SUN MICROSYSTEMS INC
Form 10-K
September 13, 2004
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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, 2004

¨ **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. ¨

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 ¨

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant, as of December 26, 2003 (the last business day of registrant s second quarter of fiscal 2004), was approximately $14.1 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 2, 2004 was 3,344,424,447.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the 2004 Annual Meeting of Stockholders are incorporated by reference into Items 10, 11, 12, 13 and 14 hereof.

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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 22 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. Together with our partners, we provide network computing infrastructure solutions that comprise computer systems (hardware and software), network storage systems (hardware and software), support services, and professional and knowledge services.

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

For the fiscal year ended June 30, 2004, we had revenues of $11.2 billion, employed approximately 35,000 employees and conducted business in over 100 countries. We were incorporated in California in February 1982 and reincorporated in Delaware in July 1987.

We can be reached on the Internet at 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/investors. 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 the addresses of these websites are intended to be inactive textual references only.

BUSINESS STRATEGY

Our business strategy is built around our singular focus on network computing. Our computer systems (hardware and software), network storage systems (hardware and software), support services, and professional and knowledge services are designed to enable network solutions that attack cost and complexity, accelerate service delivery and provide mobility with security. The core elements of our business strategy include:

An end-to-end architecture that extends our common Java technology-based programming environment across our SPARC® (Scalable Processor Architecture) technology implementation and new line of x86-based products. These products provide exceptional price-performance, flexibility and choice for devices as small as smart cards and cell phones up through large multi-million dollar systems;

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

A commitment to interoperability and open application programming interfaces;

A solution-based selling model with an emphasis on utilizing our end-to-end network computing architecture platform to integrate our products and services to address customers strategic business challenges and information technology needs;

A robust partner community (iForce), including independent software vendors (ISVs), system integrators, resellers and original equipment manufacturers (OEMs), which adds value to Sun products and services and extends our reach and expertise; and

A leading services organization that enables Sun and our partners to deliver open, innovative solutions and optimize availability and capabilities of our customers IT environment in a cost-effective manner.

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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. With this strategy, we are focused on offering the customer a platform that entails lower annual administrative costs, lower developer training costs and lower downtime costs, which decreases customers total cost of ownership.

In fiscal 2004, we introduced a number of new products supporting our strategy as an end-to-end infrastructure platform company. We improved the performance of our UltraSPARC® III processor and introduced the dual-thread UltraSPARC IV processor across our mid and high-end server lines. Targeted for mission-critical enterprise, High Performance Technical Computing (HPTC) and other compute-intensive applications, the UltraSPARC IV processor provides up to 2x the throughput of UltraSPARC III based systems. The UltraSPARC IV processor is fully binary compatible with our previous generation processor, so customers can run existing applications without the time and cost of rewriting applications.

We also strengthened our x86 low-end server product line and now provide customers the choice of either the Linux or Solaris Operating System on x86. We continued the deployment of our Solaris Operating System, which creates significant benefits to customers by reducing system downtime and upgrade costs because every release is designed to run existing applications currently running on previous Solaris Operating System releases.

Our software consists of Sun s powerful and scalable Solaris Operating System, Sun Java Enterprise System, Java Desktop System, Java Mobility System, N1 Grid 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.

Innovation

We believe that 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 15-17% of annual revenues during each of the last three fiscal years, we are continually focused on technological innovation. Over the past few years, we have made significant investments in several of our product and services technologies, including investments in:

The highly scalable UltraSPARC processor and systems architecture, including our next generation processors that enable chip multithreading to drive throughput computing at the processor level;

The x86 system architecture and advanced systems technology, including technology acquired through our purchases of Kealia and Nauticus and our new AMD Opteron-based systems;

The highly reliable and scalable Solaris Operating System;

- Mission critical clustering, messaging, directory and web services infrastructure software;

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

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

- Network-based storage systems and software, including storage management software and Sun QFS and Sun SAM-FS software; and

- Connectivity tools to provide remote diagnostics and preventive services for our customers.

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

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Interoperability

From inception, we have focused on developing products and technologies based upon open application programming interfaces (APIs). 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. To further strengthen our interoperability platform, and as part of our legal settlement with Microsoft Corporation, we entered into an agreement that is intended to enable greater interoperability of the two companies products.

The need for open APIs is at the heart of the Internet s development. We believe that without them, too many proprietary software and hardware protocols cause both incompatibility and cost issues, making it too difficult and uneconomical for individuals and organizations to fully access and harness the power of the network. Through open APIs, we believe application adoption and service deployments over the network will grow more quickly, increasing workload on the network and leading to increased demand for our computer systems. In addition, by adhering to open APIs, we are able to deliver more flexible and compatible systems products to our customers, reducing administrative costs, enabling provisioning and adding to the demand for our systems.

We deliver this performance through industry standards pioneered by Sun to provide value to our customers. For example, we have created technologies, such as the Network File System (NFS), UltraSPARC architecture and the Java technologies, providing customers with flexibility for their networking environments and facilitating industry growth. In addition, through our Sun Java System software platform, we have extended our well-established Java technology platform and utilized Web industry standards including XML (Extensible Markup Language), SOAP (Simple Object Access Protocol), UDDI (Universal Description, Discovery and Integration) and WSDL (Web Services Description Language).

Solutions-Based Selling Model

Our sales force is in the process of implementing a solutions-based selling model whereby we offer an integrated and consistent set of end-to-end networking architecture platform solutions to the marketplace. These solution sets currently encompass six core competencies and/or capabilities: the Data Center, Storage and Data Management, Desktop and Mobility, Identity and Security, Web Services Software and Network Manageability. These competencies line up directly with the three key strategies we present to our customers as part of the Sun vision attacking cost and complexity, accelerating service delivery and enabling mobility with security. We believe our solutions-based selling approach allows us to engage with our customers over the entire life cycle of their key infrastructure projects, which brings our expertise to bear in accelerating the delivery of sustainable value from the products and services we produce.

Alliances and Partner Community

In fiscal 2004, we continued to form relationships with significant partners to extend our customer solutions. We partnered with Advanced Micro Devices, Inc. (AMD) to bring Opteron processor-based x86 systems to our current line of entry-level systems giving customers greater platform choice with maximum price-performance. We also formed 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 strengthen the Solaris footprint, drive increased market share for our enterprise class systems and allow us to dedicate additional resources to throughput computing. In addition, we expanded our partnership with Accenture LTD to advance our knowledge management initiative, and we continued our relationship with Hitachi Data Systems to provide high-end storage solutions and extend Sun s 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 independent software vendors, value-added resellers, OEMs, channel development providers, independent distributors, computer systems integrators and service delivery partners 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.

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Services

We develop technology to solve complex network computing problems and we provide expertise through a broad range of global services including Support services, Professional services and Knowledge (formerly known as Educational) services which enable our customers to architect, implement and deploy systems within their IT environments. Combined with Sun Preventive Services introduced in fiscal 2004, these offerings provide a full range of system/network architecture, implementation and management as well as consulting, skills migration and training.

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. 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. We also offer component products such as central processor unit (CPU) chips and embedded boards on an OEM basis to other hardware manufacturers and supply after-market and peripheral products to their end-user installed base, both directly and through independent distributors and value-added resellers. In addition, our strategic alliance with Fujitsu will provide 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. In fiscal 2004, we organized our sales coverage within four timezone groups, which consisted of U.S., International Americas (Canada and Latin America), EMEA (Europe, Middle East and Africa) and APAC (Asia, Australia and New Zealand). Beginning in fiscal 2005, our sales coverage resources will be organized within 15 geographically established markets. We have approximately 130 sales and service offices in the United States and an additional 100 sales and service offices in 46 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 63% of our total net revenues in fiscal 2004 and more than 61% of our total net revenues in fiscal 2003. Our sales force is compensated on a channel-neutral basis to reduce potential conflict between our sales force and channel partners. 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;

Resellers 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 in which 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.

We have a wide range of marketing activities. Our Worldwide Marketing Organization oversees Sun s marketing planning, determines product and pricing strategy; coordinates advertising, demand creation and public relations activities; maintains strategic partnerships with major independent software vendors and performs competitive analyses.

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.

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Revenues from outside the United States were approximately 57% of our total net revenues in fiscal 2004 and 56% and 53% of our total net revenues in fiscal 2003 and 2002, respectively. Direct sales we make outside of the United States are generally priced in local currencies and can be subject to currency exchange fluctuations. The net foreign currency impact on total net revenues and operating results cannot be precisely measured because of the various hedging strategies we employ. However, because of the general weakening of the U.S. dollar, our best estimate of the foreign exchange benefit approximated 4% of total net revenues for fiscal 2004.

The countries primarily contributing to our international sales are the United Kingdom (UK), Germany and Japan. The UK represented approximately 8% of our total net revenues in fiscal 2004, 7% of our total net revenues in fiscal 2003 and fiscal 2002. Germany represented approximately 8% of our total net revenues in fiscal 2004 and fiscal 2003 and 7% of our total net revenues in fiscal 2002. Japan represented approximately 7% of our total net revenues in fiscal 2004, 8% of our total net revenues in fiscal 2003 and 8% of our total net revenues in fiscal 2002.

Some of our sales to international customers are made under export licenses that must be obtained from the United States 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 United States 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 United States are subject to inherent risks, including the general economic and political conditions in each country.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 14%, 11% and 12% of our fiscal 2004, 2003 and 2002 total net revenues, respectively. More than 90% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. The vast majority of the revenue included in the amounts above is from sales through a single GE subsidiary comprised 11%, 9% and 8% of total net revenues in fiscal 2004, 2003 and 2002, respectively. This GE subsidiary acts as a distributor of our products to resellers who in turn sell those products to end-users. 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. See Note 16 to the Consolidated Financial Statements for additional information concerning sales to international customers and business segments.

Our product order backlog at June 30, 2004 was $710 million, as compared with $705 million at June 30, 2003. Our backlog includes orders for which a delivery schedule within six months has been specified by the customer and shipped products for which revenue has not been recognized. Backlog levels vary with demand, product availability and our delivery lead times and are subject to significant decreases as a result of, among other things, customer order delays, changes or cancellations. As such, backlog levels may not be a reliable indicator of future operating results.

WORLDWIDE OPERATIONS

The Worldwide Operations organization manages company-wide purchasing of materials used in producing Sun products, assists in product design enhancements, oversees our own manufacturing operations and those of our manufacturing partners and coordinates logistics operations. Our manufacturing operations consist primarily of final assembly, test and quality control of enterprise and data center systems. For all other systems, we rely on external manufacturing partners. We manufacture primarily in Oregon and Scotland and distribute from California, the Netherlands and Japan. 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 fiscal 2004, we implemented a new customer fulfillment architecture that enables us to ship some products directly from our suppliers to our customers reducing cost and complexity in the supply chain. In addition, we have continued to increase our focus on quality and processes that are intended to proactively identify 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 worldwide advances in hardware, software, graphics, networking, data communications and storage technologies. In addition, we may extend our product offerings and intellectual property through acquisitions of businesses or technologies or other arrangements with our partners. Sun s 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. 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 United States, United Kingdom, France, Ireland, Germany, Japan, Norway and India. Research and development (R&D) expenses were $1,926 million, $1,837 million and $1,832 million in fiscal 2004, 2003 and 2002, respectively.

PRODUCTS

Our products consist of Computer Systems and Network Storage systems.

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 integrated systems designed, developed and produced 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, Sun Fire E20K, Sun Fire 15K and the Sun Fire 12K, 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, 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 datacenter.

Enterprise servers. Our enterprise servers, including Sun Fire E6900, Sun Fire E4900, Sun Fire E2900, Sun Fire 6800, Sun Fire 4800 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 Operating System. In fiscal 2004, 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 x86), 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 V880 and Sun Fire V480 servers, Sun Fire V240 and Sun Fire V210 that deliver network computing in a compact, low-cost package.

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Entry x86-based systems, including the Sun Fire V60x and Sun Fire V65x, provide high density, cost effective scalable solutions for both Solaris and Linux operating systems. During fiscal 2004, we introduced Sun Fire V20Z AMD Opteron-based server and V20Z Compute Grid Rack System to expand the x86 entry server line.

Our blade systems continue to combine high density hardware architecture and system management software. They allow for management of a pool of heterogeneous, modular, single board servers, such as SPARC and x86 architectures, Solaris and Linux operating systems and specialty blades, as one computing environment.

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, newly released x86-based workstations and thin Sun Ray Ultra-Thin Client products. In fiscal 2004, we introduced Sun Blade 2500, 2000 and 1500 workstations for demanding graphics, visualization and compute applications. Additionally, we released the Sun Blade W1100z and Sun Blade W2200z, which are Sun s first x86 based workstations. We recently introduced the AMD Opteron-based workstations that support Linux (Red Hat and SuSe, 32-Bit and 64-Bit) and the Solaris Operating System (32-Bit and eventually 64-Bit) and are intended to be Microsoft certified.

Processor and Network Products. The UltraSPARC microprocessors provide the computing power of most of Sun s systems. We have three series of processors that use the SPARC architecture: 1) The UltraSPARC s-Series processors power the high-end and midrange server products from Sun, as well as power desktops, and offer our highest level of performance, scalability and leading-edge reliability, availability and serviceability (RAS); 2) The UltraSPARC i-Series processors offer a higher level of integration on the central processing unit enabling the price and performance design points deployed in Sun s workgroup servers, rack mount servers and high performance desktops; and 3) The UltraSPARC e-Series processors balance cost, power consumption and performance, enabling economical 64-bit server and desktop solutions while maintaining binary compatibility with all SPARC processors, past and present. In addition, our networking and security products consist of a range of connectivity and encryption products to improve network performance and security.

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 x86 platforms that is easy to install and use, is optimized for the Java platform and supports more than 12,000 applications. It is optimized for enterprise computing, Internet and intranet business requirements, powerful databases and high performance technical computing environments. The Solaris 9 OS, our latest release of the Solaris OS, creates a services platform by combining traditional operating systems functionality with application services and identity management (management of user identities over the Internet or complex corporate networks so that users can use a single sign-on to be authenticated and authorized to access multiple files). Solaris 9 OS integrates with the Java Enterprise System making it easier to build and deploy applications and web services based on Java and XML technologies. Our Trusted Solaris OS provides a high level of privacy and reduces the risk of security violations on a commercial-grade OS. Trusted Solaris OS is available for both SPARC and x86 platforms.

Java technology. Our Java platform application environment allows development of application software independent of the underlying operating system or microprocessor. 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 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

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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 Enterprise System. Our Sun Java Enterprise System software enables enterprises to utilize their information and applications into services offered on intranets and the Internet. The Java Enterprise System software is an integrated suite of most of our infrastructure software, including application, directory, identity, integration, calendar, messaging and portal services for multiple platforms.

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.

N1 Grid System. N1 Grid 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 servers, storage and software to support 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. Our high-end data storage systems, including the Sun StorEdge 9980 and Sun StorEdge 9970, combine Hitachi Data Systems (HDS) high-end storage products with our resource management and file management software under an OEM agreement with HDS first signed in fiscal 2002.

We offer a wide range of flexible, scalable mid-range storage systems, including the Sun StorEdge 6320, Sun StorEdge 6120, Sun StorEdge 3910, Sun StorEdge A5200 Array and Sun StorEdge T3 Array, which support high-performance computing and enterprise SAN implementations, as well as storage virtualization technology. In fiscal 2004, we introduced the Sun StorEdge 6920 system, offering storage virtualization which delivers performance, flexibility and high availability for clustered environments such as high-performance computing and decision support systems.

Our Sun StorEdge products for workgroup applications, including the Sun StorEdge 3510 and 3511 Arrays, the Sun StorEdge 3310 Array, Sun StorEdge 3120 Array, Sun StorEdge S1 Array, Sun StorEdge D2 Array, Sun StorEdge A1000 and Sun StorEdge T3 Array for workgroup, 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 for increased return on investment.

Storage Software. Our Sun StorEdge software is an integral part of our complete storage solutions. Our Sun StorEdge software is based on the Sun Java System 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.

SERVICES

Our services team provides expertise in helping our customers deploy network computing environments through a broad range of services comprised of Support services (support for hardware and software) and Professional and Knowledge services. Sun Services assists customers globally, provides support services to nearly 800,000 units under contracts in more than 100 countries, training approximately 400,000 students annually and providing consulting, integration and operations assistance to IT organizations worldwide.

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SUPPORT 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.

We are in the process of growing our managed customer services. These fully managed services comprise packaged services providing risk assessment, mitigation and measurement toward availability improvement for customers. They also enable businesses to shift their operational focus from non-core competency IT management functions to running their business for competitive advantage. During fiscal 2004, we released site support services, fully managed services, Sun Preventive Services and our developing utility computing capabilities.

PROFESSIONAL AND KNOWLEDGE SERVICES

Sun s Professional services provides a suite of technical consulting and systems integration services to help customers architect, implement, and manage complex network computing environments. Our highly trained Professional services team specializes 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 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 Knowledge services group 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. Sun 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), Hewlett-Packard Company (HP), EMC Corporation (EMC), Fujitsu Limited (Fujitsu) and the Fujitsu-Siemens joint venture. We also compete with systems manufacturers and resellers of systems based on microprocessors manufactured by Intel Corporation (Intel) and the Windows family of operating systems software from Microsoft Corporation (Microsoft). These competitors include Dell Inc. and HP, in addition to Intel and Microsoft.

Customers make buying decisions based on many factors, including, among other things, new product and service offerings and features; product performance and quality; availability and quality of support and other services; price; platform; interoperability with hardware and software of other vendors; quality; reliability security features and availability of products; breadth of product line; ease of doing business; a vendor s ability to adapt to customers changing requirements; responsiveness to shifts in the marketplace; business model (e.g., utility computing, subscription based software usage, consolidation versus outsourcing); contractual terms and conditions; vendor reputation and vendor viability.
We believe competition has continued to remain intense 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.

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 competitors of Sun 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 also believe that patents are of less competitive significance than factors such as innovative skills and technological expertise. 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 report, 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.

EMPLOYEES

As of September 2, 2004, we had approximately 32,600 employees. 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.

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ITEM 2. PROPERTIES

At June 30, 2004, Sun s worldwide facilities represented aggregate floor space of 14.6 million square feet both in the U.S. and in 46 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	5.5	3.5	9.0
Total facilities	10.3	4.3	14.6

At June 30, 2004, 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	1,022,088
Newark, California	1,404,309
Santa Clara, California	816,240
Total	5,621,593

At June 30, 2004, 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, 3.1 million square feet remain vacant or sub-leased of which 1.1 million square feet is under sub-lease to non-Sun businesses and 2.0 million square feet is 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 February 11, 2002, Eastman Kodak Company (Kodak) filed a lawsuit against us entitled, Eastman Kodak Company v. Sun Microsystems, Inc., Civil Action No. 02-CV-6074, in the United States District Court for the Western District of New York and filed an amended complaint in that same court on March 22, 2002. Kodak alleges that some of our products, including aspects of our Java technology, infringe one or more Kodak patent claims contained in the following Kodak patents: U.S. Patent No. 5,206,951, U.S. Patent No. 5,421,012 and U.S. Patent No. 5,226,161 (collectively, the Kodak Patents). Kodak further alleges that we have contributed to and induced infringement of one or more claims of the Kodak Patents. Kodak seeks injunctive relief against future infringement, unspecified damages for past infringement and attorney s fees and costs. We have filed responses denying liability and asserting various affirmative defenses. The parties participated in a court-ordered settlement conference on August 4, 2004, but were unable to reach a settlement. We believe that we have not infringed any valid and enforceable claim of any Kodak Patent. Trial is scheduled to begin on September 13, 2004 and we intend to present a vigorous defense.

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 Environment, infringe on a Gobeli patent related to a system and method for controlling interrupt processing. Gobeli

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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.

On April 1, 2004, Sun and Microsoft Corporation (Microsoft) entered into several agreements including an agreement to settle all pending litigation between the two companies. Pursuant to the settlement agreement, Sun agreed to dismiss its litigation against Microsoft with prejudice and agreed to not initiate further steps to participate in the proceedings pending against Microsoft instituted by the Commission of the European Communities, and each party entered into a release of claims with respect to such matters. Microsoft agreed to pay to Sun the amount of $700 million under this settlement agreement.

Pursuant to a patent covenant and stand-still agreement, the parties agreed not to sue each other for past damages for patent infringement with respect to the other party s products and technologies (the Covenant Not to Sue for Damages). Each year until 2014, Microsoft has the option of extending the Covenant Not to Sue for Damages to apply to the preceding year in exchange for an annual extension payment, so long as Microsoft has made all previous annual extension payments and so long as Microsoft has not sued Sun or authorized licensees of its commercial products for patent infringement prior to such time. At the end of the ten-year term, if Microsoft has made all such payments and not brought any such suits, then each party will automatically grant to the other party irrevocable, non-exclusive, perpetual licenses under all of its patents and patent applications existing at the end of such period in order to allow such other party to continue to commercialize its products shipping at the end of such period and any related successor products. In addition, the parties agreed, for a period of six months, not to bring any patent infringement suit (including a suit for injunctive relief) against the other party or authorized licensees of its commercial products relating to such other party s products. Microsoft also agreed to pay to Sun the amount of $900 million under this patent covenant and standstill agreement.

Pursuant to a technical collaboration agreement, each party agreed to provide the other party with access to aspects of its desktop and server-based technology for use in developing interoperable server products. Microsoft also agreed to pay to Sun the amount of $350 million as a prepaid nonrefundable royalty under this technical collaboration agreement.

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 2004.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following sets forth certain information regarding our Executive Officers as of September 7, 2004.

Name	Age	Position
Scott G. McNealy	49	Chairman of the Board of Directors and Chief Executive Officer
Jonathan I. Schwartz	38	President and Chief Operating Officer
Crawford W. Beveridge	58	Executive Vice President, People and Places, and Chief Human Resources Officer

Robyn M. Denholm	40	Vice President and Corporate Controller
Michael A. Dillon	45	Senior Vice President, General Counsel and Secretary
Stephen T. McGowan	56	Chief Financial Officer and Executive Vice President, Corporate Resources
Gregory M. Papadopoulos	46	Executive Vice President and Chief Technology Officer

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

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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 Vice President and Corporate Controller since August 2003, 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.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock trades on The Nasdaq National Market under the symbol SUNW . As of September 2, 2004, there were approximately 23,400 stockholders of record and the closing price of Sun s common stock was $3.97 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 2004		Fiscal 2003	
	High	**Low**	**High**	**Low**
First Quarter	$ 5.18	$ 3.39	$ 6.13	$ 2.55
Second Quarter	4.59	3.14	4.58	2.34
Third Quarter	5.93	3.87	3.95	3.02
Fourth Quarter	5.12	3.64	5.64	3.13

No cash dividends were declared or paid in fiscal 2004 or fiscal 2003. We anticipate retaining available funds to finance future growth.

We issued unregistered shares of our common stock in connection with our acquisition of Kealia, Inc. (Kealia), which was completed on April 12, 2004. We issued an aggregate of approximately 20,000,000 shares of our common stock (including assumed options) in exchange for all of the outstanding stock and options of Kealia. The issuance of 15,032,475 of these shares was exempt from registration under the Securities Act of 1933, as amended, by virtue of Rule 506 of Regulation D under Section 4(2) of the Securities Act. Based upon the small number of Kealia stockholders receiving shares of our common stock in the merger, their financial position and sophistication, the information provided to these persons, the receipt of investment representations from these persons and the absence of any general solicitation, we determined that this exemption was available. The remainder of the shares, which were issued for the assumption of Kealia options, were registered pursuant to a registration statement on Form S-8 filed on April 16, 2004. No underwriters were used in connection with any of the transactions described above.

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ITEM 6. SELECTED FINANCIAL DATA(1)

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 Item 8. Financial Statements and Supplementary Data.

	Fiscal Years Ended June 30,									
	2004		**2003**		**2002**		**2001**		**2000**	
	Dollars	**%**	**Dollars**	**%**	**Dollars**	**%**	**Dollars**	**%**	**Dollars**	**%**
	(In millions, except per share amounts)									
Net revenues	$ 11,185	100.0	$ 11,434	100.0	$ 12,496	100.0	$ 18,250	100.0	$ 15,721	100.0
Cost of sales	6,669	59.6	6,492	56.8	7,580	60.7	10,040	55.0	7,540	48.0
Gross margin	4,516	40.4	4,942	43.2	4,916	39.3	8,210	45.0	8,181	52.0
Operating expenses:										
Research and development	1,926	17.2	1,837	16.1	1,832	14.7	2,016	11.0	1,630	10.4
Selling, general and administrative	3,317	29.7	3,329	29.1	3,806	30.5	4,445	24.4	4,053	25.8
Restructuring charges	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		21	0.1
Goodwill amortization							285	1.6	72	0.4
Purchased in-process research and development	70	0.6	4		3		77	0.4	12	0.1
Total operating expenses	5,706	51.0	7,666	67.0	6,164	49.3	6,899	37.8	5,778	36.8
Operating income (loss)	(1,190)	(10.6)	(2,724)	(23.8)	(1,248)	(10.0)	1,311	7.2	2,393	15.2
Gain (loss) on equity investments, net	(64)	(0.6)	(84)	(0.7)	(99)	(0.8)	(90)	(0.5)	208	1.3
Other income, net	94	0.8	155	1.3	299	2.4	363	2.0	170	1.1
Settlement income	1,597	14.3								
Income (loss) before taxes	437	3.9	(2,653)	(23.2)	(1,048)	(8.4)	1,584	8.7	2,771	17.6
Provision (benefit) for income taxes	825	7.4	776	6.8	(461)	(3.7)	603	3.3	917	5.8
Cumulative effect of change in accounting principle, net							(54)	(0.3)		
Net income (loss)	$ (388)	(3.5)	$ (3,429)	(30.0)	$ (587)	(4.7)	$ 927	5.1	$ 1,854	11.8
Net income (loss) per common share-diluted(1)	$ (0.12)		$ (1.07)		$ (0.18)		$ 0.27		$ 0.55	
Shares used in the calculation of net income (loss) per common share-diluted(1)	3,277		3,190		3,242		3,417		3,379	

	As of June 30,				
	2004	**2003**	**2002**	**2001**	**2000**

Cash, cash equivalents and marketable debt securities	$ 7,608	$ 5,741	$ 5,864	$ 6,171	$ 6,436
Total assets	$ 14,503	$ 12,985	$ 16,522	$ 18,181	$ 14,152
Long-term debt	$ 1,425(2)	$ 1,531	$ 1,653(2)	$ 1,565	$ 1,523
Other non-current obligations	$ 1,220(3)	$ 384(3)	$ 202(3)	$ 884(3)	$ 774(3)

(1) Share and per share amounts for all periods presented have been adjusted to reflect stock splits through June 30, 2004.

(2) Includes approximately $250 million and $204 million classified as current portion of long-term debt as of June 30, 2004 and 2002, respectively.

(3) Includes long-term tax liabilities as of June 30, 2004, 2001 and 2000 and long-term restructuring liabilities as of June 30, 2004, 2003, 2002 and 2001.

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

Overview

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

While we continued to face business challenges throughout the year, we saw improvement in fourth quarter total net revenues both sequentially and on a year over year basis. We saw improvement in fourth quarter revenues across most of our geographies, product lines and our larger vertical markets, including communications, financial services and government. In the fourth quarter, we saw server system unit shipment growth both sequentially and on a year over year basis. Fourth quarter revenue in the U.S. grew on a sequential basis almost 31%. We believe part of the increase is the result of our improved demand related to UltraSPARC IV-based systems, which were available across our enterprise and data center product lines. The entry level of our product line was rounded out by the successful launch of the Opteron processor based servers. In addition, an increase in our services contract penetration rate assisted our services organization in reporting its highest revenue quarter ever, exceeding $1 billion.

In fiscal 2004 total net revenues declined $249 million or 2.2% as compared to fiscal 2003 primarily due to a decrease in products net revenues. While our unit sales of Computer Systems and Network Storage systems increased as compared with fiscal 2003, we responded to competitive pressures with price reductions and sales discounting actions resulting in a decrease in fiscal 2004 products net revenue. An increase in fiscal 2004 services net revenues, as compared with fiscal 2003, partially offset the decline in products net revenues. Although services revenues were also affected by competitive pricing pressures, services revenues grew primarily due to an increase in the support services contract penetration rate, as we increased contract renewals with existing customers and entered into a higher percentage of support services contracts with new products sales.

Our overall gross margin percentage in fiscal 2004, declined $426 million or 2.8 percentage points as compared to fiscal 2003. Our products gross margin declined as compared to fiscal 2003, due to the unfavorable impact of planned list price reductions and additional discounts and product mix which were partially offset by manufacturing and component costs savings. The decline in our services gross margin as compared to fiscal 2003 was also a result of competitive pressures which increased discounting, as well as increased costs associated with specific solution-based sales.

On April 1, 2004, we entered into several agreements with Microsoft, including an agreement to settle all pending litigation between the two companies, a patent covenant and stand-still agreement, and a technical collaboration agreement. As further described in Note 13 to the Consolidated Financial Statements, we received $1,950 million in cash and recognized approximately $1.6 billion in settlement income during the fourth quarter of fiscal 2004.

In fiscal 2004, 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 2004 results included $344 million of restructuring charges related to this and other activities and we expect to record additional charges of approximately $130 million over the next several quarters.

Additionally, during fiscal 2004 we recorded a non-cash charge of approximately $300 million related to an increase to the valuation allowance of our net deferred tax assets. This increase is the result of the updating of our assumptions underlying the realization of the net deferred tax assets.

During fiscal 2004, our operating activities generated cash flows of $2,226 million, which includes the cash received in connection with the settlement with Microsoft of $1,950 million. Our focus on cash management remains a top priority and we plan to continue to focus on driving improvement in our cash conversion cycle. We ended the fourth quarter of fiscal 2004 with a cash conversion cycle of 40 days, an improvement of 6 days from June 30, 2003. At June 20, 2004, we had a total cash, cash equivalents and marketable debt securities position of approximately $7.6 billion.

Changes to Previously Announced Fiscal 2004 Fourth Quarter and Annual Results

On July 20, 2004, we announced our fiscal 2004 fourth quarter and annual results. Subsequent to that date, we obtained additional information related to certain estimates primarily related to our asset retirement obligations from leased facilities. We also finalized our accounting for the settlement with Microsoft. As a result, we adjusted our previously announced fiscal 2004 results by decreasing our fourth quarter net income by $12 million and diluted net income per common share by $0.01 and by increasing our annual net loss by $12 million and basic and diluted net loss per common share by $0.01.

Critical Accounting Policies

The accompanying discussion and analysis of our financial condition and results of operations are based upon our 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 2 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 inherently 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 loss, the estimated loss is recognized in the period the loss becomes evident. Changes in assumptions underlying these estimates and cost could materially impact the timing of revenue recognition and loss recognition.

Channel Partners selling our high volume products generally carry Sun products as inventory and we recognize revenue when we sell to the Channel Partners, if our revenue recognition criteria are met. 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. Changes in 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; 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 No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets. 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 estimated 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 2004 annual goodwill impairment analysis in the fourth quarter of fiscal 2004. Based on our estimates of forecasted discounted cash flows as well as our market capitalization, at that time, we concluded that all of the recorded goodwill of $49 million in our Knowledge services reporting unit was impaired and needed to be expensed as a non-cash charge to continuing operations during the fourth quarter of 2004. The impairment primarily related to goodwill acquired from our acquisitions of ISOPIA, Inc. of $39 million and Ed Learning Systems, Inc. of $7 million. At June 30, 2004, our remaining goodwill had a net book value of $406 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 additional impairments to our goodwill, it could 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. As required, we perform tests for impairment of intangible assets other than goodwill (Other Intangible Assets) whenever events or circumstances suggest that Other Intangible Assets may be impaired. In April 2004, due to (1) our reorganization plans; (2) certain decisions made regarding the utilization of acquired technologies and other intangible assets; and (3) decreases in cash flow projections related to certain acquired technologies and other intangible assets; we concluded there were sufficient indicators to require us to perform an analysis to assess whether any portion of our Other Intangible Assets balance was impaired. As a result of this analysis, we determined that no impairment charges were necessary at that time. We recognized

$98 million and $6 million in fiscal 2003 and 2002, respectively, as impairment charges against the carrying value of Other Intangible Assets. At June 30, 2004, we had Other Intangible Assets with a carrying value of approximately $141 million. These Other Intangible Assets consist of $127 million in intangible assets associated with business combinations and a $14 million intangible asset associated with a revenue generating technology license, which was acquired as part of the Strategic Alliance with Time Warner (see Notes 4 and 5 to the Consolidated Financial Statements for further discussion). 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, 2004, by one year or reduced the projected cash flows by 20%, up to $27 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 additional impairments to our Other Intangible Assets, it could 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 represents 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 made.

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, 2004, we had approximately $59 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 value is less than its carrying cost.

The process of assessing whether a particular equity investment s net realizable value is less than its carrying cost 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 loss on equity investments, net in the accompanying Consolidated Statements of Operations, related to our investments in privately-held companies of $67 million, $72 million and $64 million in fiscal years 2004, 2003 and 2002, respectively.

Estimating the net realizable value of investments in privately-held early-stage technology companies is inherently subjective and may contribute to significant volatility in our reported results of operations. If we incur additional impairments to our equity investments in privately-held companies, it could have an adverse impact on our future earnings.

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 Japan in recent years represented sufficient negative evidence to require a full and partial valuation allowances in these jurisdictions, respectively. At June 30, 2004 we established a valuation allowance against the deferred tax assets 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

See Note 1 to the Consolidated Financial Statements for a full description of recent accounting pronouncements including the respective expected dates of adoption and effects on results of operations and financial condition.

Product Gross Profit %
24.7% 26.1% 27.3% 27.1% 28.1% 27.9% 28.0%

(1) Calculated as net sales less purchase costs divided by net sales.

(2) Includes vendor rebates, cooperative advertising income, freight

billed to
customers,
freight
expenses, and
direct shipping
costs.

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Service gross profit in the third quarter of fiscal year 2009 was $1.3 million, or 21.4% of total service revenue, compared with $1.1 million, or 19.5% of total service revenue, in the same period of the prior fiscal year. In the third quarter of fiscal year 2009, we continued the cost control measures implemented in the second quarter of fiscal year 2009 in order to compensate for the lower than expected revenue growth, resulting in a 39.2% incremental margin from increased revenue. In general, our gross profit percentage for calibration services fluctuates on a quarterly basis due to the seasonality of our revenues (our fiscal fourth quarter is generally our strongest) and the timing of operating costs associated with our calibration laboratory operations. The following table reflects our service gross profit growth in relation to prior fiscal year quarters:

		FY 2009			FY 2008		
	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Service Gross Profit Dollar (Decline) Growth	21.2%	6.5%	(0.3%)	32.5%	14.0%	5.0%	3.8%

Operating Expenses:

	Third Quarter Ended	
	December 27, 2008	December 29, 2007
Operating Expenses:		
Selling, Marketing and Warehouse	$ 2,606	$ 2,304
Administrative	1,503	1,365
Total	$ 4,109	$ 3,669

Operating expenses increased $0.4 million, or 12.0%, from the third quarter of fiscal year 2008 to the third quarter of fiscal year 2009. Operating expenses as a percent of total revenue increased from 19.9% in the third quarter of fiscal year 2008 to 20.5% in the third quarter of fiscal year 2009. Included in the third quarter of fiscal year 2009 operating expenses were approximately $0.2 million in one-time integration expenses related to the acquisition of Westcon. Exclusive of these one-time expenses, Administrative expenses would have been relatively consistent year-over-year. Selling, Marketing and Warehouse expenses increased to $2.6 million in the third quarter of fiscal year 2009 compared with $2.3 million in the same period of the prior fiscal year, primarily related to increased cost associated with our acquisition of Westcon and strategic investments in our sales and marketing for the Service segment. Year-over-year operating expenses were positively impacted in the third quarter of fiscal year 2009 by reductions in management bonus and employee profit sharing expenses when compared with the third quarter of fiscal year 2008.

Other Expense:

	Third Quarter Ended	
	December 27, 2008	December 29, 2007
Other Expense:		
Interest Expense	$ 43	$ 17
Other Expense, net	56	135
Total	$ 99	$ 152

The increase in interest expense in the third quarter of fiscal year 2009 when compared with the third quarter of fiscal year 2008 was a result of higher debt levels due to the acquisition of Westcon. Other expenses decreased approximately $0.1 million due to reduced foreign exchange losses associated with changes in the exchange rate between the U.S. dollar and Canadian dollar. We have a program in place to hedge the majority of our risk to fluctuations in the value of the U.S. dollar relative to the Canadian dollar.

Taxes:

	Third Quarter Ended	
	December 27, 2008	**December 29, 2007**
Provision for (Benefit from) Income Taxes	$181	$ (316)

In the third quarter of fiscal year 2009, we recognized a $0.2 million provision for income taxes, compared to a $0.3 million benefit from income taxes in the third quarter of fiscal year 2008. The 2008 benefit was a result of a reversal of a $0.8 million deferred tax asset valuation allowance. We continue to evaluate our tax provision on a quarterly basis and make

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adjustments, as deemed necessary, to our effective tax rate given changes in facts and circumstances expected for the entire fiscal year.

NINE MONTHS ENDED DECEMBER 27, 2008 COMPARED TO NINE MONTHS ENDED DECEMBER 29, 2007 (dollars in thousands):

Revenue:

	Nine Months Ended	
	December 27, 2008	December 29, 2007
Net Revenue:		
Product Sales	$ 39,251	$ 35,151
Service Revenue	17,204	16,104
Total	$ 56,455	$ 51,255

Net revenue increased $5.2 million, or 10.1%, from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009.

Our product net sales, which accounted for 69.5% of our total net revenue for the first nine months of fiscal year 2009 and 68.6% of our total net revenue for the first nine months of fiscal year 2008, have increased $4.1 million, or 11.7%. Incremental sales as a result of the acquisition of Westcon accounted for $2.1 million of the increase. Organic product net sales increased $2.0 million, or 5.6%, for the first nine months of fiscal year 2009. Total sales within our direct distribution channel increased 4.8%, with Westcon contributing 89.1% of the sales dollar growth. The organic growth within our direct channel was $0.2 million and resulted from slight growth in our U.S. direct channel and 13.1% growth in our International direct channel, partially offset by a 20.2% decline in sales into our Canadian direct channel. Overall, lower than expected sales growth in the later part of the third quarter of fiscal year 2009 resulting from weakening economic conditions mostly offset sales growth achieved earlier in fiscal year 2009. The decline in Canadian sales and lower margin sales by Westcon have had a negative impact on our overall direct channel gross margin. Our direct channel s gross profit as a percent of product sales has declined 160 basis points from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009.

Within our reseller channel, we experienced a 54.7% increase in total sales and a 37.1% increase in organic sales during the first nine months of fiscal year 2009. We attribute this growth to our ability to provide resellers with a broad range of new and existing products from within our inventory. Our reseller sales growth did not come at the expense of declining profit margins within the channel. We experienced a profit margin improvement of 80 basis points in the first nine months of fiscal year 2009 compared to the first nine months of fiscal year 2008. The following table provides the percentage of net sales and the approximate gross profit percentage for significant distribution product channels for the first nine months of fiscal years 2009 and 2008:

	Nine Months Ended December 27, 2008		Nine Months Ended December 29, 2007	
	Percent of Net Sales	Gross Profit % (1)	Percent of Net Sales	Gross Profit % (1)
Direct	79.7%	24.9%	84.9%	26.5%
Reseller	18.9%	18.0%	13.6%	17.2%
Freight Billed to Customers	1.4%		1.5%	
Total	100.0%		100.0%	

(1) Calculated as net sales less purchase costs divided by net sales.

Service revenue increased $1.1 million, or 6.8%, from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009. Organic service revenue growth for the same time period was 3.3%. Service revenue in the first nine months of fiscal year 2009 was negatively impacted by the weakening economic conditions experienced in our fiscal third quarter, by Hurricane Ike which occurred in our fiscal second quarter, and an 8.4% decline in our repair business. In addition, within any nine month period, while we may add new customers, we also have customers from the prior year whose calibrations may not repeat during the same fiscal period for any number of factors. Among those factors are the variations in the timing of customer periodic calibrations on equipment, customer capital expenditures and customer outsourcing decisions.

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Gross Profit:

	Nine Months Ended December 27, 2008	Nine Months Ended December 29, 2007
Gross Profit:		
Product	$ 10,196	$ 9,845
Service	3,634	3,341
Total	$ 13,830	$ 13,186

Total gross profit dollars increased 4.9% from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009. As a percentage of total net revenue, total gross profit declined 120 basis points for the same time period.

Product gross profit increased $0.4 million, or 3.6%, from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009, primarily because of an 11.7% increase in product net sales. As a percent of product net sales, product gross profit decreased 200 basis points for the same time period. This is primarily attributable to higher international and reseller sales, which have lower profit margins, combined with lower sales to Canadian customers, which typically have higher profit margins.

Service gross profit increased approximately $0.3 million, or 8.8%, from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009. As a percent of service revenue, service gross profit has increased 40 basis points from the first nine months of fiscal year 2008 compared with the first nine months of fiscal year 2009. In the first nine months of fiscal year 2009, cost control measures were put into place to maintain relatively consistent service gross profit percentages, despite lower than expected revenue growth.

Operating Expenses:

	Nine Months Ended December 27, 2008	Nine Months Ended December 29, 2007
Operating Expenses:		
Selling, Marketing and Warehouse	$ 7,323	$ 6,627
Administrative	4,758	4,472
Total	$ 12,081	$ 11,099

Operating expenses increased $1.0 million, or 8.8%, from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009. Included in the first nine months of fiscal year 2009 were approximately $0.8 million in Westcon expenses, including $0.2 million in non-recurring Administrative expenses related to integration. Exclusive of incremental Westcon expenses, our organic Selling, Marketing and Warehouse expenses increased 5.2% in the first nine months of fiscal year 2009 compared with the first nine months of fiscal year 2008, primarily related to investments in our sales and marketing for the Service segment. Our organic Administrative expenses decreased 3.4% from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009. Operating expenses were positively impacted in the first nine months of fiscal year 2009 by reductions in employee stock-based compensation, management bonus and employee profit sharing expense when compared with the first nine months of fiscal year 2008.

Other Expense:

	Nine Months Ended	
	December 27, 2008	December 29, 2007
Other Expense:		
Interest Expense	$ 70	$ 80
Other Expense	68	425
Total	$ 138	$ 505

Interest expense decreased slightly from the first nine months of fiscal year 2008 to the first nine months of fiscal year 2009 as a result of our reduced debt prior to our acquisition of Westcon. Other expenses decreased approximately $0.4 million due to reduced foreign exchange losses. We have a program in place to hedge the majority of our risk to fluctuations in the value of the U.S. dollar relative to the Canadian dollar.

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Taxes:

	Nine Months Ended	
	December 27, 2008	December 29, 2007
Provision for (Benefit from) Income Taxes	$611	$ (58)

In the first nine months of fiscal year 2009, we recognized a $0.6 million provision for income taxes, compared to a $0.1 million benefit from income taxes in the first nine months of fiscal year 2008. The 2008 benefit was a result of a reversal of a $0.8 million deferred tax asset valuation allowance in the fiscal third quarter. We continue to evaluate our tax provision on a quarterly basis and make adjustments, as deemed necessary, to our effective tax rate given changes in facts and circumstances expected for the entire fiscal year.

LIQUIDITY AND CAPITAL RESOURCES

As of December 27, 2008, cash along with projected operating cash flows are expected to support our normal business operations and capital purchases for the foreseeable future.

Cash Flows. The following table is a summary of our Consolidated Statements of Cash Flows (in thousands):

	Nine Months Ended	
	December 27, 2008	December 29, 2007
Cash Provided by (Used in):		
Operating Activities	$ 1,345	$ 2,670
Investing Activities	(6,679)	(1,351)
Financing Activities	5,184	(1,418)

Operating Activities: Cash provided by operating activities for the first nine months of fiscal year 2009 was $1.3 million compared to $2.7 million in the first nine months of fiscal year 2008. A portion of the fiscal year 2009 decrease in cash provided by operating activities is approximately $0.6 million less in net income in the first nine months of fiscal year 2009 compared to the first nine months of fiscal year 2008. Significant working capital fluctuations were as follows:

Inventory/Accounts Payable: Due to economic conditions in the third quarter of fiscal year 2009 that we anticipate will carry forward into the fourth quarter, we have implemented tight monitoring controls to drive down inventory levels. These efforts provided approximately $0.3 million of cash for operations compared to the $1.2 million used for inventory in the first nine months of fiscal year 2008. However, in the first nine months of fiscal year 2009 operating cash flow has been negatively impacted by payments made to reduce accounts payable by $1.6 million, compared to an increase in accounts payable of $1.4 million in the first nine months of fiscal year 2008.

Receivables: We continue to generate positive operating cash flow and maintain strong collections on our accounts receivable. The following table illustrates our days sales outstanding from fiscal year 2008 to fiscal year 2009:

	December 27, 2008	December 29, 2007
Net Sales, for the last two fiscal months	$ 13,239	$ 13,055
Accounts Receivable, net	$ 8,689	$ 8,271
Days Sales Outstanding (based on 60 days)	39	38

Investing Activities: During the first nine months of fiscal year 2009, we used $6.7 million of cash for investing activities, of which approximately $5.6 million was associated with the purchase of Westcon. In addition, during the first nine months of fiscal year 2009, we used over $1.0 million of cash for the purchase of property and equipment, a $0.3 million decrease from the first nine months of fiscal year 2008, primarily for the expansion of capacity and capabilities within our calibration laboratories.

Financing Activities: The $5.2 million of cash provided by financing activities during the first nine months of fiscal year 2009 resulted primarily from borrowings to acquire Westcon.

Debt. On August 14, 2008, we amended our Chase Credit Agreement. The amendment provides for an increase in the amount available under the Revolving Credit Facility from $10 million to $15 million, an extension of the maturity date from November 2009 to August 2011 and an increase in interest and commitment fees. All other terms were unchanged. As of December 27, 2008, $5.2 million was outstanding and $9.8 million was available under the Chase Credit Agreement.

See Note 2 of our Consolidated Financial Statements in this report for more information on our debt. See Item 3, Quantitative and Qualitative Disclosures About Market Risk, of this report for a discussion of interest rates on our debt.

OUTLOOK

We are not immune to the impacts of the recession, however, we do believe we are well positioned to meet the challenge. For our Service segment, our financial strength should work to our advantage in gaining market share. We are focusing our sales and marketing assets on certain industries, such as life sciences, that require high quality calibration services as part of their regulated quality programs. Over the long term, we believe that our strategy to build stronger relations with more businesses that respect the value and integrity of our services will contribute to continued growth in this segment. We expect that despite the recession we can achieve growth in this segment as we move through fiscal 2010.

Although we believe the Product segment is affected more heavily by the economy, as we saw dramatically in the last two months of calendar 2008, we will selectively focus our marketing dollars toward markets where we believe we can continue to gain market share.

As with many companies, it is unclear how long and to what extent the current economic conditions will impact our revenue. Additionally, margins could be weakened in this environment as we carefully evaluate the use of discounts to maintain a competitive advantage and if we experience a reduction in the level of support received from our vendors for our cooperative advertising or rebate programs.

While the current economic cycle is working against us, we believe that our strategy is sound and will remain intact. We have developed significant competencies in our sales force and our laboratory technical staff and expect to maintain that infrastructure. We intend to reduce expenses, capital expenditures and inventory where possible without impacting service delivery. In spite of these efforts, we expect growth in operating income to slow until the economy recovers, at which time we should be well positioned for future growth.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATES

Our exposure to changes in interest rates results from our borrowing activities. In the event interest rates were to move by 1%, our yearly interest expense would increase or decrease by less than $0.1 million assuming our average-borrowing levels remained constant. On December 27, 2008 and December 29, 2007, we had no hedging arrangements in place to limit our exposure to upward movements in interest rates. As of December 27, 2008, $5.2 million was outstanding and $9.8 million was available under the Chase Credit Agreement.

Under our Chase Credit Agreement described in Note 2 of our Consolidated Financial Statements in this report, interest is adjusted on a quarterly basis based upon our calculated leverage ratio. Our interest rate for the first nine months of fiscal year 2009 ranged from 1.4% to 5.5%.

FOREIGN CURRENCY

Over 90% of our total net revenues for the first nine months of fiscal years 2009 and 2008 were denominated in United States dollars, with the remainder denominated in Canadian dollars. A 10% change in the value of the Canadian dollar to the United States dollar would impact our total net revenues by less than 1%. We monitor the relationship between the United States and Canadian currencies on a continuous basis and adjust sales prices for products and services sold in Canadian dollars as we believe to be appropriate.

We periodically enter into foreign exchange forward contracts to reduce the risk that our earnings would be adversely affected by changes in currency exchange rates. We do not apply hedge accounting and therefore, the change in the fair value of the contracts, which totaled less than $0.1 million during the third quarter and the first nine months of fiscal year

2009, was recognized in current earnings as a component of other expense in the Consolidated Statements of Operations and Comprehensive Income. The change in the fair value of the contracts is offset by the change in fair value on the underlying receivables denominated in Canadian dollars being hedged. On December 27, 2008, we had a foreign exchange forward contract, set to mature in February 2009, outstanding in the notional amount of $0.4 million. We do not use hedging arrangements for speculative purposes.

ITEM 4. CONTROLS AND PROCEDURES

(a) **Evaluation of Disclosure Controls and Procedures.** Our principal executive officer and our principal financial officer evaluated our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of such date.

(b) **Changes in Internal Controls over Financial Reporting.** There has been no change in our internal control over financial reporting that occurred during the last fiscal quarter covered by this quarterly report (our third fiscal quarter) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. As disclosed in this report, we acquired Westcon, Inc. on August 14, 2008 and we are in the process of integrating its operations.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

You should carefully consider the following risk factors in evaluating us and our business. These risks are not exclusive, and additional risks to which we are subject include, but are not limited to, the risks of our businesses described elsewhere in this report and in other documents we file with the SEC, including our Annual Report on Form 10-K for the fiscal year ended March 29, 2008. If any of the following risks occur, our business, financial condition and operating results could be materially adversely affected.

Our Acquisitions Or Future Acquisition Efforts, Which Are Important To Our Growth, May Not Be Successful, Which May Limit Our Growth Or Adversely Affect Our Results Of Operations And Financial Condition

Acquisitions have been an important part of our development to date. During our second quarter of fiscal year 2009, we acquired Westcon. As part of our business strategy, we may make additional acquisitions of companies that could complement or expand our business, augment our market coverage, provide us with important relationships or otherwise offer us growth opportunities. If we identify an appropriate acquisition candidate, we may not be able to negotiate successfully the terms of or finance the acquisition. In addition, we cannot assure you that we will be able to integrate the operations of our acquisitions, including Westcon, without encountering difficulties, including unanticipated costs, possible difficulty in retaining customers and supplier or manufacturing relationships, failure to retain key employees, the diversion of our management s attention or failure to integrate our information and accounting systems. As a result of our recent acquisition of Westcon and future acquisitions, we may not realize the revenues and cost savings that we expect to achieve or that would justify the acquisition investments, and we may incur costs in excess of what we anticipate. To effectively manage our expected future growth, we must continue to successfully manage our integration of the companies that we acquire and continue to improve our operational systems, internal procedures, accounts receivable and management, financial and operational controls. If we fail in any of these areas, our business growth and results of operations could be adversely affected.

Our Recently Completed Acquisition Of Westcon Makes Evaluating Our Operating Results Difficult Given The Significance To Our Operations, And Our Historical Results Do Not Give You An Accurate Indication Of How We Will Perform In The Future

Our historical results of operations do not give effect for a full fiscal year to our acquisition of Westcon. Accordingly, our historical financial information does not necessarily reflect what our financial position, operating results and cash flows will be in the future as a result of this acquisition, or give you an accurate indication of how we will perform in the future.

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The Financing Of Any Future Acquisitions We Make May Result In Dilution To Your Stock Ownership And/Or Could Increase Our Leverage And Our Risk Of Defaulting On Our Bank Debt

Our business strategy includes expansion into new markets and enhancement of our position in existing markets, including through acquisitions. In order to successfully complete targeted acquisitions we may issue additional equity securities that could dilute your stock ownership. We may also incur additional debt if we acquire another company, which could significantly increase our leverage and our risk of default under our existing credit facility. For example, in financing our recent Westcon acquisition we issued 150,000 shares of our common stock in a private placement to Westcon s sole shareholder and incurred approximately $4.6 million of additional debt under our amended credit facility to fund a portion of the purchase price.

The Global Financial Crisis May Have An Impact On Our Business And Financial Condition In Ways That We Currently Cannot Predict Including The Impact On Our Customers Activity Levels And Spending For Our Products And Services

Based on a number of economic indicators, it appears that growth in global economic activity has slowed substantially. At the present time, the rate at which the global economy will slow has become increasingly uncertain. The continued credit crisis and related turmoil in the global financial markets has had and may continue to have an impact on our business and our financial condition.

The global financial crisis has impacted and could continue to impact our liquidity. Customer collections are our primary source of cash. While we believe we have a well diversified customer base and no concentration of credit risk with any single customer, we have a number of large customers that could be effected by the slowed economy. While we believe we have a strong customer base and have experienced strong collections in the past, if the current market conditions continue to deteriorate we may experience increased unpredictability in our customer base, including reductions in their commitments to us, which could also have a material adverse effect on our liquidity. Deteriorating market and liquidity conditions may also give rise to issues which may impact our lender s ability to hold its debt commitments to us to their full term. Accordingly, while this would be highly unusual, our lender could reduce or attempt to call our current committed and drawn debt under our existing facility which would have a material adverse effect on our liquidity, even though no call provisions exist without being in default.

ITEM 6. EXHIBITS

See Index to Exhibits.

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SIGNATURES

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

	TRANSCAT, INC.
Date: February 9, 2009	/s/ Charles P. Hadded Charles P. Hadeed Chief Executive Officer, President and Chief Operating Officer
Date: February 9, 2009	/s/ John J. Zimmer John J. Zimmer Vice President of Finance and Chief Financial Officer

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INDEX TO EXHIBITS

(10) Material Contracts

10.1 Amendment to Agreement for Severance Upon Change in Control for Charles P. Hadeed dated December 16, 2008

(31) Rule 13a-14(a)/15d-14(a) Certifications

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

(32) Section 1350 Certifications

32.1 Section 1350 Certifications

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