to continue making substantial progress in the development and commercialization of acquired technologies, the expected total cost to complete the technologies and the significant assumptions underlying the valuation related to the IPRD.

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

With respect to risks related to purchased in-process research and development, there can be no assurance that any new technologies will be developed into products, that such products will achieve either technological or commercial success, or that we will receive any economic benefit from such products as a result of delays in the development of the technology or release of such products into the market, the complexity of the technology, our ability to successfully manage product introductions, lack of customer acceptance, competition and changes in technological trends, and fluctuations in market or general economic conditions.

Table of Contents

RESULTS OF OPERATIONS

Net revenues
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
Products net revenue	$ 2,269	$ 3,262	(30.4)%	$ 6,586	$ 11,922	(44.8)%
Percentage of total net revenues	73.0%	79.7%		72.6%	83.6%	
Services net revenue	$ 838	$ 833	0.6%	$ 2,490	$ 2,333	6.7%
Percentage of total net revenues	27.0%	20.3%		27.4%	16.4%	
Total net revenues	$ 3,107	$ 4,095	(24.1)%	$ 9,076	$ 14,255	(36.3)%

Products net revenue

Products net revenue consists of revenue generated from the sale of our scalable computer systems and storage products, high-speed microprocessors, and our high-performance software for operating network computing equipment. The decrease in products net revenue in the third quarter as well as in the first nine months of fiscal 2002, as compared with the corresponding periods of fiscal 2001, was caused primarily by weak global macroeconomic conditions and a resulting reduction in information technology (IT) spending.

Over 90% of our products net revenue in the third quarter as well as in the first nine months of both fiscal 2002 and 2001 was generated by Computer Systems and Network Storage. Computer Systems and Network Storage consists primarily of servers, storage and desktop computers. Substantially all of the decrease in products net revenue during the third quarter and the first nine months of fiscal 2002, when compared with the corresponding periods of fiscal 2001, was attributable to a decrease in revenues generated by our server and storage products. Revenues from the sale of desktop systems represented approximately 9% and 14% of products net revenue in the third quarter of fiscal 2002 and 2001, respectively, and 11% and 13% of products net revenue in the first nine months of fiscal 2002 and 2001, respectively. While our product mix fluctuates from quarter to quarter, we expect over the long-term an increasing percentage of products net revenue will be from server and storage products and a decreasing percentage of products net revenue will be from desktop systems.

The weak macroeconomic conditions have caused a significant reduction in IT spending by our customers. We are unable to predict if the current adverse macroeconomic conditions and reduced IT spending levels will continue or further deteriorate. At this time, we expect our products net revenue in the fourth quarter of fiscal 2002 to increase slightly, as compared with the third quarter of fiscal 2002, assuming economic conditions and IT spending levels remain the same. If the macroeconomic conditions and IT spending levels decline further, then we expect our products net revenue in the fourth quarter of fiscal 2002 to be less than products net revenues in the third quarter of fiscal 2002. See Net revenues by geographic area for further discussion and analysis regarding specific regions.

Services net revenue

Services net revenue consists of Support Services, Professional Services and Educational Services. The 0.6% and 6.7% growth in services net revenue in the third quarter and first nine months of fiscal 2002, respectively, as compared with the corresponding periods of fiscal 2001, was due to an increase in revenue from Support Services, partially offset by decreases in revenue from Professional Services and Educational Services. Support Services revenue, which represents over 65% of services net revenue for all periods presented, consists of maintenance contract revenue which is recognized ratably over the contractual period. Support Services revenue growth was primarily a result of a better mix of platinum, gold, silver and bronze service level contracts in our portfolio. On a year-over-year basis, the Professional Services revenue decrease was primarily due to a decline in the installation of new products, while the Educational Services revenue decrease was due

Table of Contents

to a combination of: (1) a reduction in customers discretionary spending; and (2) a decline in new product sales.

Because a significant portion of our services net revenue is generated by contracts related to product sales, our services net revenue could be negatively impacted by the adverse macroeconomic conditions which have been and continue to negatively impact our products net revenue.

Net revenues by geographic area
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
U.S.	$ 1,404	$ 1,639	(14.3)%	$ 4,130	$ 6,776	(39.1)%
Americas Other (Canada and Latin America)	176	229	(23.1)%	474	684	(30.7)%
Americas Total	1,580	1,868	(15.4)%	4,604	7,460	(38.3)%
Percentage of net revenues	50.9%	45.6%		50.7%	52.3%	
EMEA (Europe, Middle East and Africa)	985	1,395	(29.4)%	2,810	4,336	(35.2)%
Percentage of net revenues	31.7%	34.1%		31.0%	30.4%	
APAC (Asia, Australia and New Zealand)	542	832	(34.9)%	1,662	2,459	(32.4)%
Percentage of net revenues	17.4%	20.3%		18.3%	17.3%	
Total net revenues	$ 3,107	$ 4,095	(24.1)%	$ 9,076	$ 14,255	(36.3)%

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
U.S.	$ 1,404	$ 1,639	(14.3)%	$ 4,130	$ 6,776	(39.1)%
Percentage of net revenues	45.2%	40.0%		45.5%	47.5%	
International	$ 1,703	$ 2,456	(30.7)%	$ 4,946	$ 7,479	(33.9)%
Percentage of net revenues	54.8%	60.0%		54.5%	52.5%	
Total net revenues	$ 3,107	$ 4,095	(24.1)%	$ 9,076	$ 14,255	(36.3)%

Late in the second quarter of fiscal 2001, there was an unexpected and significant reduction in capital spending in many industries, which resulted in decreased demand in the U.S. for our products and a decline in our products net revenue. The weak U.S. economic situation evolved into adverse macroeconomic conditions beginning in the fourth quarter of fiscal 2001, resulting in reductions in capital spending in many countries within the international regions in which we do significant business and negatively impacting our non-U.S. product net revenues. These adverse macroeconomic conditions have continued throughout the third quarter of fiscal 2002, resulting in a 14.3% and 39.1% decrease in U.S. net revenues, and a 30.7% and 33.9% decrease in international net revenues in the third quarter and first nine months of fiscal year 2002, respectively, as compared with the corresponding periods of fiscal 2001.

Within the EMEA region, net revenues decreased by 29.4% and 35.2% (primarily because of decreases in revenue in the United Kingdom, Northern Europe and Germany) during the third quarter and the first nine months of fiscal 2002, respectively, as compared with the corresponding periods of fiscal 2001. Northern Europe is comprised primarily of the Scandinavian countries, the Netherlands, Belgium/Luxembourg, Eastern European countries and Russia. Within the APAC region, net revenues decreased by 34.9% and 32.4% (primarily because of decreases in revenue in Japan, Greater China and Korea) during the third quarter and the first nine months of fiscal 2002, respectively, as compared with the corresponding periods of fiscal 2001. Decreases in net revenues in the United Kingdom, Northern Europe, Germany, Japan, Greater China and Korea collectively accounted for approximately 70% of the total decrease in international net revenues for the third quarter and the first nine months of fiscal 2002, respectively, as compared with the corresponding periods of fiscal 2001.

If the adverse macroeconomic conditions persist, our revenues, and potentially our results of operations and cash flows, will continue to be adversely affected.

Gross margin
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
Products gross margin	$ 963	$ 1,398	(31.1)%	$ 2,556	$ 5,752	(55.6)%
Percentage of products net revenue	42.4%	42.9%		38.8%	48.3%	
Services gross margin	$ 344	$ 294	17.0%	$ 946	$ 814	16.2%
Percentage of services net revenue	41.1%	35.3%		38.0%	34.9%	
Total gross margin	$ 1,307	$ 1,692	(22.8)%	$ 3,502	$ 6,566	(46.7)%
Percentage of net revenues	42.1%	41.3%		38.6%	46.1%	

Products gross margin

In the third quarter of fiscal 2002, products gross margin decreased by 0.5 percentage point, as compared with the corresponding period of fiscal 2001. The 0.5 percentage point decline in products gross margin was primarily a result of reductions in product pricing (normal price list reductions and competitive transaction pricing), which were substantially offset by decreases in product costs (lower vendor product component costs and lower product quality costs).

In the first nine months of fiscal 2002, products gross margin decreased by 9.5 percentage points, as compared with the corresponding period of fiscal 2001. Substantially all of the 9.5 percentage point decline in products gross margin in the first nine months of fiscal 2002, as compared with the corresponding period of fiscal 2001, was due to: (1) reductions in product pricing (normal price list reductions and competitive transaction pricing); (2) increased product platform transition costs associated with the migration from UltraSPARC® II to UltraSPARC III; and (3) lower volumes of products manufactured. These impacts were exacerbated by a period of rapid decline in products net revenue.

Our products gross margin increased to 42.4% for the three months ended March 31, 2002, from 36.4% for the three months ended December 30, 2001. The majority of the sequential 6.0 percentage point increase in our products gross margin was attributable to: (1) lower product platform transition costs in the third quarter of fiscal 2002, as compared with the second quarter of fiscal 2002; and (2) the reductions we made to our fixed manufacturing costs to adjust to our current product volumes. We expect products gross margin in the fourth quarter of fiscal 2002 to be in the range of the fiscal 2002 third quarter products gross margin. Should the global macroeconomic conditions remain unfavorable, or the pricing pressures associated with competition continue, products gross margin could be adversely impacted.

Services gross margin

The 5.8 and 3.1 percentage point increases in services gross margin in the third quarter and the first nine months of fiscal 2002, respectively, as compared with the corresponding periods of fiscal 2001, reflect the impact of: (1) variable costs decreasing as a result of discretionary spending controls; (2) infrastructure headcount-related costs decreasing due to the restructuring in the second quarter of fiscal 2002; and (3) support services revenue increasing as a percentage of total services net revenue (support services typically generates a higher gross margin than professional services or educational services). The impact of these favorable items on services gross margin in the third quarter and the first nine months of fiscal 2002, as compared with the

Table of Contents

corresponding periods of fiscal 2001, was partially offset by: (1) increased fixed infrastructure costs; and (2) increased third party costs necessary to support global customer service expectations.

Our services gross margin increased to 41.1% for the three months ended March 31, 2002, from 37.3% for the three months ended December 30, 2001. The sequential 3.8 percentage point increase in the services gross margin rate was principally due to lower overall costs generated by the workforce reduction and other actions taken to reduce services infrastructure. We expect our services gross margin to remain in the low- to mid-40% range in the fourth quarter of fiscal 2002.

Operating expenses
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
Research and development	$ 468	$ 486	(3.7)%	$ 1,369	$ 1,473	(7.1)%
Percentage of net revenues	15.1%	11.9%		15.1%	10.3%	
Selling, general and administrative	$ 991	$ 948	4.5%	$ 2,918	$ 3,371	(13.4)%
Percentage of net revenues	31.9%	23.2%		32.2%	23.7%	
Restructuring charges	$ (4)	$	N/M	$ 521	$	N/M
Percentage of net revenues	(0.1)%	%		5.7%	%	
Goodwill amortization	$	$ 105	N/M	$	$ 160	N/M
Percentage of net revenues	%	2.6%		%	1.1%	
Purchased in-process research and development	$	$ 1	N/M	$ 3	$ 72	(95.8)%
Percentage of net revenues	%	%		%	0.5%	

Research and development expenses

R&D expenses, as a percentage of total net revenues, increased to 15.1% in the third quarter and the first nine months of fiscal 2002, respectively, from 11.9% and 10.3% in the corresponding periods of fiscal 2001. The increases in the percentage of R&D expenses to total net revenues are the result of a decrease in revenues in the third quarter and first nine months of fiscal 2002, as compared with the corresponding periods of fiscal 2001. In dollars, R&D expenses decreased by 3.7% to $468 million in the third quarter of fiscal 2002, as compared with $486 million for the corresponding period of fiscal 2001, and by 7.1% to $1,369 million in the first nine months of fiscal 2002, as compared with $1,473 million for the corresponding period of fiscal 2001.

In dollars, the decrease in R&D expenses for the third quarter of fiscal 2002, as compared with the corresponding period of fiscal 2001, was a result of: (1) significant cost cutting measures in the areas of consulting, travel and other types of discretionary spending; and (2) lower costs incurred for pre-customer release units (prototypes) developed during the early phases of product development. These reductions in expenses were partially offset by: (1) higher variable compensation; and (2) higher depreciation costs.

In dollars, the decrease in R&D expenses for the first nine months of fiscal 2002, as compared with the corresponding period of fiscal 2001, was a result of: (1) significant cost cutting measures in the areas of consulting, travel and other types of discretionary spending; (2) lower costs incurred for prototype development; (3) a reduction in incentive compensation costs; and (4) a decrease in compensation costs as a result of our mandatory shutdown in July 2001. These reductions were partially offset by higher depreciation costs. In general, fluctuations in R&D expenses will occur depending on the timing of product introductions, among other factors.

Our R&D spending reflects our continued development of a broad line of scalable and reliable systems, including servers, desktop systems, storage technologies and SPARC® microprocessors, as well as software

Table of Contents

products that utilize the Java platform, Solaris Operating Environment and Jini network technology. 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. We expect that the dollar amount of R&D expenses for the fourth quarter of fiscal 2002 will be in the same range as the amount of R&D expenses incurred during the third quarter of fiscal 2002. It is management s long-term objective to invest 10 11% of our net revenues in R&D.

Selling, general and administrative expenses

SG&A expenses, as a percentage of total net revenues, increased to 31.9% and 32.2% in the third quarter and first nine months of fiscal 2002, respectively, from 23.2% and 23.7% in the corresponding periods of fiscal 2001. The increases in the percentage of SG&A expenses to total net revenues are the result of a decrease in revenues in the third quarter and first nine months of fiscal 2002, as compared with the corresponding periods of fiscal 2001.

In dollars, SG&A expenses increased by $43 million to $991 million in the third quarter of fiscal 2002, as compared with $948 million in the third quarter of fiscal 2001, due to higher variable compensation costs, partially offset by: (1) cost cutting measures in the areas of travel, advertising, marketing, facilities and other types of discretionary spending; and (2) lower headcount-related costs as a result of our restructuring in the second quarter of fiscal 2002.

In dollars, SG&A expenses decreased by $453 million to $2,918 million in the first nine months of fiscal 2002, as compared with $3,371 million in the corresponding period of fiscal 2001, as a result of: (1) significant cost cutting measures in the areas of travel, advertising, marketing, facilities and other types of discretionary spending; (2) lower headcount-related costs as a result of our restructuring in the second quarter of fiscal 2002; and (3) a decrease in compensation costs during the first quarter of fiscal 2002 (as a result of our mandatory shutdown in July 2001).

We are continuing to focus our efforts on achieving additional future operating efficiencies by reviewing and improving upon existing business processes and evaluating our cost structure. Our company performance-based compensation incentives costs could increase or decrease during the fourth quarter of fiscal 2002, as compared with the third quarter of fiscal 2002, depending on our ability to achieve certain financial goals. If we are able to achieve our financial goals for the fourth quarter of fiscal 2002, we would expect SG&A expenses to increase slightly, as compared with the SG&A expenses we recognized in the third quarter of fiscal 2002.

Restructuring charges

The following discussion should be read in connection with Note 7, Restructuring Charges in the Notes to Condensed Consolidated Financial Statements (Unaudited). Also, for the impact of the restructuring on our future cash flows, see discussion under Liquidity and Capital Resources.

In the fourth quarter of fiscal 2001, Sun elected to exit certain building leases and building projects and charged approximately $75 million for facility exit costs associated with this decision. As a result of the continued deterioration of certain commercial real estate markets, we reduced our sublease income assumptions and, accordingly, recorded an additional $25 million charge ($14 million and $11 million in the first and third quarters of fiscal 2002, respectively) to reflect this change in estimates. As of March 31, 2002, the revised estimated facility exit cost of $100 million is net of approximately $30 million in estimated sublease income.

In the second quarter of fiscal 2002, we began implementing a workforce reduction and facility exit plan in response to the continuing global economic slowdown. This restructuring resulted in a charge of $511 million (consisting of a $146 million workforce reduction charge and a $365 million excess facility charge). The goal

Table of Contents

of the restructuring is to reduce costs and improve operating efficiencies in order to adjust to the current business environment. Specifically, it is our intent under the plan to reduce headcount by approximately 9% (or 3,400 employees and 500 contractors) and to eliminate excess facility capacity in light of revised facility requirements. During the third quarter of fiscal 2002, we reduced our estimate of the total costs of $511 million associated with this restructuring activity and recorded an adjustment of $15 million. The amount reflects the settlement for one particular lease obligation.

The following discussion relates to the restructuring activities implemented in the second quarter of fiscal 2002.

Worldwide workforce reduction

We recorded a workforce reduction charge of $146 million related to severance and fringe benefits for terminated employees. The restructuring will result in the termination of approximately 3,400 employees across all employee levels, business functions, operating units, and geographic regions. As of March 31, 2002, approximately 3,250 employees had been terminated as a result of the restructuring. We anticipate that the remaining identified employees will be terminated during the fourth quarter of fiscal 2002, depending on the local employment laws that govern such employees.

Consolidation of excess facilities

We recorded a charge of $365 million related to the consolidation of excess facilities. The facility exit charges include:

- $282 million of estimated future obligations for non-cancelable lease payments (net of $80 million of estimated sublease income) or termination fees generated by exiting excess rental facilities. The Company estimated the cost of exiting and terminating the facility leases based on the contractual terms of the agreements and then current real estate market conditions. In addition, the Company intends to sublease certain leased facilities and estimated the sublease income based on then current real estate market conditions or, where applicable, amounts being negotiated;

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

- $17 million for the impairment of property and equipment (primarily leasehold improvements) for which there are insufficient cash flows to support the carrying cost. The property and equipment impairment was determined based on the difference between the assets estimated fair value and their carrying value as of December 30, 2001.

The Company expects to exit the facilities relating to the amounts accrued under the restructuring by no later than December 31, 2002.

Goodwill amortization

On July 1, 2001, we early-adopted SFAS 142. In accordance with SFAS 142, goodwill is no longer amortized. There was no impairment of goodwill upon adoption of SFAS 142. We are required to perform goodwill impairment tests on an annual basis, and on an interim basis in certain circumstances. There can be no assurance that future goodwill impairments tests will not result in a charge to earnings. See Note 2, Summary of Significant Accounting Policies in the Notes to Condensed Consolidated Financial Statements (Unaudited) for further discussion. The $105 million and $160 million goodwill amortization for the third quarter and first nine months of fiscal 2001, respectively, was primarily attributable to the acquisitions of Cobalt Networks, Inc.

Table of Contents

(acquired in December 2000), Star Division Corporation and certain assets of Star Division Software Entwicklung und Vertriebs GmbH, and MAXSTRAT Corporation.

Purchased in-process research and development expenses

Overview

In the first nine months of fiscal 2002, we acquired Isopia, Inc. (Isopia). Purchased in-process research and development expenses (IPRD) of $3.2 million in the first quarter of fiscal 2002 represented the write-off of in-process technologies associated with Isopia. There was no purchased IPRD in the second and third quarter of fiscal 2002. During fiscal 2001, there was no purchased IPRD in the first quarter, $71 million in the second quarter, and $1 million in the third quarter. At the date of the Isopia acquisition, the projects associated with the IPRD efforts had not yet reached technological feasibility and the IPRD had no alternative future uses. Accordingly, the amount was expensed on the acquisition date.

Valuation of IPRD

We used independent third-party sources to calculate the amounts allocated to IPRD. In calculating IPRD, the independent third party used established valuation techniques accepted in the high-technology industry. These calculations gave consideration to relevant market sizes and growth factors, expected industry trends, the anticipated nature and timing of new product introductions by us and our competitors, individual product sales cycles, and the estimated lives of each of the product s underlying technology. The value of the IPRD reflects the relative value and contribution of the acquired research and development. In determining the value assigned to IPRD, we considered the R&D s stage of completion, the complexity of the work completed to date, the difficulty of completing the remaining development, costs already incurred, and the projected cost to complete the project.

The values assigned to developed technologies related to each acquisition were based upon discounted cash flows related to the existing products projected income stream. Elements of the projected income stream included revenues, cost of sales (COS), SG&A expenses, and R&D expenses. The discount rates used in the present value calculations were generally derived from a weighted average cost of capital, adjusted upward to reflect the additional risks inherent in the development life cycle, including the useful life of the technology, profitability levels of the technology, and the uncertainty of technology advances that are known at the date of each acquisition. Because each acquired entity s IPRD is unique, the discount rate, revenue, COS, R&D and SG&A assumptions used varied on a case-by-case basis. We did not expect to achieve a material amount of expense reductions or synergies, therefore the valuation assumptions did not include significant anticipated cost savings.

Valuation assumptions

The following table summarizes the significant assumptions underlying the valuation related to the IPRD for the nine months ended March 31, 2002 (dollars in millions):

					Percentage of Revenue			
Acquired Company	IPRD	Estimated Cost to Complete Technology at Time of Acquisition	Percentage Complete at Time of Acquisition	Average Revenue Growth Rate	Average COS	Average SG&A	Average R&D	Discount Rate Used
Isopia, Inc.	$3.2	$0.6	45%	58%	13%	35%	2%	26%

22

Table of Contents

Overview of significant purchased IPRD in the nine months ended March 31, 2002

Included below are further details regarding the nature of the purchased technology acquired during the nine months ended March 31, 2002.

Given the uncertainties of the commercialization process, we cannot assure you that deviations from our estimates will not occur. We believe there is a reasonable chance of realizing the economic return expected from the acquired in-process technology. However, there is risk associated with the realization of benefits related to commercialization of an in-process project due to rapidly changing customer needs, complexity of technology and growing competitive pressures. Therefore, we cannot assure you that any project will meet with commercial success. Failure to successfully commercialize an in-process project would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of our intangible assets acquired may become impaired.

At the acquisition date, Isopia was engaged in development activity associated with LearnTone , a web-based training content delivery technology. As of the acquisition date, this technology was still under development and substantial efforts needed to be completed prior to the release of a commercially viable product. We completed the development of this technology in the third quarter of fiscal 2002, and the total cost at completion was not materially different from the estimated total costs as of the acquisition date.

Overall status of business combinations prior to fiscal 2002

With respect to acquisitions completed prior to fiscal 2002, we believe that the projections we used in performing our valuations for each acquisition are still valid in all material respects; however, we cannot assure you that the projected results will be achieved. We continue to make substantial progress related to the development and commercialization of acquired technologies. Although we have experienced delays in the completion of certain of our development efforts and their related commercialization, the expected total costs to complete such technologies have not materially increased, individually or in the aggregate. We periodically evaluate our product development timeline and modify our overall business plan in response to various factors. Modifications to our business plan include the reallocation of resources among various alternative development projects. The impact of delays in the realization of economic benefits related to acquired technologies, individually or in the aggregate, has not been material to our overall consolidated financial position or results of operations as of and for the quarter ended March 31, 2002.

Loss on equity investments
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31,2002	April 1, 2001	Change
Loss on equity investments, net	$ (23)	$ (13)	76.9%	$ (81)	$ (12)	N/M
Percentage of net revenues	(0.7)%	(0.3)%		(0.9)%	0.1%	

Our equity investments portfolio, which primarily consists of publicly traded and non-publicly traded technology companies contained within our internally-managed venture capital fund, was negatively impacted by the decline in The Nasdaq National Market and the adverse macroeconomic conditions of the technology sector during the third quarter and first nine months of fiscal 2002, as compared with the corresponding periods of fiscal 2001. The loss on equity investments in the third quarter and first nine months of fiscal 2002 included impairment losses on minority equity investments in publicly and privately traded companies of $22 million and $74 million, respectively.

Our decision to sell equity investments in the future will depend upon numerous factors, including economic and strategic factors, many of which are not predictable nor within our control.

Table of Contents

Interest income, net
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
Interest income, net	$ 77	$ 110	(30.0)%	$ 252	$ 276	(8.7)%
Percentage of net revenues	2.5%	2.7%		2.8%	1.9%	

The decline in interest income (net of interest expense) in the third quarter and the first nine months of fiscal 2002, as compared with the corresponding periods of fiscal 2001, is primarily due to a combination of lower interest rates and lower cash and marketable debt securities balances, substantially offset by a $38 million and $105 million gain realized on the sale of certain fixed income marketable debt securities during the third quarter and the first nine months of fiscal 2002, respectively.

The average duration of our portfolio of marketable debt securities decreased to 1.24 years as of March 31, 2002 from 1.49 years as of April 1, 2001. In general, we would expect that the volatility of this portfolio would decrease as its duration decreases. Our interest income and expenses 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. To mitigate the impact of fluctuations in U.S. interest rates on 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.

We expect our interest income, net in the fourth quarter of fiscal 2002 will be lower than our interest income, net earned in the third quarter of fiscal 2002, primarily due to lower gains on sales of marketable debt securities.

Income taxes
(dollars in millions)

	Three Months Ended			Nine Months Ended		
	March 31, 2002	April 1, 2001	Change	March 31, 2002	April 1, 2001	Change
Provision (benefit) for income taxes	$ (57)	$ 113	(150.4)%	$ (490)	$ 685	(171.5)%
Percentage of income (loss) before taxes and cumulative effect of change in accounting principle	60.8%	45.4%		43.1%	39.1%	

Our effective income tax benefit rate was 60.8% and 43.1% for the third quarter and first nine months of fiscal 2002, respectively, as compared with effective income tax expense rates of 45.4% and 39.1% for the corresponding periods of fiscal 2001.

The difference between our current and prior quarter tax rates is primarily due to a change in our estimate of projected statutory credits to be recognized in the current fiscal year.

The primary difference between our current and prior nine-month tax rates can be explained by: (1) the elimination of certain non-recurring, non-deductible accounting charges resulting from our adoption of SFAS No. 142; (2) increased projected statutory credits to be recognized in the current fiscal year; and (3) a reduction in benefits associated with decreased profitability in certain low-tax, non-U.S. jurisdictions.

We currently expect the fourth quarter fiscal 2002 tax benefit rate to be 46.0%. Our expected rate, based on current tax law and current estimates of earnings, is subject to change.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES
(dollars in millions)

	March 31, 2002	June 30, 2001	Change
Cash and cash equivalents	$ 1,672	$ 1,472	$ 200
Marketable debt securities	4,276	4,699	(423)
Total cash, cash equivalents and marketable debt securities	$ 5,948	$ 6,171	$ (223)
Percentage of total assets	35.2%	33.9%	3.8%
Days sales outstanding (DSO)	70	67	(4.5)%
Inventory turns	10.6	12.5	(15.2)%

	Nine Months Ended		
	March 31, 2002	April 1, 2001	Change
Cash provided by operating activities	$ 703	$ 2,023	$ (1,320)
Cash used in investing activities	(248)	(2,044)	1,796
Cash used in financing activities	(255)	(541)	286
Net increase (decrease) in cash and cash equivalents	$ 200	$ (562)	$ 762

Our long-term strategy is to maintain the minimum amount of liquidity necessary in subsidiaries for operational purposes, and to invest the remaining amount of our cash in highly liquid cash equivalents and marketable debt securities. Accordingly, in addition to the $1,672 million in cash and cash equivalents we currently have for shorter-term requirements, we have approximately $4,276 million in marketable debt securities that are available for future operating, financing and investing activities, for a total liquidity position of $5,948 million.

We have a $500 million revolving credit facility (Facility) with a syndicate of commercial banks. No amounts were outstanding under the Facility as of March 31, 2002. The Facility is available subject to compliance with certain covenants and expires August 2002. If we failed to be in compliance with these covenants, the banks would have no obligation to lend us any money under this credit facility. Sun was in compliance with the financial covenants as of March 31, 2002.

In addition, Sun and its subsidiaries had uncommitted lines of credit aggregating approximately $552 million. No amounts were drawn from these lines of credit as of March 31, 2002. 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.

Our future cash obligations consist primarily of our current liabilities and our long-term debt. Our current liabilities include approximately $165 million related to the restructuring charges expected to be paid in the next twelve months. Also, we have $1.5 billion in unsecured debt securities (the Senior Notes) that are due at various times between August 2002 and August 2009 ($200 million is due on August 15, 2002 and bears interest at 7%). The Senior Notes are subject to compliance with certain covenants. As of March 31, 2002, Sun was in material compliance with the covenants. If we failed to be in compliance with these covenants, the Trustee or Holders of not less than 25% in principal amount of the Senior Notes would have the ability to demand immediate payment of all amounts outstanding.

The remaining non-current obligations totaling $873 million as of March 31, 2002 ($884 million as of April 1, 2001) consist primarily of deferred tax liabilities, deferred revenue and amounts to be paid in excess of one year on abandoned leases. As of March 31, 2002, we expect to pay $189 million of the facility restructuring accrual over the respective facility lease terms through fiscal 2018. The facility accrual includes estimates such as expected sublease income or termination fees; actual results may materially differ from our current estimates, resulting in a change in our expected cash flow requirements. See Note 7, Restructuring Charges in the Notes to the Condensed Consolidated Financial Statements (Unaudited) for further discussion. None of these non-

Table of Contents

current obligations have covenants or other requirements which could accelerate Sun s obligation to pay these amounts.

We believe that the liquidity provided by existing cash, cash equivalents, marketable debt securities, our borrowing arrangements described above 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 through debt or equity financing to strengthen our financial position, facilitate growth, and provide us with additional flexibility to take advantage of business opportunities that may arise.

Changes in Cash Flow

During the nine months ended March 31, 2002, cash, cash equivalents and marketable debt securities decreased by $223 million ($200 million increase in cash and cash equivalents and $423 million decrease in marketable debt securities). This decrease is primarily attributable to the $245 million we spent on our equity activities ($366 million spent to purchase our common stock in the open market, less $121 million received as consideration for the issuance of Sun s common stock under our stock option and employee stock purchase plans). In addition, we spent approximately $461 million for real estate development and equipment additions to support product development and infrastructure initiatives. This amount was offset by our positive cash flow from operating activities of $703 million.

Cash flows provided by operating activities were generated primarily from net income (as adjusted by noncash items) and decreases in accounts receivable (net), inventory, as well as other assets; these cash influxes were partially offset by decreases in accounts payable and other liabilities. Accounts receivable (net) decreased to $2,407 million at March 31, 2002 from $2,955 million at June 30, 2001. The decrease in accounts receivable (net) was primarily due to the lower volume of sales, partially offset by an increase in days of sales outstanding (DSO). The increase in DSO was primarily attributable to earning revenue later in the quarter, as well as the timing of customer payments. Inventory decreased to $554 million at March 31, 2002 from $1,049 million at June 30, 2001. While we were successful in decreasing inventory during the first nine months of fiscal 2002, inventory turns slightly declined. The decrease in inventory turns was a reflection of increased inventory for new product releases and lower shipment volumes, and was impacted further by the decrease in demand for our products due to adverse macroeconomic conditions. Inventory management will continue to be an area of focus as we balance the need to maintain strategic inventory levels to help ensure competitive lead times with the risk of inventory obsolescence because of rapidly changing technology and customer requirements. The accounts payable and other liabilities decrease of $1,047 million in the first nine months of fiscal 2002 as compared with June 30, 2001 is primarily due to the reduction in inventory levels and operating expenses. In addition, we reduced our other liabilities by $116 million in severance and benefits payments and $14 million in facilities-related payments in connection with our restructuring.

RISK FACTORS

If we are unable to compete effectively with existing or new competitors, our resulting loss of 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 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 a decrease in the prices of our products and services, fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability, or loss of market share. These competitive pressures could adversely affect our business and operating results.

Table of Contents

Our competitors are some of the largest, most successful companies in the world. They include International Business Machines Corporation (IBM), Hewlett-Packard Company (HP), Compaq Computer Corporation (Compaq), and EMC Corporation (EMC). Our future competitive performance depends on a number of factors, including our ability to: continually develop and introduce new products and services with better prices and performance than those offered by our competitors; offer a wide range of products and solutions from small single processor systems to large complex enterprise level systems; offer solutions to customers that operate effectively within a computing environment that includes hardware and software from multiple vendors; offer products that are reliable and that ensure the security of data and information; create products for which third party software vendors will develop a wide range of applications; and offer high quality products and services. Two of our competitors, HP and Compaq, have merged, creating an entity that is significantly larger than Sun. To the extent that they are successful in integrating their businesses, the combined company could have greater access to resources, and our business and operating results could be adversely affected by the increased competitive pressures.

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 Computer Corporation (Dell), the combined HP and Compaq company, in addition to Intel and Microsoft.

This competition creates increased pressure, including pricing pressure, on our products . We expect this competitive pressure to continue through calendar year-end, due to continued new product introductions and aggressive marketing programs from our competitors.

The computer systems that we sell are made up of many products and components, including workstations, servers, storage products, microprocessors, the Solaris Operating Environment and other software products. In addition, we sell some of these components separately and as add-ons to installed systems. If we are unable to offer products and services that compete successfully with the products and services offered by our competitors or that meet the complex needs of our customers, our business and operating results could be adversely affected. In addition, if in responding to competitive pressures, we are forced to lower the prices of our products or services and we are unable to reduce our component costs or improve operating efficiencies, our business and operating results would be adversely affected.

Over the last several years, we have invested significantly in our storage products business with a view to increasing the sales of these products both on a standalone 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 the leader in this market. To the extent we are unable to penetrate this market and compete effectively, our business and operating results could be adversely affected.

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

We operate in a highly competitive, quickly changing environment, and our future success depends on our ability to develop and introduce new products that our customers choose to buy. If we are unable to develop new products, our business and operating results could be adversely affected. We must quickly develop, introduce, and deliver in quantity new, complex systems, software, and hardware products and components. These include products which incorporate our new UltraSPARC III architecture and the Solaris Operating Environment which we will continue to deploy during fiscal 2002, and other products. The development process for these complicated products is very uncertain. It requires high levels of innovation from both our product designers and the suppliers of the components used in our products. The development process is also lengthy and costly. If we fail to accurately anticipate our customers needs and technological trends, or are otherwise unable to complete the development of a product on a timely basis, we will be unable to introduce new products into the market on a timely basis, if at all, and our business and operating results would be adversely affected.

Software and hardware products such as ours may contain known as well as undetected errors, and these defects may be found following introduction and shipment of new products or enhancements to existing products. Although we attempt to fix errors that we believe would be considered critical by our customers prior to shipment, we may not be able to detect or fix all such errors, and this could result in lost revenues and delays in customer acceptance, and could be detrimental to our business and reputation.

The manufacture and introduction of our new hardware and software 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 high enough volumes so that we can have an adequate supply of new products to meet customer demand. We must be able to manufacture the new products at acceptable costs. This requires us to be able to accurately forecast customer demand so that we can procure the appropriate components at optimal costs. Forecasting demand requires us to predict order volumes, the correct mixes of our software and hardware products, and the correct configurations of these products. We must manage new product introductions, like the continued deployments of systems which incorporate our new UltraSPARC III architecture during fiscal 2002, 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, we may decide to adjust prices of our existing products during this process to try to increase customer demand for these products. If we are introducing new products at the same time or shortly after the price adjustment, this will complicate our ability to anticipate customer demand for our new products. We continuously evaluate the competitiveness of our product and service offerings. These evaluations could also result in repricing actions in the near term. Our future operating results would be adversely affected if such repricing actions 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 volumes.

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

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

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we depend on Texas Instruments for our SPARC microprocessors and on Sony for various monitors. If we were unable to purchase the necessary parts and components from a particular vendor and we had to find a new supplier for such parts and components, our new and existing product shipments could be delayed, adversely affecting our business and operating results.

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

We depend heavily on our suppliers to timely design, manufacture, and deliver the necessary components for our products. While many of the components we purchase are standard, we do purchase some components, specifically color monitors and custom memory integrated circuits such as static random access memories (SRAMS) and video random access memories (VRAMS), 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

Table of Contents

components (specifically, dynamic random access memories (DRAMS) and SRAMS). If a component delivery from a supplier is delayed, if we experience a shortage in one or more components, or if we are unable to provide for adequate levels of component inventory, our new and existing product shipments could be delayed and our business and operating results could be adversely affected.

Since we order our components (and in some cases commit to purchase) from suppliers in advance of receipt of customer orders for our products which include these components, we face a substantial inventory risk.

As part of our component inventory planning, we frequently pay certain suppliers well in advance of receipt of customer orders. For example, we often enter into noncancelable purchase commitments 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 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 the orders are based on the forecasts of customer orders rather than actual orders. If we cannot change or be released from the noncancelable purchase commitments, we could incur significant costs from the purchase of unusable components, due to a delay in the production of the components or as a result of inaccurately predicting component orders in advance of customer orders. Our business and operating results could be adversely affected as a result of these increased costs.

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

Generally, the computer systems we sell to customers incorporate hardware and software products that we sell, such as UltraSPARC microprocessors, the Solaris Operating Environment and Sun StorEdge storage products. Any delay in the development of the software and hardware 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. For example, delays in software development could delay shipments of related new hardware products.

In addition, if customers decided to delay the adoption and implementation of new releases of our Solaris Operating Environment this could also delay customer acceptance of new hardware products tied to that release. Adopting 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 adversely affect our business.

If we are unable to continue generating substantial revenues from international sales our business could be adversely affected.

Currently, more than half of our revenues come from international sales. Our ability to sell our products internationally is subject to a number of risks. General economic and political conditions in each country could adversely affect demand for our products and services in these markets. Currency exchange rate fluctuations could result in lower demand for our products, as well as currency translation losses. 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.

Table of Contents

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

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

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

Business Practices, Processes and Information Systems. In order to increase efficiencies and remain competitive in a rapidly changing industry, we are continually improving and changing our business practices, processes and information systems. In this regard, during the first month of fiscal 2003, we plan to upgrade our business practices and related information systems affecting order entry, order fulfillment and accounts receivable (the Upgrade). The timing and duration of the implementation of the Upgrade are subject to a number of risks due to the complexity of the conversion process. This includes verifying the accuracy of the business data and information prior to conversion, the actual conversion of that data and information to the new system and then using that business data and information in the new system after the conversion. In addition, because the Upgrade is enterprise-wide, there is a need for substantial and comprehensive enterprise-wide employee training. While testing of these new systems and processes and training of employees are done in advance of implementation, there are inherent limitations in our ability to simulate a full-scale operating environment in advance of implementation. Moreover, the implementation will require Sun to be without automated order entry, order fulfillment and accounts receivable capabilities for a period of time as the company shifts to the new systems. There can be no assurance that this interruption in the use and availability of enterprise-wide information systems will not have an adverse effect on our business and operating results. Finally, to the extent that we encounter problems after introduction of these new systems and practices that prevent or limit their full utilization, our operating results could be adversely affected.

Significant Customers and Industries. Sales to a single customer (General Electric Company (GE)) accounted for approximately 13%, 19% and 15% of our fiscal 2001, 2000 and 1999 net revenues, respectively. The major customer revenues in fiscal 2001, 2000 and 1999 were primarily generated by two GE subsidiaries: (1) MRA Systems, Inc., a reseller (10%, 16% and 14% of net revenues in 2001, 2000 and 1999, respectively), acquired by GE in fiscal 1999; and (2) GE Capital, a finance/leasing company (2%, 3% and 1% of net revenues in fiscal 2001, 2000 and 1999, respectively). Revenue is generated with the finance/leasing company whenever our customer elects to lease equipment; in such cases, we sell the equipment to the leasing company. Our business could be adversely affected if GE or any other significant customer terminated its business relationship with us or significantly reduced the amount of business it did with us.

Acquisitions/Alliances. If, in the future, we acquire technologies, products, or businesses, or we form alliances with companies requiring technology investments or revenue commitments we will face a number of risks to our business. The risks we may encounter include those associated with integrating or co-managing operations, personnel, and technologies acquired or licensed, and the potential for unknown liabilities of the acquired or combined business. Also, we early adopted the new Statement of Financial Accounting Standards No. 142 (SFAS 142) Goodwill and Other Intangible Assets, as of July 1, 2001. Accordingly, our goodwill and other intangible assets that have an indefinite useful life are no longer amortized but instead reviewed at least annually for impairment. If we do not meet our long-term forecasts, we could be required to record impairment charges related to goodwill and other intangible assets, which could adversely affect our financial results. In addition, our business and operating results could be adversely affected if our acquisition or alliance activities are not successful.

Adverse Business Conditions in Specific Industries. We depend on the telecommunications, financial services and manufacturing industries for a significant portion of our revenues. Significant reduction in technology capital spending in these industries caused by adverse economic conditions, such as we experienced over the last two quarters of fiscal 2001 and the first three quarters of fiscal 2002, may continue to result in decreased revenues and earnings. Our revenues are dependent on the level of technology capital spending in the United States and international economies. A number of companies recently filed for bankruptcy protection, and others announced significant reductions and deferrals in capital spending. If capital spending continues to decline in these industries over an extended period of time, our business will continue to be adversely affected.

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 investment alliances. For example, we have purchased several companies in the past and have also formed alliances, such as our recently announced alliance with Hitachi for the collaboration on, and delivery of, a broad range of storage products and services. Acquisitions and alliance activities often involve risks, including: difficulty in assimilating the acquired operations and employees; difficulty in managing product codevelopment activities with our alliance partners; retaining the key employees of the acquired operation; disruption of our ongoing business; inability to successfully integrate the acquired technology and operations into our business and maintain uniform standards, controls, policies, and procedures; and lacking the experience to enter into new product or technology markets.

Failure to manage these alliance activities effectively and to integrate entities or assets that we acquire could adversely affect our operating results or financial condition.

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. The on-going decrease in IT spending and resulting decrease in revenues has put pressure on high technology companies to retain highly qualified technical personnel. We may not be able to attract, assimilate, or retain highly qualified technical employees in the future. These factors could adversely affect our business.

Business interruptions could adversely affect our business.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters and other critical business operations, is located near major earthquake faults. In addition, many 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. Our facilities in the State of California, including our corporate headquarters and other critical business operations, may be subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts occur, they could disrupt the operations of our affected facilities. In addition, we do not carry business interruption insurance or carry financial reserves against business interruptions arising from earthquakes and certain electrical blackouts. If a business interruption occurs, our business could be adversely affected.

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

From time to time, we make equity investments for the promotion of business and strategic objectives in publicly traded and non-publicly traded companies. The market price and valuation of the securities that we hold in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control. Many of the companies in which we have invested have experienced significant volatility in their stock prices. We typically do not attempt to reduce or eliminate this equity price risk, through hedging or similar techniques, and market price and valuation fluctuations could impact our financial results. To the extent that the fair value of these securities was less than our cost over an extended period of time, our net income would be reduced. See Item 3. Quantitative and Qualitative Disclosures about Market Risk for further discussion.

Table of Contents

Our stock price can be volatile.

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

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 March 31, 2002. Actual results may differ materially.

Interest Rate Sensitivity

Our investment portfolio of marketable debt securities consists primarily of fixed income instruments with an average duration of 1.24 years as of March 31, 2002. The primary objective of our investments in marketable 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, a hypothetical 150 BPS increase in interest rates would result in an approximate $59 million decrease in the fair value of our investments in marketable debt securities as of March 31, 2002.

We also have various interest-rate swap agreements which 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 interest rates may increase. For example, a hypothetical 150 BPS increase in interest rates would result in an approximate $23 million decrease in cash.

Foreign Currency Exchange Risk

The majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of manufacturing and sales activities outside of the U.S., we enter into transactions in other currencies, primarily the Japanese yen, the British pound and the Euro. As a result, the Company purchases currency options and forward contracts to reduce or eliminate certain foreign currency exposures that can be identified and quantified. The Company s hedges are primarily intended to protect changes in the value of the U.S. dollar.

Based on our foreign currency exchange instruments outstanding at March 31, 2002, we estimate a maximum potential one-day loss in fair value of approximately $9 million, 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 three month and nine month periods ended March 31, 2002.

Euro Conversion

On January 1, 1999, certain member countries of the European Union established fixed conversion rates between their existing currencies and the Euro. The transition period for the introduction of the Euro ends

Table of Contents

June 30, 2002. Issues facing us as a result of the introduction of the Euro include converting information technology systems, reassessing currency risk, negotiating and amending licensing agreements and contracts, and processing tax and accounting records. We continue to address these issues and do not currently expect the Euro to have a material effect on our financial conditions or results of operations.

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 $5 million decrease in the fair value of our available-for-sale equity investments as of March 31, 2002. At March 31, 2002, three equity securities represented approximately $17 million of the total fair value of the marketable equity securities of $24 million.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On February 11, 2002, Eastman Kodak Company (Kodak) filed a lawsuit in the U.S. District Court for the Western District of New York, making various patent infringement claims against Sun with respect to aspects of our Java technologies. The lawsuit was subsequently amended and served on the Company on April 3, 2002. The Lawsuit seeks injunctive relief against future infringement, unspecified damages for past infringement together with costs and attorney s fees. Based on discussions over many months with Kodak, we believe that this suit is without merit, and, accordingly, will defend ourselves vigorously. Sun cannot forecast at this time with reasonable certainty the potential costs associated with an adverse outcome of this matter.

On March 8, 2002, Sun filed a suit against Microsoft Corporation (Microsoft) in the United States District Court for the Northern District of California pursuant to United States and State of California antitrust laws alleging illegal efforts to acquire, maintain and expand a number of monopolies; illegal tying arrangements; exclusive dealings; copyright infringement; unreasonable restraint of trade; and unfair competition. Sun is seeking remedies that include: (1) preliminary injunctions requiring Microsoft to distribute Sun s binary implementation of the Java Run-time Environment as part of Windows XP and Internet Explorer and to stop the unlicensed distribution of Microsoft s Virtual Machine for Java in violation of the January 23, 2001 settlement agreement; (2) a permanent injunction to restore competition to the markets in which Microsoft is unlawfully attempting to acquire, maintain and expand a number of monopolies; and (3) compensation for losses suffered by Sun as a result of Microsoft s unlawful actions.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.84	Registrant s Nonqualified Deferred Compensation Plan, as amended June 30, 2002.
10.94	Promissory Notes issued to Robert L. Long on November 12, 2001 and January 10, 2002, and related documents (1)
10.95	Promissory Notes issued to Masood A. Jabbar on November 7, 2001, and related documents (1)

(1) Loans paid in full as of February 8, 2002.

Table of Contents

(b) Reports on Form 8-K

(1) We filed a report on Form 8-K with the Securities and Exchange Commission on February 14, 2002 announcing that we were informed by Eastman Kodak Company that Kodak had filed a lawsuit on February 11, 2002 in the U.S. District Court for the Western District of New York, alleging patent infringement against Sun with respect to aspects of Sun s Java technologies.

(2) The Company filed a report on Form 8-K with the Securities and Exchange Commission on May 3, 2002, announcing: (1) on April 25, 2002, the resignation of Michael E. Lehman, Executive Vice President, Corporate Resources and Chief Financial Officer and the appointment of Stephen T. McGowan as Executive Vice President, Corporate Resources and Chief Financial Officer effective as of July 1, 2002; and (2) on May 1, 2002, the resignation of Edward J. Zander, President and Chief Operating Officer, and the appointment of Scott G. McNealy, Chairman of the Board and Chief Executive Officer, as Chairman of the Board, Chief Executive Officer and President, effective July 1, 2002.

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/ Michael E. Lehman

Michael E. Lehman
Executive Vice President, Corporate Resources
and Chief Financial Officer
(Principal Financial Officer)

/s/ Michael L. Popov

Michael L. Popov
Vice President and Corporate Controller
(Chief Accounting Officer)

Dated: May 13, 2002