

SUN MICROSYSTEMS, INC.
Form 10-K
August 29, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended **June 30, 2007**

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

For the transition period from _____ to _____.
Commission file number **0-15086**

SUN MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

94-2805249
(I.R.S. Employer Identification No.)

4150 Network Circle
Santa Clara, CA 95054
(Address of principal executive offices,
including zip code)

(650) 960-1300
(Registrant's telephone number, including area code)
http://www.sun.com/aboutsun/investor
(Registrant's url)

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

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock

The NASDAQ Stock Market LLC

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

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. YES NO

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act). YES NO

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. YES NO

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

Large accelerated filer Accelerated filer Non-accelerated filer
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant, as of December 31, 2006 (the last business day of registrant's second quarter of fiscal 2007), was approximately \$15 billion based upon the last sale price reported for such date on The NASDAQ Stock Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 5% of the outstanding shares of Common Stock and shares held by officers and directors of the Registrant have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive.

The number of shares of the registrant's Common Stock (par value \$0.00067) outstanding as of August 22, 2007 was 3,537,517,215.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the 2007 Annual Meeting of Stockholders are incorporated by reference into Items 10, 11, 12, 13 and 14 hereof.

Table of Contents

INDEX

PART I

Item 1.	<u>Business</u>	3
	<u>Executive Officers of the Registrant</u>	9
Item 1A.	<u>Risk Factors</u>	11
Item 1B.	<u>Unresolved Staff Comments</u>	21
Item 2.	<u>Properties</u>	21
Item 3.	<u>Legal Proceedings</u>	22
Item 4.	<u>Submission of Matters to a Vote of Security Holders</u>	22

PART II

Item 5.	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	23
Item 6.	<u>Selected Financial Data</u>	25
Item 7.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
Item 7A.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	43
Item 8.	<u>Financial Statements and Supplementary Data</u>	44
	<u>Consolidated Statements of Operations</u>	45
	<u>Consolidated Balance Sheets</u>	46
	<u>Consolidated Statements of Cash Flows</u>	47
	<u>Consolidated Statements of Stockholders' Equity</u>	48
	<u>Notes to Consolidated Financial Statements</u>	49
Item 9.	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	84
Item 9A.	<u>Controls and Procedures</u>	84

PART III

Item 10.	<u>Directors and Executive Officers of the Registrant</u>	85
Item 11.	<u>Executive Compensation</u>	85
Item 12.	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	85
Item 13.	<u>Certain Relationships and Related Transactions</u>	85
Item 14.	<u>Principal Accountant Fees and Services</u>	85

PART IV

Item 15.	<u>Exhibits and Financial Statement Schedules</u>	86
----------	---	----

SIGNATURES

88

Table of Contents

PART I

ITEM 1. BUSINESS

GENERAL

Sun Microsystems, Inc. (NASDAQ: JAVA) provides network computing infrastructure product and service solutions. A consistent vision, "The Network is the Computer", has been the driving force behind our technology innovation for over 25 years. Our core brands include the Java technology platform, the Solaris operating system, Sun StorageTek storage solutions and the UltraSPARC processor. By investing in research and development, we create products and services that address the complex information technology issues that customers face today, including increasing demands for network access, bandwidth and storage. This demand is driven by our ability to expand our network's reach by sharing our technologies with the user community, which in turn presents a greater opportunity for us to provide the infrastructure that runs the network.

Our network computing infrastructure solutions are used in a wide range of industries including technical/scientific, business, engineering, telecommunications, financial services, manufacturing, retail, government, life sciences, media and entertainment, transportation, energy/utilities and healthcare. We innovate at all levels of the system and partner with market leaders to provide value and choice for our customers.

For the fiscal year ended June 30, 2007, we had net revenues of \$13.9 billion, employed approximately 34,200 employees and conducted business in over 100 countries. We were incorporated in California in February 1982 and reincorporated in Delaware in July 1987.

Our Investor Relations Web site is located at <http://www.sun.com/aboutsun/investor>. We post the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the U.S. Securities and Exchange Commission (SEC): our annual reports on Form 10-K, quarterly reports on Form 10-Q, our current reports on Form 8-K, our proxy statement related to our annual stockholders' meeting and any amendments to those reports or statements filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended. All such filings are available free of charge on our Investor Relations web site. The contents of these web sites are not intended to be incorporated by reference into this report or in any other report or document we file and our references to these web sites are intended to be inactive textual references only.

BUSINESS STRATEGY

Our business strategy is to provide superior network computing infrastructure solutions that rely on innovation as a core differentiator. We invest in research and development to create products and services that provide competitive differentiation for our customers and for developers adopting our technology. We develop and integrate software, microprocessors, storage, services and systems and share our technology in order to grow communities of developers and users, increase participation on the network and build new markets. By investing in research and development as well as product and services technology acquisitions, we believe it is possible to develop and deliver competitively differentiated systems technology and solutions to address the complex information technology issues customers face today. We intend to continue our investments into new computing technologies and remain focused on the development and delivery of leading-edge network computing products based upon our latest innovations.

Our commitment to open standards and open interfaces, the open source community, sharing and collaboration is key to our long-term success. We believe that creating communities and sharing innovations and technologies will foster global network participation and help to eliminate the digital divide. Our open source initiatives are intended to increase participation in software and hardware design by making our innovative hardware and software intellectual property freely available. A core premise of our software business is that success depends on our ability to attract innovative applications developers to our platforms: the Solaris operating system and Java. We build relationships with these communities to stimulate demand for our commercial products. More Solaris operating system licenses means more open doors for our sales force and for our partners. More Java technology-driven devices means more demand for what we build. Today, there are more than 5.5 billion Java-powered devices in the marketplace. As more people gain access to the network, we see increased opportunities for developers and businesses to deploy applications that create value, from educational institutions deploying high-performance computing (HPC) grids, to banks and social networks serving millions of users. Bringing more people to the network and encouraging development of community-based innovative intellectual property fuels greater demand for the technologies and services that we create. The key investments that we integrate to create value for customers are computer systems and microprocessors, software, services and storage.

Table of Contents

Accordingly, the cornerstones of our business strategy are:

Innovation and Intellectual Property Creation. In order to maintain our position as a leading developer of enterprise and network computing products and technologies, we must continue to invest and innovate. Some examples of our innovations since the beginning of fiscal 2007 include:

We introduced the UltraSPARC T2 processor (formerly known as Niagara 2), as part of our processor line that includes chip multi-threading (CMT) at the processor level. Using CoolThreads™ technology, this processor delivers a 64-way system on a single chip with the capability to run an operating system domain on each of its 64 threads (8 threads per core per core, 8 cores per processor). It also integrates the key functions of multiple system-virtualization, processing, networking, security, floating point units and accelerated memory access. Integrating these elements on to a single piece of silicon reduces costs and increases performance, reliability and energy efficiency, which makes it a competitive choice for a diversity of workloads, from networking equipment to high-performance computing or storage devices.

We introduced Sun™ Streaming System, a massively scalable and cost-effective video delivery platform for cable and telecommunications operators. The system delivers advanced video streaming capacity and cost-effective personalized video delivery over existing optical network infrastructure.

We introduced the Sun Blade™ 6000 Modular System. The Sun Blade 6000 Modular System, an enterprise blade platform, provides up to double the memory and double the I/O capacity of competing blades and rackmount servers.

We introduced the Solaris 10 Solaris Dynamic Tracing (DTrace) technology, which has been honored with the top prize in The Wall Street Journal's 2006 Technology Innovation Awards.

We previewed JavaFX™ Script, a radically simple scripting language for creating rich content and applications to run on billions of Java-powered devices, such as mobile phones and Blu-ray Disc players.

We announced two advances that demonstrate our continued leadership in CMT and commitment to advancing the SPARC® architecture. We successfully completed the initial design for fabrication of our new Rock processor and announced our continued enhancement of the Sun Fire T2000 servers.

We announced Project BlackBox, a virtual datacenter in a shipping container. Project BlackBox applies our network computing infrastructure and HPC expertise to provide customers with a secure, modular data center that can be deployed anywhere in a matter of weeks. Several patents are pending on the Project BlackBox, from the general system and installed rack designs, to various aspects of the cooling systems, including its environmental monitoring system that delivers breakthrough economics and energy efficiency.

We introduced the Sun Fire™ X4500 (code-named Thumper), a hybrid data server, which combines a 4-way x64 server (x64 refers to AMD and Intel 64-bit processors) with up to 48 disk drives and 24 terabytes (TB) of storage.

We also delivered key enhancements to our flagship Solaris 10 operating system, including new features and additions to our revolutionary Solaris ZFS File System. This 128-bit file system provides provable data integrity by employing 64-bit checksums that detect and correct silent data corruption and dramatically simplify storage administration and configuration.

We hold a number of U.S. and foreign patents relating to various aspects of our products and technology.

Interoperability and Choice. We take a whole system view of the products that we deliver into the marketplace. We are uniquely qualified to integrate our microelectronics, servers, storage, software and services into eco-responsible solutions that can transform information technology

(IT) into a competitive weapon for customers. Our focus on providing multi-platform implementations provides customers with greater choice for their heterogeneous environments. The Solaris operating system is now available on over 890 different systems and the Java Enterprise System is available on Linux, Windows and HP-UX in addition to Solaris. Our x64 systems are available for use with Solaris, Windows, Red Hat and SuSe Linux operating systems, and our SPARC systems are available with Solaris and Ubuntu Linux. We remain committed to standards-based designs and implementations, including standards-based networking protocols and Web services that allow customers to build heterogeneous network computing environments. Interoperability gives customers choice so they can choose best-of-breed hardware and software solutions for their IT environments.

Environmentally Responsible Products and Business Practices. Eco-responsibility is part of our overall corporate social responsibility strategy, which strives to create positive social change, minimize environmental impact and generate business. Our approach to eco-responsibility is to deliver eco-friendly products that enable sustainable computing, reduce the environmental impact of our own operations, and build and share open source solutions.

We are innovating to develop products and programs that reduce energy needs and carbon dioxide (CO²) production at all levels including microprocessors, servers, thin clients and computer grids. We are also reducing the environmental impact of our own

Table of Contents

operations by choosing less harmful materials; working to recover, remanufacture or recycle products; and continuing to strive to minimize electronic waste.

In 2006, we partnered with Pacific Gas & Electric to offer California customers an energy incentive rebate when they upgraded to Sun Fire T1000 and T2000 servers with CoolThreads technology. Our cost control objectives are facilitated by our Open Work Practice, which allows our employees to work remotely and eases pollution, reduces energy use and contributes to reduced real estate costs. More than 14,000 of our employees around the world work from home or in a flex office up to two days a week and approximately 2,800 of our employees do so from three to five days a week.

SEGMENT INFORMATION

During fiscal 2007, our operations were organized into two business segments: products and services. Our products revenue is comprised of sales of Computer Systems products and Storage products. Our services revenue is comprised of sales from two classes of services: (1) Support Services, which consists of maintenance and managed services and (2) Professional Services and Educational Services, which consists of technical consulting to help customers plan, implement and manage distributed network computing environments and developing integrated learning solutions for enterprises, IT organizations, and individual IT professionals. In fiscal 2007, 2006, and 2005, Computer Systems represented approximately 47%, 46%, and 53%, respectively, of total net revenues. In fiscal 2007, 2006, and 2005, Storage products represented approximately 17%, 18%, and 12%, respectively, of total net revenues. In fiscal 2007, 2006, and 2005, Support Services represented approximately 29%, 28%, and 27%, respectively, of total net revenues. A table providing external revenue for similar classes of products and services for the last three fiscal years is found in Note 15 to the Consolidated Financial Statements in Item 8. A table presenting revenues, operating income (loss) and total assets for each segment for the three fiscal years ended June 30, 2007 is found in Note 15 to the Consolidated Financial Statements in Item 8.

PRODUCTS

We develop innovative networking computing products and technologies that include energy-efficient servers, storage, open source software, tools, services and training. For information about revenue for similar classes of products and services, refer to Note 15 to the Consolidated Financial Statements Industry Segment, Geographic, and Customer Information and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations.

SYSTEMS

The substantial growth of network data and traffic, increasing compliance and regulatory demands, expanding needs for increased computing capacity and market pressure for energy and space reductions require a broad set of system solutions that are cost effective, reliable, scalable and eco-responsible.

Servers. We offer a full line of scalable servers based on SPARC64®, Sun UltraSPARC, AMD Opteron and Intel® Xeon® microprocessors, that range from cost- and energy-efficient entry-level servers and blade systems through data center/HPC business critical computing servers designed for heterogeneous computing environments.

Entry-level server systems. We offer a wide range of Sun Fire and Sun Blade entry-level server systems differentiated by their size, their cost, their processor architecture (UltraSPARC, SPARC64, AMD Opteron or Intel Xeon), their form factor (rack, blade or stand-alone systems) and the environment for which they are targeted (general purpose or specialized systems). These systems are compatible with the Solaris, Linux and Windows operating system environments.

Enterprise and data center servers. Our enterprise and data center servers, including the Sun Fire and SPARC Enterprise product families, are designed to offer greater performance and lower total cost of ownership than mainframe systems for business critical applications and more computational intensive environments. These systems are based on UltraSPARC, SPARC64, AMD and Intel microprocessor platforms and are also compatible with the Solaris, Linux and Windows operating system environments.

Desktops and Workstations. Our Sun Ultra workstations provide powerful solutions for a wide range of business and technical activities such as software development, mechanical design, financial analysis, graphics, visualization, simulation and education. Sun Ray Ultra-Thin Client platforms provide an alternative to traditional desktop personal computers where client applications are better suited and more economical to running on a network versus an individual desktop platform.

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

We also offer a line of products aimed at the unique needs of Original Equipment Manufacturers (OEMs) and Network Equipment Providers (NEPs). Rack-optimized systems and our blade product offerings combine high-density hardware architecture and system management software that OEMs find particularly useful in building their own solution architectures. Our NEP-certified Sun Netra systems are designed to meet the specialized needs of NEPs.

Table of Contents

Microelectronics. Our microelectronics business develops and sells silicon-based chips that facilitate networking, cryptography and HPC. These chips are utilized by OEM customers and hardware vendors worldwide in a broad range of devices from servers to routers, switches, network devices, medical imaging, industrial printing and more.

SOFTWARE

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

Solaris. The Solaris operating system is a high performance, reliable, scalable and secure operating environment for SPARC and x64 platforms. It is optimized for enterprise computing, Internet and intranet business requirements, powerful databases and HPC environments. In addition, we have made certain source code of our software available under an open source license. By making intellectual property freely available, the community is encouraged to download it, examine it, provide feedback and enhancements to it, and develop applications around it. This improves collaboration and cooperation to help accelerate innovation around these technologies. The Solaris operating system runs on hundreds of different server platforms including standard x64/x86 servers. The ability to run on multiple platforms has contributed to the rapid growth of the Solaris operating system on non-SPARC based systems over the last two years and such non-SPARC based systems, account for almost two-thirds of the registered licenses for the Solaris operating system. Additionally, we recently announced that IBM will distribute the Solaris operating system and Solaris Subscriptions for select x86-based IBM System servers and BladeCenter servers to clients through IBM's distribution channels.

Java Technology. Our Write Once, Run Anywhere Java technology, which is used on personal computers, workstation clients and mobile devices is available on the Solaris operating system, Linux, HP-UX, AIX, Tru64 UNIX®, Windows, MacOS X and other platforms. Java technology is used to develop and deploy Web services for consumer and embedded devices such as mobile phones, personal digital assistants (PDAs), digital set top boxes and residential gateways and Java Card smart card technology.

Middleware. We also offer a full range of middleware including mission-critical clustering, messaging, identity management, directory and Web services infrastructure software. Other software offerings include virtualization, provisioning and monitoring software for network computing resource optimization and systems management simplification.

STORAGE

Our entry-to-enterprise-level data storage products and services include heterogeneous tape, disk, software, networking and services for mainframe and open systems environments. With the acquisition of Storage Technology Corporation (StorageTek) in August 2005, we became a top-tier storage vendor, offering a broad range of products and services for securely managing mission critical data assets.

Our tape storage includes libraries, drives, virtualization systems, media and software. Our extensive disk system product line includes data center disks, Network Attached Storage (NAS), Enterprise Archive System, midrange disks, workgroups disks, a boot disk, and a full range of disk device software.

We are leveraging the Solaris operating system across our storage portfolio to increase data management per administrator, scalability, security, utilization rates, observability and self-healing. Our heterogeneous, industry-standard modular storage hardware works with Windows, Linux, z/OS, HP-UX, AIX and Solaris platforms along with other software, so customers can more quickly and cost-effectively adapt to changing business needs. Sun's Storage solutions help to improve data availability, providing fast data access, dynamic data protection for restoration and secure archiving for compliance.

SERVICES

Sun offers a broad range of services from Support and Managed Services for hardware, software and client solutions, to Professional and Educational Services. We assist customers globally, with nearly 850,000 units under Support Services contracts in more than 100 countries.

Our services innovation is focused on integrating technology, knowledge and process to meet customer needs. Our global service and support offerings help our customers increase system service levels, improve data center operational efficiency and effectiveness and deploy next-generation automation technologies to provide predictive, preemptive and proactive service to heterogeneous infrastructures.

SALES, MARKETING AND DISTRIBUTION

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

Our Global Sales and Services organization manages and has primary responsibility for our field sales, relationships with our selling partners, technical sales support, sales operations and delivery of Support Services and Professional and Educational Services. We

Table of Contents

sell end-to-end networking architecture platform solutions, including products and services, in most major markets globally through a combination of direct and indirect channels. We also offer component products, such as central processor unit (CPU) chips and embedded boards, on an OEM basis to other hardware manufacturers and supply after-market and peripheral products to their end-user installed base, both directly and through independent distributors and value added resellers (VARs).

We have organized our sales coverage within 16 geographically established markets (GEMs) around the world. We employ independent distributors in over 100 countries. In general, our sales coverage model calls for independent distributors to be deployed via strategic alliances with our direct sales force. However, in some smaller markets, independent distributors and Sun Plus partners may be our sole means of sales, marketing and distribution. Our relationships with channel partners are very important to our future revenues and profitability. Channel relationships accounted for more than 65%, 63% and 67% of our total net revenues in fiscal 2007, 2006 and 2005, respectively.

Our partner community is essential to our success. While our product and service offerings are very broad, we recognize that no single supplier of computing solutions can meet all of the needs of all of our customers. We have established relationships with leading Independent Software Vendors (ISVs), VARs, OEMs, channel development providers, independent distributors, computer systems integrators and Service Development Providers (SDPs) to deliver solutions that our customers demand. Through these relationships, our goal is to optimize our ability to be the technology of choice, the platform of choice, the partner of choice and to provide the end-to-end solutions that customers require to compete. Our Worldwide Marketing Organization oversees our marketing planning, determines product and pricing strategy, coordinates advertising, demand creation and public relations activities, maintains strategic alliances with major ISVs and performs competitive analyses. Additionally, ISVs help us maximize our technology footprint by integrating their software products with our platforms and technologies. SDPs, such as Internet Service Providers (ISPs) and Application Service Providers (ASPs), allow us to expand our service coverage without new large-scale investments.

We seek out companies to be our partners who align with our technology direction and our vision of enabling network participation. We partner with Advanced Micro Devices, Inc. (AMD) to expand our entry-level line of Opteron processor-based x64 systems. We have an alliance with Intel Corporation whereby Intel endorses the Solaris operating system and we have agreed to deliver a comprehensive family of servers and workstations based on Xeon processors. We also maintain a strategic alliance with Fujitsu to deliver and support a generation of SPARC-based systems that we developed through collaboration. Our relationship with Fujitsu is discussed in greater detail in Item 1A, *Risk Factors*. This alliance is intended to enlarge the Solaris operating system footprint, drive increased market share for our enterprise-class systems and allow us to dedicate additional resources to our throughput computing initiative and our next generation of processor products. We also maintain a relationship with Hitachi Data Systems (HDS) to provide high-end storage solutions and extend our storage offerings into other enterprise environments.

Revenues from outside the United States (U.S.) were approximately 59%, 58% and 60% of our total net revenues in fiscal 2007, 2006 and 2005, respectively. Direct sales we make outside of the U.S. are generally priced in local currencies and can be subject to currency exchange fluctuations. The net foreign currency impact on our total net revenues and operating results is difficult to precisely measure. However, because of the general weakening of the U.S. dollar, our best estimate of the foreign exchange benefit approximated 2% of total net revenues for fiscal 2007.

The countries primarily contributing to our international sales are the United Kingdom (U.K.), Germany and Japan. The U.K. represented approximately 8%, 9% and 9% of our total net revenues in fiscal 2007, 2006 and 2005, respectively. Germany represented approximately 7%, 7% and 8% of our total net revenues in fiscal 2007, 2006 and 2005, respectively. Japan represented approximately 5%, 6% and 7% of our total net revenues in fiscal 2007, 2006 and 2005, respectively.

For further financial information on sales outside the U.S., see *Net Revenues by Geographic Area* in Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

For a discussion of risks attendant to our foreign operations, see *Risk Factors*. Our international customers and operations subject us to a number of risks, in Item 1A. See Note 15 to the Consolidated Financial Statements in Item 8 for additional information concerning sales to international customers and business segments.

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

In January 2007, Access Distribution, the largest distributor of our products, was sold to Avnet, Inc. by General Electric Company. Avnet, which was StorageTek's largest distributor, became a distributor of Sun products after our acquisition of StorageTek in August 2005. Sales to Avnet and

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

Access Distribution accounted for approximately 11%, 11%, and 13% of net revenues in fiscal 2007, 2006 and 2005, respectively. No other customer accounted for more than 10% of our net revenues. Accounts receivable from Avnet and Access Distribution and its subsidiaries in the aggregate was approximately 13% and 12% of total accounts receivable as of June 30, 2007 and 2006, respectively.

Table of Contents

Our product order backlog at June 30, 2007 was \$1.0 billion, as compared with \$1.1 billion at June 30, 2006. Our product backlog includes orders for which customer-requested delivery is scheduled within six months and orders that have been specified by the customer for which products have been shipped but revenue has been deferred. Although actual customer delivery can occur over several periods, product backlog can be used to identify potential revenue coverage for future periods. The larger the percentage coverage of targeted pending revenue, the lower the potential risk of non-achievement. Backlog levels vary with demand, product availability, product revenue recognition treatment, and our delivery lead times and are subject to significant decreases as a result of, among other things, customer order delays, changes or cancellations. As such, backlog levels may not be a reliable indicator of future operating results.

WORLDWIDE OPERATIONS

Our Worldwide Operations organization manages company-wide purchasing of materials used in making our products, assists in product design enhancements, oversees our manufacturing operations and those of our manufacturing partners and coordinates logistics operations.

Our manufacturing operations consist primarily of final assembly, test and quality control of enterprise and data center servers and storage systems. For all other systems, we rely on external manufacturing partners. We manufacture primarily in Oregon and Scotland and distribute much of our hardware products from our facilities and our partner facilities located in California, the Netherlands and Japan.

We are expanding our direct ship capabilities, using a customer fulfillment architecture that enables us to ship certain products directly from our suppliers to our customers, with the goal of reducing cost, risk and complexity in the supply chain. We have continued to simplify the manufacturing process by increasing the standardization of components across product types. In addition, we have continued to increase our focus on quality and processes that are intended to proactively identify and solve quality issues. The early identification of products containing defects in engineering, design and manufacturing processes, as well as defects in third-party components included in our products, could prevent or reduce delays of product shipments.

RESEARCH AND DEVELOPMENT

Our research and product development programs are intended to sustain and enhance our competitive position by incorporating the latest advances in hardware, microprocessors, software, graphics, networking, data communications and storage technologies. In addition, we have extended our product offerings and intellectual property through acquisitions of businesses or technologies or other arrangements with our partners. Our product development continues to focus on enhancing the performance, scalability, reliability, availability and serviceability of our existing systems and the development of new technology standards. Additionally, we remain focused on developing system software platforms for Internet and intranet applications, telecommunications and next-generation service provider networks, advanced workstation, server and storage architectures and advanced service offerings. We devote substantial resources to research and development as we believe it provides and will continue to provide significant competitive differentiation.

We conduct research and development principally in the U.S., U.K., France, Ireland, Germany, Japan, China, Russia, Czech Republic and India. Research and development expenses were \$2.0 billion, \$2.0 billion, and \$1.8 billion in fiscal 2007, 2006 and 2005, respectively.

COMPETITION

We compete in the computer systems (hardware and software), storage (hardware and software) and services markets. These markets are intensely competitive. Our competitors are some of the largest, most successful companies in the world. They include International Business Machines Corporation (IBM), Dell, Inc. (Dell), Hewlett-Packard Company (HP), EMC Corporation (EMC), Fujitsu Limited (Fujitsu), HDS and the Fujitsu-Siemens joint venture. We also compete with (i) systems manufacturers and resellers of systems based on microprocessors manufactured by Intel, the Windows family of operating systems software from Microsoft and the Linux family of operating systems from Red Hat and others, as well as (ii) companies that focus on providing support and maintenance services for computer systems and storage products.

We continue to invest significantly in research and development, \$2.0 billion in fiscal 2007, to create hardware, software and services based on open standards and innovative business models to offer differentiated solutions to our customer, partner and developer communities. We focus our R&D investments to address complex customer issues such as escalating IT infrastructure costs, data security, under-utilized IT assets and the rising costs of power consumption, cooling and space in data-centers. We believe our innovations will continue to help businesses and developers address these IT concerns, drive high-growth business solutions and differentiate us from our major competitors.

Table of Contents

We believe competition will be at least as intense in the next fiscal year as it was over the last fiscal year. In this environment, the lack of competitive advantage with respect to our hardware, software or services offerings could lead to a loss of competitive position resulting in fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability and loss of market share. For more information about the competitive risks we face, refer to Item 1A. Risk Factors. If we are unable to compete effectively with existing or new competition, the loss of competitive position could result in price reductions, fewer customer orders, reduced revenue, reduced margins, reduced levels of profitability and loss of market share.

PATENTS, TRADEMARKS AND INTELLECTUAL PROPERTY LICENSES

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

We hold a number of U.S. and foreign patents relating to various aspects of our products and technology. While we believe that patent protection is important, we believe that factors such as innovative skills and technological expertise provide even greater competitive differentiation. From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Such notices are in various stages of evaluation, and some have resulted in current litigation. We are evaluating the desirability of entering into licensing agreements in certain of these matters. Based on industry practice, we believe that any necessary licenses or other rights could be obtained on commercially reasonable terms. However, no assurance can be given that licenses can be obtained on acceptable terms or that litigation will not occur. The failure to obtain necessary licenses or other rights, or the adverse resolution of litigation arising out of such claims, could adversely affect our business.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following sets forth certain information regarding our Executive Officers as of August 27, 2007.

Name	Age	Position
Jonathan I. Schwartz	41	Chief Executive Officer and President
Jon H. Benson	45	Senior Vice President, Storage Group
V. Kalyani Chatterjee	44	Vice President, Corporate Controller and Chief Accounting Officer
Michael A. Dillon	48	Executive Vice President, General Counsel and Secretary
John F. Fowler	46	Executive Vice President, Systems Group
Anil P. Gadre	50	Executive Vice President, Chief Marketing Officer
Donald C. Grantham	50	Executive Vice President, Global Sales and Services
Richard L. Green	51	Executive Vice President, Software Group
Michael E. Lehman	56	Chief Financial Officer and Executive Vice President, Corporate Resources
William N. MacGowan	50	Executive Vice President, People and Places, and Chief Human Resources Officer
Eugene G. McCabe	54	Executive Vice President, Worldwide Operations
Gregory M. Papadopoulos	49	Executive Vice President, Research and Development and Chief Technology Officer
David W. Yen	55	Executive Vice President, Microelectronics Group

Mr. Schwartz has served as President and Chief Executive Officer since April 2006, as President and Chief Operating Officer from April 2004 to April 2006, as Executive Vice President, Software from July 2002 to April 2004, as Senior Vice President, Corporate Strategy and Planning from July 2000 to July 2002, as Vice President, Ventures Fund from October 1999 to July 2000. Prior to that, Mr. Schwartz served in several other positions with Sun.

Mr. Benson has served as Senior Vice President, Storage Group, since March 2007 and as Vice President of Engineering for the Storage Group from September of 2005 to March 2007. Prior to joining Sun as part of the StorageTek acquisition, he served in a variety of management and executives positions for StorageTek for the period from 1987 to 2005, most recently as Vice President and General Manager of Automated Tape Solutions from September 2004 to September 2005, and as Vice President of Automated Tape Libraries from 2000 to September 2004.

Ms. Chatterjee has served as Vice President, Corporate Controller and Chief Accounting Officer (Principal Accounting Officer) since September 2006 and Vice President, Finance and Assistant Controller from February 2006 until September 2006. From March 2004 to February 2006, Ms. Chatterjee served as Sun's Senior Director and Assistant Corporate Controller. From January 2003 to March 2004, Ms. Chatterjee served as the Vice President, Finance with Hotwire, Inc. From January 2000 to November 2002, Ms. Chatterjee served as a Senior Manager at KPMG

LLP.

Table of Contents

Mr. Dillon has served as Executive Vice President, General Counsel and Secretary since April 2006, as Senior Vice President, General Counsel and Secretary from April 2004 to April 2006, and previously held the position of Vice President, Products Law Group, from July 2002 to March 2004. From October 1999 until June 2002, he served as Vice President, General Counsel and Corporate Secretary of ONI Systems Corp, an optical networking company. Mr. Dillon initially joined Sun in 1993 and thereafter held successive management positions in several legal support groups until October 1999.

Mr. Fowler has served as Executive Vice President, Systems Group since May 2006, as Executive Vice President, Network Systems Group from May 2004 to May 2006, as Chief Technology Officer, Software Group from July 2002 to May 2004 and Director, Corporate Development from July 2000 to July 2002.

Mr. Gadre has served as Executive Vice President, Chief Marketing Officer since November 2004, as Vice President, Software Marketing from May 2002 to November 2004 and Vice President and General Manager of Solaris Software from April 1999 to May 2002. Previously he has held several positions related to Product and Corporate Marketing at Sun.

Mr. Grantham has served as Executive Vice President, Global Sales and Services since April 2006, as Executive Vice President Sun Services from March 2005 to March 2006, as Senior Vice President, Global Services Delivery from January 2004 to March 2005, as Vice President, Global Sales Operations April 2002 to December 2004, as Vice President Sales Operations EMEA January 2001 to March 2002, and as Director of Product Sales and Marketing EMEA from October 1999 to December 2000. Prior to joining Sun, Mr. Grantham served in a variety of management and executive positions at IBM, for the period from 1983 to 1999.

Mr. Green has served as Executive Vice President, Software Group of Sun since May 2006. From May 2004 to May 2006, Mr. Green served as Executive Vice President, Products for Cassatt Corporation. From April 2004 to May 2004, Mr. Green served as Vice President, Java and Developer Programs of Sun and as Vice President, Java from December 1999 to April 2004.

Mr. Lehman has served as Chief Financial Officer and Executive Vice President, Corporate Resources since February 2006 and as Executive Vice President from July 2002 until his resignation from employment in September 2002. From September 2002 to February 2006, he was a member of the board of directors of Sun. He resigned from the Board when he returned to full-time employment at Sun. During that time, he served as a self-employed business consultant. From July 2000 to July 2002, he served as Executive Vice President, Corporate Resources and Chief Financial Officer of Sun, and from January 1998 to July 2000, as Vice President, Corporate Resources and Chief Financial Officer. He is a director of MGIC Investment Corporation.

Mr. MacGowan has served as Chief Human Resources Officer and Executive Vice President of People and Places since April 2006, as Senior Vice President, Human Resources, from April 2004 to April 2006, as Vice President, Human Resources, Global Centers of Expertise, from May 2003 to April 2004, as Vice President, Human Resources, Systems, Storage and Operations, from May 2002 to May 2003, Vice President, Human Resources, Enterprise Services, from May 2000 to May 2002 and as Director, Human Resources, Enterprise Services, from June 1998 to May 2000.

Mr. McCabe has served as Executive Vice President, World Wide Operations of Sun since March 2005, as Senior Vice President, Worldwide Operations from January 2003 to March 2005 and as Vice President, High-End Operations from September 1999 through January 2003. From July 1998 through September 1999, Mr. McCabe served as Vice President, High-End Operations for Compaq Computer Corporation.

Mr. Papadopoulos has served as Executive Vice President, Research and Development and Chief Technology Officer since May 2006, as Executive Vice President and Chief Technology Officer from December 2002 to May 2006, as Senior Vice President and Chief Technology Officer from July 2000 to December 2002 and as Vice President and Chief Technology Officer from April 1998 to July 2000. He served as Vice President and Chief Technology Officer of Sun Microsystems Computer Corporation (SMCC), a wholly-owned subsidiary of Sun from March 1996 to April 1998, as Chief Technology Officer of SMCC from December 1995 to March 1996 and as Chief Scientist, Server Systems Engineering from September 1994 to December 1995. Mr. Papadopoulos had a part-time, non-compensated appointment as a Visiting Professor of Electrical Engineering and Computer Science at the Massachusetts Institute of Technology from September 2002 to August 2003.

Mr. Yen has served as Executive Vice President, Microelectronics Group since March 2007, as Executive Vice President, Storage Group of Sun from May 2006 to May 2007, as Executive Vice President, Scalable Systems Group from April 2004 to May 2006, as Executive Vice President, Processor and Network Products from July 2002 to April 2004, as Vice President and General Manager, Processor Products Group from February 2001 to June 2002, as Vice President and General Manager, Integrated Products Group from July 2000 to January 2001 and as Vice President and General Manager, Enterprise Servers Products from September 1996 to June 2000.

Table of Contents

ITEM 1A. RISK FACTORS

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

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

Our competitors are some of the largest, most successful companies in the world. They include IBM, Dell, HP, EMC, Fujitsu, HDS, the Fujitsu-Siemens joint venture, Microsoft and Intel. We compete with (i) systems manufacturers and resellers of systems based on microprocessors from Intel, the Windows family of operating systems software from Microsoft and the Linux family of operating systems software from Red Hat and others, as well as (ii) companies that focus on providing support and maintenance services for computer systems and storage products. Certain of these competitors compete aggressively on price and seek to maintain very low cost structures. Some of these competitors are seeking to increase their market share, which creates increased pressure, including pricing pressure, on our product lines and service offerings. In particular, we are seeing increased competition and pricing pressures from competitors offering systems running Linux software and other open source software, as well as competitors offering support services. In addition, certain of our competitors, including IBM and HP, have financial and human resources that are substantially greater than ours, which increases the competitive pressures we face. These competitors also have significant installed bases, and it can be very difficult to win a new customer that has made significant investments in a competitor's platform.

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

Fujitsu and its subsidiaries have, for many years, been key strategic channel partners for Sun, distributing substantial quantities of our products throughout the world. We entered into a number of agreements with Fujitsu intended to substantially increase the scope of our relationship with them, including through collaborative selling efforts and joint development and marketing of server products known as the Advanced Product Line (APL). The first group of APL server products was released in April 2007 and branded as the SPARC Enterprise line of servers. However, Fujitsu is also a competitor of Sun and, as a licensee of various technologies from Sun and others, it has developed products that currently compete directly with our products.

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

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

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

One of our business strategies is to derive a competitive advantage and a resulting enhancement of our gross margins from our investment in innovative new technologies which customers value. As a result, as a percentage of total net revenues, we incur

Table of Contents

higher fixed R&D costs than many of our competitors. To the extent that we are unable to develop and sell products with attractive gross margins in sufficient volumes, our earnings may be materially and adversely affected by our cost structure. We continue to add new products to our entry-level server product line that are offered at a lower price point and that may provide us with a lower gross margin percentage than our products as a whole. Although our strategy is to sell these products as part of overall systems that include other products with higher gross margin percentages, to the extent that the mix of our overall revenues represented by sales of lower gross margin products increases, our gross margins and earnings may be materially and 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 that incorporate certain UltraSPARC microprocessors and the Solaris operating system, the Java platform, Sun Java System portfolio and Sun N1 Grid architecture, among others. The development process for these complicated products is very uncertain. It requires high levels of innovation from both our product designers and the suppliers of the components used in our products. The development process is also lengthy and costly. If we fail to accurately anticipate our customers' needs and technological trends, or are otherwise unable to complete the development of a product on a timely basis, we will be unable to introduce new products into the market on a timely basis, if at all, and our business and operating results would be materially and adversely affected.

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

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

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

We have entered into a number of agreements with Fujitsu with respect to collaborative sales and marketing efforts and the joint development and manufacturing of server products known as the Advanced Product Line (APL). The first group of APL server products was released in April 2007 and branded as the Sun SPARC Enterprise line of servers. The APL server products are intended to eventually replace a portion of our server product portfolio. In addition, the agreements contemplate that Sun and Fujitsu dedicate substantial financial and human resources to this relationship. As a result, our future performance and financial condition may be impacted by the success or failure of this relationship.

Joint development and marketing of a complex new product line is an inherently difficult undertaking and is subject to numerous risks. If we fail to satisfy certain development or supply obligations under the agreements, or if we otherwise violate the terms of the agreements, we may be subject to significant contractual or legal penalties. Further, if Fujitsu encounters any of a number of potential problems in its business, such as intellectual property infringement claims, supply difficulties, or difficulties in meeting development milestones or financial challenges, these problems could impact our strategic relationship with them and could result in a material adverse effect on our business or results of operations. There can be no assurance that our strategic relationship with Fujitsu will be successful or that the economic terms of the agreements establishing the relationship will ultimately prove to be favorable to us. If any of these risks come to pass, they may have a material adverse effect on our business, results of operations or financial condition.

Table of Contents

We have licensed significant elements of our intellectual property, including our Solaris operating system and Java technology, as open source software and intend to license additional intellectual property in the future under open source licenses, which could reduce the competitive advantage we derive from this intellectual property.

We have released significant elements of our intellectual property, including the Solaris operating system, the Java Enterprise System infrastructure software platform, the Sun N1 Management software and various developer tools, to the open source development community as open source software under an open source license and have made the hardware source code of our UltraSPARC T1 processor available under an open source license. We have also released our Java SE, Java EE and Java ME technologies under an open source license. Although open source licensing models vary, generally open source software licenses permit the liberal copying, modification and distribution of a software program allowing a diverse programming community to contribute to the software. As a result of such release, there could be an impact on revenue related to this intellectual property, and we may no longer be able to exercise control over some aspects of the future development of this intellectual property. In particular, the feature set and functionality of the Solaris operating system may diverge from those that best serve our strategic objectives, move in directions in which we do not have competitive expertise or fork into multiple, potentially incompatible variations. We currently derive a significant competitive advantage from our development, licensing and sale of the Solaris operating system, Java technologies, and system products based on the UltraSPARC family of microprocessors, and any of these events could reduce our competitive advantage or impact market demand for our products, software and services. In addition, disclosing the content of our source code could limit the intellectual property protection we can obtain or maintain for that source code or the products containing that source code and could facilitate intellectual property infringement claims against Sun.

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

Most of the our products and components are manufactured in whole or in part by third-party manufacturers. Further, there are some components that can only be purchased from a single vendor due to price, quality, technology or other business constraints. For example, we currently depend on Texas Instruments for the manufacture of our UltraSPARC microprocessors, AMD for Opteron processors and several other companies for custom integrated circuits. If we were unable to purchase on acceptable terms or experienced significant delays or quality issues in the delivery of necessary parts and/or components from a particular vendor and we had to find a new supplier for these parts and components, our new and existing product shipments could be delayed which could have a material adverse effect on our business, results of operations and financial conditions.

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

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

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

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

Table of Contents

supply orders in advance of customer orders. Our business and operating results could be materially and adversely affected as a result of these increased costs.

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

Generally, the computer systems we sell to customers incorporate various hardware and software products that we sell, such as UltraSPARC microprocessors, various software elements, from the Solaris operating system to the Java platform, Sun Java System portfolio, Sun N1 Grid, the Sun StorageTek SL8500 modular library system and Sun StorEdge array products. Any delay in the development, delivery or acceptance of key elements of the hardware or software included in our systems could delay our shipment of these systems. Delays in the development and introduction of our products may occur for various reasons.

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

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

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

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

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

Currently, more than half of our revenues come from international sales. In addition, a portion of our operations consists of manufacturing and sales activities outside of the U.S. Our ability to sell our products and conduct our operations internationally is subject to a number of risks. Local economic, political and labor conditions in each country could adversely affect demand for our products and services or disrupt our operations in these markets. We may also experience reduced intellectual property protection or longer and more challenging collection cycles as a result of different customary business practices in certain countries where we do business which could have a material adverse effect on our business operations and financial results. Currency fluctuations could also materially and adversely affect our business in a number of ways. Although we take steps to reduce or eliminate certain foreign currency exposures that can be identified or quantified, we may incur currency translation losses as a result of our international operations. Further, in the event that currency fluctuations cause our products to become more expensive in overseas markets in local currencies, there could be a reduction in demand for our products or we could lower our pricing in some or all of these markets resulting in reduced revenue and margins. Alternatively, a weakening dollar could result in greater costs to us for our overseas operations. Changes to and compliance with a variety of foreign laws and regulations may increase our cost of doing business in these jurisdictions. Trade protection measures and import and export licensing requirements subject us to additional regulation and may prevent us from shipping products to a particular market, and increase our operating costs. In addition, we could be subject to regulations, fines and penalties for violations of import and export regulations. Although we implement policies and procedures designed to ensure compliance with these laws, there can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, including those based in or from countries where practices which violate such United States laws may be customary, will not take actions in violation of our policies. These violations could result in penalties, including prohibiting us from exporting our products to one or more countries, and could materially and adversely affect our business.

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

Moreover, local laws and customs in many countries differ significantly from those in the U.S. We incur additional legal compliance costs associated with our international operations and could become subject to legal penalties in foreign countries if

Table of Contents

we do not comply with local laws and regulations, which may be substantially different from those in the United States. In many foreign countries, particularly in those with developing economies, it is common for local business people to engage in business practices that violate their local laws and that are prohibited by United States laws applicable to us such as the Foreign Corrupt Practices Act. Although we implement policies, training, and procedures designed to ensure compliance with these laws, there can be no assurance that all of our employees, contractors and agents, as well as our resellers and those companies to which we outsource certain of our business operations, including those based in or from countries where practices which violate such United States laws may be common, will not engage in actions which violate the law or our policies. Any such violation, even if prohibited by our policies, could have a material adverse effect on our business.

We intend to enter into one or more joint ventures with distribution partners with the goal of increasing sales of Sun's products and services in selected geographic markets. Forming a joint venture will subject us to additional compliance and legal risks related to the actions of the joint venture partner.

We are currently implementing a new enterprise resource planning system, and problems with the design or implementation of this system could interfere with our business and operations.

We have commenced a project to consolidate all of our database infrastructure to a single global enterprise resource planning (ERP) system. We have invested, and will continue to invest, significant capital and human resources in the design and implementation of the ERP system, which may be disruptive to our underlying business. Any disruptions or delays in the design and implementation of the new ERP system, particularly any disruptions or delays that impact our operations, could adversely affect our ability to process customer orders, ship products, provide services and support to our customers, bill and track our customers, fulfill contractual obligations, file SEC reports in a timely manner and otherwise run our business. Further, as we are dependent upon our ability to gather and promptly transmit accurate information to key decision makers, our business, results of operations and financial condition may be materially and adversely affected if our database infrastructure does not allow us to transmit accurate information, even for a short period of time. Even if we do encounter these adverse effects, the design and implementation of the new ERP system may be much more costly than we anticipated. If we are unable to successfully design and implement the new ERP system as planned, our financial position, results of operations and cash flows could be negatively impacted.

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

We continuously seek to make our cost structure more efficient and focus on our core strengths. We continue to develop and implement our global resourcing strategy and operating model which includes activities that are focused on increasing workforce flexibility and scalability, and improving overall competitiveness by leveraging external talent and skills worldwide. We rely on partners or third party service providers for the provision of certain key business process functions, including IT services and the human resources function, and as a result, we may incur increased business continuity risks. We may no longer be able to exercise control over some aspects of the future development, support or maintenance of outsourced operations and processes, including the internal controls associated with those outsourced business operations and processes, which could adversely affect our business. If we are unable to effectively develop and implement our resourcing strategy due to, among other things, data protection, contract and regulatory compliance issues, we may not realize cost structure efficiencies and our operating and financial results could be materially and adversely affected. Given the uncertainty in forecasting and other variables, actual financial impact from outsourcing may materially differ from our projections. In addition, if we are unable to effectively utilize or integrate and interoperate with external resources or if our partners or third party service providers experience business difficulties or are unable to provide business process services as anticipated, we may need to seek alternative service providers or resume providing these business processes internally, which could be costly and time consuming and have a material adverse effect on our operating and financial results.

We also rely on partners for the provision of key manufacturing activities. Recently, Texas Instruments indicated publicly that it will not be making UltraSPARC microprocessors for Sun on a foundry basis at the 45-nm node. Consequently, we are reviewing alternative foundry solutions, and are considering plans to transition the 45-nm mode foundry operations and supply chain to other potential vendors. If we are unable to effectively execute the transition, we may experience difficulty in delivering our 45-nm next generation microelectronics products and technologies, which could materially and adversely affect our business.

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

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

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

Table of Contents

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

Foreign Currency Fluctuations. As a large portion of our business takes place outside of the U.S., we enter into transactions in other currencies. Although we employ various hedging strategies, we are exposed to changes in exchange rates, which cause fluctuations in our quarterly operating results.

Deferred Tax Assets. Estimates and judgments are required in the calculation of certain tax liabilities and in the determination of the recoverability of certain of the deferred tax assets, which arise from net operating losses, tax credit carryforwards and temporary differences between the tax and financial statement recognition of revenue and expense. SFAS 109, Accounting for Income Taxes, also requires that the deferred tax assets be reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the recorded deferred tax assets will not be realized in future periods.

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

Goodwill and Other Intangible Assets. We perform an analysis on our goodwill balances to test for impairment on an annual basis or whenever events occur that may indicate impairment possibly exists. Goodwill is deemed to be impaired if the net book value of the reporting unit exceeds the estimated fair value. The impairment of a long-lived intangible asset is only deemed to have occurred if the sum of the forecasted undiscounted future cash flows related to the asset are less than the carrying value of the intangible asset we are testing for impairment. If the forecasted cash flows are less than the carrying value, then we must write down the carrying value to its estimated fair value. We recognized an impairment charge of \$70 million related to acquired intangible assets during the fourth quarter of fiscal 2006. As of June 30, 2007, we had a goodwill balance of \$2,514 million. Going forward, we will continue to review our goodwill and other intangible assets for possible impairment. Any additional impairment charges could adversely affect our future earnings.

Income tax laws and regulations subject us to a number of risks and could result in significant liabilities and costs.

As a multinational corporation, we are subject to income taxes in the U.S. and various foreign jurisdictions. Our domestic and foreign tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we operate. We are regularly subject to audits by tax authorities. While we endeavor to comply with all applicable income tax laws, there can be no assurance that a governing tax authority will not have a different interpretation of the law than we do or that we will comply in all respects with applicable tax laws, which could result in additional taxes. We regularly review the likelihood of adverse outcomes resulting from tax audits to determine if additional income taxes, penalties and interest would be assessed. There can be no assurance that the outcomes from these audits will not have an adverse effect on our results of operations in the period for which the review is made.

We are dependent on significant customers, specific industries and geographies.

In January 2007, Access Distribution, the largest distributor of our products, was sold to Avnet, Inc. by General Electric Company (the Acquisition). Sales to Avnet and Access Distribution accounted for approximately 11%, 11%, and 13% of net revenues in fiscal 2007, 2006 and 2005, respectively. Avnet, which was StorageTek's largest distributor, became a distributor of Sun products after our acquisition of StorageTek in August 2005. No other customer accounted for more than 10% of our net revenues. The Acquisition may be disruptive to Avnet's business and could, consequently, adversely impact our business. Moreover, if our distribution arrangement with Avnet significantly deteriorates or is terminated, and we are unable to find another distributor for our products on similar financial terms, our future operating results could be adversely affected.

Table of Contents

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

Weakening economic conditions in specific geographic areas, particularly the United States or Europe, can also adversely affect our operating results.

We are dependent upon our channel partners for a significant portion of our revenues.

Our channel partners include distributors, original equipment manufacturers (OEMs), independent software vendors, system integrators, service providers and resellers. We continue to see an increase in revenues via our reseller channel. We face ongoing business risks due to our reliance on our channel partners to maintain customer relationships and create customer demand with customers where we have a limited or no direct relationship. Should our relationships with our channel partners or their effectiveness decline, we face risk of declining demand which could affect our results of operations.

Adverse resolution of litigation may harm our operating results or financial condition.

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition. We are currently involved in litigation with the General Services Administration (GSA) and the Department of Energy (DOE). Additional information is provided in Note 11 to the Consolidated Financial Statements in Item 8.

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

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

Our acquisition, divestiture and alliance activities could disrupt our ongoing business and subject us to significant risks.

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

From time to time, we evaluate our products and service offerings and may adjust our strategic priorities by reducing investment in or divesting certain business operations. Decisions to eliminate or divest certain business operations may involve a number of risks, including the diversion of management's attention, significant costs and expenses, the assumption of contractual obligations, realization of losses, facility consolidation, the loss or disruption of customer relationships, the loss of employees, the elimination of revenues along with associated costs and the disruption

of operations in the affected business or related businesses, any of which could cause our operating results to decline and may fail to yield the expected benefits.

Table of Contents

We may be materially affected by a decrease in demand for our tape products or by an inability to maintain key competitive advantages in tape.

As a result of the acquisition of StorageTek, a significant portion of Storage products revenue is generated by sales of our tape products. If overall demand for tape storage products declines, or if we lose significant market share in tape, our financial condition and results of operations could be materially affected.

One of the key competitive advantages that our tape products have over competing disk products is that tape products store data at a fraction of the price of disk storage. The price of disk storage continues to decrease rapidly due to competition and decreasing manufacturing costs. We must continue to develop and introduce new tape products that reduce the cost of tape storage at a rate that is similar to or greater than the decline in disk storage costs in order to maintain this competitive advantage. For a discussion of risk associated with new products, see 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, above. We cannot provide any assurance that we will be able to reduce the price of our tape products at a rate similar to the decline in disk storage costs.

Credit rating downgrades could adversely affect our business and financial condition.

Three credit rating agencies follow Sun. Fitch Ratings has rated us BBB-, which is an investment grade rating. Moody's Investor Services and Standard & Poor's have assigned us non-investment grade ratings of Ba1 and BB+, respectively. All three credit rating agencies have placed us on stable outlook. These ratings reflect those credit agencies' expectations that the intense competitive environment facing Sun in its core markets will continue to challenge our revenue and profitability, at least over the near term. If we were to be downgraded by these ratings agencies, such downgrades could increase our costs of obtaining, or make it more difficult to obtain or issue, new debt financing. Any of these events could materially and adversely affect our business and 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. Because our compensation packages include equity-based incentives, pressure on our stock price could affect our ability to offer competitive compensation packages to current employees. In addition, we must continue to motivate employees and keep them focused on our strategies and goals, which may be difficult due to morale challenges posed by our workforce reductions, global resourcing strategies and related uncertainties. Should these conditions continue, we may not be able to retain highly qualified employees in the future which could adversely affect our business.

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

We maintain a program of insurance with third-party insurers for certain property, casualty and other risks. The policies are subject to deductibles and exclusions that result in our retention of a level of risk on a self-insurance basis. We retain risk with regard to certain loss events, such as California earthquakes, the indemnification or defense payments we, as a company, may make to or on behalf of our directors and officers as a result of obligations under applicable agreements, our by-laws and applicable law, and for potential liabilities that are not insured, and we sponsor a number of health and welfare insurance plans for our employees. The types and amounts of insurance obtained vary from time to time and from location to location, depending on availability, cost, and our decisions with respect to risk retention. In the event that the frequency of losses experienced by us increased unexpectedly, the aggregate of such losses could materially increase our liability and adversely affect our financial condition, liquidity, cash flows and results of operations. In addition, because the insurance market continues to limit the availability of certain insurance products and because the costs of certain products continue to increase, we will continue to evaluate the types and magnitudes of claims we include in our self-insurance program. Additions and changes to this self insurance program may increase our risk exposure and therefore increase the risk of a material adverse effect on our financial condition, liquidity, cash flows and results of operations. In addition, we have made certain judgments as to the limits on our existing insurance coverage that we believe are in line with industry standards, as well as in light of economic and product availability considerations. Unforeseen catastrophic loss scenarios could prove our limits to be inadequate, and losses incurred in connection with the known claims we self-insure could be substantial. Either of these circumstances could materially adversely affect our financial and business condition.

Business interruptions could adversely affect our business.

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

Table of Contents

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

Our failure to comply with contractual obligations may result in significant penalties.

We offer terms to some of our distributors and other customers that, in some cases, include complex provisions for pricing, data protection and other terms. In connection with these contracts, we are in some cases required to allow the customer to audit certain of our records to verify compliance with these terms. In particular, government agency customers audit and investigate government contractors, including us. These agencies review our performance under the applicable contracts as well as compliance with applicable laws, regulations and standards. The government also may review the adequacy of, and our compliance with, contractual obligations, our internal control systems and policies, including our purchasing, property, estimating, compensation, management information systems and data protection requirements. If an audit uncovers improper or illegal activities, we may be subject to claims for damages, penalties and other sanctions. With respect to claims by government agencies, sanctions may include treble damages, fines and possibly debarment or suspension from sales to the federal government. In addition, we may suffer serious harm to our reputation if allegations of impropriety were made against us. The federal government has intervened in a case filed in the United States District Court for the Eastern District of Arkansas alleging that Sun has violated the Federal False Claims and Anti-Kickback Acts and breached our contracts with the General Services Administration (GSA), among other claims. These claims are based in part on certain audit reports prepared by the GSA Office of the Inspector General with respect to our prior GSA Multi-Award Schedule. Claims by the federal government pursuant to the lawsuit or otherwise in the administration of our contracts, and any judgment or settlement related thereto, could expose us to damages, penalties and other sanctions, up to and including debarment or suspension from federal sales, loss of sales opportunities, business interruption and damage to our reputation.

Some of our Restructuring Plans may not result in the anticipated cost saving and benefits.

Since March 2004, our Board of Directors and our management have approved a series of restructuring plans including the restructuring plan announced on August 1, 2007. Our ability to achieve the cost savings and operating efficiencies anticipated by these restructuring plans is dependent on our ability to effectively implement the workforce and excess capacity reductions contemplated. If we are unable to implement these initiatives effectively, we may not achieve the level of cost savings and efficiency benefits expected for fiscal 2008 and beyond.

Commercial real estate market conditions could affect our ability to sublease properties in our portfolio.

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

Environmental laws and regulations subject us to a number of risks and could result in significant liabilities and costs.

Some of our operations are subject to state, federal, and international laws governing protection of the environment, human health and safety, and regulating the use of certain chemical substances. We endeavor to comply with these environmental laws, yet compliance with such laws could increase our operations and product costs; increase the complexities of product design, development, procurement, and manufacture; limit our ability to manage excess and obsolete non-compliant inventory; limit our sales activities; and impact our future financial results. Any violation of these laws can subject us to significant liability, including fines, penalties, and possible prohibition of sales of our products into one or more states or countries, and result in a material adverse effect on our financial condition.

Currently, a significant portion of our revenues come from international sales. Recent environmental legislation within the European Union (EU), including the EU Directive on Waste Electrical and Electronic Equipment (WEEE) and the EU Directive on Restriction of Hazardous Substances (RoHS), may increase our cost of doing business internationally and impact our revenues from EU countries as we endeavor to comply with and implement these requirements.

In addition, similar environmental legislation has been or may be enacted in other jurisdictions, including the U.S. (under federal and state laws), China, Japan, Canada, Korea and certain Latin American countries, the cumulative impact of which

Table of Contents

could be significant. We are committed to offering products that are environmentally responsible and to complying with any current or future laws protecting the environment, human health and safety.

We may not realize the economic return expected from the acquired in-process research and development (IPRD).

During fiscal 2006, we recorded total in-process research and development expense of \$60 million related to our acquisitions of StorageTek and SeeBeyond. At the time of the acquisitions, we believed there was a reasonable chance of realizing the economic return expected from the acquired in-process technology. However, as there is risk associated with the realization of benefits related to commercialization of an in-process project due to rapidly changing customer needs, the complexity of technology, and growing competitive pressures, there can be no assurance that any project will meet commercial success.

We continue to make substantial progress related to the development and commercialization of acquired technologies. With respect to StorageTek and SeeBeyond, key product releases and major enhancements contemplated by acquired IPRD projects were completed for all significant projects during FY06, with the exception of VSM Open solution which is scheduled for release during Q3 FY2008. In addition, ongoing feature and function enhancements on all of our acquired IPRD projects are expected to continue for several more years. 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, from our estimates at the time of the acquisitions. However, failure to successfully commercialize an in-process project, or unanticipated costs to complete such technologies, would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of our intangible assets may become impaired.

Our ongoing restructuring plans may also impact the expected economic return from acquired in-process technology. During the fourth quarter of fiscal 2006, as a result of our Phase VI restructuring activities, we exited certain StorageTek product lines comprising \$9 million of the total \$49 million assigned to IPRD as of the acquisition date. Future economic benefits for these IPRD projects will not be realized.

Our business may suffer if it is alleged or found that we or our contractors have violated data privacy or confidentiality obligations.

Compliance with a variety of domestic and foreign laws and regulations related to data privacy, as well as various contractual obligations related to confidentiality, increase our cost of doing business. Such obligations include regulations related to the protection of various types of data and information, such as personal healthcare information, personally identifiable information and other confidential information. Although we implement policies and procedures designed to ensure compliance with these obligations, there can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, will not take actions in violation of our policies. Further, our ability to comply with these obligations may depend upon future investments in systems and processes, and such investments may have a material adverse effect on our business, operating results, or financial condition. Failure to comply with these obligations, or even allegations that we have failed to comply with these obligations, may also cause a material adverse effect on our business, operating results, or financial condition.

Our stock price can be volatile.

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

The accounting method for convertible debt securities with net share settlement, like our Convertible Notes, may be subject to change.

On January 26, 2007, we issued \$700 million of convertible notes with a net share settlement feature. For the purpose of calculating diluted earnings per share, a convertible debt security providing for net share settlement of the conversion value and meeting specified requirements under EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (Net Share Convertibles), is accounted for interest expense purposes similarly to non-convertible debt, with the stated coupon constituting interest expense and any shares issuable upon conversion of the security being accounted for under the treasury stock method. The effect of the treasury stock method is that the shares potentially issuable upon conversion of the notes are not included in the calculation of our earnings per share except to the

Table of Contents

extent that the conversion value of the notes exceeds their principal amount, in which case the number of shares of our common stock necessary to settle the conversion are treated as having been issued for earnings per share purposes.

At the July 25, 2007 FASB meeting, the Board agreed to issue for comment a proposed FASB Staff Position (FSP) addressing convertible instruments that may be settled in cash upon conversion. The proposed FSP, as expected to be drafted, would require, among other things, the issuer to separately account for the liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate and would be effective for fiscal periods beginning after December 15, 2007. We cannot predict the outcome of the EITF deliberations or any other changes in GAAP that may be made affecting accounting for convertible debt securities. Any change in the accounting method for convertible debt securities could have an adverse impact on our past or future financial results. In addition, these impacts could adversely affect the trading price of our common stock.

Internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations.

Pursuant to the Sarbanes-Oxley Act of 2002, we are required to provide a report by management on internal control over financial reporting, including management's assessment of the effectiveness of such control. Internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Therefore, even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. In addition, projections of any evaluation of effectiveness of internal control over financial reporting to future periods are subject to the risk that the control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. If we fail to maintain the adequacy of our internal controls, including any failure to implement required new or improved controls, or if we experience difficulties in their implementation, our business and operating results could be harmed, we could fail to meet our reporting obligations, and there could be a material adverse effect on our stock price.

FORWARD-LOOKING STATEMENTS

This quarterly report, including the foregoing sections, contains forward-looking statements, particularly statements regarding: Sun's vision and business strategy; future investments in companies, products and technologies; the environmental impact of our technologies; the expansion of our direct ship capabilities; competitive pressures; our ability to secure licenses to third-party technology on commercially reasonable terms; the effect on us of pending litigation matters and intellectual property claims; our plans to eliminate excess facility capacity; estimates of future sublease income to be generated from sublease contracts not yet negotiated; estimated future restructuring liabilities; expected operating cost savings; expectations regarding future severance payments; expected cash flow from operations for the fiscal year ending June 30, 2008; future payments to settle the current portion of our Senior Notes; the utilization and funding of the workforce reduction assumed liabilities; our ability to utilize deferred tax assets; the reduction of our channel partner inventory; our competitive position in the storage market; efforts to improve our cost structure; charges related to facilities reductions; our valuation of deferred tax assets; our plans to defend certain proceedings; our plans to continue hedge programs; and our belief that the liquidity provided by existing cash, cash equivalents, marketable debt securities and cash generated from operations will provide sufficient capital to meet our requirements for at least the next 12 months.

These forward-looking statements involve risks and uncertainties, and the cautionary statements set forth above and those contained in RISK FACTORS, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

At June 30, 2007, our worldwide facilities represented aggregate floor space of 14.2 million square feet both in the U.S. and in 47 other countries. We believe that our existing properties are in good condition and are suitable for the conduct of our business. In square feet, our properties consisted of (in millions):

	U.S.	Rest of the World	Total
Owned facilities	4.6	1.0	5.6

Edgar Filing: SUN MICROSYSTEMS, INC. - Form 10-K

Leased facilities	5.0	4.0	9.0
Total facilities	9.6	5.0	14.6

Table of Contents

At June 30, 2007, our owned properties consisted of:

Location	Square Footage of Facility
Broomfield, Colorado	1,079,636
Farnborough (Guillemont Park), England	440,024
Linlithgow, Scotland	437,498
Louisville, Colorado	1,707,005
Menlo Park, California	1,022,008
Ponce, Puerto Rico	83,105
Santa Clara, California	816,240
Total	5,585,516

During fiscal 2007, we entered into sales-leaseback transactions for our Newark, California and Burlington, Massachusetts campuses. The total reduction in owned square footage as a result of these two transactions was approximately 2.1 million square feet.

At June 30, 2007, we had approximately 112,000 square feet under construction and approximately 313,000 square feet of existing shell facilities available for future build-out. We continually evaluate our facility requirements in light of our business needs and stage the future construction accordingly. In addition, we own approximately 314 acres of undeveloped land in Colorado.

Starting in fiscal 2001, we began to vacate properties in the U.S. and internationally. Of the properties that were vacated under all facility exit plans, 3.3 million square feet remain vacant or sub-leased of which 1.1 million square feet are under sub-lease to non-Sun businesses and 2.2 million square feet are vacant.

Substantially all of our facilities are used jointly by our Product groups, Sun Services group, Global Sales Organization and other functions. Our manufacturing facilities are located in Ponce, Puerto Rico; Toulouse, France; Linlithgow, Scotland and Beaverton, Oregon.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we become involved in claims and legal proceedings that arise in the ordinary course of our business. We are currently subject to several such claims and legal proceedings. We presently do not believe that the resolution of these legal proceedings will have a material adverse effect on us. Additional information with respect to certain claims and legal proceedings may be found in Note 11 to the Consolidated Financial Statements in Item 8.

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

No matters were submitted to a vote of stockholders of Sun during the fourth quarter of fiscal 2007.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock trades on the NASDAQ Global Select Market under the symbol JAVA. Prior to August 27, 2007, our common stock traded under the symbol SUNW. As of August 22, 2007, there were approximately 19,939 stockholders of record and the closing price of our common stock was \$4.86 per share as reported by The NASDAQ Stock Market.

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

	Fiscal 2007		Fiscal 2006	
	High	Low	High	Low
First Quarter	\$ 5.28	\$ 3.82	\$ 4.29	\$ 3.57
Second Quarter	5.73	4.97	4.56	3.62
Third Quarter	6.64	5.54	5.00	4.14
Fourth Quarter	5.95	4.92	5.38	3.93

No cash dividends were declared or paid in fiscal 2007 or 2006. We anticipate retaining available funds to finance future growth and have no present intention to pay cash dividends.

Issuer Purchases of Equity Securities

The table below sets forth information regarding the Company's purchases of its equity securities during the three fiscal months ended June 30, 2007.

Period	Total # of Shares Purchased ⁽¹⁾	Average Price per Share	Total # of Shares Purchased as Part of Publicly Announced Programs ⁽²⁾	Maximum That May Be Purchased Under Current Program \$ (millions) ⁽²⁾
April 2, 2007 through May 4, 2007	13,774	\$ 0.49		\$ 3,000
May 5, 2007 through June 1, 2007	24,811,197	\$ 5.22	24,811,197	\$ 2,871
June 2, 2007 through June 30, 2007	13,991,980	\$ 5.05	13,990,719	\$ 2,800
Total	38,816,951	\$ 5.15	38,801,916	\$ 2,800

- (1) The total number of shares repurchased includes those shares of our common stock that our employees surrender for tax withholding purposes in connection with vesting of restricted stock. As of June 30, 2007, approximately 674,000 shares are subject to repurchase by us.
- (2) In May 2007, our Board of Directors authorized management to repurchase up to \$3 billion of our outstanding common stock. Under this authorization, the timing and actual number of shares subject to repurchase are at the discretion of management and are contingent on a number of factors, such as levels of cash generation from operations, cash requirements for acquisitions, repayment of debt and our share price. During the fiscal year ended June 30, 2007, we repurchased approximately 38.8 million shares or \$200 million of common stock under this repurchase authorization.

Table of Contents

Stock Performance Graphs and Cumulative Total Return

The graph below compares the cumulative total stockholder return on our common stock with the cumulative total return on the S&P's 500 Index and the S&P Computer Hardware Index for each of the last five fiscal years ended June 30, assuming an investment of \$100 at the beginning of such period and the reinvestment of any dividends. The comparisons in the graphs below are based upon historical data and are not indicative of, nor intended to forecast, future performance of our common stock.

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

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

	Fiscal Years Ended June 30,									
	2007		2006		2005		2004		2003	
	Dollars	%	Dollars	%	Dollars	%	Dollars	%	Dollars	%
	(In millions, except per share amounts)									
Net revenues	\$ 13,873	100.0%	\$ 13,068	100.0%	\$ 11,070	100.0%	\$ 11,185	100.0	\$ 11,434	100.0%
Cost of sales	7,608	54.8	7,439	56.9	6,481	58.5	6,669	59.6	6,492	56.8
Gross margin	6,265	45.2	5,629	43.1	4,589	41.5	4,516	40.4	4,942	43.2
Operating expenses:										
Research and development	2,008	14.5	2,046	15.6	1,785	16.1	1,926	17.2	1,837	16.1
Selling, general and administrative	3,851	27.8	4,039	30.9	2,919	26.4	3,317	29.7	3,329	29.1
Restructuring charges and related impairment of long-lived assets	97	0.7	284	2.2	262	2.4	344	3.1	371	3.2
Impairment of goodwill and other intangible assets			70	0.5			49	0.4	2,125	18.6
Purchased in-process research and development			60	0.5			70	0.6	4	
Total operating expenses	5,956	42.9	6,499	49.7	4,966	44.9	5,706	51.0	7,666	67.0
Operating income (loss)	309	2.2	(870)	(6.7)	(377)	(3.4)	(1,190)	(10.6)	(2,724)	(23.8)
Gain (loss) on equity investments, net	6		27	0.2	6		(64)	(0.6)	(84)	(0.7)
Interest and other income, net	214	1.5	114	0.9	133	1.2	94	0.8	155	1.3
Settlement income	54	0.4	54	0.4	54	0.5	1,597	14.3		
Income (loss) before taxes	583	4.2	(675)	(5.2)	(184)	(1.7)	437	3.9	(2,653)	(23.2)
Provision (benefit) for income taxes	110		189	1.4	(77)	(0.7)				