SUN MICROSYSTEMS, INC.
Form 10-K
September 13, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended June 30, 2005

.. **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: **None**

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

* **Common Stock**

* **Share Purchase Rights**

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

Indicate by check mark 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 the 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. x

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

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

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant, as of December 23, 2004 (the last business day of registrant s second quarter of fiscal 2005), was approximately $18.0 billion based upon the last sale price reported for such date on The Nasdaq National 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 September 6, 2005 was 3,410,044,325.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the 2005 Annual Meeting of Stockholders are incorporated by reference into Items 10, 11, 12, 13 and 14 hereof.

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Restatement Explanatory Note

Sun Microsystems, Inc. has restated its consolidated financial statements for fiscal 2004 and 2003, quarterly financial data for each of the quarters within fiscal 2005 and 2004, and selected financial data for fiscal 2004 and 2003 (the Restatement). The determination to restate these financial statements and selected financial data was made by our management in consultation with the Audit Committee on September 12, 2005, as a result of our identification of errors related to the accounting for deferred taxes in certain foreign jurisdictions, as well as the aggregate effect of corrections to provisions for State and foreign tax returns and withholding taxes. In addition, the determination to restate our quarterly financial statements within fiscal 2005 was the result of evaluating the impact of certain pre-tax accounting adjustments recorded throughout the year. Our Audit Committee discussed these matters with our independent registered public accounting firm. These errors were largely identified through the operation of our internal controls over financial reporting. Although we believe such errors were immaterial to our consolidated financial statements and selected financial information for fiscal 2004 and 2003, under relevant Securities and Exchange Commission accounting interpretations, a restatement of the consolidated financial statements of such prior periods to correct immaterial misstatements therein is required if the aggregate correcting adjustment related to such errors would be material to the financial statements of the current period.

The Restatement reduces the benefit from income taxes for fiscal 2005 by $45 million and decreases the provision for income taxes for fiscal 2004 and 2003 by zero and $45 million, respectively.

The Restatement has an immaterial effect on our consolidated balance sheets at the end of each of the restated periods and has no net effect on revenues or operating cashflows for those periods. Although there is no pre-tax impact as a result of these adjustments to the consolidated financial statements for fiscal 2005, the pre-tax accounting adjustments throughout the year would be considered material to the previously reported quarters of fiscal 2005. Accordingly, the fiscal 2005 quarters have been restated. The following tables set forth the effects of the Restatement on our previously reported financial statements of operations for fiscal 2004 and 2003 and the affected quarters of fiscal 2005 and 2004 (in millions, except per share amounts):

	Fiscal Years Ended June 30,	
	2004	2003
		(Restated)
Impact of adjustments to provision for (benefit from) income taxes	$	$ (45)
Net loss as previously reported	$ (388)	$ (3,429)
Impact of restatement		45
Net loss as restated	$ (388)	$ (3,384)
Net loss per share basic and diluted as previously reported	$ (0.12)	$ (1.07)
Impact of restatement		0.01
Net loss per share basic and diluted as restated	$ (0.12)	$ (1.06)

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	Fiscal 2005				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year ended June 30, 2005
	(Restated)	(Restated)	(Restated)		
Impact of pre-tax adjustments to income (loss) before taxes	$ 14	$ (14)	$ (3)	$ 3	$
Impact of tax adjustments to provision for (benefit from) income taxes			22	23	45
Net impact of adjustments to net income (loss)	$ 14	$ (14)	$ (25)	$ (20)	$ (45)
Net income (loss) as previously reported/announced	$ (147)	$ 18	$ (3)	$ 70(*)	$ (62)(*)
Impact of restatement	14	(14)	(25)	(20)	(45)
Net income (loss) as restated	$ (133)	$ 4	$ (28)	$ 50	$ (107)
Net income (loss) per share basic and diluted as previously reported/announced	$ (0.04)	$ 0.01	$ (0.00)	$ 0.02(*)	$ (0.02)(*)
Impact of restatement		(0.01)	(0.01)	(0.01)	$ (0.01)
Net income (loss) per share basic and diluted, as restated	$ (0.04)	$ 0.00	$ (0.01)	$ 0.01	$ (0.03)

(*) Amount reflects the impact of certain adjustments made to our reported results subsequent to the date of our earnings announcement. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations for further information.

	Fiscal 2004				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year ended June 30, 2004
	(Restated)	(Restated)	(Restated)	(Restated)	
Impact of adjustments to provision for (benefit from) income taxes	$ 2	$ 1	$ (6)	$ 3	$
Net income (loss) as previously reported	$ (286)	$ (125)	$ (760)	$ 783	$ (388)
Impact of restatement	(2)	(1)	6	(3)	
Net income (loss) as restated	$ (288)	$ (126)	$ (754)	$ 780	$ (388)
Net income (loss) per share basic as previously reported	$ (0.09)	$ (0.04)	$ (0.23)	$ 0.24	$ (0.12)
Impact of restatement				(0.01)	
Net income (loss) per share basic as restated	$ (0.09)	$ (0.04)	$ (0.23)	$ 0.23	$ (0.12)
Net income (loss) per share diluted as previously reported	$ (0.09)	$ (0.04)	$ (0.23)	$ 0.23	$ (0.12)
Impact of restatement					

Net income (loss) per share diluted as restated	$ (0.09)	$ (0.04)	$ (0.23)	$ 0.23	$ (0.12)

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PART I

ITEM 1. BUSINESS

GENERAL

Sun s business is singularly focused on providing network computing products and services. Network computing has been at the core of our offerings for the 23 years of our existence and is based on the premise that the power of a single computer system can be increased dramatically when interconnected with other computer systems for the purposes of communication and sharing of computing power. Interoperability, long-term investment protection and value-added innovation across many different computing platforms and devices remain fundamental elements of our approach and are unique parts of what makes our offerings valuable to customers. Customers value us for our thought leadership, our ability to create and nurture large communities of developers around innovation and the value that the resulting solutions create for their own businesses.

Core beliefs like invention, openness, community, sharing, freedom and collaboration are a fundamental part of our culture and DNA. With these beliefs as our foundation, together with our partner community, we provide network computing infrastructure solutions that comprise Computer Systems (hardware and software), Network Storage Systems (hardware and software), Support Services, and Client solutions and Educational services (formerly known as Professional and Knowledge services). Core brand franchises include the Solaris operating system (Solaris OS), the Java technology platform and products and the UltraSPARC® processor technology.

Our customers use our products and services to build mission-critical network computing environments to operate essential elements of their businesses. Our network computing infrastructure solutions are used in a wide range of technical, scientific, business and engineering applications in industries such as telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare. Typical applications which customers operate on our infrastructure solutions range, for example, from webserving to high-performance technical computing to enterprise-wide Resource Planning and Customer Relationship Management.

For the fiscal year ended June 30, 2005, we had net revenues of $11.1 billion, employed approximately 31,000 employees and conducted business in over 100 countries. We were incorporated in California in February 1982 and reincorporated in Delaware in July 1987.

Our Internet address is http://www.sun.com. Our most recent annual report on Form 10-K and certain of our other filings with the Securities and Exchange Commission (SEC) are available in PDF format through our Investor Relations website at http://www.sun.com/aboutsun/investor. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports are also available on the SEC website at http://www.sec.gov, which can be reached from our Investor Relations website. The contents of these websites 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 websites are intended to be inactive textual references only.

BUSINESS STRATEGY

Our business strategy is built around our singular focus on network computing infrastructure and the community that it enables. Our Computer Systems (hardware and software), Network Storage Systems (hardware and software), Support Services, as well as our Client solutions and Educational services are designed to enable network solutions that attack cost and complexity, accelerate network service deployment and enable mobility with security. The core elements of our business strategy include:

On-going innovation in systems design, networking integration, microprocessor architecture, operating systems and software to ensure continuing technology leadership and resulting price-performance advantage;

An end-to-end architecture that extends our common Java technology-based programming environment across our SPARC® (Scalable Processor Architecture) technology implementation and our line of x64-based products. Our products provide exceptional price-performance, flexibility, scalability and choice for devices as small as smart cards and cell phones up through large, multi-million dollar systems;

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A commitment to interoperability and open source development as the key to building stronger communities, higher value solutions for our customers and opening up new market opportunities;

Our emphasis on customers infrastructure investment protection as demonstrated through legacy application support, our binary compatibility guarantee and the ability to selectively upgrade single processor boards within the same system;

A solutions-based selling model which emphasizes our end-to-end network computing architecture platform to integrate our products and services to address customers strategic business challenges and information technology needs;

Innovative business opportunities which make customers more active participants in how we innovate and offer them new ways of acquiring and deploying IT solutions. These business models are augmenting the types of products and services we offer, as well as how we assemble them into customer solutions;

Expansion of our Network Computing vision to include data storage technology which enables us to help customers tightly integrate advanced data management technologies to acquire, use and distribute knowledge, as well as store, manage and retrieve it; and

A robust partner community, including independent software vendors (ISVs), system integrators, resellers and original equipment manufacturers (OEMs), whose members collaborate in building new and innovative solutions based on our products and services while extending our reach and expertise.

Innovation

In order to be a leading developer of enterprise and network computing products and technologies, we must continue to invest and innovate. As indicated by our research and development investments of approximately 16-17% of annual revenues during each of the last three fiscal years, we continue to focus on technological innovation. Over the past few years, we have also made significant investments in several product and services technology acquisitions. Our investments in research and development and acquisitions include:

The highly reliable and scalable Solaris Operating System (Solaris OS) and our most recent release, Solaris 10, which debuted several major advancements in availability, performance and security to help customers proactively manage their computing resources. These innovations are now available through the OpenSolaris project, which is intended to drive a deeper understanding of Solaris and expand adoption in the ISV community;

The highly scalable UltraSPARC processor and systems architecture. Our latest processor technology incorporates chip multithreading at the processor level as part of our throughput computing initiative. We are driving towards significant gains in performance for the same footprint and power consumption, leveraging technology acquired through our purchase of Afara Websystems, Inc. (fiscal 2003);

The fast growing x64 systems offering based on AMD s Opteron processor, which has won 32 world record benchmarks and is creating new opportunities for Sun in a variety of customer and industry environments. including grid computing environments for high-performance technical computing;

The x64 system architecture and advanced systems technology acquired with our purchase of Kealia, Inc. (fiscal 2004). These developments bring to the market our next generation of x64 rack-optimized servers and further our strategy of horizontal scalability on our AMD Opteron-based systems;

Mission-critical clustering, messaging, identity management, directory and web services infrastructure software known as Java Enterprise System and an industry-leading business model based on per employee pricing, which makes middleware substantially more affordable compared to the traditional model by being priced on a per employee basis;

The cross-platform Java software development environment, spanning smart cards, cellular handsets, set top boxes, desktop computers and servers, used by our customers and ISV partners;

Virtualization, provisioning and monitoring software architecture for network computing resource optimization and systems management simplification;

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Enterprise desktop technologies, Java Desktop System, StarOffice, including technologies acquired through Tarantella, Inc. s (fiscal 2006) Secure Global Desktop family of products which, combined with SunRay thin client can provide seamless access to virtually any application environment;

Network-based storage systems and software, including our acquisition of Procom Technology, Inc. s (fiscal 2005) network attached storage (NAS) intellectual property assets and engineering expertise, which will better enable us to build our next generation of NAS and file-based storage system; and

Remote and proactive managed services offerings delivered through a secure connection to Sun. Our new services technology provides remote diagnostics and preventive services for our customers, now enhanced to include multi-platform support, through our acquisition of managed service provider SevenSpace, Inc. (fiscal 2005). The Sun Connection is the first of many such products which deepen our relationships with customers and allow us to deliver ongoing value to them.

Many of these technologies provide us with a competitive advantage and differentiation in the marketplace. By investing in research and development, as well as product and services technology acquisitions, we believe we are able to develop and deliver more valuable systems technology and better address the complex issues our customers face. We intend to continue our investments into new computing technologies and are focused on the development and delivery of leading-edge network computing products based upon our innovations.

End-to-End Architecture

Developing and deploying services over the network requires an infrastructure platform that is enterprise-ready, developer-rich and economically compelling. This means that we are focused on providing the optimal combination of software, hardware and services that will give the customer the best value through lower annual administrative costs, lower developer training costs and lower downtime costs, which, in turn, will decrease the customers total cost of ownership.

In fiscal 2005, we upgraded a number of current products supporting our strategy as an end-to-end infrastructure platform company. We improved the performance of our dual-thread UltraSPARC IV processor across our mid and high-end server lines. Targeted for mission-critical enterprises, the UltraSPARC IV processor is fully binary compatible with our previous generation processor, so customers can run existing applications without the time and expense of rewriting, retesting or re-certifying applications. This provides unique advantages for us over our competitors.

We also strengthened our x64 low-end server product line and now provide customers the choice of either the Linux or Solaris Operating System on x64. We introduced a new version of our Solaris OS, which brings significant benefits to customers by reducing system downtime and upgrade costs. Solaris 10, like all our past versions of the Solaris OS, comes with our binary compatibility guarantee that every release is designed to run existing applications currently running on previous Solaris OS releases.

Our software consists of Sun s powerful and scalable Solaris OS, Sun Java Enterprise System, Java Desktop System, N1 Grid Engine System and the Java Studio development environment. Our software builds upon our well-established Java technology to meet the needs of developers, CIOs and operators to provide information, data and applications anywhere, anytime and on any device, using open application programming interfaces that work with a wide array of operating systems and applications.

Interoperability

From our inception, we have focused on developing products and technologies based upon open standards. We believe the real power in computing lies in the ability to freely access and share information over the network, while unconstrained by proprietary software and hardware standards. We pioneered this approach with the invention of Network File System technology in 1985 and since then have focused on optimizing the interoperability of different systems on different networks.

For our customers, interoperability means the freedom to build heterogeneous networks and to choose best-of-breed hardware and software solutions for their IT environments. Interoperability, and the simplicity and flexibility that it

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provides, constitute an important element of our value proposition to customers. With the advent of webservices, the Java platform has proven itself as a key enabler of an entire generation of new applications and dynamic content in the form of new consumer services for phones, PCs and other devices. The thought leadership displayed by Sun is valued by customers because the window it provides them into critical developments in the industry is relevant to the success of their business infrastructures.

In May 2005, Sun and Microsoft Corporation (Microsoft) reaffirmed a commitment to joint collaboration based on a 10-year intellectual property licensing and technology collaboration agreement. Since then, we have taken a number of steps to further our joint goal of interoperability. Sun and Microsoft announced joint authorship and commitment to the system management specification, Web Services-Management, which, when implemented, is expected to enable full system management across our Solaris OS and Microsoft Windows environments. A number of other collaboration projects are also underway to improve compatibility and close integration between our respective products.

Investment Protection

Our customers have made significant investments in hardware and software assets for their companies. To help our customers maximize the return on their investments, we make Investment Protection a priority in all our products. We guarantee that customer applications running on earlier versions of Solaris will run on our newest version, Solaris 10, without the need to recompile, thus avoiding cost and risk. As the Solaris OS runs on both our UltraSPARC-based data center servers as well as our x64 systems, customers are able to leverage the same application environment and skill sets thereby lowering their cost of operations. Our hardware also supports heterogeneous environments so that customers not only have the choice but also have the flexibility to change operating systems as their needs change. Our customers can purchase our x64 servers and storage and deploy them with the Solaris OS, Linux, or Microsoft Windows. They can then redeploy as needed the very same hardware using a different operating system choice without the daunting task of purchasing and porting to a new hardware platform. On our data center servers, we also provide the ability to selectively upgrade single processor boards within the same system, meaning customers have the ability to gradually adopt faster processors without having to buy completely new hardware. This extends the lifecycle of a customer s investment. By building investment protection into our product offerings, we make it easier for customers to manage change, complexity and costs in their IT infrastructure.

Solutions-Based Selling Model

With our solutions-based selling model, we offer an integrated and consistent set of end-to-end networking architecture solutions and methodologies to the marketplace. This set of solutions and methodologies brings together a combination of servers, software, storage and services to help customers address their most complex problems, including business compliance, reducing costs, providing secure global access and designing next-generation data centers. We have organized our resources, technical understanding and business expertise into the following six competencies:

Data Center: Focused on enabling enterprises to leverage our systems products, architectures and best practices at the heart of next-generation, service-oriented data centers;

Storage and Data Management: Focused on information life cycle management, and the products and processes necessary to manage business continuity, legislative compliance, storage consolidation, and content repositories at the heart of the global storage industry;

Desktop and Mobility: Focused on leveraging open-source products to drive cost savings in desktop deployments with SunRay, Java Desktop System, and StarOffice;

Identity Management: Focused on securing the enterprise, and automating the provisioning processes associated with granting and denying access to users, systems and enterprise resources;

Enterprise Web Services: Focused on enabling enterprises to leverage Java 2 Enterprise Edition (J2EE) web services platform, and evolving service oriented architectures (SOAs) and service delivery platforms (SDPs); and

Manageability Services: Focused on our global service offerings, enabling increased system service levels, data center operational efficiency and effectiveness, as well as next-generation automation technologies to provide predictive, preemptive and proactive service to heterogeneous infrastructures.

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These competencies line up directly with the three key strategies we present to our customers as part of our vision attacking cost and complexity, accelerating network service deployment and enabling mobility with security. We believe our solution-based selling approach allows us to engage with our customers over the entire lifecycle of their key infrastructure projects, improving the delivery of sustainable value from the products and services we produce.

Innovative Business Opportunities

As a company, we are continually exploring new ways of doing business and collaborating with our partners and customers to deliver greater value.

OpenSolaris: A community is built through the sharing of ideas, technologies and markets. Accordingly, in June 2005, we released OpenSolaris, an initiative to make the source code for Solaris 10 available under the Open Source Initiative (OSI) approved Common Development and Distribution License (CDDL). Consistent with our heritage of open source and open standards-based software, our intention in making Solaris 10 free is to help foster the innovation and collaboration needed to provide for new opportunities for developers, customers and partners. Making Solaris source code an open environment encourages a deeper understanding of Solaris and its innovations by providing a direct channel of feedback from the engineering community, thus helping to drive the cycle of innovation even further and even faster.

Subscription Model: We continue to use our subscription model to greatly simplify the pricing, licensing, delivery and maintenance of our product and service offerings for our customers. We combine our software and services into an integrated package to facilitate quick deployment and reduce cost, complexity and risks to our customers over the lifetime of the subscription. Customers receive new products and upgrades automatically over the term of the subscription. The subscription model offers customers a simple, predictable and affordable way to buy our software and services.

Utility Computing: We have developed a number of hardware and software products, service offerings, solution architectures and business models aligned with our vision of utility computing. In fiscal 2005, we introduced products such as Sun Storage Grid Utility and Sun Storage Grid Rack. Our N1 Grid Engine is the software that enables all the individual components of the grid to act together as one system. We have built service offerings specifically to help customers build their own private grid or buy into our public grid utility. Our subscription business model makes all this easy and predictable to purchase; some offerings are as easy as $1 per-employee per year or $1 per GB of storage per hour. As customers come to realize the potential for cost savings and significant reductions in complexity, we expect utility computing to become an important element of our product and services strategy.

Remote Services Delivery: Sun Connection, introduced in fiscal 2005, is an integrated, secured service connection that links customers, partners, developers and Sun in a dynamic and collaborative network-based community. Our Customer Networked Services group, which is driving the Remote Services Delivery effort, is an internal partnership between our Services and Software organizations to deliver advanced Support and Educational Services through software innovation. Sun Management Connection, which incorporates the remote managed services technology from our recent SevenSpace Inc. acquisition, allows us to deliver scalable, 24x7x365 remote management of heterogeneous IT environments over the Internet without customer investment in IT infrastructure.

Data Storage Technology

Recently, data retention requirements on companies have been multiplying with stricter regulations from such sources as the Sarbanes-Oxley Act, the U.S. Food and Drug Administration and the Securities and Exchange Commission. We see an opportunity and need to expand our network computing infrastructure to include data archival technology and Information Lifecycle Management (ILM). We anticipate that our ILM strategy, and its focus on data storage, retention, retrieval and appropriate destruction, will become an important part of our end-to-end solutions. Accordingly, in August 2005, we acquired Storage Technology Corporation (StorageTek) to support our efforts. As a result of this acquisition, we expect to broaden our storage product portfolio, expand our storage channel network, and strengthen our sales and service forces in line with our expanded vision.

Alliances and Partner Community

Revolutionary solutions come from the meeting of many different minds. We seek out partners with whom we share common interest and cause. In fiscal 2005, we continued to form relationships with significant partners to extend our

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customer solutions. We also continue to partner with Advanced Micro Devices, Inc. (AMD) to expand our entry-level line of Opteron processor-based x64 systems, giving customers greater platform choice with maximum price performance. We also maintain a strategic alliance with Fujitsu to collaborate on the development, delivery and support of a future generation of SPARC-based systems. This alliance is intended to enlarge the Solaris 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. In addition, we continued our relationship with Hitachi Data Systems to provide high-end storage solutions and extend our storage offering into enterprise environments.

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 its customers. We have established relationships with leading ISVs, value-added resellers (VARs), OEMs, channel development providers, independent distributors, computer systems integrators and 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.

SALES, MARKETING AND DISTRIBUTION

Our Global Sales Organization manages and has primary responsibility for our field sales, relationships with our selling partners, technical sales support, sales operations and delivery of professional services covering our six competency areas. We 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 VARs. In addition, our strategic alliance with Fujitsu provides expanded distribution of both companies existing SPARC product lines.

Our sales force serves the telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare industries. We have organized our sales coverage within 15 geographically established markets (GEMs) around the world. We have approximately 78 sales and service offices in the United States and an additional 145 sales and service offices in 47 other countries. We employ independent distributors in over 100 countries. In general, our sales coverage model calls for independent distributors to be deployed in partnership with our direct sales force. However, in some smaller markets, independent distributors 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 67%, 63% and 61% of our total net revenues in fiscal 2005, 2004 and 2003, respectively. Our channel partners include:

- Systems integrators, both government and commercial, who serve the market for large commercial projects requiring substantial analysis, design, development, implementation and support of custom solutions;
- Channel development providers who supply our products and provide product marketing and technical support services to our smaller resellers;
- VARs who provide added value in the form of software packages, proprietary software development, high-end networking integration, vertical integration, vertical industry expertise, training, installation and support;

OEMs who integrate our products with their hardware and software; and

Independent distributors who primarily serve foreign markets where we do not have a direct presence.

Additionally, ISV partners 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 have a wide range of marketing activities. Our Worldwide Marketing Organization oversees our marketing planning, determines product and pricing strategy, coordinates advertising, demand creation and public relations activities, maintains strategic partnerships with major ISVs and performs competitive analyses.

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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.

Revenues from outside the United States (U.S.) were approximately 60% of our total net revenues in fiscal 2005 and 57% and 56% of our total net revenues in fiscal 2004 and 2003, 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 3% of total net revenues for fiscal 2005.

The countries primarily contributing to our international sales are the United Kingdom (U.K.), Germany and Japan. The U.K. represented approximately 9%, 8% and 7% of our total net revenues in fiscal 2005, 2004 and 2003, respectively. Germany represented approximately 8%, 7% and 8% of our total net revenues in fiscal 2005, 2004 and 2003, respectively. Japan represented approximately 7%, 7% and 8% of our total net revenues in fiscal 2005, 2004 and 2003, respectively. For information about sales to unaffiliated customers and revenues by geographic areas, refer to Note 16 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.

Some of our sales to international customers are made under export licenses that must be obtained from the U.S. Department of Commerce. In addition, all of our export transactions are subject to U.S. export control laws, and certain transactions could require prior approval of the U.S. Department of Commerce. Protectionist trade legislation in either the U.S. or other countries, such as a change in the current tariff structures, export compliance laws or other trade policies, could adversely affect our ability to sell or to manufacture in international markets. Furthermore, revenues from outside the U.S. are subject to inherent risks, including the general economic and political conditions in each country. See Note 16 to the Consolidated Financial Statements for additional information concerning sales to international customers and business segments.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 16%, 14% and 11% of our fiscal 2005, 2004 and 2003 total net revenues, respectively. More than 80% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. The vast majority of the revenue included in the amounts above is from sales through a single GE subsidiary, having comprised 13%, 11% and 9% of total net revenues in fiscal 2005, 2004 and 2003, respectively. This GE subsidiary acts as a distributor of our products to resellers who in turn sell those products to end-users. Our business could be adversely affected if GE or another significant customer terminated its business relationship with us or significantly reduced the amount of business it did with us.

Our product order backlog at June 30, 2005 was $805 million, as compared with $834 million at June 30, 2004. 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. In either case, sufficient evidence of an arrangement exists and final delivery has yet to be completed. 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. However, backlog orders are supported by evidence of a customer arrangement (typically a customer purchase order), or customer pre-payment (whereby customer delivery occurs over a period of time or through specific milestones). Although actual customer delivery can occur over several periods, product backlog can be used to identify potential revenue coverage for pending periods. The larger the percentage coverage of targeted pending revenue, the lower the potential risk of non-achievement. As we explore new ways of doing business and collaborate with our partners and customers to deliver greater value, our backlog metric may evolve to better identify potential revenue coverage for pending periods.

WORLDWIDE OPERATIONS

Our Worldwide Operations organization manages company-wide purchasing of materials used in producing our products, assists in product design enhancements, oversees our own manufacturing operations and those of our

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manufacturing partners and coordinates logistics operations. Our manufacturing operations consist primarily of final assembly, test and quality control of enterprise and data center 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 which enables us to ship some products directly from our suppliers to our customers, reducing cost, risk and complexity in the supply chain. We have continued efforts to simplify the manufacturing process by reducing the diversity of system configurations offered and 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 result in delays of product shipments.

We depend on many suppliers for the necessary parts and components to manufacture our products. There are a number of vendors producing the parts and components that we need. However, there are some components that can only be purchased from a single vendor due to price, quality, or technology reasons. For example, we depend on Texas Instruments for our SPARC® microprocessors and several other companies for custom integrated circuits. If we were unable to purchase the necessary parts and components on acceptable terms from a particular vendor and we had to find a new supplier for such parts and components, our new and existing product shipments could be delayed, adversely affecting our business and operating results. Similarly, our ability to purchase components in sufficient quantities to meet customer demand could impact our future operating results. Further, we also face the risk of ordering too many components, or conversely, not enough components, because orders are generally based on forecasts of customer orders rather than actual orders, which subjects us to inventory risk.

RESEARCH AND DEVELOPMENT

Our research and product development programs are intended to sustain and enhance our competitive position by incorporating the latest global advances in hardware, 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 system software platforms for Internet and intranet applications, telecommunications and next-generation service provider networks, developing advanced workstation, server and storage architectures and advanced service offerings. We devote substantial resources to software 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, Norway and India. Research and development (R&D) expenses were $1,785 million, $1,926 million and $1,837 million in fiscal 2005, 2004 and 2003, respectively.

PRODUCTS

Our products consist of Computer Systems and Network Storage systems, a variety of software and services related to both systems and storage. For information about external revenue for similar classes of products and services, refer to Note 16 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.

COMPUTER SYSTEMS

Our Computer Systems products and technologies, including our full line of scalable workgroup and enterprise servers, our UltraSPARC microprocessors and our software, are designed, developed and produced as integrated systems for network computing environments.

Servers. We offer a full range of servers from our data center/high-performance computing servers through our entry servers and blade systems.

Data Center servers. Our data center servers, including the Sun Fire E25K and Sun Fire E20K, are designed to offer greater performance and lower total cost of ownership than mainframe systems and are used for server consolidations, application migrations, data mining and warehousing, custom applications, on-line transaction support,

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enterprise resource planning, high performance technical computing and databases. The Sun Fire E25K server is one of the most scalable UNIX® platform-based systems in the marketplace and incorporates our UltraSPARC IV microprocessor, bringing dual-threaded capability to the data center.

Enterprise servers. Our enterprise servers, including Sun Fire E6900, Sun Fire E4900, Sun Fire E2900 and Sun Fire V1280 servers, provide reliability, availability and scalability to address the needs of data centers and enterprise-scale network computing at a moderate cost. These servers are available with various options in processor and memory expandability, hardware redundancy and component accessibility and run on the Solaris OS. In fiscal 2005, we introduced the Sun Fire E2900, Sun Fire E4900 and Sun Fire E6900 servers, which use the UltraSPARC IV processor and are built to deliver dual-threaded capability and fault management technology into our family of mid-range Sun Fire servers.

Entry server systems. We also offer an expansive line of entry server systems differentiated by their size, their processor architecture (SPARC or x64), their form factor (rackable or stand-alone systems) and the environment for which they are targeted (general purpose or specialized systems).

Entry SPARC-based systems include our Sun Fire V240, Sun Fire V210 and Sun Fire V440 servers, which deliver network computing in a compact, low-cost package. In fiscal 2005, we introduced the Sun Fire V890 and the Sun Fire V490 servers, which use the new UltraSPARC IV processor and Solaris 10 OS.

During the latter half of fiscal 2005, we upgraded our Sun Fire V20z server and Compute Grid Rack System, as well as the new Sun Fire V40z server, with the new industry-standard, dual-core AMD Opteron processors. We also enhanced our x64 server line in fiscal 2005 with the new dual-core AMD Opteron processors. These processors, which integrate four microprocessors with two complete cores, have improved processing performance without the need to increase power consumption or rack/floor space.

We offer an additional line of products aimed at the unique needs of OEMs and Network Equipment Providers (NEPs). Rack-optimized systems, such as 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 and ruggedized Netra systems are designed to meet the specialized needs of NEPs.

Desktops and Workstations. Our desktops and workstations provide powerful solutions for a wide range of business and technical activities such as software development, mechanical design, financial analysis and education. Our product line includes high-performance 64-bit workstations, graphics accelerator boards, x64-based workstations and thin Sun Ray Ultra-Thin Client products. The Sun Blade 2500 and 1500 workstations are designed to meet the needs of demanding graphics, visualization and compute applications. The Sun Blade W1100z and Sun Blade W2200z are AMD Opteron-based workstations that support Linux (Red Hat and SuSe, 32-Bit and 64-Bit) and the Solaris OS (32-Bit and 64-Bit) and are Microsoft certified.

Processor and Network Products. In fiscal 2005, the UltraSPARC processor lines were reoriented to reflect the two main types of workloads our customers experience. Our data-intensive processor line includes the UltraSPARC IV, with dual-core processors, which furthers our throughput computing initiative. Our multi-core technology enables customers to experience real performance improvements in their workloads. For network-intensive workloads which require more horizontal scaling, we offer the UltraSPARC IIIi+ processors, which are mainly used on our entry and workgroup servers.

In fiscal 2005, we also began offering our first application switching network system, the Sun N2000 Series Secure Application switch, a productization of technology from our acquisition of Nauticus Networks, Inc. (January 2004). The N2000 Series reduces cost and complexity in network computing through improved resource utilization, service consolidation and leading price-to-performance ratio.

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

Solaris Operating System (OS). The Solaris OS is a high-performance, highly reliable, scalable and secure operating environment for SPARC and x64 platforms that is easy to install and use, is optimized for the Java platform and supports more than 8,000 applications. It is optimized for enterprise computing, Internet and intranet business requirements, powerful databases and high performance technical computing environments.

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With our newest version of Solaris OS, Solaris 10, customers now have access to our latest technical innovations such as Solaris Containers, Predictive Self-healing and Solaris Dynamic Tracing (DTrace) capability, all while maintaining binary compatibility with previous Solaris versions. Solaris Containers is an advanced approach to system virtualization with multiple software partitions per single instance of the Solaris OS, making consolidation simple, safe and secure. Predictive Self-Healing delivers improved service availability with on-line error detection and auto recovery. Dynamic Tracing (DTrace) equips users with a tool for analyzing and diagnosing elusive bottlenecks in real-time. The Solaris 10 source code was recently made available through the OSI as a project called OpenSolaris. OpenSolaris is helping to drive even more innovation into our Solaris OS and has fostered a deeper understanding of Solaris features in the ISV community.

Our Trusted Solaris OS provides a high level of privacy and reduces the risk of security violations on a commercial-grade OS. Our current version, Trusted Solaris 8 OS is available for both SPARC and x64 platforms.

Java technology. Our Java platform application environment allows development of application software independent of the underlying operating system or microprocessor based on open standards. Java technology allows a developer to write applications once for a wide range of platforms and devices. Our Java platforms are based on a common core architecture and include the Java 2 Platform, Standard Edition (J2SE) technology used on personal computers and workstation clients and available on Solaris OS, Linux, HP-UX, AIX, Tru64 Unix, Windows, MacOS X and other platforms; Java 2 Platform, Enterprise Edition (J2EE) technology used to develop and deploy web services which enable secure, robust and interoperable business applications; Java 2 Platform, Micro Edition (J2ME) technology, which extends Java technology to 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.

Sun Java Enterprise System. Our Sun Java Enterprise System (Java ES) software enables enterprises to utilize their information and applications into services offered on intranets and the Internet. The Java ES business model drove a market transformation by making enterprise software more simple, affordable and predictable through a new subscription acquisition model. In fiscal 2005, we began offering a new release of Java ES along with more targeted Java Suites covering Identity management, Application platform services, System availability, Web infrastructure and Enterprise communications.

Sun Java Studio Developer tools. We develop and market software development tools designed to aid in application development and integration. The Java 2 Software Development Kit enables developers to create and run both applets (miniature applications written in the Java programming language) that run inside a web browser and applications that run outside of a browser. Our Sun Java Studio Developer Platform provides a desktop-to-mainframe development and test environment for programming in C, C++ and Java programming languages.

Sun Java Desktop System. Our desktop software includes all the key components of a user s environment, ranging from the user interface and desktop utilities to a browser, multimedia capabilities and the StarOffice personal productivity suite. The StarOffice office productivity suite has a fully integrated set of applications including word processing, spreadsheet, graphic design, presentations, database access, HTML editor, mail/news reader, event planner and formula editor tools. It runs on most major operating environments and platforms, including the Solaris OS, Microsoft Windows, Linux, OS/2 and Java platforms.

Sun N1 Grid Engine. N1 Grid Engine software is our vision and architectural blueprint for reducing the cost and complexity of managing enterprise data centers by allowing a data center to work like a single system by combining an enterprise s IT resources (e.g. servers, storage and network devices) with virtualization, provisioning, policy and automation, and monitoring.

NETWORK STORAGE

Our Network Storage systems integrate storage, storage components and software to complete our end-to-end data management solutions across heterogeneous environments.

Storage Systems. Our high-end data storage systems provide a platform for direct attach storage or storage area network (SAN) solutions. They are designed for extreme availability, performance, scalability, connectivity and manageability required for the Data Center. Our high-end data storage systems, including the Sun StorEdge 9980, Sun StorEdge 9970 and the new Sun StorEdge 9990, combine Hitachi Data Systems (HDS) high-end storage hardware with our resource management and file management software under an OEM agreement with HDS first signed in fiscal 2002.

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We offer a wide range of flexible, scalable mid-range storage systems, including the Sun StorEdge 6320, Sun StorEdge 6120, Sun StorEdge 6130 and Sun StorEdge A5200 Array, which support high-performance computing and enterprise SAN implementations, as well as storage virtualization technology. In fiscal 2005, we announced several significant enhancements to the Sun StorEdge 6920 system, including heterogeneous storage virtualization, which will allow customers to integrate multivendor storage assets into a single modular system and simplify storage management and improve resource utilization.

Our Sun StorEdge products for workgroup applications, including the Sun StorEdge 3510 and StorEdge 3511 Arrays and the Sun StorEdge 3310 Array, offer a flexible, compact, cost-effective approach for growing storage demands. Their building-block architecture is designed to allow users to expand and customize as needed, offering performance and flexibility at low cost for a variety of environments enabling increased return on investment.

Storage Software. Our Java StorEdge software is an integral part of our complete storage solutions. Our Java StorEdge software is based on the Java ES architecture and comprises an open, integrated and automated storage management software family. The Sun StorEdge software suites are focused on availability, utilization, performance and storage resource management. In fiscal 2005, we introduced Sun Java StorEdge Software (Java SS) and Suites, which allow customers to acquire and deploy our comprehensive suite of storage and data management software and services in-house on an annual per-employee or capacity basis. Our targeted Java SS Suites cover StorEdge Consolidation, StorEdge Continuity, StorEdge Content and StorEdge Compliance.

We also announced our new Sun Grid Storage Utility as part of our vision for a standardized, open, grid-based computing infrastructure available to customers as a utility, pay-as-you-go model. This new offering includes fully integrated hardware, software and services, provided, managed and serviced by us on a 24x7x365 basis.

SERVICES

Our services team provides expertise in helping our customers deploy network computing environments through a broad range of services comprised of support services for hardware and software and Client solutions and Educational services. Sun Services assists customers globally, provides support services to nearly 850,000 units under contracts in more than 100 countries, trains approximately 400,000 students annually and provides consulting, integration and operations assistance to IT organizations globally.

SUPPORT AND MANAGED SERVICES

The SunSpectrum[SM] Support services product offerings allow customers the power and flexibility to customize their support services contracts. Customers can choose from four levels of support that range from mission critical to self-support. This service is sold separately or packaged with hardware, software and peripherals as a single-price support service. Each contract type is specifically designed to enable high availability and continuous operation for our customers. Our resources in the field for services delivery are complemented by third-party service providers who primarily deliver hardware support services such as spares inventories and manpower. Investments by these third-party service providers help us expand our geographic coverage without additional fixed cost investments on our part. Software support is primarily delivered by our software support engineers. In fiscal 2005, we announced a new integrated, secure network services connection called Sun Connection intended to simplify and standardize IT as a service. Customers who pay the annual subscription fee can turn on a secure connection to allow us to automatically and systematically manage their security updates, systems monitoring and predictive diagnostic tests over that connection, thereby reducing management costs and increasing system availability.

CLIENT SOLUTIONS AND EDUCATIONAL SERVICES

Our Client solutions organization brings together more than 10,000 experts across Sun, focused on our six competencies: Data Center, Storage and Data Management, Desktop and Mobility, Identity Management, Enterprise Web Services and Manageability Services. Our highly trained Client solutions teams specialize in providing customers with advanced systems, software, storage and network architecture design consulting, platform integration, enterprise systems management and operation such as network security and identity management, wireless network-based systems and advanced Sun Java System software integration solutions. We provide people, processes and technology and we partner with third-party systems integrators, to deliver solutions tailored to meet our customers needs. Our technical and project management experts help design IT architectures and plan migrations from legacy systems to

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network computing or help customers upgrade existing network computing environments. Additionally, to keep customer computing environments operating at peak performance, operations experts help customers manage the complexity of heterogeneous systems and networks.

Our Educational Services organization develops and delivers integrated learning solutions for enterprises, IT organizations and individual IT professionals. These solutions help ensure that the necessary talent is available and properly aligned to meet our clients network computing needs, as well as business objectives. Our learning solutions include education consulting services, learning management technologies, multi-mode learning content and professional certifications.

COMPETITION

We compete in the computer hardware, 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) and Fujitsu Limited (Fujitsu). We also compete with systems manufacturers and resellers of systems based on microprocessors manufactured by Intel Corporation (Intel) and the Windows family of operating systems software from Microsoft.

Customers make buying decisions based on many factors, including 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. 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, each factor on which we compete is critical 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. For more information about the competitive risks we face, refer to Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Risk Factors.

We have encouraged the use of SPARC technology as a standard in the computer marketplace by licensing much of the technology and promoting open interfaces to the Solaris OS, as well as by offering microprocessors and enabling technologies to third party customers. As a result, several licensees, including Fujitsu and the Fujitsu-Siemens joint venture company, also offer products based on the Solaris OS and the SPARC architecture that compete directly with our products. We have also worked to make our Java programming language a standard for complex networks. We develop applications, tools and systems platforms, as well as work with third parties to create products and technologies, in order to continue to enhance the Java platform s capabilities. As part of this effort, we license Java technology which widely encourages our competitors to also develop products competing with these applications, tools and platforms. If we are unable to compete effectively, our business could be harmed.

PATENTS, TRADEMARKS AND INTELLECTUAL PROPERTY LICENSES

We have used, registered or applied to register certain trademarks and service marks to distinguish genuine Sun 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 differentiators. From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Several pending claims are in various stages of evaluation. With the exception of the matters further disclosed at Item 3. Legal Proceedings of this Form 10-K, we believe no material litigation has arisen from these claims. We are evaluating the desirability of entering into licensing agreements in certain of these cases. 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 litigation arising out of such claims, could adversely affect our business.

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ENVIRONMENT

We are committed to developing and shipping products that are environmentally responsible. We are a leader in energy efficient computing technologies and commitment to reductions in factors contributing to global climate change through what we call sustainable computing. We create technologies that will enable, at least, three significant shifts in the computing industry, changes which hold enormous potential for positive environmental impact: 1) transition to thin client computing from traditional desktop PCs thereby increasing overall energy efficiency and reducing material waste; 2) increases in computing resource utilization with throughput computing technology and N1 Grid virtualization technology across data centers; and 3) transition to increased teleworking allowing large employers to unleash the social, environmental and economic benefits of mobility with security.

We are further committed to reducing regulated chemicals from our products and operations. In January 2003, the European Union (EU) issued a directive called the Reduction of Hazardous Substances (RoHS) stating that all EU member states must ensure that after July 1, 2006, no new electrical and electronics equipment containing lead and other hazardous substances be sold into the EU. Currently, a number of our products contain such substances above the set regulatory level. Given the potentially large impact to our customers and to our sales and the fact that other government entities are also considering enacting similar legislation, we understand the critical necessity to ensure that all our products are environmentally safe and RoHS compliant. Our efforts to ensure RoHS compliance across our entire product line are progressing, and we intend to meet or exceed all requirements and similar environmental legislation, although there can be no assurance of this.

The EU issued another environmental directive in January 2003, known as the Directive on Waste Electrical and Electronic Equipment (the WEEE Directive). The WEEE Directive requires that a producer of electronic equipment be responsible for financing and managing waste from its products placed on the EU market after August 13, 2005. Our WEEE compliance program is progressing as planned, and we intend to meet all requirements of the Directive in a timely manner. On August 13, 2005, we implemented a product collection and waste management program that addresses the labeling, take back, treatment, recovery, reuse and disposal of covered electronic products sold or imported into the EU.

EMPLOYEES

As of June 30, 2005, we had approximately 31,000 employees. We expect our headcount to increase by approximately 8,500 employees as a result of our acquisitions of SeeBeyond and StorageTek in the first quarter of fiscal 2006. 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. Although we have entered into a limited number of employment contracts with certain current and former executive officers, 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. As our stock price has decreased and because we offer equity-based incentive compensation, our ability to continue to offer competitive compensation packages to current employees has been negatively impacted. Consequently, these pressures have affected our ability to attract and retain highly qualified personnel. If these adverse conditions continue, we may not be able to retain highly qualified employees in the future and this could harm our business.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following sets forth certain information regarding our Executive Officers as of September 6, 2005.

Name	Age	Position
Scott G. McNealy	50	Chairman of the Board of Directors and Chief Executive Officer
Jonathan I. Schwartz	39	President and Chief Operating Officer
Crawford W. Beveridge	59	Executive Vice President, People and Places, and Chief Human Resources Officer
Robyn M. Denholm	41	Senior Vice President, Finance
Michael A. Dillon	46	Senior Vice President, General Counsel and Secretary
Stephen T. McGowan	57	Chief Financial Officer and Executive Vice President, Corporate Resources
Gregory M. Papadopoulos	47	Executive Vice President and Chief Technology Officer
Bret C. Schaefer	48	Vice President, Finance and Corporate Controller

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Mr. McNealy is a Founder of Sun and has served as Chairman of the Board of Directors and Chief Executive Officer since April 2004, as Chairman of the Board of Directors, President and Chief Executive Officer from June 2002 to April 2004, as Chairman of the Board of Directors and Chief Executive Officer from April 1999 to June 2002, as Chairman of the Board of Directors, President and Chief Executive Officer from December 1984 to April 1999, as President and Chief Operating Officer from February 1984 to December 1984 and as Vice President of Operations from February 1982 to February 1984. Mr. McNealy has served as a director of the Company since the incorporation of the Company in February 1982.

Mr. Schwartz has served as President and Chief Operating Officer of Sun since April 2004, as Executive Vice President, Software of Sun 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, as Vice President, Internet and Application Products from May 1999 to October 1999, as Vice President, Enterprise Products Group from July 1998 to May 1999 and as Director, Product Marketing, Javasoft, from July 1997 to July 1998.

Mr. Beveridge has served as Executive Vice President, People and Places, and Chief Human Resources Officer of Sun since March 2000 and as Vice President, Corporate Resources from March 1985 to December 1990. From January 1991 to February 2000, Mr. Beveridge served as Chief Executive, Scottish Enterprise, a Scottish quasi-autonomous non-governmental organization involved in economic development in Scotland. Mr. Beveridge serves on the Board of Directors of Autodesk, Inc., a digital design and content company.

Ms. Denholm has served as Senior Vice President, Finance since August 2005, as Vice President and Corporate Controller from August 2003 to August 2005, as Vice President and Acting Corporate Controller from June 2003 through August 2003, as Vice President, Finance, Services and Finance Systems and Processes from August 2001 through June 2003, as Director, Asia Pacific Shared Financial Services from April 1998 through August 2001 and as Australasian Financial Controller, Computer Systems from January 1996 through April 1998.

Mr. Dillon has served as Senior Vice President, General Counsel and Secretary of Sun since April 2004, 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. McGowan has served as Chief Financial Officer and Executive Vice President, Corporate Resources of Sun since July 2002, as Vice President, Finance, Global Sales Operations from July 2001 to June 2002, as Vice President, Staff Operations, Global Sales Operations from June 2000 to June 2001, as Vice President, Finance, Computer Systems, Network Storage and Network Service Providers from February 1998 to June 2000, as Vice President, Finance, Worldwide Financial Operations of Sun Microsystems Computer Corporation (SMCC), a wholly-owned subsidiary of Sun, from July 1994 to February 1998 and as Vice President, Finance, North America and Australia Field Operations of SMCC from October 1992 to July 1994.

Mr. Papadopoulos has served as Executive Vice President and Chief Technology Officer of Sun since December 2002, 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. Schaefer has served as Vice President, Finance and Corporate Controller since August 2005. He served as Vice President, Finance Global Sales Operations from May 2003 to August 2005, as Vice President, Finance Worldwide Operations from July 2002 to May 2003, and as Senior Finance Director, Global Sales Operation from August 2000 to July 2002. Prior to August 2000 and from the time he joined Sun in July 1991, Mr. Schaefer held successive management positions in Sun s finance organization.

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ITEM 2. PROPERTIES

At June 30, 2005, Sun s worldwide facilities represented aggregate floor space of 13.9 million square feet both in the U.S. and in 47 other countries. In square feet, our properties consisted of (in millions):

	U.S.	Rest of the World	Total
Owned facilities	4.8	0.8	5.6
Leased facilities	4.5	3.8	8.3
Total facilities	9.3	4.6	13.9

At June 30, 2005, our owned properties consisted of:

Location	Square Footage of Facility
Bagshot, England	25,995
Broomfield, Colorado	916,045
Burlington, Massachusetts	693,846
Farnborough (Guillemount Park), England	320,000
Linlithgow, Scotland	423,070
Menlo Park, California	1,022,008
Newark, California	1,404,309
Santa Clara, California	816,240
Total	5,621,513

At June 30, 2005, we had no offices under construction, however we have approximately 1.2 million square feet of facilities available for future construction. We continually evaluate our facility requirements in light of our business needs and stage the future construction accordingly. In addition, we own approximately 38 acres of undeveloped land in Austin, Texas.

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 1.2 million square feet are under sub-lease to non-Sun businesses and 2.1 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 Linlithgow (Scotland) and Beaverton (Oregon).

ITEM 3. LEGAL PROCEEDINGS

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

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 2005.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock trades on The Nasdaq National Market under the symbol SUNW . As of September 6, 2005, there were approximately 22,503 stockholders of record and the closing price of Sun s common stock was $3.84 per share as reported by The Nasdaq National 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 National Market:

	Fiscal 2005		Fiscal 2004	
	High	Low	High	Low
First Quarter	$ 4.33	$ 3.29	$ 5.18	$ 3.39
Second Quarter	5.62	3.93	4.59	3.14
Third Quarter	5.65	3.87	5.93	3.87
Fourth Quarter	4.16	3.42	5.12	3.64

No cash dividends were declared or paid in fiscal 2005 or 2004. We anticipate retaining available funds to finance future growth and have no present intention to pay cash dividends.

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ITEM 6. SELECTED FINANCIAL DATA[1]

The following information has been restated to reflect adjustments that are further discussed in the Restatement Explanatory Note in the forepart of this Form 10-K and in Note 2 Restatement of Financial Statements to our Consolidated Financial Statements included in Part II, Item 8. Financial Statements and Supplementary Data of this Form 10-K.

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 restated Consolidated Financial Statements included in Item 8. Financial Statements and Supplementary Data.

	Fiscal Years Ended June 30,									
	2005		2004		2003		2002		2001	
	Dollars	%	Dollars	%	Dollars	%	Dollars	%	Dollars	%
	(Restated) (In millions, except per share amounts)									
Net revenues	$ 11,070	100.0	$ 11,185	100.0	$ 11,434	100.0	$ 12,496	100.0	$ 18,250	100.0
Cost of sales	6,481	58.5	6,669	59.6	6,492	56.8	7,580	60.7	10,040	55.0
Gross margin	4,589	41.5	4,516	40.4	4,942	43.2	4,916	39.3	8,210	45.0
Operating expenses:										
Research and development	1,785	16.1	1,926	17.2	1,837	16.1	1,832	14.7	2,016	11.0
Selling, general and administrative	2,919	26.4	3,317	29.7	3,329	29.1	3,806	30.5	4,445	24.4
Restructuring charges	262	2.4	344	3.1	371	3.2	517	4.1	75	0.4
Impairment of goodwill and other intangible assets			49	0.4	2,125	18.6	6		1	
Goodwill amortization									285	1.6
Purchased in-process research and development			70	0.6	4		3		77	0.4
Total operating expenses	4,966	44.9	5,706	51.0	7,666	67.0	6,164	49.3	6,899	37.8
Operating income (loss)	(377)	(3.4)	(1,190)	(10.6)	(2,724)	(23.8)	(1,248)	(10.0)	1,311	7.2
Gain (loss) on equity investments, net	6		(64)	(0.6)	(84)	(0.7)	(99)	(0.8)	(90)	(0.5)
Interest and other income, net	133	1.2	94	0.8	155	1.3	299	2.4	363	2.0
Settlement income	54	0.5	1,597	14.3						
Income (loss) before taxes	(184)	(1.7)	437	3.9	(2,653)	(23.2)	(1,048)	(8.4)	1,584	8.7
Provision (benefit) for income taxes	(77)	(0.7)	825	7.4	731	6.4	(461)	(3.7)	603	3.3
Cumulative effect of change in accounting principle, net									(54)	(0.3)
Net income (loss)	$ (107)	(1.0)	$ (388)	(3.5)	$ (3,384)	(29.6)	$ (587)	(4.7)	$ 927	5.1
Net income (loss) per common share basic	$ (0.03)		$ (0.12)		$ (1.06)		$ (0.18)		$ 0.28	
Net income (loss) per common share diluted[1]	$ (0.03)		$ (0.12)		$ (1.06)		$ (0.18)		$ 0.27	
Shares used in the calculation of net income (loss) per common share basic	3,368		3,277		3,190		3,242		3,234	

Shares used in the calculation of net income (loss) per common share diluted[1]	3,368	3,277	3,190	3,242	3,417

	As of June 30,				
	2005	2004	2003	2002	2001
		(Restated)	(Restated)		
Cash, cash equivalents and marketable debt securities	$ 7,524	$ 7,608	$ 5,741	$ 5,864	$ 6,171
Total assets[2]	$ 14,190	$ 14,805	$ 13,295	$ 16,522	$ 18,181
Long-term debt	$ 1,123	$ 1,432[3]	$ 1,531	$ 1,654[3]	$ 1,565
Other non-current obligations[2]	$ 1,083[4]	$ 1,460[4]	$ 642[4]	$ 202[4]	$ 884[4]

(1) Share and per share amounts for all periods presented have been adjusted to reflect stock splits through June 30, 2005.
(2) Certain amounts from prior years, relating to deferred income taxes, have been changed to conform to the current year presentation.
(3) Includes approximately $257 million and $205 million classified as current portion of long-term debt as of June 30, 2004 and 2002, respectively.
(4) Includes deferred settlement income from Microsoft as of June 30, 2005 and 2004, long-term tax liabilities as of June 30, 2005, 2004 and 2001 and long-term restructuring liabilities for all periods presented.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Changes to Previously Announced Fiscal 2005 Fourth Quarter and Annual Results

Subsequent to the July 26, 2005 announcement of our preliminary fourth quarter and full fiscal year results for 2005, we have made certain adjustments to our reported results. These adjustments resulted in a reduction in fourth quarter net income and an increase in full fiscal year net loss for 2005 of $51 million. These adjustments principally related to an increase in our tax provision of $33 million to correct computational errors that were identified through a control procedure that was performed subsequent to the date of our earnings release and an increase in our commission and other accruals of $18 million due in part to the receipt of more accurate information.

In addition, having fully reviewed the impact of accounting adjustments recorded in fiscal 2005, we have restated our consolidated financial statements for fiscal 2004 and 2003, and the quarters of fiscal 2005 with respect to errors related to, our accounting for deferred taxes in certain foreign jurisdictions as well as the aggregate effect of corrections to provisions for State and foreign tax returns and withholding taxes. The adjustments associated with these corrections in our accounting for taxes decreased our previously announced net income for the fourth quarter for fiscal 2005 by $23 million, offset by the correction of $3 million of pretax inter-quarter accounting adjustments. These adjustments further increased our previously announced net loss for fiscal year 2005 by $45 million.

Set forth below is a reconciliation of the July 26, 2005 announcement of our preliminary results press release to amounts reported in this Annual Report on Form 10-K which reflects the above mentioned adjustments (in millions, except per share amounts):

	Three Months Ended June 30, 2005			Year Ended June 30, 2005		
	Previously Announced	Net Change	Reported in Annual Report on Form 10-K	Previously Announced	Net Change	Reported in Annual Report on Form 10-K
Operating loss	$ (100)	$ (15)	$ (115)	$ (359)	$ (18)	$ (377)
Loss before taxes	(69)	(15)	(84)	(166)	(18)	(184)
Benefit from income taxes	(190)	(56)	(134)	(155)	(78)	(77)
Net income (loss)	121	(71)	50	(11)	(96)	(107)
Net income (loss) per common share basic and diluted	$ 0.04		$ 0.01	$ (0.00)		$ (0.03)

Restatement of Financial Statements

We have restated our historical fiscal 2004 and 2003 consolidated financial statements for the cumulative impact of errors in accounting for deferred taxes in certain foreign jurisdictions totaling $41 million and for corrections to provisions for State and foreign tax returns and withholding taxes of $4 million. These errors were identified in the third and fourth quarters of fiscal 2005. In addition, as a result of evaluating certain pre-tax accounting adjustments recorded throughout fiscal year 2005, we restated the previously reported quarters of fiscal 2005.

The determination to restate these consolidated financial statements was made as a result of our assessment that these tax items, although immaterial to the consolidated financial statements for fiscal 2004 and 2003, would be considered material to the consolidated financial statements for the full fiscal year and previously reported quarters of 2005.

The adjustments associated with the above corrections in our accounting for taxes reduced our net loss by $45 million or net loss per share by $0.01 in fiscal 2003 and had no net impact on the previously reported annual net loss for fiscal 2004, but did result in restatements to our previously filed quarterly financial information for fiscal 2004.

The information included in this Form 10-K sets forth the effects of the Restatement on the previously reported financial statements of operations for fiscal 2004 and 2003 and the affected quarters of 2005 and 2004.

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Further information on the nature and impact of these adjustments to fiscal year 2004 and 2003 as well as the impact to our quarterly financial information for fiscal 2005 and 2004 is provided in Note 2, Restatement of Financial Statements, to our consolidated financial statements. The impact of the restatement on the results of operations for fiscal years 2004 and 2003 is shown in the table below (in millions, except per share amounts):

	Fiscal Years Ended June 30,	
	2004	2003
		(Restated)
Impact of adjustments to provision for (benefit from) income taxes	$	$ (45)
Net loss as previously reported	$ (388)	$ (3,429)
Impact of restatement		45
Net loss as restated	$ (388)	$ (3,384)
Net loss per share basic and diluted as previously reported	$ (0.12)	$ (1.07)
Impact of restatement		0.01
Net loss per share basic and diluted as restated	$ (0.12)	$ (1.06)

Executive Overview

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

During the fourth quarter of fiscal 2005, we experienced a year over year decrease in total net revenues of approximately $136 million or 4.4%, which included a favorable foreign currency impact of approximately 2%. For the full fiscal year 2005, as compared with fiscal 2004, we experienced a decrease in total net revenues of approximately $115 million or 1.0%. Our Products net revenue for the fourth quarter and full fiscal year 2005 was unfavorably impacted by competition and a continuing market shift in overall computer system demand away from our data center servers towards the use of entry-level servers. This decrease was partially offset by an increase in Client solutions and Educational services revenue.

During the fourth quarter of fiscal 2005, we experienced a year over year increase in gross margin of approximately $7 million or 2.0 percentage points. For the full fiscal year 2005, as compared with fiscal 2004, we experienced an overall increase in gross margin of approximately $73

million or 1.1 percentage points. Our Products gross margin during the fourth quarter of fiscal 2005 increased 1.3 percentage points, primarily due to manufacturing and component cost reductions partially offset by the unfavorable impact of discounting and pricing actions. Our Products gross margin during the full fiscal year 2005 decreased by $113 million or 0.3 percentage points, primarily due to planned list price reductions, sales discounting actions and the impact of our patent related settlement with Kodak, partially offset by supply chain restructuring and component cost reductions. Our Services gross margin during the fourth quarter of fiscal 2005 increased by $38 million or 3.6 percentage points and during the full fiscal year 2005 increased $186 million or 3.6 percentage points, primarily due to the favorable impact of our improved utilization, cost reductions and productivity measures. This increase was partially offset by a fourth quarter adjustment associated with spares and fixed asset amortization of $20 million.

During fiscal 2005, as compared with fiscal 2004, our research and development expenses decreased $141 million and our sales, general and administrative expenses decreased $398 million, primarily due to our on-going cost reduction

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and productivity improvement initiatives. In fiscal 2005, we continued to reduce our on-going cost structure by reducing our global workforce, consolidating our global property portfolio and taking other expense reduction measures. Our fiscal 2005 results included $262 million of restructuring charges related to these activities and we expect to record additional charges over the next several quarters.

During fiscal 2005, we recorded a net tax benefit of $77 million. This benefit included a $213 million tax benefit arising from adjustments to our income tax reserves resulting from the conclusion of both a U.S. income tax audit and a foreign income tax audit and a benefit of $69 million related to the impact of a change in the U.S.-Dutch withholding tax treaty. This was offset by a tax expense of $205 million on income generated in certain foreign jurisdictions and adjustments for the differences between estimated amounts recorded and actual liabilities resulting from the filing of prior periods tax returns.

During fiscal 2005, our operating activities provided cash flows of $369 million. Our focus on cash management remains a top priority and we plan to continue to drive improvement in our cash conversion cycle. We ended the fourth quarter of fiscal 2005 with a cash conversion cycle of 30 days, an improvement of 10 days from June 30, 2004. At June 30, 2005 we had a total cash, cash equivalents and marketable debt securities balance of approximately $7.5 billion, which will be impacted by our first quarter of fiscal 2006 acquisitions of Storage Technology Corporation (StorageTek) and SeeBeyond Technology Corporation (SeeBeyond). See Note 18 to the Consolidated Financial Statements.

Critical Accounting Policies and Estimates

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

Revenue Recognition

As discussed in Note 3 to our Consolidated Financial Statements, we enter into agreements to sell hardware, software, services and multiple deliverable arrangements that include combinations of products and/or services. Additionally, while the majority of our sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, significant contract interpretation is sometimes required to determine the appropriate accounting including: (1) whether an arrangement exists; (2) how the arrangement consideration should be allocated among the deliverables if there are multiple deliverables; (3) when to recognize revenue on the deliverables; and (4) whether undelivered elements are essential to the functionality of delivered elements. In addition, our revenue recognition policy requires an assessment as to whether collectibility is probable, which requires us to evaluate the creditworthiness of our customers. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

We recognize revenue as work progresses on fixed price professional services contracts when we can reliably evaluate progress to completion. We perform periodic analyses of these contracts in order to determine if the applicable estimates regarding total revenue, total cost and the extent of progress toward completion require revision. For fixed price professional services contracts, when the current estimates of total contract revenue and contract cost indicate a

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loss, the estimated loss is recognized in the period the loss becomes evident. Changes in assumptions underlying these estimates and costs could materially impact the timing of revenue recognition and loss recognition.

Channel Partners selling our high-volume products generally carry Sun products as inventory, if our revenue recognition criteria are met, we recognize revenue when we sell to the Channel Partners. Channel Partners selling our high-end products generally purchase our products at the time an end-user is identified. The revenue we recognize associated with channel sales transactions requires us to make estimates in several areas including: (1) creditworthiness of the Channel Partner; (2) the amount of credits we will give for subsequent changes in our price list (i.e., price protection); (3) the amount of credits we will give for additional discounts in certain competitive transactions (i.e., margin protection); (4) the amount of stock rotation; and (5) the likelihood of returns. We reduce revenue in these areas using assumptions that are based on our historical experience. Changes in these assumptions could require us to make significant revisions to our estimates that could materially impact the amount of net revenue recognized.

Goodwill

We review goodwill for impairment on an annual basis and whenever events or changes in circumstances indicate the carrying value of goodwill may not be recoverable. In testing for a potential impairment of goodwill, we: (1) allocate goodwill to the various Sun businesses to which the acquired goodwill relates; (2) estimate the fair value of those Sun businesses to which goodwill relates based on future expected discounted cash flows; and (3) determine the carrying value (book value) of those businesses, as some of the assets and liabilities related to those businesses, such as property and equipment and accounts receivable, are not held by those businesses but by functional departments (for example, our Global Sales Organization and Worldwide Operations organization). Prior to this allocation of the assets to the reporting units, we are required to assess long-lived assets for impairment in accordance with Statement of Financial Accounting Standard (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). Furthermore, if the estimated fair value is less than the carrying value for a particular business, then we are required to estimate the fair value of all identifiable assets and liabilities of the business, in a manner similar to a purchase price allocation for an acquired business. This can require independent valuations of certain internally generated and unrecognized intangible assets such as in-process research and development and developed technology. Only after this process is completed is the amount of any goodwill impairment determined.

The process of evaluating the potential impairment of goodwill is subjective and requires significant judgment at many points during the analysis. In estimating the fair value of the businesses with recognized goodwill for the purposes of our annual or periodic analyses, we make estimates and judgments about the future cash flows of these businesses. Although our cash flow forecasts are based on assumptions that are consistent with the plans and estimates we are using to manage the underlying businesses, there is significant judgment in determining the cash flows attributable to these businesses over their estimated remaining useful lives. In addition, we make certain judgments about allocating shared assets such as accounts receivable and property and equipment to the balance sheet for those businesses. We also consider our market capitalization (adjusted for unallocated monetary assets such as cash, marketable debt securities and debt) on the date we perform the analysis.

We performed our fiscal 2005 annual goodwill impairment analysis in the fourth quarter of fiscal 2005. Based on our estimates of forecasted discounted cash flows as well as our market capitalization, at that time, we concluded that our goodwill was not impaired. At June 30, 2005, our remaining goodwill had a net book value of $441 million.

We may incur charges for impairment of goodwill in the future if the net book value of our operating reporting units exceeds the estimated fair value. If we incur future impairments to our goodwill, it would have an adverse impact on our future earnings.

Other Intangible Assets

SFAS 144 is the authoritative standard on the accounting for the impairment of other intangible assets. In accordance with SFAS 144 and our internal accounting policy, we perform tests for impairment of intangible assets other than goodwill (Other Intangible Assets) semi-annually and whenever events or circumstances suggest that Other Intangible Assets may be impaired. In fiscal 2005, we performed our impairment analysis, and determined that no impairment charges were necessary.

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At June 30, 2005, we had Other Intangible Assets with a carrying value of approximately $141 million. These Other Intangible Assets consist primarily of $113 million in acquisition-related intangible assets and $28 million in intangible assets primarily associated with patent licenses acquired through our settlement with Kodak. To evaluate potential impairment, SFAS 144 requires us to assess whether the future cash flows related to these assets will be greater than their carrying value at the time of the test. Accordingly, while our cash flow assumptions are consistent with the plans and estimates we are using to manage the underlying businesses, there is significant judgment in determining the cash flows attributable to our Other Intangible Assets over their respective estimated useful lives. For example, if we reduced the estimated useful life of all intangible assets as of June 30, 2005, by one year or reduced the projected cash flows by 20%, up to $36 million of our Other Intangible Assets would be considered to be impaired and we would be required to recognize an impairment based on the difference between the fair value of these Other Intangible Assets and their carrying value.

We are required to periodically evaluate our Other Intangible Assets balances for impairments. If we incur impairments to our Other Intangible Assets, it would have an adverse impact on our future earnings.

Restructuring

We have engaged and may continue to engage in restructuring actions and activities associated with productivity improvement initiatives and expense reduction measures, which require us to make significant estimates in several areas including: 1) realizable values of assets made redundant, obsolete or excess; 2) expenses for severance and other employee separation costs; 3) the ability to generate sublease income, as well as our ability to terminate lease obligations at the amounts we have estimated; and 4) other costs. The amounts we have accrued represent our best estimate of the obligations we expect to incur in connection with these actions, but could be subject to change due to various factors including market conditions and the outcome of negotiations with third parties. Should the actual amounts differ from our estimates, the amount of the restructuring charges could be materially impacted. For a full description of our restructuring actions, refer to our discussion of restructuring charges and workforce rebalancing efforts in the Results of Operations section. Any additional restructuring actions could have an adverse impact on our operating results in the period in which any such action is taken.

Equity Investments in Privately-Held Companies

Our investments in privately-held companies are made as part of Sun s strategic equity investment strategy. Our strategy is to invest up to certain authorized amounts in companies developing products, markets and services that are strategic to Sun s business and technology. These equity investments are generally made in connection with a round of financing with other third-party investors. At June 30, 2005, we had approximately $26 million of equity investments in privately-held companies. As our equity investments generally do not permit us to exert significant influence or control over the entity in which we are investing, these amounts generally represent our cost of the investment, less any adjustments we make when we determine that an investment s net realizable is other than temporarily impaired as defined by SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS 115).

The process of assessing whether a particular equity investment is other than temporarily impaired requires a significant amount of judgment. In making this judgment, we carefully consider the investee s cash position, projected cash flows (both short and long-term), financing needs, recent financing rounds, most recent valuation data, the current investing environment, management/ownership changes, and competition. This valuation process is based primarily on information that we request from these privately-held companies. This information is not subject to the same disclosure and audit requirements as the reports required of U.S. public companies, and as such, the reliability and accuracy of the data may vary. Based on our evaluation, we recorded net impairment charges, which are reflected in gain (loss) on equity investments, net in the accompanying Consolidated Statements of Operations, related to our investments in privately-held companies of $15 million, $67 million and $72 million in fiscal years 2005, 2004 and 2003, respectively.

Estimating whether our investments in privately-held, early-stage technology companies are other than temporarily impaired is inherently subjective and may contribute to significant volatility in our reported results of operations. If we incur additional other than temporary impairments to our equity investments in privately-held companies, it could have an adverse impact on our future earnings.

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Income Taxes

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

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

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes and interest will be due. If events occur and the payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R requires measurement of all employee stock-based compensation awards using a fair-value method and the recording of such expense in the consolidated financial statements. In addition, the adoption of SFAS 123R will require additional accounting related to the income tax effects and disclosure regarding the cash flow effects resulting from share-based payment arrangements. In January 2005, the U.S. Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which provides supplemental implementation guidance for SFAS 123R. SFAS 123R is effective for our first quarter of fiscal 2006. We have selected the Black-Scholes option-pricing model as the most appropriate fair-value method for our awards and will recognize compensation cost on a straight-line basis over our awards vesting periods. We expect that the adoption of SFAS 123R will have a material impact on our results of operations. However, uncertainties, including our future stock-based compensation strategy, stock price volatility, estimated forfeitures and employee stock option exercise behavior, make it difficult to determine whether the stock-based compensation expense that we will incur in future periods will be similar to the SFAS 123 pro forma expense disclosed in Note 3 to the Consolidated Financial Statements. In addition, the amount of stock-based compensation expense to be incurred in future periods will be reduced by our acceleration of certain unvested and out-of-the-money stock options in fiscal 2005 as disclosed in Note 15 to the Consolidated Financial Statements.

See Note 3 to the Consolidated Financial Statements for a description of certain other recent accounting pronouncements including the expected dates of adoption and effects on our results of operations and financial condition.

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RESULTS OF OPERATIONS

Net Revenues

For the fiscal year ended June 30,

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

	2005	Change	2004	Change	2003
Computer Systems products	$ 5,826	(0.5)%	$ 5,854	(6.2)%	$ 6,243
Network Storage products	1,300	(13.4)%	1,501	(3.2)%	1,550
Products net revenue	$ 7,126	(3.1)%	$ 7,355	(5.6)%	$ 7,793
Percentage of total net revenues	64.4%	(1.4) pts	65.8%	(2.4) pts	68.2%
Support services	$ 3,031	1.1%	$ 2,999	5.5%	$ 2,844
Client solutions and Educational services	913	9.9%	831	4.3%	797
Services net revenue	$ 3,944	3.0%	$ 3,830	5.2%	$ 3,641
Percentage of total net revenues	35.6%	1.4 pts	34.2%	2.4 pts	31.8%
Total net revenues	$ 11,070	(1.0)%	$ 11,185	(2.2)%	$ 11,434
Services contract penetration rate[1]	52.7%	8.4 pts	44.3%	8.2 pts	36.1%
Revenue per employee[2]	$ 342	9.3%	$ 313	2.0%	$ 307

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

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

Due to the generally weakened U.S. dollar during fiscal 2005 and 2004, our total net revenues were favorably impacted by foreign currency exchange rates as compared with fiscal 2004 and 2003, respectively. The net foreign currency impact to our total net revenues is difficult to precisely measure. However, our best estimate of the foreign exchange rate impact in fiscal 2005 as compared with fiscal 2004, approximated a benefit of 2% of Products net revenue and a benefit of 4% of Services net revenue. Our best estimate of the foreign exchange benefit in fiscal 2004 as compared with fiscal 2003, approximated a benefit of 3% of Products net revenue and a benefit of 6% of Services net revenue.

Products Net Revenue

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

During fiscal 2005, as compared with fiscal 2004, Computer Systems revenue decreased, primarily due to reduced sales of our data center servers resulting from intense competition and a continuing market shift in overall computer system demand towards the usage of our lower-priced entry level servers. The decrease in Computer Systems revenue was partially offset by increased unit sales of our entry level servers, which included servers running on our SPARC and AMD s Opteron processors. During fiscal 2005, as compared with fiscal 2004, Network Storage revenue decreased due to intense competition and reduced sales of our entry level and data center storage systems and low-end storage components, which were only partially offset by increased unit sales of our mid-range storage systems.

During fiscal 2004, as compared with fiscal 2003, our Computer Systems and Network Storage products net revenue decreased, primarily as a result of an intensely competitive environment. While our unit shipments for both Computer

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Systems and Network Storage systems increased as compared with fiscal 2003, we responded to competitive pressures for both product groups with price reductions, which negatively impacted our revenue. Network Storage products revenue was impacted to a lesser degree than Computer Systems products revenue during fiscal 2004, as Network Storage products revenue benefited from our focus on including storage products as an element of our solution-based selling strategy.

Services Net Revenue

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

Support services revenue consists primarily of maintenance contract revenue, which is recognized ratably over the contract period and represents approximately 77%, 78% and 78% of services net revenue in fiscal 2005, 2004 and 2003, respectively. During fiscal 2005, as compared with fiscal 2004, Support services net revenue increased due to the benefit of foreign exchange and an increase in the number of systems under a Support services contract. These increases were substantially offset by competitive pricing pressures. The increase in the number of systems under a Support services contract is primarily due to our continuing emphasis on our solution-based selling strategy, which includes Support services as an essential element of a sale. The 8.4 percentage point increase in the services contract penetration rate is due to a continued increase in the systems under contract and a decrease in the estimate of the number of active systems that comprise the installed base.

During fiscal 2004, as compared with fiscal 2003, excluding the benefit of foreign currency exchange rates, the increase in Support Services net revenue was primarily due to renewing contracts with existing customers and entering into a higher percentage of Support services contracts with new products sales. The impact of the increase in the number of systems under an active Support service contract was substantially offset by competitive pricing pressures, a change in the mix towards maintenance contracts sold or renewed with reduced service levels and a shift in product sales mix to a greater proportion of low-end products, which are typically sold with reduced levels of services.

Client solutions and Educational services revenue consists primarily of revenue generated from professional services such as technical consulting that helps our customers plan, implement, and manage distributed network computing environments. The overall increase in Client solutions and Educational services revenues during fiscal 2005, as compared with fiscal 2004, was largely due to revenue recognized on a significant solution sale in the United Kingdom and our solution-based selling strategy internationally, particularly in EMEA.

During fiscal 2004, as compared with fiscal 2003, excluding the benefit of foreign currency exchange rates, the factors contributing to the overall increase in Client solutions and Educational services revenue included a combination of higher Client solutions services revenues, resulting primarily from the success of our solution-based selling strategy in certain countries within EMEA in the fiscal year, partially offset by a reduction in customers discretionary spending related to Educational services and, to a lesser extent, the decline in new product revenues.

Net Revenues by Geographic Area

For the fiscal year ended June 30,

(dollars in millions)

	2005	Change	2004	Change	2003
U.S.	$ 4,392	(7.9)%	$ 4,768	(5.5)%	$ 5,048
Percentage of net revenues	39.7%	(2.9) pts	42.6%	(1.5) pts	44.1%
Americas Other (Canada and Latin America)	$ 590	5.0%	$ 562	3.5%	$ 543
Percentage of net revenues	5.3%	0.3 pts	5.0%	0.2 pts	4.8%
EMEA (Europe, Middle East and Africa)	$ 4,152	5.3%	$ 3,942	4.2%	$ 3,783
Percentage of net revenues	37.5%	2.2 pts	35.3%	2.2 pts	33.1%
APAC (Asia, Australia and New Zealand)	$ 1,936	1.2%	$ 1,913	(7.1)%	$ 2,060
Percentage of net revenues	17.5%	0.4 pts	17.1%	(0.9) pts	18.0%
International revenues	$ 6,678	4.1%	$ 6,417	0.5%	$ 6,386
Percentage of net revenues	60.3%	2.9 pts	57.4%	1.5 pts	55.9%
Total net revenues	$ 11,070	(1.0)%	$ 11,185	(2.2)%	$ 11,434

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United States (U.S.)

During fiscal 2005, as compared with fiscal 2004, net revenues in the U.S. declined primarily due to a decrease in products net revenue. In the U.S., our sales mix has traditionally included a higher proportion of product sales, which has contributed to the challenge in growing revenue in this geographic market as we continue to experience intense competitive pressures, especially in selling our high-end server products in certain key sectors. In the government and telecommunications sector, we continue to experience intense competition and reduced spending in certain areas which have traditionally been sources of relative competitive strength. During fiscal 2005, increased merger and acquisition activity in the telecommunication sector correlated to reduced customer spending in key accounts. Partially offsetting the decline in net revenue from the government and telecommunications sectors during fiscal 2005, was year over year growth in sales to our Wall Street financial services customer base.

During fiscal 2004, as compared with fiscal 2003, our net revenues in the U.S. declined primarily as the result of an intensely competitive environment. Although difficult to accurately quantify, our fiscal 2004 product transition from UltraSPARC III to UltraSPARC IV may have impacted revenue in the U.S. to a greater extent than other regions as the mix of products sold in the U.S. product market included a higher proportion of products undergoing the transition to UltraSPARC IV.

The following table sets forth net revenues in geographic markets contributing significantly to changes in international net revenues during the last three fiscal years ended June 30:

(dollars in millions)

	2005	Change	2004	Change	2003
United Kingdom	$ 1,000	5.8%	$ 945	11.3%	$ 849
Germany[1]	$ 877	5.9%	$ 828	(6.7)%	$ 887
Japan	$ 730	(4.2)%	$ 762	(18.6)%	$ 936
Central and North EMEA[2]	$ 708	4.9%	$ 675	2.3%	$ 660

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

(2) CNE consists primarily of Finland, Norway, Sweden, the Netherlands, Belgium, Luxembourg and Switzerland. In prior quarterly and annual reports we included an international area called Northern Europe that consisted of Finland, Norway, Sweden, the Netherlands, Belgium, Luxembourg, Eastern European countries and Russia. The results for Eastern European countries and Russia have moved to another geographic market. This change to CNE reflects the manner in which we manage our international operations.

United Kingdom (U.K.)

During fiscal 2005, as compared with fiscal 2004, net revenues in the U.K. increased due to our solution-based selling approach as well as overall growth in the U.K. economy and the benefit of foreign currency exchange rates. These increases were offset by a continuing market shift

in overall computer system demand towards the use of entry-level servers. Our revenue mix in the U.K. included a higher proportion of services revenues when compared to other geographic markets such as the U.S. and Japan, which contributed to our overall revenue growth in this geographic market for the fiscal year. The government sector primarily contributed to the increase in revenue during fiscal 2005, as compared with fiscal 2004, and included $62 million of revenue recognized in the first quarter of fiscal 2005, related to the first phase of a multi-year, solution-based sale to a health care services provider.

During fiscal 2004, as compared with fiscal 2003, total net revenues in the majority of our products and service categories continued to grow in the U.K., primarily due to the benefit of foreign currency exchange rates and overall growth in the U.K. economy, which resulted in increased sales activity in certain key vertical markets such as financial services.

Germany

During fiscal 2005, as compared with fiscal 2004, net revenues in Germany increased due to the benefit of foreign currency exchange rates and the benefits arising from certain elements of our strategic alliance with Fujitsu. These

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increases were partially offset by intense competition, the weak demand for our data center servers and a challenging macroeconomic environment. Despite these challenges, the government sector remained a source of overall revenue strength during fiscal 2005.

During fiscal 2004, as compared with fiscal 2003, we experienced lower revenues in Germany, primarily due to a decreased number of major infrastructure solution deals during fiscal 2004, an increase in the length of sales cycles and intense product competition in a challenging economic environment.

Japan

During fiscal 2005, as compared with fiscal 2004, net revenues in Japan decreased, primarily due to a decrease in Products net revenue, partially offset by a slight increase in Support services and Client solutions revenues and the benefit of foreign currency exchange rates. The decrease in Products net revenue in Japan is primarily a result of the implementation of certain elements of our broad-based strategic alliance with Fujitsu. As noted above, the revenue impact of this alliance in Japan was offset by other financial benefits received. Irrespective of the impact of the Fujitsu alliance in Japan, the actions we initiated in fiscal 2004 to adjust to the intense competitive business environment have contributed towards stabilization of this geographic market s revenue.

During fiscal 2004, as compared with fiscal 2003, we experienced a decline in revenue in Japan due to intense competitive pressures in a challenging Japanese economic environment. This negatively impacted our overall share of the server market and in particular sales of our high-end server products. In Japan we took certain actions in fiscal 2004, which included a change in management and implementation of a plan to reduce our future costs, to adjust to the intensely competitive business environment.

Central and Northern Europe (CNE)

During fiscal 2005, as compared with fiscal 2004, net revenues in CNE increased primarily due to increases in both Products and Client solutions revenues. The increase in net revenue occurred in a variety of sectors and across the majority of products and services categories that, in part, can be attributed to the success of our solution-based sales approach in this geographic market.

In CNE, the increase in our total net revenues in fiscal 2004, as compared to fiscal 2003, was primarily a result of the favorable foreign currency impact and an improving CNE telecommunications sector.

Gross Margin

For the fiscal year ended June 30,

(dollars in millions)

	2005	Change	2004	Change	2003
Products gross margin	$ 2,952	(3.7)%	$ 3,065	(11.2)%	$ 3,451
Percentage of products net revenue	41.4%	(0.3) pts	41.7%	(2.6) pts	44.3%
Services gross margin	$ 1,637	12.8%	$ 1,451	(2.7)%	$ 1,491
Percentage of services net revenue	41.5%	3.6 pts	37.9%	(3.1) pts	41.0%
Total gross margin	$ 4,589	1.6%	$ 4,516	(8.6)%	$ 4,942
Percentage of net revenues	41.5%	1.1 pts	40.4%	(2.8) pts	43.2%

Products Gross Margin

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

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During fiscal 2005, as compared with fiscal 2004, our products gross margin percentage decreased by 0.3 percentage points due to planned list price reductions and sales discounting actions of approximately 5 percentage points, changes in product mix to a greater proportion of lower-margin products of approximately 1 percentage point and the impact of our settlement with Kodak of approximately 1 percentage point. Offsetting these decreases were cost reductions due to supply chain restructuring, product cost engineering and continued use of dynamic bidding events, which collectively benefited gross margin by approximately 6 percentage points.

During fiscal 2004, as compared with fiscal 2003, the 2.6 percentage points decrease in our products gross margin percentage was primarily due to planned list-price reductions and sales discounting actions of approximately 7 percentage points and changes in product mix to a greater proportion of lower-margin products of approximately 1 percentage point. These decreases were partially offset by manufacturing and component cost reductions benefiting products gross margin of approximately 6 percentage points, which primarily consisted of reductions in platform specific costs and lower costs of certain commodities including CPU boards, drives and removables.

Services Gross Margin

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

During fiscal 2005, as compared with fiscal 2004, our services gross margin increased by 3.6 percentage points due to revenue volume efficiencies of approximately 3 percentage points and costs savings associated with renegotiated contracts with our partners and our workforce reductions of approximately 2 percentage points. These increases were partially offset by the negative impact of increased costs associated with a change in services mix to a higher proportion of Client solutions with lower margins of approximately 1 percentage point.

During fiscal 2004, as compared with fiscal 2003, the 3.1 percentage point decrease in our services gross margin reflected the negative impact of competitive pricing pressures of approximately 3 percentage points and increased costs associated with specific solution-based sales of approximately 1 percentage point. These decreases were partially offset by efficiencies realized from increased sales volume over a fixed cost base of approximately 1 percentage point.

Operating Expenses

For the fiscal year ended June 30,

(dollars in millions)

	2005	Change	2004	Change	2003
Research and development	$ 1,785	(7.3)%	$ 1,926	4.8%	$ 1,837
Percentage of net revenues	16.1%	(1.1) pts	17.2%	1.1 pts	16.1%
Selling, general and administrative	$ 2,919	(12.0)%	$ 3,317	(0.4)%	$ 3,329

Percentage of net revenues	26.4%	(3.3) pts	29.7%	0.6 pts	29.1%
Restructuring charges	$ 262	(23.8)%	$ 344	(7.3)%	$ 371
Percentage of net revenues	2.4%	(0.7) pts	3.1%	(0.1) pts	3.2%
Impairment of goodwill and other intangible assets	$	(100)%	$ 49	(97.7)%	$ 2,125
Percentage of net revenues	%	(0.4) pts	0.4%	(18.2) pts	18.6%
Purchased in-process research and development	$	(100)%	$ 70	N/M	$ 4
Percentage of net revenues	%	(0.6) pts	0.6%	0.6 pts	%
Total operating expenses	$ 4,966	(13.0)%	$ 5,706	(25.6)%	$ 7,666

N/M Not meaningful

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Research and Development (R&D) Expenses

During fiscal 2005, as compared with fiscal 2004, R&D expenses decreased by $141 million, primarily due to $125 million in cost savings associated with workforce reductions, $50 million in cost savings associated with discretionary and outside services spending and an $18 million decrease in depreciation and amortization. These decreases were partially offset by a $38 million increase in compensation costs associated with salaries and bonuses and a $10 million increase in prototype expenses associated with new product introductions.

During fiscal 2004, as compared with fiscal 2003, R&D expenses increased by $89 million primarily due to a $77 million increase in compensation costs associated with acquisitions and annual salary adjustments in effect since the third quarter of fiscal 2003 and a $29 million increase in variable compensation costs. These increases were partially offset by a decrease of $15 million in depreciation and amortization.

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