



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

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

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

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

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

The aggregate market value of the voting stock (Common Stock) held by non-affiliates of the registrant, as of December 23, 2005 (the last business day of registrant's second quarter of fiscal 2006), was approximately \$15 billion based upon the last sale price reported for such date on The NASDAQ Stock Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 5% of the outstanding shares of Common Stock and shares held by officers and directors of the Registrant have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive.

The number of shares of the registrant's Common Stock (par value \$0.00067) outstanding as of September 6, 2006 was 3,509,259,866.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Parts of the Proxy Statement for the 2006 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 provides innovative products and services for network computing. Our customers use those innovations to create and operate the network services upon which they run their businesses. The Network Is The Compute has articulated the consistent vision at the core of our offerings throughout the 24 years of our existence. Every day, this vision becomes increasingly real, as consumers use and experience a richer array of network based services, including online banking, tax filing, auctions and interactive media and entertainment. Customers' growing use of advanced digital services fuels the demand for industrial-grade, reliable, secure and highly scalable computing infrastructures' systems, software, storage and related services. We focus on creating, selling and managing those infrastructures. Our core brands include the open and multi-platform Solaris Operating System, our Java Platform software and programming offerings, our SPARC® and AMD Opteron based lines of Sun Fire servers, the StorageTek line of storage systems and our SunSpectrum<sup>SM</sup> service offerings. Our world-class software solution and system partners, together with our extensive network of value-added resellers, help create a strong ecosystem around Sun's core innovation, thereby bringing greater value to customers.

Our customers use our products and services to build and operate mission-critical network computing environments running essential elements of their businesses, including a wide range of technical, scientific, business and engineering applications. Our systems power the infrastructure underlying a range of business and technical processes' from webserving to high-performance technical computing to enterprise-wide resource planning, customer relationship management and database management' in a wide range of industries, including telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare.

Customers do business with Sun in part because of the value our business brings to their business, particularly our thought leadership, innovative products and solutions and our ability to create and nurture large communities of developers around our software platforms. The reliability, security and scalability of our offerings are key differentiators along with interoperability and long-term investment protection across many different computing platforms. We have built our business around a multi-platform strategy that includes our Solaris Operating System running on x86 and SPRAC machines, the Write Once, Run Anywhere concept of the Java Platform, and the ability for our systems to support Solaris, Windows and Linux platforms and for our storage products to support both UNIX® and mainframe environments.

Sun relies upon, and contributes much to, the power of open source and community development. A core premise of our software business is that long term success depends on the ability to successfully attract innovative application developers to our platforms (Solaris, Java and the Java Enterprise System). Those innovative applications in turn lead to design wins for Sun deployments, thereby driving demand for the full array of our offerings. Our long standing belief that openness, community, sharing and collaboration speed innovation and create markets faster is key to our success. Sun contributes to a wide variety of open source communities including OpenSolaris, Java, Netbeans, OpenOffice.org, OpenSPARC and many other industry-wide community development efforts.

For the fiscal year ended June 30, 2006 we had net revenues of \$13.1 billion, employed approximately 38,000 employees and conducted business in over 100 countries. We were incorporated in California in February 1982 and reincorporated in Delaware in July 1987.

Our Internet address is <http://www.sun.com>. On our Investor Relations web site, located at <http://www.sun.com/aboutsun/investor>, we post the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the U.S. Securities and Exchange Commission (SEC): our annual reports on Form 10-K, quarterly reports on Form 10-Q, our current reports on Form 8-K, our proxy statement on Form 14A related to our annual shareholders' meeting and any amendments to those reports or statements filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended. All such filings are available free of charge on our Investor Relations web site. The contents of these web sites are not intended to be incorporated by reference into this report or in any other report or document we file, and our references to these web sites are intended to be inactive textual references only.

**BUSINESS STRATEGY**

Our business strategy is to provide superior offerings that rely on innovation as a core differentiator. We take a holistic systems approach to the critical elements customers require' systems, software, storage and services. The elements of our business strategy include:

***Innovation.*** We rely on on-going innovation in systems design, networking integration, microprocessor architecture, operating systems and software to ensure continuing technology leadership, which our customers experience in the form of both new enabling capability and/or greater

cost efficiencies.

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***Interoperability.*** We focus on standards-based designs and implementations, including standards-based networking protocols and webservices, identity management and other elements, thereby allowing customers to build heterogeneous network computing environments.

***Customers Investment Protection.*** We emphasize protecting our customers infrastructure investments and lowering their total cost of ownership. We demonstrate that commitment through legacy application support, binary compatibility with previous versions of our operating systems, and the ability to selectively upgrade a single processor board within a larger system.

***Solutions-Based Selling Model.*** We use a solutions-based selling model that emphasizes our end-to-end network computing architecture platform, with integrated product and service offerings that address customers strategic business challenges and not just their information technology needs.

***Innovative Business Models.*** We utilize innovative business models that address specific customer needs. Examples include our Sun Grid utility computing offering priced at \$1 per CPU-hour and our innovative per-employee indexed pricing for all of our middleware software offerings. Both appeal to customers struggling to make their IT expenditure more predictable while lowering the overall IT cost.

***Robust Partner Community.*** We cultivate a robust partner community, including independent software vendors (ISVs), system integrators, resellers and original equipment manufacturers (OEMs), whose members collaborate in building new and innovative solutions based on our products and services, thus extending our reach and expertise.

***Environmentally Responsible Products.*** Our aim is Sustainable Computing. We strive to design, develop and ship environmentally friendly products that not only meet regulatory requirements, but also have minimal impact on the environment.

Each of these elements of our business strategy are discussed in more detail below.

### ***Innovation***

In order to maintain our position as a leading developer of enterprise and network computing products and technologies, we must continue to invest and innovate. Over the past few years, in addition to significant investments in research and development, we have also made significant investments in several product and services technology acquisitions. Our investments in research and development and acquisitions include the following:

Innovation at the operating system level is evidenced by the Solaris 10 operating system, which is the market share leading UNIX operating environment. We believe it provides significant advantages over traditional UNIX offerings as well as Linux implementations and has won numerous awards for its technological features. The Solaris 10 operating system is multi-platform and runs on Dell, HP, IBM and numerous other platforms. It includes several major advancements in availability, performance and security to help customers proactively manage their computing resources.

Our latest UltraSPARC® processor technology incorporates chip multithreading at the processor level as part of our throughput computing initiative. We are driving toward significant gains in performance for the same physical size and power consumption. The introduction of the innovative Niagara CoolThread technology has led the way to next generation processor chip architecture with an 8 core processor with 4 threads per core, for a total of 32 threads per processor. This is particularly critical for the new breed of webservices and Java applications which need a high degree of parallel processing of separate threads. Sun's leading implementation in the Sun Fire T1000 and T2000 systems provide significant advantages in throughput, power consumption, and space consumed, which we believe is very compelling to customers experiencing power, cooling, and space constraints.

Our x64 systems offerings based on AMD's Opteron processor are creating new opportunities for Sun in a variety of customer and industry environments, including grid computing environments for high-performance technical computing. Innovation at the system architecture level allows Sun to leverage the off-the-shelf processor offerings available in the industry from suppliers such as AMD and innovate at the system architecture level. This is evidenced by our Sun Fire x64 line, which offers competitive price/performance and enterprise class reliability features. These systems allow the customer to choose Solaris, Windows or Linux platforms making them versatile for multi-OS deployments in small and large enterprises.

We currently offer a full range of middleware including mission-critical clustering, messaging, identity management, directory and webservices infrastructure software known as Java Enterprise System and an industry-leading business model based on per employee pricing.

The cross-platform Java software development environment, spanning smart cards, cellular handsets, set top boxes, desktops, computers and servers, provides our customers and ISV partners with an end-to-end architecture that extends our common Java technology-based programming environment across many different platforms, making real the concept of Write Once, Run Anywhere. Our products provide exceptional price-performance, flexibility, scalability and choice for devices as small as smart cards and cell phones up through large, multi-million dollar systems.

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Our enterprise desktop technologies, including Java Desktop System, StarOffice, and the Secure Global Desktop family of products that we acquired through our acquisition of Tarantella, Inc., combined with our SunRay thin clients, can provide access to the customer's desktop in virtually any application environment.

We offer a robust line of network-based storage systems and software, including products added through our acquisition of StorageTek's technologies and product portfolio, providing a comprehensive storage portfolio for data management. Our network computing vision has expanded to include the combination of identity management with data storage technology, which enables us to help customers store, manage and retrieve information in an increasingly complex technical and regulatory environment.

Our new services technologies, including Sun Connection and a suite of proactive managed services, provide remote diagnostics and preventive services for our customers, and are now enhanced to include multi-platform support.

Our software offerings include virtualization, provisioning and monitoring software for network computing resource optimization and systems management simplification.

Open Source Initiatives such as OpenSolaris, OpenSPARC, Open Source Availability of Netbeans, Java Development Tools, Java Middleware and Java Platform Technologies are aimed to significantly increase participation in processor architecture development, software and application design by making cutting-edge hardware and software intellectual property freely available. This helps lower barriers to the next big build-out of the Internet, encourage innovation and foster bringing new products to market.

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

### ***Interoperability***

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

For our customers, interoperability means the freedom to build heterogeneous networks and to choose best-of-breed hardware and software solutions for their IT environments. Interoperability, and the simplicity and flexibility that it provides, constitute an important element of our value proposition to customers. With the advent of webservices, the Java platform has proven itself as a key enabler of an entire generation of new applications and dynamic content in the form of new consumer services for phones, PCs and other devices. The thought leadership displayed by Sun is valued by customers because the window it provides them into critical developments in the industry is relevant to the success of their business infrastructures.

### ***Investment Protection***

Our customers have made significant investments in hardware and software assets. To help them to maximize the return on their investments, we make investment protection a priority in all our products. Applications running on earlier versions of Solaris will run on our newest version, Solaris 10, without the need to recompile, thus helping to avoid cost and risk. As the Solaris OS runs on both our UltraSPARC-based data center servers as well as our x64 systems, customers are able to leverage the same application environment and skill sets thereby lowering their cost of operations.

Our hardware also supports heterogeneous environments so that customers not only have the choice but also have the flexibility to change operating systems as their needs change. Our customers can purchase our x64 servers and storage and deploy them with the Solaris OS, Linux, or Microsoft Windows. They can then redeploy as needed the very same hardware using a different operating system choice without the daunting task of purchasing and porting to a new hardware platform. On our data center servers, we also provide the ability to selectively upgrade single processor boards within the same system, meaning customers have the ability to gradually adopt faster processors without having

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to buy completely new hardware. By building investment protection into our product offerings, we make it easier for customers to manage change, complexity and costs in their IT infrastructure.

The focus on providing multiplatform implementations provides customers with greater choice and confidence. Solaris is available on over 500 different systems, Java Enterprise System middleware is available on RedHat, Windows and HP-UX in addition to Solaris. Our x64 Systems are certified for Solaris, Windows, RedHat and SuSe. Our SPARC systems are available with Solaris and Ubuntu Linux.

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### ***Solutions-Based Selling Model***

Our solutions-based selling model offers an integrated set of networking architecture solutions and methodologies, bringing together a combination of servers, software, storage and services to help customers address complex problems, including business compliance, providing secure global access and designing next-generation data centers. Beginning in Fiscal 2007, we will be focusing on the following four competencies that drive demand for our systems infrastructure offerings:

*Systems:* Focused on enabling enterprises to leverage our systems products, architectures and best practices at the heart of next-generation, service-oriented data centers by boosting capacity and application performance while driving space and energy savings;

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

*Software:* Focused on leveraging open-source products such as the Solaris OS and Java Desktop Systems to drive cost savings in servers and desktop deployments; Identity Management for securing the enterprise; Enterprise Web Services for enabling enterprises to leverage Java 2 Enterprise Edition (Java EE) web services platform, and evolving service oriented architectures (SOAs) and service delivery platforms (SDPs); and

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

These competencies will line up directly with the key strategies presented to our customers as part of our vision. We believe our solution-based selling approach allows us to engage with our customers over the entire lifecycle of their key infrastructure projects, improving the delivery of sustainable value from the products and services we produce.

### ***Innovative Business Model Opportunities***

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

*Open Source:* A community is built through the sharing of ideas, technologies and markets. Accordingly, we offer OpenSolaris, which makes a version of the source code for Solaris 10 available under the Open Source Initiative (OSI) approved Common Development and Distribution License (CDDL). Consistent with our heritage of open source and open standards-based software, our intention in making Solaris 10 freely available is to help foster the innovation and collaboration needed to provide for new opportunities for developers, customers and partners. Making Solaris source code an open environment encourages a deeper understanding of Solaris and its innovations by providing a direct channel of feedback from the engineering community, thus helping to drive the cycle of innovation even further and faster. OpenSPARC is a community created around the SPARC CoolThreads technology. With OpenSPARC we aim to broaden the footprint of the SPARC architecture by fostering community development.

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

*Utility Computing:* We have introduced the Sun Grid offering, a utility computing capability available at [www.network.com](http://www.network.com). We have developed a number of hardware and software products, service offerings, solution architectures and business models aligned with our vision of utility computing such as Sun Storage Grid Utility and Sun Storage Grid Rack. Our Sun N1 Grid Engine is the software that enables all the individual components of the grid to act together as one system. We have built service offerings specifically to help customers build their own private grid or buy into our public grid utility.

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

### *Alliances and Partner Community*

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

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leading ISVs, value-added resellers (VARs), OEMs, channel development providers, independent distributors, computer systems integrators and SDPs to deliver solutions that our customers demand. Through these relationships, our goal is to optimize our ability to be the technology of choice, the platform of choice, the partner of choice and to provide the end-to-end solutions that customers require to compete.

We seek out partners with whom we share common interest. We continue to partner with Advanced Micro Devices, Inc. (AMD) to expand our entry-level line of Opteron processor-based x64 systems. We also maintain a strategic alliance with Fujitsu to collaborate on the development, delivery and support of a future generation of SPARC-based systems. This alliance is intended to enlarge the Solaris footprint, drive increased market share for our enterprise-class systems and allow us to dedicate additional resources to our throughput computing initiative and our next generation of processor products. In addition, we continue our relationship with Hitachi Data Systems to provide high-end storage solutions and extend our storage offering into enterprise environments.

### ***Environmentally Responsible Products***

We are committed to developing and selling products that are environmentally responsible because we think this is good for the planet and good for the business. Our business benefits because these initiatives directly make our products more competitive and provide our customers with lower cost and more efficient solutions. We are a leader in energy efficient computing technologies and committed to reducing factors contributing to global climate change through what we call sustainable computing. We create technologies that we believe will enable, at least, four significant shifts in the computing industry, changes which hold enormous potential for positive environmental impact: (i) transition to thin client computing from traditional desktop PCs thereby increasing overall energy efficiency and reducing material waste; (ii) increases in computing resource utilization with throughput computing technology and Sun N1 Grid virtualization technology across data centers; (iii) transition to increased teleworking allowing large employers to unleash the social, environmental and economic benefits of mobility with security and (iv) transition to products that consume significantly less energy than current industry-standard products.

## **SALES, MARKETING AND DISTRIBUTION**

Our Global Sales and Services organization manages and has primary responsibility for our field sales, relationships with our selling partners, technical sales support, sales operations and delivery of support, managed and professional services covering our competency areas. We sell end-to-end networking architecture platform solutions, including products and services, in most major markets globally through a combination of direct and indirect channels. We also offer component products, such as central processor unit (CPU) chips and embedded boards, on an OEM basis to other hardware manufacturers and supply after-market and peripheral products to their end-user installed base, both directly and through independent distributors and VARs. In addition, our strategic alliance with Fujitsu provides expanded distribution of both companies' existing SPARC product lines.

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

Our sales force serves the telecommunications, government, financial services, manufacturing, education, retail, life sciences, media and entertainment, transportation, energy/utilities and healthcare industries. We have organized our sales coverage within 16 geographically established markets (GEMs) around the world. We have approximately 78 sales and service offices in the United States and an additional 145 sales and service offices in 47 other countries. We employ independent distributors in over 100 countries. In general, our sales coverage model calls for independent distributors to be deployed in partnership with our direct sales force. However, in some smaller markets, independent distributors may be our sole means of sales, marketing and distribution.

Our relationships with channel partners are very important to our future revenues and profitability. Channel relationships accounted for more than 63%, 67% and 63% of our total net revenues in fiscal 2006, 2005 and 2004, respectively. Our channel partners include:

Systems integrators, who serve the market for large commercial projects requiring substantial analysis, design, development, implementation and support of custom solutions;

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Channel development providers who supply our products and provide product marketing and technical support services to our smaller resellers;

VARs who provide added value in the form of software packages, proprietary software development, high-end networking integration, vertical integration, vertical industry expertise, training, installation and support;

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

Independent distributors who primarily serve foreign markets where we do not have a direct presence. Additionally, ISV partners help us maximize our technology footprint by integrating their software products with our platforms and technologies. SDPs, such as Internet Service Providers (ISPs) and Application Service Providers (ASPs), allow us to expand our service coverage without new large-scale investments.

Revenues from outside the United States (U.S.) were approximately 59%, 60% and 57% of our total net revenues in fiscal 2006, 2005 and 2004, respectively. Direct sales we make outside of the U.S. are generally priced in local currencies and can be subject to currency exchange fluctuations. The net foreign currency impact on our total net revenues and operating results is difficult to precisely measure. However, because of the general strengthening of the U.S. dollar, our best estimate of the foreign exchange detriment approximated 2% of total net revenues for fiscal 2006.

The countries primarily contributing to our international sales are the United Kingdom (U.K.), Germany and Japan. The U.K. represented approximately 9%, 9% and 8% of our total net revenues in fiscal 2006, 2005 and 2004, respectively. Germany represented approximately 7%, 8% and 7% of our total net revenues in fiscal 2006, 2005 and 2004, respectively. Japan represented approximately 6%, 7% and 7% of our total net revenues in fiscal 2006, 2005 and 2004, respectively. For information about sales to unaffiliated customers and revenues by geographic areas, refer to Note 15 to the Consolidated Financial Statements – Industry Segment, Geographic, and Customer Information and Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Results of Operations.

Some of our sales to international customers are made under export licenses that must be obtained from the U.S. Department of Commerce. In addition, all of our export transactions are subject to U.S. export control laws, and certain transactions could require prior approval of the U.S. Department of Commerce. Protectionist trade legislation in either the U.S. or other countries, such as a change in the current tariff structures, export compliance laws or other trade policies, could adversely affect our ability to sell or to manufacture in international markets or to secure adequate supplies of component parts. Furthermore, revenues from outside the U.S. are subject to inherent risks, including the general economic and political conditions in each country. See Note 15 to the Consolidated Financial Statements for additional information concerning sales to international customers and business segments. For a discussion of risks attendant to Sun’s foreign operations, see Risk Factors – Our international customers and operations subject us to a number of risks, in Item 1A, which is incorporated herein by reference.

Sales to General Electric Company (GE) and its subsidiaries in the aggregate accounted for approximately 15%, 16%, and 14% of our fiscal 2006, 2005 and 2004 total net revenues, respectively. More than 70% of the revenue attributed to GE was generated through GE subsidiaries acting as either a reseller or financier of our products. The vast majority of the revenue included in the amounts above is from sales through a single GE subsidiary, having comprised 11%, 13%, and 11% of total net revenues in fiscal 2006, 2005 and 2004, respectively. This GE subsidiary acts as a distributor of our products to resellers who in turn sell those products to end-users. Our business could be adversely affected if GE or another significant customer terminated its business relationship with us or significantly reduced the amount of business it did with us.

Our product order backlog at June 30, 2006 was \$1.1 billion, as compared with \$805 million at June 30, 2005. Our product backlog includes orders for which customer-requested delivery is scheduled within six months and orders that have been specified by the customer for which products have been shipped but revenue has been deferred. Backlog orders are supported by evidence of a customer arrangement (typically a customer purchase order), or customer pre-payment (whereby customer delivery occurs over a period of time or through specific milestones). In either case, sufficient evidence of an arrangement exists and final delivery has yet to be completed. Although actual customer delivery can occur over several periods, product backlog can be used to identify potential revenue coverage for pending periods. The larger the percentage coverage of targeted pending revenue, the lower the potential risk of non-achievement. Backlog levels vary with demand, product availability, product revenue recognition treatment, and our delivery lead times and are subject to significant decreases as a result of, among other things, customer order delays, changes or cancellations. As such, backlog levels may not be a reliable indicator of future operating results. As we explore new ways of doing business and collaborate with our partners and customers to deliver greater value, our backlog metric may evolve to better identify potential revenue coverage for pending periods.

## **WORLDWIDE OPERATIONS**

Our Worldwide Operations organization manages company-wide purchasing of materials used in making our 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 servers and storage systems. For all other systems, we rely on external manufacturing partners. We manufacture primarily in Oregon,



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Puerto Rico and Scotland and distribute much of our hardware products from our facilities and our partner facilities located in California, Puerto Rico, the Netherlands and Japan. We are in the process of closing our Puerto Rico facilities and outsourcing those manufacturing operations.

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

## **RESEARCH AND DEVELOPMENT**

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

We conduct research and development principally in the U.S., U.K., France, Ireland, Germany, Japan, China, Russia, Czech Republic and India. Research and development (R&D) expenses were \$2.0 billion, \$1.8 billion, and \$1.9 billion in fiscal 2006, 2005 and 2004, respectively.

## **SEGMENT INFORMATION**

During fiscal 2006, our operations were organized into two business segments: products and services. Our product classes comprise revenue from computer systems products and data management products. Our services revenue consists of sales from two classes of services: (1) support services which consists of maintenance contracts and (2) client solutions and educational services, which consists of technical consulting to help customers plan, implement, and manage distributed network computing environments and developing integrated learning solutions for enterprises, IT organizations, and individual IT professionals. In each of the last three fiscal years, computer systems, data management products and support services each accounted for more than 10% of our consolidated net revenues. A table providing external revenue for similar classes of products and services for the last three fiscal years is found in Note 15 to the Consolidated Financial Statements in Item 8, which is incorporated herein by reference. A table presenting revenues, interdivision revenues, operating income (loss) and total assets for our segments for the three years ended June 30, 2006 is found in Note 15 to the Consolidated Financial Statements in Item 8, which is incorporated herein by reference.

## **PRODUCTS**

Our products consist of computer systems and storage product lines, and a variety of software and services related to both systems and storage. For information about external revenue for similar classes of products and services, refer to Note 15 to the Consolidated Financial Statements Industry Segment, Geographic, and Customer Information and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations.

## **SYSTEMS**

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

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

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



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

*Enterprise servers.* Our enterprise servers, including Sun Fire E6900, Sun Fire E4900, Sun Fire E2900 and Sun Fire V1280 servers, address the needs of data centers and enterprise-scale network computing at a moderate cost. These servers are available with various options in processor and memory expandability, hardware redundancy and component accessibility and run on the Solaris OS. The UltraSPARC IV+ processor is 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 a wide range line of entry server systems differentiated by their size, their processor architecture (SPARC or x64), their form factor (rack, blade or stand-alone systems) and the environment for which they are targeted (general purpose or specialized systems).

In fiscal 2006 we introduced the T1000/T2000 CoolThreads servers with chip multi-threaded technology and a SPARC processor architecture. These servers offer improved throughput performance as well as energy and space efficiencies and are aimed at web and application tier deployments.

Additional Entry SPARC-based systems include our Sun Fire V240, Sun Fire V210 and Sun Fire V440 servers, which deliver network computing in a compact, low-cost package. In fiscal 2005, we introduced the Sun Fire V890 and the Sun Fire V490 servers, which use the new 1.5GHz UltraSPARC IV+ processor and Solaris 10 OS.

We also have introduced a complete new line of x64 servers, based on AMD's Opteron processor. Our X2100, X4100, X4200, X4600 servers provide the highest performance level in their class, support multiple operating environments and are targeted at web tier, application, databases, HPTC/Grid as well as development environments.

We also offer a line of products aimed at the unique needs of OEMs and Network Equipment Providers (NEPs). Rack-optimized systems and our blade product offerings combine high-density hardware architecture and system management software that OEMs find particularly useful in building their own solution architectures. Our NEP-certified Netra systems are designed to meet the specialized needs of NEPs. This year, we introduced the Netra 1290, and the Netra CT900 ATCA server.

*Desktops and Workstations.* Our desktops and workstations provide powerful solutions for a wide range of business and technical activities such as software development, mechanical design, financial analysis and education. Our product line includes high-performance 64-bit workstations, graphics accelerator boards, x64-based workstations and thin Sun Ray Ultra-Thin Client products. In fiscal 2006, we introduced the Sun Ultra 25, Sun Ultra 45, and Sun Ultra 3 mobile workstation, using SPARC processors, which are designed to meet the needs of demanding graphics, visualization and compute applications. We also introduced the Sun Ultra 20 and Sun Ultra 40 workstations, which are AMD Opteron-based workstations that support Linux (Red Hat and SuSe, 32-Bit and 64-Bit) and the Solaris OS (32-Bit and 64-Bit) and are Microsoft certified.

*Processor and Network Products.* In fiscal 2006, the UltraSPARC processor lines were reoriented to reflect the two main types of workloads our customers experience. Our data-intensive processor line includes the refreshed 1.5GHz UltraSPARC IV+, with dual-core processors, which furthers our throughput computing initiative. For network-intensive workloads which require more horizontal scaling, we offer the updated 1.5GHz UltraSPARC III+ processors, which are mainly used on our entry and workgroup servers. In addition, we introduced the UltraSPARC T1 processor featuring CoolThreads technology. This processor offers up to eight 4-threaded cores, with typical processor power consumption of only 72 watts while delivering 32 simultaneous threads.

## **SOFTWARE**

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

*Solaris Operating System (OS).* The Solaris OS is a high performance, highly reliable, scalable and secure operating environment for SPARC and x64 platforms that is easy to install and use, is optimized for the Java platform and supports more than 8,000 applications. It is optimized for enterprise computing, Internet and intranet business requirements, powerful databases and high performance technical computing environments. With Solaris 10, customers now have access to our latest technical innovations such as Solaris Containers, Predictive Self-healing and Solaris Dynamic Tracing (DTrace) capability, all while maintaining binary compatibility with previous Solaris versions. Solaris Containers is an advanced approach to system virtualization with multiple software partitions per single instance of the Solaris OS, making consolidation simple, safe and secure. Predictive Self-Healing delivers improved service availability with on-line error detection and auto recovery. Dynamic Tracing

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(DTrace) equips users with a tool for analyzing and diagnosing elusive bottlenecks in real-time. The Solaris 10 source code is available through an OSI-approved open source license as a project called OpenSolaris.

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**Java Technology.** Our Java platform application environment allows development of application software independent of the underlying operating system or microprocessor based on open standards. Java technology allows a developer to write applications once for a wide range of platforms and devices. Our Java platforms are based on a common core architecture and include the Java Platform, Standard Edition (Java SE) 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 Platform, Enterprise Edition (Java EE) technology used to develop and deploy web services; Java Platform, Micro Edition (Java ME) technology, which extends Java technology to consumer and embedded devices such as mobile phones, personal digital assistants (PDAs), digital set top boxes and residential gateways; and Java Card smart card technology.

**Sun Java Enterprise System.** Our Sun Java Enterprise System (Java ES) software enables enterprises to utilize their information and applications and deploy services offered on intranets and the Internet. Our new release of Java ES includes a composite application platform for service oriented architecture (SOA) deployments along with more targeted Java Suites covering Identity management, Application platform services, System availability, Web infrastructure and Enterprise communications.

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

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

**Sun Java Composite Application Suite:** The Sun Java Composite Application Suite complements the other suites of the Java Enterprise System and contains all the components to develop and deploy a SOA (service oriented architecture) platform for the re-use of existing applications, the delivery of new services, and to enable legacy and packaged applications to rapidly integrate within an existing infrastructure. The Suite is SOA-based, fully integrated, and delivers a rich set of integration and composite application capabilities including Business Process Management (BPM), messaging, rich transformation, and a broad and deep array of connectors. The Java Composite Application Platform Suite also features Business Activity Monitoring (BAM) for development of sophisticated dashboards and alerting; Extraction, Transformation and Loading (ETL) capabilities for moving bulk data; extensive B2B support and an advanced facility for enabling the development of a single master index for entities such as customer, patient, product or supplier.

**STORAGE**

Our storage systems comprise storage, storage components, software, and services to complete our end-to-end data management solutions across heterogeneous environments. With the acquisition of Storage Technology Corporation (StorageTek) in August 2005, our storage portfolio includes:

**Tape Storage:** Our tape storages include tape libraries, tape drives, tape virtualization systems as well as tape media and tape device software.

**Enterprise Tape Libraries:** Tape libraries help to better manage and protect data with highly productive consolidated storage. Our high-end tape storage systems enable traditional data protection and archive based solutions. The SL8500 and the SL9310 tape library systems are fast, highest-quality and space-efficient tape libraries. The capacity tapes libraries T9940 and T10000 store large amounts of data and provide onsite back-up and archive and/or offsite disaster recovery. The tape drive T9840 is used for quick data retrieval and in line data storage that provides a low cost alternative to disk. The Virtual Storage Manager (VSM) 4e and 5 systems, which consist of a server, disks and software, positioned between mainframe servers, and tape libraries, help aggregate storage from heterogeneous devices providing a single storage resource pool, thereby providing the ability to access data faster, allowing legacy and newer technologies to co-exist.

**Entry and Midrange Tape Libraries:** We offer a wide range of entry and midrange tape systems, which enable traditional data protection and archive based solutions, with high levels of reliability, longevity and expandability. The C2/C4 tape libraries are entry products. The SL500 tape library provides modular scalability and enterprise level RAS feature in a space efficient, recounted library. The SL700 and SL1400 provide capacity and performance approaching the entry capabilities of an enterprise library. The tape drives used in these libraries are mainly industry standard tape drives that Sun buys from third party manufacturers.



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***Disk Systems:*** Our extensive disk system product line includes data center disks, midrange and workgroup systems as well as specialized storage arrays providing heterogeneous support.

***Data Center:*** Our high-end data storage systems provide a platform for direct attach storage or storage area network (SAN) solutions. Our high-end data storage systems, including the Sun StorEdge 9990, combine Hitachi Data Systems (HDS) high-end storage hardware with our resource management and file management software under an OEM agreement with HDS first signed in fiscal 2002.

***Midrange Disks:*** We offer a wide range of flexible, scalable mid-range storage systems, including the Sun StorEdge 6120/30/40, Sun StorEdge 6320, and Sun StorEdge 6920 which support high-performance computing and enterprise SAN implementations, as well as storage virtualization technology. The 6920 is a midrange scalable disk system that provides a cost effective combination of performance, availability, scalability and centralized data management features for business critical enterprise applications. Our network attached storage (NAS) products, including the Sun Storage 5310 NAS are simple, integrated, plug and play storage systems which provide multi protocol support, multi level redundancy clustering and scalability.

***Entry Level/Workgroup Disks:*** The entry level low cost modular arrays provide direct attached and SAN attached storage for task critical applications. We offer a wide range of entry level products including the Sun StorEdge 3120, 3320, 3510 and 3511.

We also offer specialized storage arrays, including nearline storage solutions that deliver very low cost/MB storage capacity for nearline or archival applications, HPTC storage that cost effectively supports extreme data throughput performance requirements, Thin/Boot Storage that meets the small form factor and low cost requirements for rack systems or system boot devices, and NEBS/MilSpec Storage that meets rigorous environmental requirements.

***Storage Networking Products:*** Sun OEMs SAN switch technology that provides flexibility required to scale to business needs, helping reduce overall network costs by enabling access through lower cost edge switches and distribution sites versus utilizing more expensive ports across the entire network.

***Storage Management Software:*** Storage Management software includes Storage Resource Management, Data Protection, Data Management software as well as the Java StorEdge software. Sun storage management software locates storage resources; assesses utilization levels; provides capacity planning, trending and forecasting; identifies back up failures; streamlines provisioning; automates tasks; helps with data classification and provides reports on data placement and movement.

***Enterprise Storage Manager:*** The Enterprise Storage Manager (ESM) is a storage and data management portfolio consisting of multiple modules. These are standards based modules, enabling heterogeneous platform and application support. The innovative ESM portal provides a dashboard across all modules, displaying relevant business information to each user. The enterprise storage manager includes multiple business modules such as base device management, business analytics and operations management. It is a single, integrated tool for configuration, utilization, performance and provisioning, supporting devices and environments from multiple vendors.

***Data and Archive Management:*** Sun's powerful data and archive management software classifies and manages data across tiers of storage (disk, tape, optical), automatically backs up and replicates files, migrates and archives legacy data and performs large scale tape migrations.

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

### ***Sun Grid Storage Utility:***

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

## **SERVICES**

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

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**Support and Managed Services:** The SunSpectrum 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. Sun Connection, an integrated, secure network services connection, is intended to simplify and standardize IT as a service. Customers who pay the annual subscription fee can turn on a secure connection to allow us to automatically and systematically manage their security updates, systems monitoring and predictive diagnostic tests over that connection, thereby reducing management costs and increasing system availability.

**Professional and Educational Services:** Our Professional Services organization brings together more than 10,000 experts across Sun, focused on our competencies: Systems, Storage, Software and Services. Our Professional Services teams specialize in providing customers with advanced systems, software, storage and network architecture design consulting, platform integration, enterprise systems management and operation such as network security and identity management, wireless network-based systems and advanced Sun Java System software integration solutions. We provide people, processes and technology and we partner with third-party systems integrators, to deliver solutions tailored to meet our customers' needs. Our technical and project management experts help design IT architectures and plan migrations from legacy systems to network computing or help customers upgrade existing network computing environments. Operations experts help customers manage the complexity of heterogeneous systems and networks.

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

## **COMPETITION**

We compete in the computer systems (hardware and software), storage (hardware and software) and services markets. These markets are intensely competitive. Our competitors are some of the largest, most successful companies in the world. They include International Business Machines Corporation (IBM), Dell, Inc. (Dell), Hewlett-Packard Company (HP), EMC Corporation (EMC), Fujitsu Limited (Fujitsu), Hitachi Data Systems, Inc. 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 and the Linux family of operating systems.

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

## **PATENTS, TRADEMARKS AND INTELLECTUAL PROPERTY LICENSES**

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

We hold a number of U.S. and foreign patents relating to various aspects of our products and technology. While we believe that patent protection is important, we believe that factors such as innovative skills and technological expertise provide even greater competitive differentiators. From time to time we have been notified that we may be infringing certain patents or other intellectual property rights of others. Such notices are in various stages of evaluation, but as of June 30, 2006, no claims had been made that we believe to be material. We are evaluating the desirability of entering into licensing agreements in certain of



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these matters. Based on industry practice, we believe that any necessary licenses or other rights could be obtained on commercially reasonable terms. However, no assurance can be given that licenses can be obtained on acceptable terms or that litigation will not occur. The failure to obtain necessary licenses or other rights, or litigation arising out of such claims, could adversely affect our business.

**EMPLOYEES**

As of June 30, 2006 we had approximately 38,000 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.

**EXECUTIVE OFFICERS OF THE REGISTRANT**

The following sets forth certain information regarding our Executive Officers as of September 6, 2006.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Jonathan I. Schwartz	40	Chief Executive Officer and President
Michael A. Dillon	47	Executive Vice President, General Counsel and Secretary
John F. Fowler	45	Executive Vice President, Systems Group
Anil P. Gadre	49	Executive Vice President and Chief Marketing Officer
Donald C. Grantham	49	Executive Vice President, Global Sales and Services
Richard L. Green	50	Executive Vice President, Software Group
Michael E. Lehman	56	Chief Financial Officer and Executive Vice President, Corporate Resources
William N. MacGowan	49	Executive Vice President, People and Places, and Chief Human Resources Officer
Eugene G. McCabe	53	Executive Vice President, World Wide Operations