

SILICON GRAPHICS INC  
Form 10-Q  
February 09, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

**For the quarterly period ended December 26, 2003.**

or

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

**For the transition period from                    to                    .**

**Commission File Number 1-10441**

**SILICON GRAPHICS, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**94-2789662**

(I.R.S. Employer  
Identification No.)

**1500 Crittenden Lane, Mountain View, California 94043-1351**

(Address of principal executive offices) (Zip Code)

**(650) 960-1980**

(Registrant's telephone number, including area code)

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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  No

As of January 30, 2004 there were 212,835,811 shares of Common Stock outstanding.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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**SILICON GRAPHICS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

**SILICON GRAPHICS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(unaudited)**

(In thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Product and other revenue	\$ 141,883	\$ 156,877	\$ 266,749	\$ 290,360
Service revenue	96,030	105,861	189,191	214,096
Total revenue	237,913	262,738	455,940	504,456
Costs and expenses:				
Cost of product and other revenue	78,204	89,382	149,468	171,006
Cost of service revenue	48,704	59,156	100,881	121,811
Research and development	30,226	42,920	65,575	85,563
Selling, general and administrative	69,845	74,086	148,444	160,863
Other operating expense (1)	12,986	5,817	37,222	14,261
Total costs and expenses	239,965	271,361	501,590	553,504
Operating loss	(2,052)	(8,623)	(45,650)	(49,048)
Interest and other income (expense), net	(4,695)	(7,448)	(11,607)	(8,008)
Loss on extinguishment of tendered debt	(30,915)		(30,915)	
Loss before provision (benefit) for income taxes	(37,662)	(16,071)	(88,172)	(57,056)
Income tax provision (benefit)	(294)	926	(2,875)	1,013
Net loss	\$ (37,368)	\$ (16,997)	\$ (85,297)	\$ (58,069)
Net loss per share - basic and diluted	\$ (0.18)	\$ (0.08)	\$ (0.41)	\$ (0.29)
Common shares outstanding - basic and diluted	211,034	200,748	210,302	200,212

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(1) Represents charges for estimated restructuring costs and asset impairments in each of the three and six-month periods ended December 26, 2003 and December 27, 2002.

*The accompanying notes are an integral part of these condensed consolidated financial statements.*

**SILICON GRAPHICS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands)

	December 26, 2003 (unaudited)	June 27, 2003 (1)
<b>Assets:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 107,511	\$ 140,836
Short-term marketable investments	1,246	440
Short-term restricted investments	35,557	35,298
Accounts receivable, net	120,836	133,166
Inventories	72,095	71,426
Prepaid expenses and other current assets	45,467	51,727
<b>Total current assets</b>	<b>382,712</b>	<b>432,893</b>
Restricted investments	903	1,430
Property and equipment, net	88,987	108,062
Other assets	98,723	107,469
	\$ 571,325	\$ 649,854
<b>Liabilities and Stockholders Deficit:</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 76,631	\$ 76,507
Accrued compensation	36,809	38,916
Income taxes payable	18,803	22,666
Deferred revenue	141,189	149,434
Other current liabilities	113,040	109,147
Current portion of restructuring charge	23,390	17,840
Current portion of long-term debt	22,477	16,894
<b>Total current liabilities</b>	<b>432,339</b>	<b>431,404</b>
Long-term debt	310,916	291,956
Other liabilities	76,478	91,385
<b>Total liabilities</b>	<b>819,733</b>	<b>814,745</b>
<b>Stockholders deficit:</b>		
Common stock and additional paid-in-capital	1,462,839	1,467,798
Accumulated deficit	(1,685,498)	(1,606,049)
Treasury stock	(6,715)	(6,715)
Accumulated other comprehensive loss	(19,034)	(19,925)
<b>Total stockholders deficit</b>	<b>(248,408)</b>	<b>(164,891)</b>
	\$ 571,325	\$ 649,854

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(1) The balance sheet at June 27, 2003 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

*The accompanying notes are an integral part of these condensed consolidated financial statements.*

## SILICON GRAPHICS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(In thousands)	Six Months Ended	
	December 26, 2003	December 27, 2002
<b>Cash Flows From Operating Activities:</b>		
Net loss	\$ (85,297)	\$ (58,069)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	42,128	49,225
Loss on sale of real estate	414	4,687
Non-cash loss on extinguishment of tendered debt	30,915	
Non-cash asset impairment charges	2,541	1,051
Other	1,934	(599)
Changes in operating assets and liabilities:		
Accounts receivable	12,330	24,485
Inventories	(2,720)	21,557
Accounts payable	124	(16,020)
Accrued compensation	(2,108)	(13,171)
Deferred revenue	(8,245)	(21,072)
Other assets and liabilities	(897)	(17,723)
Total adjustments	76,416	32,420
Net cash used in operating activities	(8,881)	(25,649)
<b>Cash Flows From Investing Activities:</b>		
Proceeds from sale of real estate and fixed assets	10,615	6,432
Purchases of marketable investments	(844)	(449)
Proceeds from the maturities of marketable investments	38	1,178
Purchases restricted investments	(55,079)	(113,851)
Proceeds from the maturities of restricted investments	55,687	119,715
Capital expenditures	(17,811)	(7,821)
Increase in other assets	(9,054)	(14,015)
Net cash used in investing activities	(16,448)	(8,811)
<b>Cash Flows From Financing Activities:</b>		
Payments of debt principal	(8,678)	(2,450)
Sale of SGI common stock	682	1,464
Net cash used in financing activities	(7,996)	(986)
Net decrease in cash and cash equivalents	(33,325)	(35,446)
Cash and cash equivalents at beginning of period	140,836	213,302
Cash and cash equivalents at end of period	\$ 107,511	\$ 177,856



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*The accompanying notes are an integral part of these condensed consolidated financial statements*

**SILICON GRAPHICS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation.**

The condensed consolidated financial statements include the accounts of SGI and our wholly owned subsidiaries. The unaudited results of operations for the interim periods shown herein are not necessarily indicative of operating results for the entire fiscal year. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. The unaudited condensed consolidated financial statements included in this Form 10-Q should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 27, 2003 filed with the Securities and Exchange Commission. Certain reclassifications of prior year amounts have been made on the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Cash Flows and Notes to Condensed Consolidated Financial Statements to conform to the current year presentation.

We have incurred net losses and negative cash flows from operations during each of the past four fiscal years, and had negative working capital of \$50 million at December 26, 2003. Our unrestricted cash and marketable investments at December 26, 2003 were \$109 million, down from \$141 million at June 27, 2003. While a forecast of future events is inherently uncertain, we believe that the combination of our current resources and cash expected to be generated from our fiscal 2004 financial plan will be sufficient to meet our financial obligations through fiscal 2004.

We are committed to our goal of reestablishing profitable operations and positive cash flow. If we experience a material shortfall versus our plan for fiscal 2004, we will take all appropriate actions to ensure the continued operation of our business and to mitigate any negative impact on our profitability and cash reserves. We have a range of actions we can take to achieve this outcome, including but not limited to expense-related actions such as further reductions in headcount-related expenses, additional consolidation of administrative functions and re-evaluation of our global distribution model. We also can take actions to generate cash by selling non-core businesses, licensing intellectual property, seeking funding from marketing partners and key government customers, and seeking further equity or debt financing from strategic partners or financial sources. See **Risks That Affect Our Business**.

**2. Stock-Based Compensation.**

We have various stock-based compensation plans, which are more fully described in our 2003 Annual Report on Form 10-K. We have elected to continue to follow the recognition and measurement principles of Accounting Principles Board ( APB ) Opinion No. 25, **Accounting for Stock Issued to Employees**, and related interpretations, for our stock-based compensation plans. No employee stock-based compensation cost is reflected in net loss (with the exception of restricted stock awards) during the six month periods ended December 26, 2003 and December 27, 2002, as all options granted to employees under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net loss and net loss per share as if we had applied the fair value recognition provisions of SFAS No. 123, **Accounting for Stock Based Compensation**, as amended by SFAS 148, **Accounting for Stock-Based Compensation Transition and Disclosure**, to stock-based employee compensation:

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(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Net loss as reported	\$ (37,368)	\$ (16,997)	\$ (85,297)	\$ (58,069)
Additions:				
Stock-based employee compensation expense, net of tax effect, included in net loss above	68	74	135	150
Deductions:				
Stock-based employee compensation expense determined under fair value method for all awards, net of tax effect	(57)	(786)	(111)	(920)
Pro forma net loss	\$ (37,357)	\$ (17,709)	\$ (85,273)	\$ (58,839)
Net loss per share basic and diluted as reported	\$ (0.18)	\$ (0.08)	\$ (0.41)	\$ (0.29)
Net loss per share basic and diluted pro forma	\$ (0.18)	\$ (0.09)	\$ (0.41)	\$ (0.29)

The pro forma information above may not be representative of the effects on potential pro forma results for future years.

### 3. **Other Operating Expense.**

We have substantially completed our execution of the fiscal 2000 and fiscal 2001 restructuring plans, with the exception of certain vacated leased facilities that have lease terms expiring through the end of fiscal 2006 and fiscal 2010, respectively. Our obligations associated with these leases as of December 26, 2003 were approximately \$8 million and \$6 million, respectively, net of aggregate sublease income of approximately \$3 million between the two plans.

Throughout fiscal 2003, we announced and began to implement additional restructuring actions ( fiscal 2003 restructuring plan ) in an effort to further reduce our operating expenses to be better aligned with expected revenue levels. These actions resulted in aggregate charges of \$19 million recorded in fiscal 2003 and the elimination of approximately 370 positions across all levels and functions. Severance payments and related charges of \$14 million consisted primarily of salary and expected payroll taxes, extended medical benefits, statutory legal obligations and outplacement services. Our plans included vacating approximately 60,000 square feet of leased facilities throughout the world, with lease terms expiring through fiscal 2009, which require ongoing lease payments of \$5 million, net of \$3 million of estimated sublease income. In the fourth quarter of fiscal 2003, we increased our estimate of severance payments and related charges by approximately \$2 million, due to higher than originally estimated severance and related costs and unfavorable fluctuations in foreign exchange rates. As a result of the fiscal 2003 restructuring activities described above, we also wrote down approximately \$2 million of fixed assets, which included leasehold improvements and associated furniture and fixtures held for disposal in the vacated offices and buildings. In addition, we recorded approximately \$3 million in impairment charges against the value of the Switzerland manufacturing facility as a result of the fair value reassessment by an independent third party. This facility was subsequently sold in the first quarter of fiscal 2004 resulting in net proceeds of \$11 million and a slight loss.

During the fourth quarter of fiscal 2003, we announced and began to implement additional restructuring activities ( fiscal 2004 restructuring plan ). These actions resulted in aggregate charges of \$10 million and the elimination of approximately 320 positions across all levels and functions. Severance payments and related charges of \$9 million consisted primarily of salary and expected payroll taxes, medical benefits, statutory legal obligations and outplacement services. The remaining \$1 million in charges was comprised of costs associated with third party contracts cancellations, outside consulting and vacating approximately 6,400 square feet of administrative facilities overseas, with lease terms expiring through fiscal 2004. Estimated sublease income associated with these vacated facilities is negligible.

During the first six months of fiscal 2004, we continued restructuring activities under the fiscal 2004 restructuring plan. These actions resulted in aggregate charges of \$24 million and the elimination of approximately 475 positions across all levels and functions in the first quarter of fiscal 2004 and aggregate charges of \$13 million and the elimination of approximately 45 positions in the second quarter of fiscal 2004. Severance payments and related charges of \$15 million and \$4 million, respectively, consisted primarily of salary and expected payroll taxes, medical benefits, statutory legal obligations and outplacement services. As a result of fiscal 2004 restructuring activities and moving our headquarters as described below, we also wrote down approximately \$2 million and \$1 million of fixed assets in the first and second quarters of fiscal 2004, respectively. These write-downs included charges against leasehold improvements and associated furniture and fixtures held for disposal in the vacated buildings.

In the first quarter of fiscal 2004, we also agreed to sublease our Amphitheatre Technology Center campus in Mountain View, California and relocate our headquarters to our nearby Crittenden Technology Center campus. Under this sublease arrangement, we expect to record charges of \$73 million through fiscal 2013, of which \$68 million represents the net sublease loss component, and \$5 million represents other facility costs directly associated with this arrangement. Pursuant to SFAS No. 146, we are required to determine the fair value of future contractual obligations using our credit-adjusted risk-free interest rate at the point we cease to use the respective buildings. As such, we have estimated the cease-use dates for the respective properties, which are all estimated to occur within fiscal 2004 and have discounted the future remaining obligations for each building, which approximates \$18 million. We are also required to accrete this discounted estimated net sublease loss up to its undiscounted value of \$68 million from the respective cease-use dates to the end of the lease terms ending in fiscal 2013. During the second quarter of fiscal 2004, we increased the fiscal 2004 restructuring accrual related to our headquarters relocation by \$22 million by reclassifying to

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restructuring a previously recorded deferred gain associated with our old Amphitheatre Technology Center campus headquarters that was included in other liabilities.

During the first six months of fiscal 2004, we incurred facilities and other related costs and impairment charges of approximately \$9 million in both the first and second quarters of fiscal 2004 in conjunction with the above arrangement. The relocation of our Mountain View, California headquarters is expected to result in a net reduction in our facilities occupancy costs of approximately \$14 million to \$17 million per year beginning in fiscal 2005. During the transition period, we expect to incur incremental cash outflows of \$2 million to \$3 million associated with the move. Approximately \$26 million in incremental charges will be recorded throughout fiscal 2004, of which \$9 million was recorded in each of the first and second quarters of fiscal 2004. In addition, beginning in fiscal 2005, we will record annual accretion expense as noted above of approximately \$1 million to \$8 million through fiscal 2013. The cash impact of these charges will be spread over the term of the sublease and we expect that the restructuring of these facilities will result in approximately \$76 million in cash savings over that same period.

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The remaining restructuring accrual balance of approximately \$58 million at December 26, 2003 includes \$4 million in severance obligations, \$4 million of other restructuring related liabilities and \$50 million of facility-related liabilities, net of estimated sublease income of \$93 million. Approximately \$3 million and \$1 million will be paid in the third and fourth quarters of fiscal 2004, respectively, for severance and related charges, \$4 million will be paid in the third quarter of fiscal 2004 for other restructuring-related charges and approximately \$50 million will be paid through fiscal 2013 for vacated facilities related expenditures.

The following table depicts the restructuring and impairment activity during the first six months of fiscal 2004 (in thousands):

Category	Severance and Related Charges	Canceled Contracts	Vacated Facilities	Other	Impairment Charges	Total
Balance at June 27, 2003	\$ 7,191	\$ 13	\$ 24,648	\$	\$	\$ 31,852
Additions fiscal 2004 restructuring and impairment	14,640	234	4,134	4,014	1,714	24,736
Adjustments:						
(Decrease) non-cash	(500)					(500)
Expenditures:						
Cash	(10,645)	(247)	(3,604)	(467)		(14,963)
Non-cash					(1,714)	(1,714)
Balance at September 26, 2003	\$ 10,686	\$	\$ 25,178	\$ 3,547	\$	\$ 39,411
Additions fiscal 2004 restructuring and impairment	3,596	407	9,416	1,143	827	15,389
Adjustments:						
(Decrease) non-cash	(303)		(2,100)			(2,403)
Reclassification (non-cash)			22,403			22,403
Expenditures:						
Cash	(10,137)	(407)	(5,062)	(613)		(16,219)
Non-cash					(827)	(827)
Balance at December 26, 2003	\$ 3,842	\$	\$ 49,835	\$ 4,077	\$	\$ 57,754

The total amount of severance and related charges, cancelled contracts, facilities and other charges for each reportable segment incurred during the third and fourth quarters of fiscal 2003 and the first and second quarters of fiscal 2004, the cumulative amounts incurred to date and the total amount of costs expected to be incurred in connection with our restructuring plans are presented below (in thousands):

Category	Servers	Workstations	Global Services	Total
<b>Fiscal 2003 restructuring:</b>				

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<b>Costs incurred to date: (1)</b>									
Severance and Related Charges	\$	5,358	\$	2,241	\$	5,697	\$	13,296	
Canceled Contracts		69		28		73		170	
Vacated Facilities		77		32		81		190	
Total fiscal 2003	\$	5,504	\$	2,301	\$	5,851	\$	13,656	
<b>Fiscal 2004 restructuring:</b>									
<b>Costs incurred to date:</b>									
Severance and Related Charges	\$	7,851	\$	1,865	\$	7,717	\$	17,433	
Canceled Contracts		291		75		275		641	
Vacated Facilities		5,202		1,335		4,914		11,451	
Other		2,324		555		2,278		5,157	
Impairment Charges		1,147		279		1,114		2,540	
<b>Total first six months of fiscal 2004</b>	\$	16,815	\$	4,109	\$	16,298	\$	37,222	
<b>Cumulative at December 26, 2003</b>									
	\$	22,319	\$	6,410	\$	22,149	\$	50,878	
<b>(1) Cost incurred to date closely approximate total costs expected to be incurred</b>									
<b>Estimated future costs to be incurred under the 2004 restructuring plan:</b>									
Severance	\$	851	\$	231	\$	778	\$	1,860	
Vacated Facilities		24,934		6,773		22,799		54,506	
Other		355		96		325		776	
Impairment charges		65		18		60		143	
Total costs to be incurred in future periods	\$	26,205	\$	7,118	\$	23,962	\$	57,285	
<b>Total costs expected to be incurred</b>									
	\$	48,524	\$	13,528	\$	46,111	\$	108,163	

**4. Inventories.**

(In thousands)	December 26, 2003	June 27, 2003
Components and subassemblies	\$ 34,507	\$ 39,939
Work-in-process	12,884	8,897
Finished goods	11,598	12,000
Demonstration systems	13,106	10,590
Total inventories	\$ 72,095	\$ 71,426

**5. Property and Equipment.**

(In thousands)	December 26, 2003	June 27, 2003
Property and equipment, at cost	\$ 512,038	\$ 576,330
Accumulated depreciation and amortization	(423,051)	(468,268)
Property and equipment, net	\$ 88,987	\$ 108,062

In September 2003, we completed the sale of our manufacturing facility in Cortaillod, Switzerland for approximately \$11 million and this transaction is the primary contributor of the decline in property and equipment from June 27, 2003.

**6. Other Assets.**

(In thousands)	December 26, 2003	June 27, 2003
Spare parts	\$ 37,467	\$ 44,505
Investments	19,144	20,655
Software licenses, goodwill and other	42,112	42,309
	\$ 98,723	\$ 107,469

**7. Financing Arrangement.**

We currently have an asset-based credit facility that matures in April 2005. This facility is also subject to acceleration upon various events of default. The facility is secured by our U.S. and Canadian accounts receivable, U.S. inventory and equipment, the pledge of certain intellectual property and a \$15 million cash deposit. Available credit under our asset-based credit facility is determined monthly based on 85% of eligible accounts receivable and an inventory collateral calculation based on the terms of the agreement. Generally, we do not use this facility for cash borrowings, but rather to support letters of credit, including letters of credit we are required to provide as security under certain lease obligations.



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We are currently using our full borrowing capacity under this line to secure \$50.5 million in outstanding letters of credit. This obligation bears interest payable monthly at the prime rate plus 0.25% (4.25% at December 26, 2003) for cash advances and at 2.0% for letters of credit. We deposit additional cash collateral when the eligible accounts receivable and other collateral, which fluctuate within the quarter, are below the level needed to secure our outstanding

letters of credit. At December 26, 2003, the credit facility was secured by a total of \$25 million cash collateral, which is included as a component of Short-term Restricted Investments. The credit facility contains financial and other covenants. During the second quarter of fiscal 2004 we had a violation of a covenant that was administrative in nature for which we received a waiver of compliance. We also obtained a waiver of compliance with the covenants of the predecessor to this facility from the lender in the first, third and fourth quarters of fiscal 2003. In the event we are not able to comply with the financial and other covenants of this facility in the future, or there is a material adverse change affecting our ability to repay the outstanding balance, the facility may be declared to be in default. If a default is declared and not waived it could have a significant impact on our working capital position.

## 8. Debt

(In thousands)	December 26, 2003		June 27, 2003	
Senior Secured Convertible Notes due June 1, 2009 at 6.50%, including unamortized premium of \$30,434	\$	254,790	\$	
Convertible Subordinated Debentures due February 1, 2011 at 6.125%, net of unamortized discount of \$7,710 (\$8,097 at June 27, 2003)		49,066		48,679
Japanese Yen fixed rate loan due in quarterly installments through December 31, 2004 at 10.00% (1)		23,284		29,563
Senior Convertible Notes due September 1, 2004 at 5.25%		3,849		230,591
Senior Secured Notes due June 1, 2009 at 11.75%		2,386		
Other		18		17
		333,393		308,850
Less amounts due within one year		(22,477)		(16,894)
Amounts due after one year	\$	310,916	\$	291,956

(1) The Japanese yen fixed rate loan of approximately 2.5 billion yen was converted at a rate of 107.37 yen per U.S. dollar at December 26, 2003. This loan is collateralized by our remaining ownership interest in SGI Japan.

In December 2003, we exchanged \$224 million of newly issued 6.50% Senior Secured Convertible Notes due 2009 and \$2 million of 11.75% Senior Secured Notes due 2009 for 98% of our existing 5.25% Senior Convertible Notes due in September 2004 (the 2004 Senior Notes). The Senior Secured Convertible Notes are convertible at the holders' option into shares of common stock at a conversion price equal to \$1.25 per share. The earliest our Senior Secured Convertible Notes are redeemable at our option is the beginning of December 2005. During calendar 2006, the Senior Secured Convertible Notes may be redeemed at our option at 100% of the principal amount if the closing price of our common stock has been at least 150% of the conversion price for the 20 consecutive trading days ending two trading days prior to the notice of redemption. Thereafter, the Senior Secured Convertible Notes may be redeemed at our option at 100% of the principal amount. The Senior Secured Notes are not convertible and are redeemable at our option at varying prices based on the year of redemption beginning in June 2004 at 104% of the principal amount. Both the Senior Secured Convertible Notes and the Senior Secured Notes are redeemable at the option of the holder in the event of the sale of all, or substantially all, of our common stock for consideration other than common stock traded on a U.S. exchange or approved for quotation on the Nasdaq National Market. Both the Senior Secured Convertible Notes and the Senior Secured Notes are also secured by a junior priority security interest in those assets in which the lenders under our secured credit facility currently hold a senior priority security interest. See Note 8 to the Condensed Consolidated Financial Statements for further information regarding our secured credit facility.

The debt exchange was accounted for as an extinguishment of the tendered debt and resulted in a non-cash loss of approximately \$31 million, primarily representing the difference between the fair value of the new debt instruments and the net carrying value of the extinguished debt. The difference is treated as a premium on the new 6.50% Senior Secured Convertible Notes that will be amortized as an offset to interest expense over the term of the Notes. Also included in the \$31 million loss is a write-off of \$0.4 million in debt issuance costs associated with the extinguished debt.

The remaining 2004 Senior Notes are convertible into shares of common stock at a conversion price equal to \$18.70 per share. The 2004 Senior Notes are redeemable at our option at 100% of the principal amount. The 2004 Senior Notes are redeemable at the holder's option in the event of the sale of all, or substantially all, of our common stock for consideration other than common stock traded on a U.S. exchange or approved for quotation on the NASDAQ National Market. In the first quarter of fiscal 2004, the 2004 Senior Notes were reclassified from long-term to short-term, reflecting their September 2004 maturity date. In December 2003, we successfully completed an exchange offer for 98% of the 2004 Senior Notes as noted above and approximately \$4 million aggregate principal amount not tendered for exchange remained outstanding at December 26, 2003.

In connection with the fiscal 1996 acquisition of Cray Research Inc., SGI assumed the Convertible Subordinated Debentures. These debentures are convertible into SGI's common stock at a conversion price of \$39.17 per share at any time prior to maturity and may be redeemed at our option at a price of 100% of the principal amount. Prior to our acquisition of Cray, Cray repurchased a portion of the debentures with a face value of \$33 million. The repurchase satisfied the first six required annual sinking fund payments of approximately \$6 million originally scheduled for fiscal years 1997 through 2002. In fiscal 2000 and fiscal 1999, we repurchased additional portions of the debentures with a face value of \$11 million and \$15 million, respectively. These repurchases satisfied the next four required annual sinking fund payments of approximately \$6 million originally scheduled for fiscal years 2003 through 2006. Remaining annual sinking fund payments of approximately \$5 million in fiscal 2007 and approximately \$6 million each from

fiscal 2008 to 2010 are scheduled, with a final maturity payment of approximately \$35 million in 2011.

**9. Guarantees.**

SGI, as the guarantor, enters into three types of guarantees, namely financial guarantees, performance guarantees and indemnifications.

Financial guarantees include contracts that contingently require us to make payments to the beneficiary of the guarantee based on changes in an underlying variable (e.g. a specified interest rate, security price or other variable) that is related to an asset, liability or equity security of the guaranteed party. Currently, we have issued financial guarantees: to cover rent on leased facilities and equipment; in favor of government authorities and certain other parties to cover liabilities associated with the importation of goods; and to support payments in advance of future delivery on our goods and services. The majority of our guarantees within this category have terms no greater than one year.

Performance guarantees include contracts that contingently require us to make payments to the beneficiary of the guarantee based on another entity's failure to perform under an obligating agreement. We had no outstanding performance guarantees at December 26, 2003 that are subject to the disclosure requirements of FIN 45.

Indemnifications include agreements that contingently require us to make payments to an indemnified party based on changes in an underlying variable (e.g. a specified interest rate, security price or other variable) that is related to an asset, liability, or an equity security of the indemnified party. Indemnifications include agreements to indemnify the guaranteed party for an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law. Indemnifications for this purpose do not include agreements in favor of customers with respect to potential intellectual property or other liabilities. Currently, we have issued indemnifications to cover potential exposure related to the payment of additional taxes. The term of an indemnification is based on the length of time required to settle the dispute.

The following table discloses our maximum potential obligations under guarantees as of December 26, 2003:

(In thousands)	Maximum Potential Amount of Future Payments		Assets Held as Collateral	
Financial guarantees	\$	54,886	\$	54,886
Indemnifications		662		646
<b>Total</b>	<b>\$</b>	<b>55,548</b>	<b>\$</b>	<b>55,532</b>

The following table depicts product warranty activity during the first six months of fiscal 2004 and 2003:

(In thousands)	2004	2003
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Product warranty beginning balance	\$	6,711	\$	8,958
New warranties issued		5,194		5,413
Warranties paid		(5,887)		(7,238)
Changes in estimate		(788)		103
Product warranty ending balance	\$	5,230	\$	7,236

**10. Loss Per Share.**

The following table sets forth the computation of basic and diluted loss per share:

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Net loss available to common stockholders	\$ (37,368)	\$ (16,997)	\$ (85,297)	\$ (58,069)
Weighted average shares outstanding - basic and diluted (1)	211,034	200,748	210,302	200,212
Net loss per share - basic and diluted	\$ (0.18)	\$ (0.08)	\$ (0.41)	\$ (0.29)
Potentially dilutive weighted securities excluded from computations because they are anti-dilutive (2)	30,683	17,241	31,098	17,135

(1) In July 2003, the remaining 5.6 million of a total 8 million shares of common stock were issued in settlement of a securities class action lawsuit.

(2) The increase in potentially dilutive securities in the three and six-month periods ended December 26, 2003 is primarily the result of approximately 13.8 million weighted shares (179.5 million non-weighted) associated with the convertible feature of our new 6.50% Senior Secured Convertible Notes.

**11. Comprehensive Loss.**

The components of comprehensive loss, net of tax, are as follows:

(In thousands)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Net loss	\$ (37,368)	\$ (16,997)	\$ (85,297)	\$ (58,069)
Change in unrealized gain (loss) on derivative instruments designated and qualifying as cash flow hedges	(627)	(150)	(250)	1,276
Foreign currency translation gain (loss) adjustments	762	282	1,141	(159)
Comprehensive loss	\$ (37,233)	\$ (16,865)	\$ (84,406)	\$ (56,952)

The components of accumulated other comprehensive loss, net of tax, are as follows:

(In thousands)	December 26, 2003	June 27, 2003
Unrealized loss on derivative instruments designated and qualifying as cash flow hedges	\$ (631)	\$ (381)
Foreign currency translation adjustments	(18,403)	(19,544)
Accumulated other comprehensive loss	\$ (19,034)	\$ (19,925)

## 12. Segment Information.

SGI is a leading provider of products, services and solutions for use in high-performance computing, visualization and storage. We sell highly scalable servers, advanced visualization systems, desktop workstations, storage solutions and a range of software products which enable our customers in the scientific, technical and creative communities to solve their most challenging problems and provide them with strategic and competitive advantages in their marketplace. We also offer a range of technical solutions, including professional services, Reality Center® immersive visualization centers, customer support and education. These products and services are targeted primarily towards five market segments: Defense and Homeland Security, Science, Manufacturing, Energy and Media.

Effective for fiscal 2004, we removed our prior generations of workstations, graphics systems and high-performance servers included in the

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Remarketed Products Group from the Server and Workstations segments after reassessment of factors such as economic characteristics, homogeneity of products, technology and other factors. The Remarketed Products Group does not meet the quantitative thresholds required for separate disclosure and is included in Other in the reconciliation of reported revenue and operating profit. Prior year amounts have been reclassified to conform to current year presentation.

The Server segment's current products include visualization systems, high-performance servers and integrated storage solutions. The Server segment's systems include the SGI® Onyx® family of graphics systems and the SGI® Altix® and Origin® families of high-performance servers. Our servers are high-performance supercomputing systems designed for technical computing applications. Our servers are also used as storage management servers for managing very large data repositories that contain critical information and media servers for video on demand, media streaming and broadcast television applications. These products are distributed through our direct sales force, as well as through indirect channels including resellers and distributors.

The Workstation segment's current products include the Silicon Graphics® Tezro™, the Silicon Graphics Fuel®, and the Silicon Graphics® Octane2 workstations. Our workstations are used in a variety of applications including computer-aided design, medical imaging, 2D and 3D animation, broadcast, modeling and simulation. These products are distributed through our direct sales force, as well as through indirect channels including resellers and distributors.

The Global Services segment supports our computer hardware and software products and provides professional services to help customers realize the full value of their information technology investments. Our Professional Services organization provides technology consulting, education and managed services.

We evaluate each of these segments based on profit or loss from operations before interest and taxes.

Expenses of the research and development, sales and marketing, manufacturing, finance and administration groups are allocated to the reportable segments and are included in the results reported. The revenue and related expenses of our Remarketed Products Group and our wholly-owned software subsidiary Alias, as well as certain corporate-level revenue and expenses are not allocated and are included in Other in the reconciliation of reported revenue and operating profit.

We do not identify or allocate assets or depreciation by operating segment, nor do we evaluate segments on these criteria. Operating segments do not sell product to each other, and accordingly, there is no inter-segment revenue to be reported.

Information on reportable segments is as follows (in thousands):

	Three Months Ended			Six Months Ended		
	Servers	Workstations	Global Services	Servers	Workstations	Global Services
December 26, 2003:	\$ 95,357	\$ 25,902	\$ 87,191	\$ 180,137	\$ 45,361	\$ 171,905



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Revenue from external customers

Segment (loss) profit	\$	(9,410)	\$	(11,642)	\$	29,506	\$	(34,427)	\$	(30,807)	\$	51,583
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December 27, 2002:

Revenue from external customers

	\$	90,515	\$	37,524	\$	98,171	\$	161,055	\$	77,107	\$	198,868
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Segment (loss) profit	\$	(23,830)	\$	(19,475)	\$	30,996	\$	(67,985)	\$	(31,743)	\$	55,904
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Reconciliation to SGI as reported (in thousands):

	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
<b>Revenue:</b>				
Total reportable segments	\$ 208,450	\$ 226,210	\$ 397,403	\$ 437,030
Other	29,463	36,528	58,537	67,426
Total SGI consolidated	\$ 237,913	\$ 262,738	\$ 455,940	\$ 504,456
<b>Operating loss:</b>				
Total reportable segments	\$ 8,454	\$ (12,309)	\$ (13,651)	\$ (43,824)
Other	2,480	9,503	5,223	9,037
Other operating (expense) income	(12,986)	(5,817)	(37,222)	(14,261)
Total SGI consolidated	\$ (2,052)	\$ (8,623)	\$ (45,650)	\$ (49,048)

**13. Recent Accounting Pronouncements.**

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. The Interpretation establishes accounting guidance for consolidation of variable interest entities that function to support the activities of the primary beneficiary. Interpretation 46 applies to any business enterprise, both public and private, that has a controlling interest, contractual relationship or other business relationship with a variable interest entity. Originally the provisions of Interpretation No. 46 were effective immediately for all variable interests in variable interest entities created before February 1, 2003 and no later than the first fiscal period beginning after June 15, 2003 for all variable interests in variable interest entities created before February 1, 2003. In October 2003, the FASB agreed to a broad-based deferral of Interpretation 46 for public companies until the end of periods ending after December 15, 2003. In December 2003, the FASB again deferred the effective date of the Interpretation's provisions and agreed to a revised model for adoption allowing differing effective dates based on certain factors. SGI will provide the disclosure requirements of Interpretation 46 beginning with our third quarter ending March 26, 2004. The adoption of Interpretation 46 (revised in December 2003) will not have a material impact on our consolidated financial position, results of operations or cash flows. If we enter into any such arrangement with a variable interest entity in the future, and we are the primary beneficiary, our consolidated financial position or results of operations could be impacted.

In March 2003, the EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21), which provides guidance on accounting for arrangements involving the delivery or performance of multiple products, services and/or rights to use assets. Specifically, EITF 00-21 addresses: (1) how to determine whether an arrangement with multiple deliverables contains more than one unit of accounting, and (2) how the arrangement consideration should be measured and allocated among the separate units of accounting. The provisions of EITF 00-21 were effective for revenue arrangements entered into by us beginning June 28, 2003. The adoption of EITF 00-21 did not have a material impact on our results of operations or financial position.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under FAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The Statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Most of its provisions should be applied prospectively. The adoption of SFAS 149 had no impact on our results of operations or financial position.

**14. Legal Proceedings.**

In June 2002, we reached an agreement to resolve the claims asserted in a lawsuit originally filed as *Collette Sweeney v. Silicon Graphics, Inc. and Does 1-50, inclusive, CV 790199*, on June 5, 2000 in the Superior Court for the County of Santa Clara, State of California, and later dismissed by the plaintiffs but refiled as a representative action under California Business and Professions Code section 17200 by the plaintiffs original counsel. The lawsuit asserts claims for violations of provisions of the California Labor Code and California Wage Orders. The settlement agreement outlines a process for identifying and resolving claims from members of the represented class. Once this process is complete, the complaint will be dismissed. We currently expect to complete this process in fiscal 2004. However, we do not expect all claims to be resolved through this process.

In October 2002, the Internal Revenue Service completed its examination of our U.S. income tax returns for fiscal years ended 1996 through 1999 and proposed certain adjustments. We are contesting these adjustments and believe that adequate amounts have been provided for adjustments that may ultimately result from these examinations.

SCO Group, the successor to AT&T as the owner of certain UNIX® system V intellectual property and as our licensor, has publicly claimed that certain elements of the Linux® operating system infringe SCO Group's intellectual property rights. We have received a letter from SCO Group alleging that, as a result of our activities related to the Linux operating system, we are in breach of the fully paid license under which we distribute our IRIX® operating system. The letter purports to terminate our UNIX System V license effective October 14, 2003. We believe that the SCO Group's allegations are without merit and that our fully paid license is non-terminable. There can be no assurance that this dispute with SCO Group will not escalate into litigation, which could have a material adverse effect upon SGI, or that SCO Group's intellectual property claims, which include a widely-publicized litigation against IBM Corporation, will not impair the market acceptance of the Linux operating system.

On September 30, 2003, a lawsuit captioned *FuzzySharp Technologies Incorporated v. Silicon Graphics, Inc.* alleging patent infringement by an SGI workstation product was filed by FuzzySharp in the United States District Court for the Northern District of California, Civil Action No. C 03-4404 JCS. SGI is aggressively defending this action.

We also routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or we may seek to obtain a license. We are in discussions with several parties that have asserted intellectual property infringement claims. There can be no assurance in any given case that a license will be available on terms we consider reasonable, or that litigation will not ensue.

We are not aware of any pending disputes, including those described above that would be likely to have a material adverse effect on our financial condition, results of operations or liquidity. However, our evaluation of the likely impact of these pending disputes could change in the future.

## **Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition.**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS**

This Form 10-Q includes forward-looking statements regarding our business, objectives, financial condition and future performance. These forward-looking statements include, among others, statements relating to: expected levels of revenue, gross margin, operating expense, future profitability, our expectations for new product introductions and market conditions, our liquidity and capital resources, our belief that we have sufficient capital to meet our requirements for fiscal 2004, headcount reductions and the expected impact on our business of legal proceedings and government actions. We have based these forward-looking statements on our current expectations about future events. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, potential or continue or the negative of such terms or other comparable terminology. These statements are only predictions.

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These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied in such forward-looking statements. Such risks and uncertainties include, among other things: adverse changes in general economic or business conditions; adverse changes in the specific markets for our products, including expected rates of growth and decline in our current markets; risks related to liquidity and the adequacy of our capital resources; risks related to our ability to achieve profitable operations or limit losses; risks associated with intellectual property disputes; adverse business conditions; changes in customer order patterns; the impact of employee attrition rates; heightened competition, reflecting rapid technological advances and constantly improving price/performance, which may result in significant discounting and lower gross profit margins; continued success in technological advancements and new product introduction, including timely development and successful introduction of strategic products for specific markets; risks related to the acceptance of new products, including the SGI Altix family of servers and superclusters, and storage offerings based on our CXFS shared file system; risks related to dependence on our partners and suppliers; risks related to market perceptions regarding proprietary versus open standard technologies; risks related to foreign operations (including weak or disrupted economies, unfavorable currency movements and export compliance issues); risks associated with implementation of new business practices, processes and information systems; uncertainties arising from claims and litigation; and other factors including those listed under the heading Risks That Affect Our Business.

We undertake no obligation to publicly update or revise any forward-looking statements, whether changes occur as a result of new information, future events or otherwise. The matters addressed in this discussion, with the exception of the historical information presented, are forward-looking statements involving risks and uncertainties, including business transition and other risks discussed under the heading Risks That Affect Our Business and elsewhere in this report. Our actual results may differ significantly from the results discussed in the forward-looking statements.

**Results of Operations**

(Numbers may not add due to rounding) (In millions, except per share amounts)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Total revenue	\$ 238	\$ 263	\$ 456	\$ 504
Cost of revenue	127	149	250	293
Gross profit	111	114	206	212
Gross profit margin	46.7%	43.5%	45.1%	42.0%
Total operating expenses	113	123	251	261
Operating loss	(2)	(9)	(46)	(49)
Interest and other income (expense), net	(5)	(7)	(12)	(8)
Loss on extinguishment of tendered debt	(31)		(31)	
Loss before (benefit) provision for income taxes	(38)	(16)	(88)	(57)
Net loss	\$ (37)	\$ (17)	\$ (85)	\$ (58)
Net loss per share basic and diluted	\$ (0.18)	\$ (0.08)	\$ (0.41)	\$ (0.29)

**Revenue**

The following discussion of revenue is based on the results of our reportable segments as described in Note 12 to the Condensed Consolidated Financial Statements. Total revenue is principally derived from three reportable segments: Servers, Workstations and Global Services, which were determined based on factors such as customer base, homogeneity of products, technology, delivery channels and other factors. Effective for fiscal 2004, we removed our prior generations of workstations, graphics systems and high-performance servers included in the Remarketed Products Group from the Server and Workstations segments and included it in Other. Prior year amounts have been reclassified to conform to current year presentation.

Revenue for the second quarter and first six months of fiscal 2004 decreased \$25 million or 9% and \$49 million or 10%, respectively, compared with the corresponding periods of fiscal 2003, as growth in sales of our recently introduced Altix servers and our integrated storage solutions was insufficient to offset continued declines in our traditional UNIX workstations and services. See Risks That Affect Our Business.

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The following table presents total revenue by reportable segment:

(Numbers may not add due to rounding) \$ in millions	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Servers	\$ 95	\$ 90	\$ 180	\$ 161
% of total revenue	40%	34%	40%	32%
Workstations	\$ 26	\$ 38	\$ 45	\$ 77
% of total revenue	11%	14%	10%	15%
Global Services	\$ 87	\$ 98	\$ 172	\$ 199
% of total revenue	37%	37%	38%	39%
Other	\$ 29	\$ 37	\$ 59	\$ 67
% of total revenue	12%	14%	13%	13%

Server revenue (which includes visualization systems, high-performance servers and integrated storage solutions) for the second quarter and first six months of fiscal 2004 increased \$5 million or 5% and \$19 million or 12%, respectively, compared with the corresponding periods in fiscal 2003 primarily due to increased sales of high-performance servers and integrated storage solutions, offset in part by a decline in sales of our visualization systems. High-performance server volumes declined in both the second quarter and first six months of fiscal 2004 compared with the corresponding periods of fiscal 2003. Although our newly introduced Altix family of servers is sold at a lower price point than the Origin family of servers, a shift in mix to higher-end configurations of both the Origin family of servers since the first quarter of fiscal 2003 and the Altix family of servers since the beginning of fiscal 2004, resulted in an increase in server revenue. Integrated storage solutions revenue for the second quarter of fiscal 2004 compared with the corresponding period of fiscal 2003 remained relatively flat despite increased volumes, primarily due to a shift in product mix to lower-end storage solutions with lower average selling prices. Integrated storage solutions revenue for the first six months of fiscal 2004 compared with the corresponding period of fiscal 2003 increased due to both increased sales volume and higher average selling prices. Despite increased sales volume in both the second quarter and first six months of fiscal 2004 compared with the corresponding periods of fiscal 2003, a significant decline in the average selling price of higher-end visualization systems resulting from a shift in mix from the higher-end visualization systems to the lower-end visualization systems with a lower average selling price contributed to the decline in visualization system revenue.

Workstation revenue for the second quarter and first six months of fiscal 2004 decreased \$12 million or 32% and \$32 million or 42%, respectively, compared with the corresponding periods in fiscal 2003. The decrease in both periods was primarily attributable to the continuing decline in the overall UNIX market. The decline for both the second quarter and first six months of fiscal 2004 compared with the corresponding periods of fiscal 2003 reflected reduced volumes as we reach the end of life of our O2® and Octane® families of visual workstations. Declines in workstation revenue due to reduced volumes were offset in part by a slight increase in average selling prices as product mix shifted from the lower-end workstations such as the O2 and Fuel, to higher-priced workstations such as the Octane and our newly introduced Silicon Graphics® Tezro visual workstation which has a higher average selling price than previous generation workstation products. In addition, the mix of Tezro workstations sold was comprised of more high-end configurations, which also somewhat offset the overall decline in the volume of workstation revenue.

Global Services revenue is comprised of hardware and software support and maintenance and professional services. Global Services revenue for the second quarter and first six months of fiscal 2004 decreased \$11 million or 11% and \$27 million or 14%, respectively, compared with the corresponding periods in fiscal 2003. The decline for both the second quarter and first six months of fiscal 2004 compared with the corresponding periods of fiscal 2003 was primarily attributable to a reduction in our traditional customer support revenue that is being affected by lower selling prices for new contracts compared with existing contracts, coupled with a decline in the overall installed base reflecting lower system sales volumes in recent periods. Professional Services revenue, which includes SGI product, third party product and SGI consulting services, also declined in both the second quarter and first six months of fiscal 2004 compared with the corresponding periods of fiscal 2003 due to the same factors influencing the decline in Server, Workstation and Global Services revenue.

Other revenue is generally comprised of our operating units that are not reportable segments, including the product and service revenue of our application software subsidiary, Alias, and revenue associated with prior generations of workstations, graphics systems and high-performance servers available through our Remarketed Products Group. Other revenue for the second quarter and first six months of fiscal 2004 decreased \$8 million or 22% and \$8 million or 12%, respectively, compared with the corresponding periods in fiscal 2003, primarily due to a decrease in revenue associated with our re-marketed graphics systems and high-performance servers. Revenue declines were offset in part by increases in revenue generated by Alias and to a smaller degree, increased revenue associated with our re-marketed workstations.



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Total revenue by geographic area was as follows (in millions):

Area	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Americas	\$ 149	\$ 163	\$ 292	\$ 322
Europe	63	68	112	117
Rest of World	26	32	52	65
Total revenue	\$ 238	\$ 263	\$ 456	\$ 504

Geographic revenue as a percentage of total revenue was as follows:

Area	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Americas	63%	62%	64%	64%
Europe	26%	26%	24%	23%
Rest of World	11%	12%	12%	13%

Geographic revenue as a percentage of total revenue in the second quarter and first six months of fiscal 2004 compared with the corresponding periods in fiscal 2003 remained relatively consistent.

Our consolidated backlog at December 26, 2003 was \$119 million, up slightly from \$118 million at September 26, 2003. Backlog is comprised of committed purchase orders for products and professional services deliverable within three to nine months, depending on the product family. From a geographic perspective, backlog declined in the Americas, offset in part by improvements in both Europe and Rest of World. From a segment standpoint, the increase was noted across all reportable segments with the exception of Servers where backlog declined 16%.

### **Gross Profit Margin**

Cost of product and other revenue includes costs related to product shipments, including materials, labor, overhead and other direct or allocated costs involved in their manufacture or delivery. Cost of service revenue includes all costs incurred in the support and maintenance of our products, as well as costs to deliver professional services.

Gross margin for the second quarter and the first six months of fiscal 2004 increased from 43.5% to 46.7% and from 42.0% to 45.1%, respectively, compared with the corresponding periods of fiscal 2003. Product and other gross margin for the second quarter and first six months of fiscal 2004 improved 1.9 and 2.9 percentage points, respectively, compared with the corresponding periods of fiscal 2003. These improvements were primarily due to a shift in mix to higher-margin product configurations for the Origin and Altix families within our Server segment and within our Workstation segment and overall cost savings including lower warranty and material costs and favorable manufacturing variances resulting from improved efficiencies in material procurement. These improvements were offset in part by lower volumes and a shift in

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mix to lower-margin product configurations for Integrated Storage Solutions and Visualization Systems within our Server segment. Service gross profit margin for the second quarter and first six months of fiscal 2004 improved 5.2 and 3.6 percentage points compared with the corresponding period in fiscal 2003 despite declining revenue levels primarily due to overall cost control measures.

### *Operating Expenses*

(In millions)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Research and development	\$ 30	\$ 43	\$ 66	\$ 86
% of total revenue	12.7%	16.3%	14.4%	17.0%
Selling, general and administrative	\$ 70	\$ 74	\$ 148	\$ 161
% of total revenue	29.4%	28.2%	32.6%	31.9%
Other	\$ 13	\$ 6	\$ 37	\$ 14
% of total revenue	5.5%	2.2%	8.2%	2.8%

*Operating Expenses (excluding Other Operating Expense).* Operating expenses for the second quarter and the first six months of fiscal 2004 declined in absolute dollars 14% and 13%, respectively, and as a percentage of total revenue from 44.5% to 42.1% and from 48.9% to 46.9%, respectively, compared with the corresponding periods of fiscal 2003. The decline in all categories of operating expenses, in absolute dollars and as a percentage of revenue, is primarily due to lower headcount as a result of recent restructuring activities and attrition and the impact of our overall expense

control measures aimed at bringing operating expenses more in line with revenues. As a result of restructuring actions and attrition, from the second quarter of fiscal 2003 through the second quarter of fiscal 2004, we have reduced our headcount associated with research and development by roughly 140 or 21% and headcount associated with our selling, general and administrative functions by approximately 720 or 25%. Also included in selling, general and administrative expense for the second quarter and first six months of fiscal 2004 is a \$5 million partial reversal of an estimated employee benefit liability due to a modification in the benefit plan during the second quarter.

*Other Operating Expense.* Other operating expense for the first six months of fiscal 2004 represented a \$37 million charge for estimated restructuring and asset impairment. Specifically, we recorded \$18 million in severance and related costs, \$1 million in facilities restructuring and \$18 million in costs associated with our Mountain View, California headquarters relocation. This relocation charge was comprised of \$15 million in charges for vacated facilities and related charges and \$3 million associated with the impairment of assets. Other operating expense for the first six months of fiscal 2003 represented a \$14 million charge for estimated restructuring costs associated with the fiscal 2003 restructuring plan. In the first half of fiscal 2003, we recorded \$8 million in severance and related costs and \$6 million in costs associated with vacating leased facilities worldwide. See Note 3 to the Condensed Consolidated Financial Statements, Other Operating Expense, for further information regarding these activities.

#### *Interest and Other*

(In thousands)	Three Months Ended		Six Months Ended	
	December 26, 2003	December 27, 2002	December 26, 2003	December 27, 2002
Interest expense	\$ (5,182)	\$ (6,185)	\$ (12,071)	\$ (12,404)
Investment gain (loss)		(270)		(270)
Foreign exchange gain (loss)	(122)	970	1,350	3,954
Miscellaneous (expense) income	137	(2,299)	(2,275)	(327)
Interest income	70	336	987	1,039
Interest and other income (expense), net	\$ (5,097)	\$ (7,448)	\$ (12,009)	\$ (8,008)
Loss on extinguishment of tendered debt	\$ (30,915)	\$	\$ (30,915)	\$

*Interest and Other Income (Expense), Net.* Interest and other income (expense), net includes interest on our cash investments, interest expense, gains and losses on other investments, and other non-operating items. Interest and other income (expense), net representing \$5 million in expense in the second quarter of fiscal 2004, improved from \$7 million in expense in the second quarter of fiscal 2003 primarily due to lower interest on our Yen-based borrowing as the principal is paid down quarterly and lower interest associated with our financing arrangement (See Note 7). Interest and other income (expense), net for the first six months of fiscal 2004 also included a loss on our minority interest in SGI Japan and the second quarter of fiscal 2003 included a loss on the sale of land.

*Loss on Extinguishment of Tendered Debt* During the second quarter of fiscal 2004, we successfully completed an exchange offer for 98.3% of our 5.25% Senior Convertible Notes due to mature in September 2004. The exchange offer was

accounted for as a debt extinguishment and resulted in a non-cash loss of approximately \$31 million, primarily representing the difference between the fair value of the new debt instruments and the net carrying value of the extinguished debt. Also included in the \$31 million loss is a write-off of \$0.4 million in debt issuance costs associated with the extinguished debt. See Note 8 to the Condensed Consolidated Financial Statements for further information.

*Taxes.* Our net benefit for income taxes of \$3 million for the first six months of fiscal 2004 arose principally from a reduction in prior period tax contingencies in foreign jurisdictions and the refund of certain U.S. and State income taxes paid in prior years, partially offset by net income taxes payable in foreign jurisdictions. Our provision for income taxes of \$1 million for the first six months of fiscal 2003 arose principally from taxes currently payable in foreign jurisdictions.

***Financial Condition***

At December 26, 2003, unrestricted cash and cash equivalents and marketable investments totaled \$109 million compared with \$141 million at June 27, 2003. Also included in the balance sheet at December 26, 2003 and June 27, 2003 was approximately \$36 million and \$37 million, respectively, of restricted investments. Restricted investments consist of short- and long-term investments held under a security agreement or pledged as collateral against letters of credit.

Primarily as a result of net losses, operating activities used \$9 million during the first six months of fiscal 2004 compared with using \$26 million during the corresponding period of fiscal 2003. To present cash flows from operating activities, net loss for the first six months of fiscal year 2004 was adjusted for certain significant non-cash items, such as a \$31 million loss on the early extinguishment of tendered debt, \$42 million in depreciation and amortization and \$3 million in asset impairments associated with restructuring activities. Net loss for the first six months of fiscal 2003 was adjusted for \$1 million in asset impairments

associated with restructuring activities.

Negative operating cash flow in the first six months of fiscal 2004 was partially due to approximately \$31 million in cash payments for severance, contractual obligations, and vacated facilities related to our restructuring plans. These restructuring actions are expected to result in future cash outlays of approximately \$115 million, about \$20 million of which are expected to occur in fiscal 2004 and be funded from cash and cash equivalents. As a result of the workforce reduction implemented in the second quarter of fiscal 2004 we expect to save approximately \$3 million in operating expenses annually. Restructuring of operating facilities initiated in the first six months of fiscal 2004 are projected to save us approximately \$76 million over the next 10 years. The negative operating cash flows were partially offset by a decrease in accounts receivable attributable to lower revenue coupled with improved customer cash collections. Our days sales outstanding improved from 61 days at the end of June 2002 to 46 days at the end of December 2003.

Investing activities, other than changes in available-for-sale and restricted investments, consumed \$16 million in cash in the first six months of fiscal 2004 and \$15 million in cash during the first six months of fiscal 2003. Principal investing activities in the first six months of fiscal 2004 included \$18 million of capital expenditures and \$9 million of other asset purchases, partially offset by \$11 million net cash proceeds received from the sale of our facility in Cortaillod, Switzerland. Principal investing activities in the first half of fiscal 2003 consisted of purchases of software licenses, equity income resulting from our investment in SGI Japan and capital expenditures of \$8 million, offset in part by \$6 million in proceeds received from the sale of land. Capital expenditures in the first six months of fiscal 2004 compared with the corresponding period of fiscal 2003 increased primarily due to spending related to our corporate headquarters relocation to the new Crittenden Technology Center Campus. The landlord reimburses a significant portion of these expenditures to us and we only expect to incur incremental cash outflows of between \$2 million to \$3 million associated with this relocation.

The principal financing activities during both the first six months of fiscal 2004 and fiscal 2003 represented debt repayment of \$9 million and \$2 million, respectively.

At December 26, 2003, our principal sources of liquidity included cash and cash equivalents and unrestricted marketable investments of \$109 million. Based on our revenue outlook for the third quarter ending March 26, 2004 and the timing of various future payments, we expect to continue to consume cash during the third quarter of fiscal 2004. We also experience significant intra-quarter fluctuations in our cash levels due to timing differences between our payments to vendors and our collections from customers, with the result that our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times. As a result, we continue to focus on expense controls and working capital efficiencies to maintain adequate levels of unrestricted cash within each quarter. We also are exploring alternatives for generating additional cash through financing transactions and dispositions of non-core assets.

We are committed to our goal of re-establishing profitable operations and positive cash flow. While a forecast of future events is inherently uncertain, we believe that the combination of our current resources and cash expected to be generated from our fiscal 2004 financial plan will be sufficient to meet our financial obligations through fiscal 2004. If we experience a material shortfall versus our plan for fiscal 2004, we will take all appropriate actions to ensure the continued operation of our business and to mitigate any negative impact on our profitability and cash reserves. We have a range of actions we can take to achieve this outcome, including but not limited to expense-related actions such as further reductions in headcount-related expenses, additional consolidation of administrative functions, re-evaluation of our global distribution model, and delayed implementation of information systems initiatives. We also can take actions to generate cash by selling non-core businesses, licensing intellectual property, seeking funding from marketing partners and key government customers, and seeking further equity or debt financing from strategic partners or financial sources. See **Risks That Affect Our Business**.



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As of December 26, 2003, future payments due under debt and lease obligations, including facilities vacated as part of our restructuring activities and excluding the benefit of contractual and estimated sublease income on our vacated facilities, are as follows (in thousands):

Fiscal year ended	2004		2005		2006		2007		2008		Thereafter	Total		
10% loan payable to SGI Japan due December 2004 (payable in quarterly installments)	\$	9,921	\$	13,363	\$		\$		\$		\$	23,284		
5.25% Senior Convertible Notes due September 2004				3,849								3,849		
6.50% Senior Secured Convertible Notes due June 2009											224,356	224,356		
11.75% Senior Secured Notes due June 2009											2,386	2,386		
6.125% Convertible Subordinated Debentures due February 2011							5,026		5,750		46,000	56,776		
Non-cancelable operating leases		26,313		50,557		44,226		37,369		35,805	164,350	358,620		
<b>Total</b>	\$	<b>36,234</b>	\$	<b>67,769</b>	\$	<b>44,226</b>	\$	<b>42,395</b>	\$	<b>41,555</b>	\$	<b>437,092</b>	\$	<b>669,271</b>

**Critical Accounting Policies and Estimates**

SGI's discussion and analysis of its financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. 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 liabilities. On an on-going basis, we evaluate these estimates, including: those related to customer programs and incentives; product returns; bad debts; inventories; warranty obligations; impairment of long-lived assets and intangibles; and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

Management has discussed the development and selection of the following critical accounting policies and estimates with the audit committee of our board of directors and the audit committee has reviewed our disclosures relating to them.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For all these policies, we caution that future events often do not develop exactly as forecasted, and that even the best estimates routinely require adjustment.

*Revenue Recognition.* A majority of our revenue is derived from sales that are recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable and collectibility is reasonably assured. Certain revenue is generated from high performance systems that may include customer acceptance criteria and for which revenue is deferred until such acceptance is obtained. Certain revenue is generated on contracts that are longer-term in duration. In these instances, we typically recognize revenue as work progresses using the percentage-of-completion method of accounting. A small portion of our product revenue is derived from product sales that require estimates for sales returns and other allowances at the time of revenue recognition. These estimates are based on historical information, current economic trends and other factors. If the data used to calculate these estimates does not properly anticipate future returns and allowances, revenue could be misstated. To date, actual experience has been consistent with our estimates.

*Product Warranties.* We provide for the estimated cost to warrant our products against defects in materials and workmanship at the time revenue is recognized. We estimate our warranty obligation based on factors such as product lifecycle analysis and historical experience, and our estimate is affected by data such as product failure rates, material usage and service delivery costs incurred in correcting product failures. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required. On a quarterly basis, these estimates are reviewed and adjusted as considered necessary based on the factors noted above.

*Manufacturing Inventory and Spare Parts.* We write down our manufacturing inventory for estimated excess, obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value. At the end of each quarter, we perform an in depth excess and obsolete analysis of all manufacturing inventory parts on order and on hand based upon assumptions about future demand and current market



conditions. For all spare parts on hand, our analysis is based on assumptions about product life cycles, historical usage, current production status and installed base. Additional adjustments to manufacturing inventory and parts may be required if actual market conditions are less favorable than those projected by us during the analyses.

*Bad Debts.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When we become aware of a specific customer's inability to pay their outstanding obligation for reasons such as a deterioration in their operating results or financial position or bankruptcy proceedings, we record a specific reserve for bad debt to reduce their receivable to an amount we reasonably believe is collectible. If the financial condition of specific customers were to change, our estimates of the recoverability of receivables could be further adjusted. We also record allowances for doubtful accounts for all other customers based on a variety of factors including the length of time the receivables are past due and historical experience. On a quarterly basis, these estimates are reviewed and adjusted as considered necessary based on the criteria noted above.

*Restructuring.* In recent fiscal years, we have recorded significant accruals in connection with our restructuring programs. These accruals include estimates of employee separation costs and the settlements of contractual obligations, including lease terminations resulting from our actions. Accruals associated with vacated facilities and related asset impairments are estimated in accordance with SFAS No. 5, *Accounting for Contingencies*. Estimates may be adjusted upward or downward upon occurrence of a future triggering event. Triggering events may include, but are not limited to, changes in estimated time to sublease, sublease terms and sublease rates. Due to the extended contractual obligations of certain of these leases and the inherent volatility of commercial real estate markets, we expect to make future adjustments to these vacated facilities accruals.

*Income Taxes.* Estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain deferred tax assets, which arise from temporary differences and carryforwards. We regularly assess the likelihood that our deferred tax assets will be realized from recoverable income taxes or recovered from future taxable income based on the realization criteria set forth under SFAS 109, *Accounting for Income Taxes*, and we record a valuation allowance to reduce our deferred tax assets to the amount that we believe to be more likely than not realizable. In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. 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 will be due. If 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.

*Loss Contingencies.* We record an obligation for loss contingencies when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Contingent liabilities are often resolved over long time periods and there is a reasonable probability that the ultimate loss will differ from and perhaps exceed the recorded provision. Estimating probable losses requires analysis of multiple factors that often depend on judgments about the outcome of pending lawsuits and potential actions by third parties including government agencies.

*Long-Term Investments.* We hold or have held investments in other companies, which are accounted for under either the cost method or equity method of accounting and we monitor these investments for indicators of impairment. Some of these investments could be in companies that are publicly traded and have volatile share prices, while other investments could be in companies that are not publicly traded and therefore the fair value may be difficult to determine. Many of our investments in non-publicly traded companies represent emerging technology companies which are inherently risky because the markets for the technologies or products they have under development are typically in the early stages and may never develop. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. Fair values for investments in public companies are determined using quoted market prices. Fair values for investments in privately-held companies are estimated based upon factors such as liquidation values, the values of recent rounds of financing, or quoted market prices of comparable public companies. To determine whether a decline in value is other-than-temporary, we evaluate, among other factors, the duration and extent to which the fair value has been less than the carrying value and the financial health of and specific prospects for the company.

*Other Significant Accounting Policies.* Other significant accounting policies not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. Policies regarding financial instruments, stock-based compensation and consolidation require difficult judgments on complex matters that are often subject to multiple sources of authoritative guidance. Certain of these matters are among topics currently under reexamination by accounting standards setters and regulators. Although no specific conclusions reached by these standards setters appear likely to cause a material change in our accounting policies, outcomes cannot be predicted with confidence.

## Risks That Affect Our Business

SGI operates in a rapidly changing environment that involves a number of risks, some of which are beyond our control.

*We have recently introduced a number of new products, including the SGI Altix product family, but we cannot assure you they will achieve market acceptance.* In January 2003, we introduced the SGI Altix family of servers and superclusters based on the Intel® Itanium® 2 processor and the Linux® operating system, and we have continued to introduce additional products in the Altix line during fiscal 2004. Risks associated with this new product line include dependence on Intel in terms of price, supply, performance, and product roadmaps; the availability of Linux applications optimized for the 64-bit Itanium platform or our scalable systems architecture; acceptance of the Linux operating system in demanding environments; and competition from other suppliers of Intel-based servers. There can be no assurance that this new product line will achieve market acceptance or provide significant incremental revenue. In July 2003, we introduced new highly scalable visualization products. Our ability to achieve future revenue growth will depend significantly on the market success of these products. If one or more of the product lines were to fail in the market, it could have an adverse effect on our business.

*We are concentrating our R&D investments.* As an increasing percentage of our R&D and marketing budget is devoted to potential growth areas, including the SGI Altix family, visualization and storage, a declining amount both in percentage and absolute terms is being devoted to the traditional MIPS® and IRIX products, which continue to supply the bulk of our revenue. Managing this transition without unduly compromising the competitiveness of the MIPS and IRIX family and the quality of support received by customers will be key to our success. There can be no assurance that this transition will not impair our customer relationships and our competitive position.

*We have been incurring losses and consuming cash in our operations and must reverse these trends and generate cash from other sources in fiscal 2004.* We have incurred net losses and negative cash flows from operations during each of the past several fiscal years. At December 26, 2003, our principal sources of liquidity included unrestricted cash and marketable investments of \$109 million, down from \$141 million at June 27, 2003. We expect to continue to consume cash from operations in the third quarter of fiscal 2004. Due to the significant intra-quarter fluctuations in our cash levels that result from timing differences between our payments to vendors and our collections from customers, our cash levels tend to be at their highest at the end of the quarter. As a result, we continue to focus on expense controls and working capital efficiencies to maintain adequate cash levels. We also are exploring alternatives for generating cash through financing transactions and dispositions of non-core assets and will consider a range of alternatives in the event of a material revenue shortfall. See Financial Condition. If we fail to reduce the cash consumption from operations and to generate cash from these other sources on a timely basis, or if the cash requirements of our business change as the result of changes in terms from vendors or other causes, we could no longer have the cash resources required to run our business.

*We may not be able to obtain additional capital when needed.* We have an asset-based credit facility that may be declared to be in default if we fail to meet certain financial and other covenants. This facility matures in April 2005, subject to

acceleration upon various events of default. The facility is secured by our U.S. and Canadian accounts receivable, U.S. inventory and equipment, the pledge of certain intellectual property and \$10 million cash collateral. We also deposit additional cash when eligible accounts receivable and other collateral, which fluctuate within the quarter, are below the level needed to secure our letters of credit. At December 26, 2003, this facility was secured by a total of \$25 million cash collateral. During the second quarter of fiscal 2004 we had a violation of a covenant that was administrative in nature for which we received a waiver of compliance. We also obtained waivers of compliance with the covenants of the facility from the lenders in the first, third and fourth quarters of fiscal 2003. If we are not able to comply with the financial and other covenants of this facility or there is a material adverse change impairing our ability to repay the outstanding balance, the facility may be declared to be in default. If a default is declared and not waived or if the facility matures and is not renewed, we may not be able to obtain alternative sources of financing on acceptable terms.

In the future, we may need to obtain additional financing to fund our business or repay our debt, and there can be no assurance that financing will be available in amounts or on terms acceptable to us. In addition, if funds are raised through further incurrence of debt, our operations and finances may become subject to further restrictions and we may be required to limit our service or product development activities or other operations, or otherwise modify our business strategy. If we obtain additional funds by selling any of our equity securities or if we issue equity derivative securities in connection with obtaining debt financing, the percentage ownership of our stockholders will be reduced, stockholders may experience additional dilution, or the equity securities may have rights, preferences or privileges senior to the common stock.

*We may become involved in intellectual property disputes.* We routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or may seek to obtain a license. We are in discussions with several parties that have asserted intellectual property infringement claims. In any given case there is a risk that a license will not be available on terms that we consider reasonable, or that litigation will ensue. We expect that, as the number of hardware and software patents issued continues to increase, and as competition in the markets we address intensifies, the volume of these intellectual property claims will also increase.

In addition, our increasing visibility as a supplier of Linux-based systems and as a participant in the open source software community increases our risk of becoming embroiled in the intellectual property disputes concerning these subjects, such as the current widely reported litigations between SCO Group on the one hand and IBM and Red Hat on the other. We recently received a notice from SCO Group stating its intention to terminate our fully paid license to certain UNIX operating system-related code, under which we distribute our IRIX operating system, on the basis that we have breached the

terms of such license. We believe that the SCO Group's allegations are without merit and that our fully paid license is non-terminable. Nonetheless, there can be no assurance that this dispute with SCO Group will not escalate into litigation, which could have a material adverse effect on SGI, or that SCO Group's intellectual property claims will not impair the market acceptance of the Linux operating system.

***We are increasingly dependent on partners and suppliers.*** Our business has always involved close collaboration with partners and suppliers. However, many elements of our current business strategy, including the recent addition of scalable servers based on Itanium 2 processors and the Linux operating system, will increase our dependence on Intel and other partners, and on our manufacturing partners and other component suppliers. Our business could be adversely affected, for example, if Intel fails to meet product release schedules, if we experience supply constraints, or if we experience any other interruption or delay in the supply chain. The competitiveness of our system products, particularly our servers, is significantly affected by the availability on our platform of third-party software applications that are important to customers in our target markets. Our ability to work with our software partners to ensure porting of these applications to our IRIX operating system and to Linux is a key factor to our business success.

***We are dependent on sales to the U.S. government.*** A significant portion of our revenue is derived from sales to the U.S. government, either directly by us or through system integrators and other resellers. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruptions due to appropriation and spending patterns. The U.S. government can typically terminate or modify its contracts with us at any time for its convenience. Any disruption or limitation in our ability to do business with the U.S. Government could have an adverse impact on SGI.

A portion of our business requires security clearances from the U.S. government. We have implemented measures to maintain our clearances in light of the fact that our Chairman and Chief Executive Officer, Robert Bishop, is an Australian citizen. These arrangements are subject to periodic review by customer agencies and the Defense Security Service of the Department of Defense.

***Our business experiences period-to-period fluctuations in operating results.*** Our operating results may fluctuate for a number of reasons. Delivery cycles, other than those for large-scale server products, are typically short. Over half of each quarter's product revenue results from orders booked and shipped during the third month, and disproportionately in the latter half of that month. These factors make the forecasting of revenue inherently uncertain. Because we plan our operating expenses, many of which are relatively fixed in the short term, on expected revenue, even a relatively small revenue shortfall may cause a period's results to be substantially below expectations. Such a revenue shortfall could arise from any number of factors, including lower than expected demand, supply constraints, delays in the availability of new products, transit interruptions, overall economic conditions, military or terrorist actions, or natural disasters. Demand can also be adversely affected by concerns specifically associated with our financial health and by product and technology transition announcements by SGI or our competitors. The timing of customer acceptance of certain large-scale server products may also have a significant effect on periodic operating results. Margins are heavily influenced by revenue levels, mix considerations, including geographic concentrations, the mix of product and service revenue, and the mix of server and desktop product revenue as well as the mix of configurations within these product categories.

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The present global economic uncertainty has impacted the timing of buying decisions of our customers. Unless and until the global economic environment becomes more positive it will be difficult for us to experience growth in revenue.

*Many of our international sales require export licenses.* Our sales to foreign customers are subject to export regulations. Sales of many of our high-end products require clearance and export licenses from the U.S. Department of Commerce under these regulations. Our international sales would be adversely affected if such regulations were tightened, or if they are not modified over time to reflect the increasing performance of our products.

The Swiss authorities are investigating compliance with their export regulations in connection with exports from the Swiss manufacturing facility that was closed during the second quarter of fiscal 2002. We believe that this matter will be resolved without a significant adverse effect on our business, operating results or financial condition.

*We may not be able to develop and introduce new products on a timely basis.* Meeting our objectives for the future will require that our recently introduced products achieve success in the marketplace and that we succeed in the timely development and introduction of more successful new products. Product transitions are a recurring part of our business. A number of risks are inherent in this process.

The development of new technology and products is increasingly complex and uncertain, which increases the risk of delays. The introduction of new computer systems requires close collaboration and continued technological advancement involving multiple hardware and software design teams, internal manufacturing teams, outside suppliers of key components such as semiconductors and outsource manufacturing partners. The failure of any one of these elements could cause our products under development to fail to meet specifications or to miss the aggressive timetables that we establish. There is no assurance that development or acceptance of our new systems will not be affected by delays in this process.

Short product life cycles place a premium on our ability to manage the transition to new products. We often announce new products in the early part of a quarter while the product is in the final stages of development and testing, and seek to manufacture and ship the product in volume during the same quarter. Our results could be adversely affected by such factors as development delays, the release of products to manufacturing late in any

quarter, quality or yield problems experienced by suppliers, variations in product costs and excess inventories of older products and components. In addition, some customers may delay purchasing existing products in anticipation of new product introductions.

Most products are upgraded during their product life cycle. The ability to upgrade products in a timely fashion is necessary to compete in the computer industry. Delay in introducing updates and upgrades can adversely affect acceptance and demand for product.

***Downward fluctuations in the price of our common stock may cause our common stock to be delisted.*** On October 24, 2002 we were notified by the New York Stock Exchange that we were not in compliance with its requirement that listed securities trade at a minimum per share price of \$1.00 averaged over a thirty day trading period. Our stock price subsequently increased to more than \$1.00, but if it were to decline again and not recover, the NYSE could terminate the listing of our common stock. As of February 3, 2004, the 30-day trading average of our stock was \$2.25. Declines in the price of our common stock may be caused by our failure to meet the investment community's expectations for quarterly revenue or earnings or by broader market trends unrelated to our performance. Delisting would adversely affect the liquidity and market price of our common stock.

***We operate in a highly competitive industry.*** The computer industry is highly competitive, with rapid technological advances and constantly improving price/performance. Most of our competitors have substantially greater technical, marketing and financial resources. They also generally have a larger installed base of customers and a wider range of available applications software. Competition may result in significant discounting and lower gross margins.

***We may not be able to retain and attract qualified employees.*** Our success depends on our ability to continue to attract, retain and motivate highly qualified technical, sales and marketing and management personnel. The uncertainties surrounding our business prospects and our continuing restructuring actions have increased the challenges of retaining world-class talent. We implemented further restructuring actions during fiscal 2003 and the first quarter of fiscal 2004. As we continue to work through the turnaround process, there is no guarantee that we will not lose highly qualified employees or that we will be able to hire highly qualified candidates, as new skills are needed.

***We may not be able to utilize a significant portion of our net operating loss and credit carryforwards.*** We have generated a significant amount of net operating loss carryforwards due to prior period losses. U.S. and State income tax laws limit the amount of these carryforwards a company can utilize upon a greater than 50% cumulative shift of stock ownership over a three year period. The issuance of additional common stock, in financing transactions or on conversion of our outstanding convertible bonds such as the 2009 Senior Convertible Notes issued in December 2003, will count towards this cumulative ownership shift. There is a risk that our ability to use our existing carryforwards in the future could be limited, and not available to offset income tax liabilities from future profits. This would have an effect on our cash balances and liquidity, but would not reduce our income after taxes since any affected loss and credit carryforwards have been subjected to a valuation allowance in prior periods.

*Our business is subject to market risk.* In the normal course of business, our financial position is routinely subjected to a variety of risks, including market risk associated with interest rate movements and currency rate movements on non-U.S. dollar denominated assets and liabilities, as well as collectibility of accounts receivable. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, we do not anticipate material losses in these areas.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

The information required under this Item 3 is included in the section above entitled *Our Business is Subject to Market Risk* and should be read in connection with the information on market risk related to changes in interest rates and non-U.S. currency exchange rates in Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended June 27, 2003.

**Item 4. Controls and Procedures.**

(a) *Evaluation of disclosure controls and procedures.* Our chief executive officer and our chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15-d-14(c)) as of December 26, 2003 (the *Evaluation Date*), have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiaries would be made known to them by others within those entities.

(b) *Changes in internal controls.* There were no significant changes in our internal controls or, to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

In June 2002, we reached an agreement to resolve the claims asserted in a lawsuit originally filed as *Collette Sweeney v. Silicon Graphics, Inc. and Does 1-50, inclusive, CV 790199*, on June 5, 2000 in the Superior Court for the County of Santa Clara, State of California, and later dismissed by the plaintiffs but refiled as a representative action under California Business and Professions Code section 17200 by the plaintiffs original counsel. The lawsuit asserts claims for violations of provisions of the California Labor Code and California Wage Orders. The settlement agreement outlines a process for identifying and resolving claims from members of the represented class. Once this process is complete, the complaint will be dismissed. We currently expect to complete this process in fiscal 2004. However, we do not expect all claims to be resolved through this process.



In October 2002, the Internal Revenue Service completed its examination of our U.S. income tax returns for fiscal years ended 1996 through

1999 and proposed certain adjustments. We are contesting these adjustments and believe that adequate amounts have been provided for adjustments that may ultimately result from these examinations.

SCO Group, the successor to AT&T as the owner of certain UNIX system V intellectual property and as our licensor has publicly claimed that certain elements of the Linux operating system infringe SCO Group's intellectual property rights. We have received a letter from SCO Group alleging that, as a result of our activities related to the Linux operating system, we are in breach of the fully paid license under which we distribute our IRIX operating system. The letter purports to terminate our UNIX System V license effective October 14, 2003.

We believe that the SCO Group's allegations are without merit and that our fully paid license is non-terminable. There can be no assurance that this dispute with SCO Group will not escalate into litigation, which could have a material adverse effect upon SGI, or that SCO Group's intellectual property claims, which include a widely-publicized litigation against IBM Corporation, will not impair the market acceptance of the Linux operating system.

On September 30, 2003, a lawsuit captioned *FuzzySharp Technologies Incorporated v. Silicon Graphics, Inc.* alleging patent infringement by an SGI workstation product was filed by FuzzySharp in the United States District Court for the Northern District of California, Civil Action No. C 03-4404 JCS. SGI is aggressively defending this action.

We also routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or we may seek to obtain a license. We are in discussions with several parties that have asserted intellectual property infringement claims. There can be no assurance in any given case that a license will be available on terms we consider reasonable, or that litigation will not ensue.

We are not aware of any pending disputes, including those described above that would be likely to have a material adverse effect on our financial condition, results of operations or liquidity. However, our evaluation of the likely impact of these pending disputes could change in the future.

**Item 4. Submission of Matters to a Vote of Security Holders.**

(a) SGI held its Annual Meeting of Stockholders on December 16, 2003. Proxies for the meeting were solicited pursuant to Regulation 14A.

(b) SGI's Board of Directors is divided into three classes serving staggered terms of office. Accordingly, not all Directors are elected at each Annual Meeting of Stockholders. James A. McDivitt, Arthur L. Money and Anthony R. Muller were re-elected as Directors at the meeting. The Directors whose terms of office continued after the meeting are Lewis S. Edelheit, Charles A. Steinberg, Robert M. White and Robert R. Bishop.

(c) The matters described below were voted on at the Annual Meeting of Stockholders, and the number of votes cast with respect to each matter and, with respect to the election of directors, were as indicated.

1. To elect three Class II Directors, each for a three-year term.

**Class II Directors**

James A. McDivitt:	For: 168,949,442	Withheld: 13,059,601
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Arthur L. Money:	For: 169,180,289	Withheld: 12,828,754
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Anthony R. Muller:	For: 168,432,449	Withheld: 13,576,594
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2. To approve an increase in the number of shares reserved for issuance under the 1998 Employee Stock Purchase Plan.

For: 62,283,429	Against: 11,244,609	Abstain: 241,023	No Vote: 107,939,982
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3. To approve the issuance of up to 185,000,000 additional shares of common stock in connection with our exchange offer or other refinancing of our 5.25% Senior Convertible Notes due 2004.

For: 61,282,430	Against: 12,326,958	Abstain: 459,673	No Vote: 107,939,982
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4. To approve an amendment to our certificate of incorporation to increase the number of authorized shares of common stock from 500,00,000 to 750,000,000.

For: 161,154,620      Against: 20,426,493      Abstain: 427,930

5. To ratify the appointment of Ernst & Young LLP, as independent auditors of SGI for the fiscal year ending June 25, 2004.

For: 174,600,249      Against: 6,830,756      Abstain: 578,038

**Item 6. Exhibits and Reports on Form 8-K.**

(a) Exhibits.

10.25 Amendment dated November 11, 2003, to the Amended and Restated Loan and Security between the Company and Foothill Capital Corporation and the Bank of America, N.A. dated September 20, 2002.

10.26 Amendment dated February 3, 2004, to the Amended and Restated Loan and Security between the Company and Foothill Capital Corporation and the Bank of America, N.A. dated September 20, 2002.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Robert R. Bishop and Jeffrey V. Zellmer.

(b) Reports on Form 8-K.

A Form 8-K was filed on December 17, 2003 reporting the Company's announcement of its new corporate headquarters and reporting the results of the Company's annual shareholders' meeting held on December 16, 2003.



**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.

Dated: February 6, 2004

SILICON GRAPHICS, INC.  
a Delaware corporation

By:

/s/ Jeffrey Zellmer  
Jeffrey Zellmer  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

By:

/s/ Kathy Lanterman  
Kathy Lanterman  
Vice President and Corporate Controller  
(Principal Accounting Officer)