

STORAGE TECHNOLOGY CORP  
Form 10-Q  
November 10, 2003

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 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 1-7534

**STORAGE TECHNOLOGY CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**84-0593263**  
(I.R.S. Employer  
Identification Number)

**One StorageTek Drive, Louisville, Colorado**  
(Address of principal executive offices)

**80028-4309**  
(Zip Code)

Registrant's telephone number, including area code **303-673-5151**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).  Yes  No

The registrant had 110,625,078 shares of common stock outstanding as of November 3, 2003.

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**STORAGE TECHNOLOGY CORPORATION**  
**INDEX TO FORM 10-Q**  
**September 26, 2003**

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**STORAGE TECHNOLOGY CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
**(In Thousands, Except Share Amounts)**

	<u>09/26/03</u>	<u>12/27/02</u>
	<u>(unaudited)</u>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 888,204	\$ 657,599
Short-term investments	9,950	--
Accounts receivable	474,175	566,863
Inventories	115,258	133,275
Deferred income tax assets	116,217	99,246
Other current assets	3,572	7,256
Total current assets	1,607,376	1,464,239
Long-term investments	29,873	--
Property, plant, and equipment	214,165	240,021
Spare parts for maintenance	45,437	39,346
Deferred income tax assets	103,060	114,002
Other assets	118,460	118,532

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	09/26/03	12/27/02
	<u>          </u>	<u>          </u>
Total assets	\$ 2,118,371	\$ 1,976,140
	<u>          </u>	<u>          </u>
<b>LIABILITIES</b>		
Current liabilities:		
Current portion of long-term debt	\$ 1,015	\$ 773
Accounts payable	111,556	135,348
Accrued liabilities	429,125	421,511
Income taxes payable	229,703	215,240
Other current liabilities	51,725	35,144
	<u>          </u>	<u>          </u>
Total current liabilities	823,124	808,016
Long-term debt	10,576	10,361
	<u>          </u>	<u>          </u>
Total liabilities	833,700	818,377
	<u>          </u>	<u>          </u>
Commitments and Contingencies (Note 5)		
<b>STOCKHOLDERS EQUITY</b>		
Common stock, \$0.10 par value, 300,000,000 shares authorized; 110,387,783 shares issued at September 26, 2003, and 106,849,329 shares issued at December 27, 2002	11,039	10,685
Capital in excess of par value	975,275	908,100
Retained earnings	337,727	260,160
Accumulated other comprehensive loss	(19,020)	(9,584)
Treasury stock, 268,238 shares at September 26, 2003, and 238,276 shares at December 27, 2002, at cost	(5,142)	(4,444)
Unearned compensation	(15,208)	(7,154)
	<u>          </u>	<u>          </u>
Total stockholders equity	1,284,671	1,157,763
	<u>          </u>	<u>          </u>
Total liabilities and stockholders equity	\$ 2,118,371	\$ 1,976,140
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of the consolidated financial statements.

**STORAGE TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(In Thousands, Except Per Share Amounts)

	Quarter Ended		Nine Months Ended	
	09/26/03	09/27/02	09/26/03	09/27/02
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Revenue:				
Storage products	\$ 312,435	\$ 307,335	\$ 906,844	\$ 889,379
Storage services	207,825	194,370	620,634	560,167
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total revenue	520,260	501,705	1,527,478	1,449,546
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
<b>Cost of revenue:</b>				
Storage products	164,285	166,719	486,774	497,027
Storage services	118,907	106,801	353,211	311,096
	<u>283,192</u>	<u>273,520</u>	<u>839,985</u>	<u>808,123</u>
Total cost of revenue				
Gross profit	237,068	228,185	687,493	641,423
Research and product development costs	49,803	53,354	150,786	162,385
Selling, general, and administrative expense	145,028	141,958	432,051	412,952
	<u>42,237</u>	<u>32,873</u>	<u>104,656</u>	<u>66,086</u>
Operating profit				
Interest income	2,556	2,837	7,564	7,439
Interest expense	(486)	(540)	(1,353)	(1,568)
	<u>44,307</u>	<u>35,170</u>	<u>110,867</u>	<u>71,957</u>
Income before income taxes				
Provision for income taxes	(13,300)	(11,300)	(33,300)	(23,000)
	<u>\$ 31,007</u>	<u>\$ 23,870</u>	<u>\$ 77,567</u>	<u>\$ 48,957</u>
Net income				

**EARNINGS PER COMMON SHARE**

Basic earnings per common share	\$ 0.29	\$ 0.23	\$ 0.72	\$ 0.47
	<u>108,612</u>	<u>105,268</u>	<u>107,652</u>	<u>104,903</u>
Weighted-average shares				
Diluted earnings per common share	\$ 0.28	\$ 0.22	\$ 0.70	\$ 0.46
	<u>111,502</u>	<u>107,121</u>	<u>110,273</u>	<u>107,360</u>
Weighted-average and dilutive potential shares				

The accompanying notes are an integral part of the consolidated financial statements.

**STORAGE TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(In Thousands)

	<u>Nine Months Ended</u>	
	<u>09/26/03</u>	<u>09/27/02</u>
<b>OPERATING ACTIVITIES</b>		
Cash received from customers	\$ 1,649,037	\$ 1,465,480
Cash paid to suppliers and employees	(1,395,623)	(1,202,442)
Interest received	7,123	7,078
Interest paid	(960)	(1,288)
Income tax paid	(9,461)	(11,229)
	<u>                    </u>	<u>                    </u>

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	Nine Months Ended	
	Quarter Ended	Nine Months Ended
Net cash provided by operating activities	250,116	257,599
<b>INVESTING ACTIVITIES</b>		
Purchases of investments	(39,703)	--
Purchases of property, plant, and equipment	(31,844)	(83,003)
Proceeds from sale of property, plant, and equipment	3,746	354
Other assets	1,045	(14,321)
Net cash used in investing activities	(66,756)	(96,970)
<b>FINANCING ACTIVITIES</b>		
Repayments of credit facilities, net	--	(73,401)
Proceeds from employee stock plans	45,549	14,280
Proceeds from other debt	676	1,166
Repayments of other debt	(1,382)	(1,868)
Net cash provided by (used in) financing activities	44,843	(59,823)
Effect of exchange rate changes on cash	2,402	(4,066)
Increase in cash and cash equivalents	230,605	96,740
Cash and cash equivalents - beginning of the period	657,599	453,217
Cash and cash equivalents - end of the period	\$ 888,204	\$ 549,957
<b>RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES</b>		
Net income	\$ 77,567	\$ 48,957
Depreciation and amortization expense	64,760	70,501
Inventory writedowns	18,565	28,996
Translation (gain) loss	21,990	(461)
Other non-cash adjustments to income	(20,307)	17,433
Decrease in accounts receivable	121,559	15,934
Decrease in other current assets	7,758	531
(Increase) decrease in inventories	(3,087)	42,695
Increase in spare parts	(13,214)	(17,724)
(Increase) decrease in deferred income tax assets	(4,907)	993
Increase (decrease) in accounts payable	(26,246)	26,934
Increase (decrease) in accrued liabilities	(9,494)	8,938
Increase (decrease) in other current liabilities	(4,198)	3,694
Increase in income taxes payable	19,370	10,178
Net cash provided by operating activities	\$ 250,116	\$ 257,599

The accompanying notes are an integral part of the consolidated financial statements.

**STORAGE TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(Unaudited)  
(In Thousands)

Quarter Ended

Nine Months Ended

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	09/26/03	09/27/02	09/26/03	09/27/02
Net income	\$ 31,007	\$ 23,870	\$ 77,567	\$ 48,957
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on marketable securities:				
Holding gains (losses), net of tax (benefit) expense of \$(171), \$0, \$394, and \$0	(456)	--	861	--
Reclassification adjustment for net gains included in net income, net of tax expense of \$165, \$0, \$699, and \$0	(386)	--	(1,631)	--
Foreign currency hedging contracts:				
Net gains (losses) on foreign currency cash flow hedges, net of tax (benefit) expense of \$(7,719), \$322, \$(16,381), and \$(11,431)	(12,279)	516	(26,174)	(18,338)
Reclassification adjustment for net losses included in net income, net of tax benefit of \$6,580, \$3,402, \$10,969, and \$1,396	10,467	5,457	17,508	2,240
Other comprehensive income (loss), net of tax	(2,654)	5,973	(9,436)	(16,098)
Comprehensive income	\$ 28,353	\$ 29,843	\$ 68,131	\$ 32,859

The accompanying notes are an integral part of the consolidated financial statements.

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**STORAGE TECHNOLOGY CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**NOTE 1 BASIS OF PREPARATION**

The accompanying interim consolidated financial statements of Storage Technology Corporation and its wholly owned subsidiaries (StorageTek or the Company) have been prepared on substantially the same basis as the Company's annual consolidated financial statements and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 27, 2002. In the opinion of management, the interim consolidated financial statements reflect all adjustments necessary for the fair presentation of results for the periods presented, and such adjustments are of a normal, recurring nature. Certain prior year amounts have been reclassified to conform to the current year presentation.

The consolidated results for interim periods are not necessarily indicative of expected results for the full fiscal year.

**NOTE 2 STOCK-BASED COMPENSATION PLANS**

The Company accounts for stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Stock-based compensation cost related to restricted stock is reflected in net income. No stock-based compensation cost related to stock options is reflected in net income, as all options granted under those plans have 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 income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based compensation (in thousands, except per share amounts):

Quarter Ended                      Nine Months Ended

**NOTE 2 STOCK-BASED COMPENSATION PLANS**

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	<u>09/26/03</u>	<u>09/27/02</u>	<u>09/26/03</u>	<u>09/27/02</u>
Net income, as reported	\$ 31,007	\$ 23,870	\$ 77,567	\$ 48,957
Add: Stock-based compensation expense included in reported net income, net of related tax effects	1,143	592	3,061	1,666
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(5,275)	(5,614)	(16,105)	(17,499)
Pro forma net income	<u>\$ 26,875</u>	<u>\$ 18,848</u>	<u>\$ 64,523</u>	<u>\$ 33,124</u>
Earnings per share:				
Basic, as reported	\$ 0.29	\$ 0.23	\$ 0.72	\$ 0.47
Basic, pro forma	\$ 0.25	\$ 0.18	\$ 0.60	\$ 0.32
Diluted, as reported	\$ 0.28	\$ 0.22	\$ 0.70	\$ 0.46
Diluted, pro forma	\$ 0.25	\$ 0.17	\$ 0.60	\$ 0.31

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**NOTE 3 INVESTMENTS**

Short- and long-term investments consist of the following available-for-sale securities as of September 26, 2003 (in thousands):

	<u>Amortized Cost</u>	<u>Unrealized Holding Gains</u>	<u>Estimated Fair Value</u>
U.S. Government and agency securities	\$ 35,619	\$ 114	\$ 35,733
Corporate securities	4,080	10	4,090
	<u>\$ 39,699</u>	<u>\$ 124</u>	<u>\$ 39,823</u>

The Company's short- and long-term investments, which consist of marketable debt securities, have been classified as available-for-sale securities and recorded at estimated fair value based on quoted market prices. Unrealized gains and losses on these investments are reported, net of tax, as a component of accumulated other comprehensive income (loss). Securities with original maturities of greater than three months and less than one year are classified as short-term investments. Securities with original maturities greater than one year are classified as long-term investments.

Amortized cost is determined based on specific identification. Interest earned on investments is included in interest income. There were no realized gains or losses on sales of short- or long-term investments for the third quarter or nine months ended September 26, 2003 and September 27, 2002.

The following table summarizes the amortized cost and estimated fair value of debt securities by contractual maturity as of September 26, 2003 (in thousands):

	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Due within one year	\$ 9,949	\$ 9,950
Due after one year through three years	29,750	29,873
	<u>\$ 39,699</u>	<u>\$ 39,823</u>

**NOTE 3 INVESTMENTS**

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**NOTE 4 INVENTORIES**

Inventories, net of associated reserves, consist of the following (in thousands):

	09/26/03	12/27/02
Raw materials	\$ 23,973	\$ 22,095
Work-in-process	24,920	40,344
Finished goods	66,365	70,836
	\$ 115,258	\$ 133,275

**NOTE 5 LITIGATION**

The Company is involved in a number of pending legal proceedings that arise from time to time in the ordinary course of business. Management believes that any liability as a result of adverse outcomes in such proceedings would not have a material adverse effect on the financial condition of the Company taken as a whole. However, the outcome of these actions is inherently difficult to predict. In the event of an adverse outcome, the ultimate potential loss could have a material adverse effect on the Company's financial condition or reported results of operations in a particular quarter. An unfavorable decision, particularly in patent litigation, could require material changes in production processes and products or result in the Company's inability to ship products or components found to have violated third-party patent rights.

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**NOTE 6 FINANCING ARRANGEMENTS**

Effective July 31, 2003, the Company reduced its existing \$150.0 million revolving credit facility (the Revolver) to \$75.0 million. The Revolver expires in October 2004. The interest rates for borrowing under the Revolver are dependent on the Company's Total Debt to rolling four quarter Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA) ratio and the term of the outstanding borrowing. The rate ranges from the applicable LIBOR plus 1.75% to 2.50% or the agent bank's base rate plus 0.00% to 0.50%. The Company pays a 0.50% per annum commitment fee on any unused borrowings. The Company had no outstanding borrowings under the Revolver as of September 26, 2003. The Revolver is secured by the Company's U.S. accounts receivable and U.S. inventory, and contains certain financial and other covenants, including restrictions on the payment of cash dividends on the Company's common stock.

**NOTE 7 OPERATIONS OF BUSINESS SEGMENTS**

The Company is organized into two reportable business segments based on the definitions provided in SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information": storage products and storage services. The storage products segment includes sales of tape, disk, network, and other miscellaneous products. The storage services segment includes maintenance and support services, as well as professional services.

The Company does not have any intersegment revenue, and segment operating performance is evaluated based on gross profit. The aggregate gross profit by segment equals the consolidated gross profit, and the Company does not allocate research and product development costs; selling, general, and administrative expense; interest income; interest expense; or benefit (provision) for income taxes to the segments. The following table shows revenue and gross profit by segment (in thousands):

	Quarter Ended		Nine Months Ended	
	09/26/03	09/27/02	09/26/03	09/27/02
Revenue:				
Storage products	\$ 312,435	\$ 307,335	\$ 906,844	\$ 889,379
Storage services	207,825	194,370	620,634	560,167
Total revenue	\$ 520,260	\$ 501,705	\$ 1,527,478	\$ 1,449,546

**NOTE 7 OPERATIONS OF BUSINESS SEGMENTS**

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	Quarter Ended		Nine Months Ended	
Gross profit:				
Storage products	\$ 148,150	\$ 140,616	\$ 420,070	\$ 392,352
Storage services	88,918	87,569	267,423	249,071
Total gross profit	\$ 237,068	\$ 228,185	\$ 687,493	\$ 641,423

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The following table provides supplemental financial data regarding revenue from the Company's storage products segment (in thousands):

	Quarter Ended		Nine Months Ended	
	09/26/03	09/27/02	09/26/03	09/27/02
Tape products	\$ 240,729	\$ 239,736	\$ 692,302	\$ 702,500
Disk products	38,074	33,309	117,487	88,570
Network products	23,776	24,851	65,852	61,616
Other	9,856	9,439	31,203	36,693
Total storage products revenue	\$ 312,435	\$ 307,335	\$ 906,844	\$ 889,379

**NOTE 8 EARNINGS PER COMMON SHARE**

The following table presents the calculation of basic and diluted earnings per share (in thousands, except per share amounts):

	Quarter Ended		Nine Months Ended	
	09/26/03	09/27/02	09/26/03	09/27/02
Net income	\$ 31,007	\$ 23,870	\$ 77,567	\$ 48,957
Weighted average common shares outstanding:				
Basic	108,612	105,268	107,652	104,903
Effect of dilutive common stock equivalents	2,890	1,853	2,621	2,457
Diluted	111,502	107,121	110,273	107,360
Earnings per common share:				
Basic	\$ 0.29	\$ 0.23	\$ 0.72	\$ 0.47
Diluted	\$ 0.28	\$ 0.22	\$ 0.70	\$ 0.46

For the quarters ended September 26, 2003, and September 27, 2002, options to purchase 401,785 and 7,239,457 shares of common stock, respectively, were excluded from the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the Company's common stock, and therefore, the effect would have been antidilutive. For the nine months ended September 26, 2003, and September 27, 2002, options to purchase 1,146,145 and 5,352,769 shares of common stock, respectively, were excluded from the computation of diluted earnings per share for the same reason.

**NOTE 9 INDEMNIFICATIONS AND WARRANTIES**

Financial Accounting Standards Board (FASB) Interpretation No. 45 (FIN 45), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, requires that a liability be recorded in the guarantor's balance sheet upon issuance of certain guarantees. FIN 45 also requires additional disclosures about the guarantees an entity has issued, including a rollforward of the entity's product warranty liabilities.

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In the normal course of business, the Company is party to a variety of agreements under which it may be obligated to indemnify the other party for certain matters. These obligations typically arise in contracts where the Company customarily agrees to hold the other party harmless against losses arising from a breach of representations or covenants for certain matters such as title to assets and intellectual property rights associated with the sale of products. The Company also has indemnification obligations to its officers and directors. The duration of these indemnifications varies, and in certain cases, is indefinite. In each of these circumstances, payment by the Company depends upon the other party making an adverse claim according to the procedures outlined in the particular agreement, which procedures generally allow the Company to challenge the other party's claims. In certain instances, the Company may have recourse against third parties for payments made by the Company.

The Company is unable to reasonably estimate the maximum potential amount of future payments under these or similar agreements due to the unique facts and circumstances of each agreement and the fact that certain indemnifications provide for no limitation to the maximum potential future payments under the indemnification. The Company has not recorded any liability for these indemnifications in the accompanying consolidated balance sheets; however, the Company does accrue losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is both probable and reasonably estimable.

The Company provides warranties associated with the sale of its products. The Company's standard product warranties provide for the repair or replacement of products that fail to meet their published specifications. In situations where a product fails its essential purpose to the customer, the Company may also be responsible for refunding the purchase price of the product if the Company cannot remedy the product failure. The Company establishes a warranty liability for the estimated cost of warranty-related claims at the time revenue is recognized. The following table summarizes information related to the Company's warranty reserves (in thousands):

	Nine Months Ended	
	09/26/03	09/27/02
Balance at beginning of period	\$ 41,155	\$ 34,242
Accruals for warranties issued	33,462	30,280
Adjustments to warranties	5,432	1,498
Amortization	(35,447)	(29,637)
Balance at end of period	\$ 44,602	\$ 36,383

**NOTE 10 RECENT ACCOUNTING PRONOUNCEMENTS**

In November 2002, the Emerging Issues Task Force (EITF) issued EITF Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 addresses how to determine whether a revenue arrangement involving multiple deliverables contains more than one unit of accounting for the purposes of revenue recognition and how the revenue arrangement consideration should be measured and allocated to the separate units of accounting. EITF Issue No. 00-21 applies to all revenue arrangements that the Company enters into after June 27, 2003. The adoption of this statement did not have a material impact on the Company's financial condition or results of operations.

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 provides guidance on how to identify a variable interest entity (VIE) and determine when the assets, liabilities, and results of operations of a VIE need to be included in a company's consolidated financial statements. FIN 46 also requires additional disclosures by primary beneficiaries and other significant variable interest holders in a VIE. The provisions of FIN 46 are effective immediately for all VIEs created after January 31, 2003. For VIEs created before February 1, 2003, the provisions of FIN 46 must be adopted at the beginning of the first interim or annual reporting period beginning after June 15, 2003. The adoption of this statement did not have a material impact on the Company's financial condition or results of operations.

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In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement did not have a material impact on the Company's financial condition or results of operations.

In May 2003, the EITF reached consensus on Issue No. 01-8, Determining Whether an Arrangement Contains a Lease. The FASB ratified this consensus in May 2003. EITF Issue No. 01-8 provides guidance on how to identify a lease in an arrangement that also provides for the delivery of other goods or services by the seller (lessor), such as outsourcing arrangements. The provisions of EITF Issue No. 01-8 apply to arrangements entered into or modified after June 28, 2003, the beginning of the first reporting period after May 28, 2003. The adoption of this statement did not have a material impact on the Company's financial condition or results of operations.

In May 2003, the EITF reached a consensus on Issue No. 03-5, Applicability of AICPA Statement of Position (SOP) 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software. The FASB ratified this consensus in August 2003. EITF Issue No. 03-5 affirms that the revenue recognition guidance in SOP 97-2 applies to non-software deliverables, such as computer hardware, in an arrangement if the software is essential to the functionality of the non-software deliverables. The Company is required to adopt EITF Issue No. 03-5 in the fourth quarter of 2003. The adoption of EITF Issue No. 03-5 is not anticipated to have a material impact on the Company's financial condition or results of operations.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### FORWARD-LOOKING STATEMENTS

All assumptions, anticipations, expectations, and forecasts contained in the following discussion regarding our business, future products, business plans, financial results, performance, and future events are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Our actual results may differ materially because of a number of risks and uncertainties. Some of these risks are detailed below in FACTORS THAT MAY AFFECT FUTURE RESULTS and elsewhere in this Form 10-Q. Forward-looking statements can be identified by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, or other comparable words, the negative of such terms, or other comparable words. Forward-looking statements also include the assumptions underlying or relating to any such statements. The forward-looking statements contained in this Form 10-Q represent a good-faith assessment of our future performance for which management believes there is a reasonable basis. We disclaim any obligation to update the forward-looking statements contained herein, except as may be otherwise required by law.

### BUSINESS SEGMENTS SUMMARY (in thousands, except percentages)

	Quarter Ended		Nine Months Ended	
	09/26/03	09/27/02	09/26/03	09/27/02
<b>Revenue</b>				
Storage products	\$ 312,435	\$ 307,335	\$ 906,844	\$ 889,379
Storage services	207,825	194,370	620,634	560,167
Total revenue	<u>\$ 520,260</u>	<u>\$ 501,705</u>	<u>\$ 1,527,478</u>	<u>\$ 1,449,546</u>
<b>Cost of revenue</b>				
Storage products	\$ 164,285	\$ 166,719	\$ 486,774	\$ 497,027
Storage services	118,907	106,801	353,211	311,096
Total cost of revenue	<u>\$ 283,192</u>	<u>\$ 273,520</u>	<u>\$ 839,985</u>	<u>\$ 808,123</u>

BUSINESS SEGMENTS SUMMARY (in thousands, except percentages)

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	Quarter Ended		Nine Months Ended	
<b>Gross profit</b>				
Storage products	\$ 148,150	\$ 140,616	\$ 420,070	\$ 392,352
Storage services	88,918	87,569	267,423	249,071
Total gross profit	\$ 237,068	\$ 228,185	\$ 687,493	\$ 641,423
<b>Gross profit margin</b>				
Storage products	47.4%	45.8%	46.3%	44.1%
Storage services	42.8%	45.1%	43.1%	44.5%
Total gross profit margin	45.6%	45.5%	45.0%	44.3%
<b>Supplemental financial data - storage products revenue</b>				
Tape products	\$ 240,729	\$ 239,736	\$ 692,302	\$ 702,500
Disk products	38,074	33,309	117,487	88,570
Network products	23,776	24,851	65,852	61,616
Other	9,856	9,439	31,203	36,693
Total storage products revenue	\$ 312,435	\$ 307,335	\$ 906,844	\$ 889,379

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**THIRD QUARTER 2003 FINANCIAL OVERVIEW**

We increased revenue and earnings in the third quarter of 2003, compared to the third quarter of 2002, despite the continued weakness in the economies in Europe and the flat information technology spending environment. We continue to focus on providing our customers with integrated storage solutions that optimize their storage environments. We also continue to focus on reducing costs and expenses.

Our cash and investments increased from \$657.6 million as of December 27, 2002, to \$928.0 million as of September 26, 2003, a \$270.4 million increase. Our debt-to-capitalization ratio remains constant at 1%, and we continue to generate positive cash flows from operations.

**REVENUE AND GROSS PROFIT MARGIN**

Total revenue for the third quarter of 2003 was \$520.3 million, an increase of 4% compared to the same period in 2002. Total revenue for the nine months of 2003 was \$1.5 billion, an increase of 5% compared to the same period in 2002. These increases were primarily due to favorable foreign currency fluctuations, as well as increased revenue from storage services and disk products. Total gross profit margin for the third quarter of 2003 was 45.6%, basically unchanged compared to the same period in 2002. Total gross profit margin for the nine months of 2003 was 45.0%, an increase from 44.3% for the same period in 2002. These increases were primarily due to higher gross profit margins from the storage products segment.

**Storage Products**

Our storage products revenue primarily consists of sales of tape, disk, and network products, including related software, for the mainframe and open-systems markets. The open-systems market consists of products designed to operate in the UNIX, NT, and other non-MVS operating environments.

Storage products revenue increased 2% for both the third quarter and nine months of 2003, respectively, compared to the same periods in 2002, primarily due to an increase in disk product revenue. The increase in disk product revenue is primarily the result of an increase in the amount of storage capacity we sold, and reflects the continued strength of our open-systems disk offerings and incremental sales of our recently introduced disk product, Bladestore. Sales of open-systems tape products also contributed to the increase in product revenue. These increases were partially offset by decreased sales revenue from enterprise tape products. Storage products gross profit margin increased from 45.8% and 44.1% for the third quarter and nine months of 2002, respectively, to 47.4% and 46.3% for the same periods in 2003, primarily due to our efforts to reduce product costs and improve inventory management.

## **Storage Services**

Our storage services revenue primarily consists of revenue associated with the maintenance and support of StorageTek products and third-party storage products, as well as professional services revenue associated with various storage consulting activities.

Storage services revenue increased 7% and 11% during the third quarter and nine months of 2003, respectively, compared to the same periods in 2002. The growth in service revenue was driven by both increased maintenance and professional services revenue. Storage services gross profit margin decreased to 42.8% and 43.1% for the third quarter and nine months of 2003, respectively, from 45.1% and 44.5% for the same periods in 2002, primarily as a result of an increasing revenue contribution from professional services, which typically carry lower margins.

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## **RESEARCH AND PRODUCT DEVELOPMENT**

Research and product development costs decreased 7% during the third quarter and nine months of 2003, compared to the same periods in 2002. Research and product development costs as a percentage of revenue were 10% for the third quarter and nine months of 2003. This percentage compares to 11% for the third quarter and nine months of 2002. The decrease is primarily due to engineering initiatives designed to improve research and product development productivity, increase strategic alignment, and reduce non-essential spending. We continue to evaluate and prioritize research and product development programs to maximize our return on investment. Our research and product development activities focus on tape and disk products, virtual storage, storage area network (SAN) products, and related services.

## **SELLING, GENERAL, AND ADMINISTRATIVE EXPENSE**

Selling, general, and administrative expense (SG&A) increased 2% and 5% during the third quarter and nine months of 2003, respectively, compared to the same periods in 2002, primarily due to the unfavorable impacts of foreign currency movements on the operating expenses of our international operations. As a percentage of revenue, SG&A was basically unchanged from the third quarter and nine months of 2002. We are continuing our efforts to control discretionary spending and identify new opportunities to drive increased profitability. We continue to make investments in the sales and marketing areas of our business. These investments are principally focused on expanding sales coverage in the growing open-systems market.

## **INCOME TAXES**

Our effective tax rate was 30% for the third quarter and nine months of 2003, compared to 32% for the same periods in 2002. The decrease in the effective tax rate is primarily due to the continued realization of benefits associated with our global manufacturing and distribution strategy.

Statement of Financial Accounting Standards (SFAS) No. 109 requires that deferred income tax assets be recognized to the extent realization of such assets is more likely than not. Based on the currently available information, we have determined that we will more likely than not realize \$219.3 million of deferred income tax assets as of September 26, 2003. Our valuation allowance of approximately \$24.7 million as of September 26, 2003, relates principally to foreign net operating loss carryforwards.

## **CRITICAL ACCOUNTING POLICIES**

Our critical accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 27, 2002. We have made no changes to those policies during the nine months ended September 26, 2003.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

For information regarding recent accounting pronouncements, see Note 10 of NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, included in Item 1 of this Form 10-Q, which information is incorporated by reference into this Item 2.

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**LIQUIDITY AND CAPITAL RESOURCES**

**Internal Sources of Liquidity**

Our cash balance increased \$230.6 million during the nine months of 2003 primarily as a result of cash flows generated by our operations. Our operating activities provided cash of \$250.1 million during the nine months of 2003, basically unchanged compared to cash of \$257.6 million generated from operations during the same period in 2002. Cash used in investing activities decreased to \$66.8 million during the nine months of 2003 from \$97.0 million during the nine months of 2002. The decrease in cash used in investing activities is primarily due to a \$52.2 million payment for the purchase of equipment from Electronic Data Systems Corporation in 2002, partially offset by purchases of short- and long-term investments of \$39.7 million during the third quarter of 2003. Our financing activities provided \$44.8 million of cash during the nine months of 2003, primarily related to proceeds from employee stock plans. Cash used in financing activities was \$59.8 million during the nine months of 2002, primarily as a result of the repayment of borrowings under our credit facilities, partially offset by proceeds from employee stock plans.

We expect that cash flows from operations will continue to serve as our principal source of working capital. Cash flows from operations could be negatively impacted by a decrease in demand for our products and services as a result of rapid technological changes and other risks described under **FACTORS THAT MAY AFFECT FUTURE RESULTS**.

**External Sources of Liquidity**

Effective July 31, 2003, we reduced our existing \$150.0 million revolving credit facility (the Revolver) to \$75.0 million. The Revolver expires in October 2004. The interest rates for borrowing under the Revolver are dependent on our Total Debt to rolling four quarter Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA) ratio and the term of the outstanding borrowing. The rate ranges from the applicable LIBOR plus 1.75% to 2.50% or the agent bank's base rate plus 0.00% to 0.50%. We pay a 0.50% per annum commitment fee on any unused borrowings. We had no outstanding borrowings under the Revolver as of September 26, 2003. The Revolver is secured by our U.S. accounts receivable and U.S. inventory, and contains certain financial and other covenants, including restrictions on the payment of cash dividends on our common stock.

Our debt-to-capitalization ratio was 1% as of September 26, 2003. See **Internal Sources of Liquidity** above for a discussion of cash sources and uses.

**INTERNATIONAL OPERATIONS**

International operations accounted for approximately 51% and 53% of our revenue during the third quarter and nine months of 2003, respectively, compared to 48% and 49% during the same periods of 2002. We also sell products through U.S. indirect distribution channels that have end-user customers located outside the United States. We expect that we will continue to generate a significant portion of our revenue from international operations. See **We may be materially affected by the risks of conducting business outside the United States** under **FACTORS THAT MAY AFFECT FUTURE RESULTS** for a discussion of the risks associated with international operations.

The majority of our international operations involve transactions denominated in the local currencies of countries within western Europe, principally Germany, France, and the United Kingdom; Australia; Canada; Japan; and South Korea. An increase in the exchange value of the U.S. dollar reduces the value of revenue and profits generated by our international operations. As a result, our operating and financial results can be materially affected by fluctuations in foreign currency exchange rates. In an attempt to mitigate the impact of foreign currency fluctuations, we employ a foreign currency hedging program. See **MARKET RISK MANAGEMENT** below.

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**MARKET RISK MANAGEMENT**

**Foreign Currency Exchange Rate Risk**

Our primary market risk relates to changes in foreign currency exchange rates. The functional currency for our foreign subsidiaries is the U.S. dollar. A significant portion of our revenue is generated by our international operations. As a result, our financial condition, results of operations, and cash flows can be materially affected by changes in foreign currency exchange rates. We attempt to mitigate this exposure as part of our

foreign currency hedging program. The primary goal of our foreign currency hedging program is to reduce the risk of adverse foreign currency movements on the reported financial results of our non-U.S. dollar transactions. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. All foreign currency derivatives are authorized and executed pursuant to our policies. We do not hold or issue derivatives or any other financial instruments for trading or speculative purposes.

To implement our foreign currency hedging program, we use foreign currency options and forwards. These derivatives are used to hedge the risk that forecasted revenue denominated in foreign currencies might be adversely affected by changes in foreign currency exchange rates. Foreign currency forwards are also used to reduce our exposure to foreign currency exchange rate fluctuations in connection with monetary assets and liabilities denominated in foreign currencies.

A hypothetical 10% adverse movement in foreign exchange rates applied to our foreign currency exchange rate sensitive instruments held as of September 26, 2003, and as of December 27, 2002, would result in a hypothetical loss in fair value of approximately \$71.1 million and \$64.5 million, respectively. The increase in the hypothetical loss is primarily due to an increase in outstanding derivatives used to hedge forecasted cash flows. These hypothetical losses do not take our underlying international operations into consideration. We anticipate that any hypothetical loss associated with our foreign currency exchange rate sensitive instruments would be substantially offset by gains associated with our underlying international operations.

### **Interest Rate Risk**

Changes in interest rates affect interest income earned on our cash investments, as well as interest expense on short-term borrowings. A hypothetical 10% adverse movement in interest rates applied to cash investments, short- and long-term investments, and short-term borrowings as of September 26, 2003, and December 27, 2002, would not have a material adverse effect on our financial condition, results of operations, or cash flows.

### **Credit Risk**

We are exposed to credit risk associated with cash investments, short- and long-term investments, foreign currency derivatives, and trade receivables. We do not believe that our cash investments, short- and long-term investments, and foreign currency derivatives present significant credit risks, because the counterparties to the instruments consist of major financial institutions, and we manage the notional amount of contracts entered into with any single counterparty. Substantially all trade receivable balances are unsecured. Our credit risk on trade receivables is limited by the large number of customers in our customer base and their dispersion across various industries and geographic areas. Although we have a large number of customers who are dispersed across different industries and geographic areas, a prolonged economic downturn could increase our exposure to credit risk on our trade receivables. We perform credit evaluations of our customers and maintain an allowance for potential credit losses.

## ***FACTORS THAT MAY AFFECT FUTURE RESULTS***

### **We may be materially affected by global economic and political conditions**

Our ability to generate revenue growth during the last several years was adversely affected by the slowdown in the global economy as customers delayed their purchase decisions, reduced their information technology spending budgets, increased their purchase authorization approval requirements, and reduced their capital expenditures by optimizing the current capacities of their data storage equipment. While we have seen some signs of economic improvement in the United States and the emerging market areas during the nine months of 2003, the rate of improvement has been slow and we did not see much improvement in Europe. We do not currently anticipate any significant economic improvement during the remainder of 2003. During 2001 and 2002, we implemented various cost-saving measures to help mitigate the adverse effects of the slowdown in the global economy on our results of operations. We cannot provide any assurance that a prolonged economic downturn will not have additional adverse effects on our financial condition, results of operations, or our ability to generate revenue growth. Furthermore, we cannot provide any assurance that our cost-saving measures will be successful or sufficient to allow us to continue to generate improved operating results in future periods.

Our financial condition and results of operations could also be materially affected by unstable global political conditions. Terrorist attacks or acts of war could significantly disrupt our operations and the operations of our customers, suppliers, distributors, or resellers. We cannot predict the potential impact on our financial condition or results of operations should such events occur.

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

In the third quarter and nine months of 2003, approximately 77% of our storage products revenue was generated by sales of our tape products. Services associated with our tape products also represent a significant portion of our storage services revenue. If overall demand for tape storage products declines, or if we lose market share in tape, our financial condition and results of operations could be materially affected.

One of the key competitive advantages that our tape products have over competing disk products is that tape products store data at a fraction of the cost of disk storage. The cost of disk storage continues to decrease rapidly due to competition and new disk drive technologies such as Advanced Technology Attachment (ATA). We must continue to develop and introduce new tape products that reduce the cost of tape storage at a rate that is similar to or greater than the decline in disk storage costs in order to maintain this competitive advantage. We cannot provide any assurance that we will be able to reduce the cost of our tape products at a rate similar to the decline in disk storage costs.

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**We may be materially affected by aggressive competition**

The data storage industry is highly competitive, and customers make their decisions based on a number of competitive factors, including the following:

- Functionality
- Technology
- Performance
- Reliability
- System scalability
- Price
- Quality
- Product availability
- Customer service
- Brand recognition

We must address each of these factors effectively in order to successfully compete. If we are unable to adapt our products and services to changes in these competitive factors, we may lose market share to our competitors.

In order to grow revenue in the future, it is critical that we execute on our Information Lifecycle Management™ (ILM) strategy by continuing to capitalize on our ability to deliver complete storage solutions that satisfy customer storage requirements. Our ILM strategy requires that we successfully integrate the sale of products and services. We have achieved some initial success in our efforts to address customer storage needs by focusing on the delivery of storage solutions that include a combination of tape, disk, and network products, together with the associated services. This success has resulted in increased revenue contributions from disk and network products, as well as services. We have also seen the adoption of strategies similar to our ILM strategy by our competitors. We cannot provide any assurance that we will successfully execute our ILM strategy or that this strategy will provide us a competitive advantage in the data storage industry.

**We may be materially affected by our ability to grow our indirect channels successfully**

We are continually developing our indirect distribution channels, including original equipment manufacturers (OEMs), value-added distributors (VADs), value-added resellers (VARs), and other distributors. Indirect channels sales contributed approximately 48% of our total product revenue for the nine months of 2003 compared to 45% for the same period in 2002. Increasing our sales through these indirect channels is critical to expanding our reach into the growing open-systems market. Successfully managing the interaction of our direct and indirect channel efforts to effectively reach all of the potential customer segments for our products and services is a complex process. We cannot provide any assurance that we will be successful in expanding our indirect channel sales. Our ability to forecast future demand for our products may be adversely affected by unforeseen changes in demand from our indirect channel partners. Storage product margins may be adversely impacted on a percentage basis to the extent we continue to receive a larger portion of our sales through our indirect channels in the future. Maintenance revenue also may be adversely affected in future periods to the extent that customers of our indirect channel partners elect to purchase maintenance services from our competitors. Our financial results may also be negatively affected if the financial condition of one or more of our channel partners weakens or if the current economic downturn continues.

**We may be materially affected by the risks associated with expanding our service offerings**



Services contributed approximately 40% and 41% of our total revenue in the third quarter and nine months of 2003, respectively, compared to approximately 39% for the same periods in 2002. This growth was partially driven by new service offerings such as storage consulting services, implementation services, and storage management services. The development and delivery of these new services are critical to the success of our plan to deliver complete storage solutions to our customers. We must ensure that service professionals have the necessary skill sets, experience, tools, and training to support these new service offerings. Revenue growth from these new service offerings is needed to offset possible future declines in maintenance revenue from our installed service base of products under maintenance contracts as these products are displaced by sales of new StorageTek products under warranty. Any failure to properly develop or deliver our new and existing service offerings could have a material adverse effect on our financial condition and results of operations.

**We may be materially affected by the risks associated with sole source suppliers**

We purchase certain key parts, components, and services from sole source suppliers who we believe are currently the only providers that meet our specifications or for which alternative sources of supply are not readily available. The following table shows our significant sole source suppliers and the products or services they provide:

<b>Name of sole source supplier</b>	<b>Product or service provided</b>
Imation Corporation	T9840 and T9940 series tape media
Sanmina-SCI Corporation	Printed circuit boards and certain other manufacturing and repair services
LSI Logic Storage Systems	D-Series open-systems disk products
Fujitsu Electronics America	Application-specific integrated circuits (ASICs) for various tape and disk products
Philips Semiconductors	ASICs for various tape and disk products
Celestica	SN6000 network product
Herald Datatetics Ltd. (HDL)	Key component used in certain tape products

We also obtain certain key parts and components from less significant sole source suppliers. If a sole source supplier did not continue to provide its products or services, we would need to identify and qualify other acceptable suppliers. This process could take an extended period, and we cannot provide any assurance that we could identify and qualify an alternative source on a timely basis or at an acceptable quality or price. We cannot provide any assurance that significant sole source suppliers will be able to meet our ongoing quality or delivery requirements. Failure to meet these requirements may have a material adverse impact on our financial condition and results of operations.

HDL is located in the People's Republic of China (PRC). Our dependence on HDL is subject to additional risks beyond those associated with other sole source suppliers, including the lack of a well-established court system or acceptance of the rule of law in the PRC, the degree to which the PRC permits economic reform policies to continue, the political relationship between the PRC and the United States, and broader political and economic factors. To date, we have not experienced any material problems securing key components from HDL; however, we cannot provide any assurance that we will not experience material problems in the future.

**We may be materially affected by a failure to obtain quality parts and components in a timely manner or by a failure to effectively manage inventory levels**

We generally use standard parts and components for our products and believe that there are a number of alternative, competent vendors for most of those parts and components. Certain suppliers have experienced occasional technical, financial, or other problems that have delayed deliveries in the past. An unanticipated failure of suppliers to meet our requirements for an extended period, or the inability to secure comparable components in a timely manner, could result in a shortage of key components or products, longer lead times, reduced control over production and delivery schedules, and an inability to fulfill customer orders in a timely manner.

We have implemented various lean manufacturing initiatives to help us manage our inventory levels. As we continue to move toward a lean manufacturing environment, we will become increasingly dependent on a limited supplier base to deliver quality parts and components in a timely manner. A supplier's inability to deliver parts and components on a timely basis, or our failure to effectively manage inventory levels,

**We may be materially affected by aggressive competition**

could have a material adverse effect on our financial condition and results of operations.

**We may be materially affected by uneven sales patterns and by our ability to forecast customer demand accurately**

In the past, our results have followed a seasonal pattern, which reflects the tendency of customers to make their purchase decisions at the end of a calendar year. During any fiscal quarter, a disproportionately large percentage of total product sales are earned in the last weeks or days of the quarter. It is difficult to predict the extent to which these historical trends will continue in the future. We cannot provide any assurance that we will be able to manage our uneven sales patterns.

We prepare and update our forecasts on a regular basis to predict customer demand for our products and services. If predicted demand is higher than actual demand, we may have excess inventory or an underutilized employee base. If actual demand exceeds predicted demand, we may not be able to meet customer requirements in a timely manner due to sourcing, manufacturing, or service constraints. We cannot provide any assurance that we will be able to forecast customer demand accurately or respond quickly to changes in customer demand.

**Our gross profit margin may be materially affected by product mix, channel mix, and resale of third-party products**

We provide a variety of solutions to meet customer needs, including tape, disk, and network products, along with associated services. Our products and services contribute varying gross profit margins, and the gross margin earned on a customer's total solution is dependent on the amounts and types of products or services involved. We cannot provide any assurance that our future gross profit margin will be similar to our historical gross profit margin.

We market our solutions through a combination of a direct sales organization and indirect channel partners. Direct sales to the end-user customer usually result in higher gross profit margins than indirect channel sales. We cannot provide any assurance that changes in our channel mix will not have a material impact on gross profit margin in the future.

Third-party product sales continue to increase as a percentage of total product sales, and our gross profit margin may be adversely affected as those products become a larger portion of our total storage solutions. We may also be at a cost disadvantage in acquiring third-party products that are manufactured by competitors.

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**We may be materially affected by rapid technological change and evolving industry standards**

Short product life cycles are inherent in high-technology industries due to rapid technological change and evolving industry standards. Our financial condition and results of operations depend on our ability to respond effectively to these changes. We cannot provide any assurance that we will be able to successfully develop, manufacture, and market innovative new products or adapt our current products to new technologies or new industry standards. In addition, customers may be reluctant to adopt new technologies and standards, or they may prefer competing technologies and standards.

SAN solutions are an example of the rapid technological change in our industry, since SAN technologies and standards are continually evolving. We continue to develop the necessary product modifications and professional services knowledge to implement our SAN solutions successfully in various customer operating environments. Because the SAN market changes so quickly, it is difficult to predict the future rate of adoption of our SAN solutions.

**We may be materially affected by risks associated with new product development**

New product research and development is complex and requires the investigation and evaluation of multiple alternatives, as well as planning the design and manufacture of those alternatives selected for further development. Research and development efforts could be adversely affected by any of the following:

- Hardware and software design flaws
- Product development delays
- Changes in data storage technology
- Changes in operating systems
- Changes in industry standards

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In addition, we have outsourced software development for certain tape and network products. We cannot provide any assurance that research and development activities will be successful in bringing new products to market.

Manufacturing new products involves integrating complex designs and processes, coordinating with suppliers for parts and components, and managing manufacturing capacities to accommodate forecasted demand. Failure to obtain sufficient quantities of parts and components, as well as other manufacturing delays or constraints, could adversely affect the timing of new product introductions. We have experienced product development and manufacturing delays in the past that adversely affected our results of operations and competitive position.

When we introduce new products, we must effectively manage the transition from our existing products to the new products. If we do not manage the transition effectively, we may be subject to the following adverse effects:

- Excess or obsolete inventory
- Insufficient inventory or manufacturing capacity to meet customer demand
- Delayed customer purchases
- Lost sales if customers purchase from our competitors

In addition, sales of our new products may replace some of the sales of our existing products. We cannot provide any assurance that we will be able to successfully manage the development, introduction, or transition of new products in the future.

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### **We may be materially affected by the risks associated with developing and protecting intellectual property**

We depend on our ability to develop new intellectual property that does not infringe on the rights of others. We cannot provide any assurance that we will be able to continue to develop such new intellectual property.

We rely on a combination of U.S. patent, copyright, trademark, and trade secret laws to protect our intellectual property rights. We enter into confidentiality agreements relating to our intellectual property with our employees and consultants, and we include confidentiality provisions in license and non-exclusive sales agreements with our customers.

We also file patent and trademark registration applications with foreign governments; however, many foreign countries do not have intellectual property laws that are as well developed as those of the United States.

Despite our efforts to protect our intellectual property rights, unauthorized parties may attempt to copy or otherwise obtain or use our intellectual property. Monitoring the unauthorized use of our intellectual property is difficult, particularly in foreign countries. We cannot provide any assurance that we will be able to adequately protect our intellectual property.

### **We may be materially affected if we are unable to attract and retain key employees**

Our future success depends in large part on our ability to attract and retain our key employees. For example, our financial results in Europe during 2003 have been adversely affected by transitions in our European management team. We face significant competition for individuals who possess the skills required to sell our products and services, as well as design, develop, manufacture, service, and market those products and services. An inability to successfully attract and retain these employees could have an adverse effect on our future financial condition and results of operations.

### **We may be materially affected by the risks of conducting business outside the United States**

Our international business may be affected by changes in demand resulting from global and localized economic, business, and political conditions. We are subject to the risks of conducting business outside the United States, including the following risks:

- Adverse political and economic conditions
- Impositions of tariffs or quotas
- Changes in laws or regulations
- Difficulty in obtaining export licenses
- Potentially adverse tax or labor laws
- The burdens of complying with a variety of foreign laws
- Longer payment cycles typically associated with international sales
- Other factors outside our control

We may be materially affected by risks associated with new product development

We expect these risks to increase in the future as we expand our operations in Eastern Europe, Latin America, and Asia. We cannot provide any assurance that these factors will not have a material adverse effect on our financial condition or results of operations in the future.

**Our manufacturing operations may be materially affected by weather-related risks**

We manufacture and assemble a significant portion of our products in Puerto Rico. Our ability to perform these activities may be significantly affected by weather-related risks beyond our control. We believe that if the Puerto Rico facility were significantly affected by adverse weather, we could relocate to an alternative facility within a reasonable period of time; however, we cannot provide any assurance that we would be able to relocate that facility without a material adverse impact on our financial condition or results of operations.

**We may be materially affected by restructuring activities**

We have recognized significant restructuring charges in the past and it is possible that changes in our business, industry, or in the global economy may necessitate restructuring activities in the future. The necessity for restructuring activities may result in expenses that adversely affect our financial condition and results of operations and may require incremental cash payments.

**ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information required under this Item 3 is included in the section above entitled MARKET RISK MANAGEMENT.

**ITEM 4 CONTROLS AND PROCEDURES**

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures (as defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934) as of September 26, 2003, the end of the period covered by this report. Based on their evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective.

During the fiscal quarter ended September 26, 2003, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II**

**ITEM 1 LEGAL PROCEEDINGS**

For information regarding legal proceedings, see Note 5 of NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, included in Part 1, Item 1, of this Form 10-Q, which information is incorporated by reference into this Part II, Item 1.

**ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits:

The exhibits listed below are filed as part of this Quarterly Report on Form 10-Q or are incorporated by reference into this Quarterly Report on Form 10-Q:

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- 3.1 Restated Certificate of Incorporation of Storage Technology Corporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.2 Certificate of Amendment dated May 22, 1989, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.3 Certificate of Second Amendment dated May 28, 1992, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.4 Certificate of Third Amendment dated May 21, 1999, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 1999, filed on August 9, 1999, and incorporated herein by reference)
- 3.5 Restated Bylaws of Storage Technology Corporation, as amended through November 16, 2002 (previously filed as Exhibit 3.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 4.1 Specimen Certificate of Common Stock, \$0.10 par value of Registrant (previously filed as Exhibit (c)(2) to the Company's Current Report on Form 8-K dated June 2, 1989, and incorporated herein by reference)
- 10.1<sup>1</sup> Storage Technology Corporation Amended and Restated 1987 Employee Stock Purchase Plan, as amended through May 21, 2003 (previously filed as Exhibit 4.6 to the Company's Registration Statement on Form S-8 (Registration No. 333-106930) filed on July 10, 2003, and incorporated herein by reference)
- 10.2<sup>1,2</sup> Storage Technology Corporation Amended and Restated 1995 Equity Participation Plan, as amended through December 2001

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- 10.3<sup>1</sup> Storage Technology Corporation Management by Objective Bonus Plan (previously filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
  - 10.4<sup>1</sup> Storage Technology Corporation Amended and Restated Stock Option Plan for Non-Employee Directors (previously filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 1996, filed on August 12, 1996, and incorporated herein by reference)
  - 10.5<sup>1</sup> Storage Technology Corporation Flexible Option Plan, dated December 2001 (previously filed as Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002, and incorporated herein by reference)
  - 10.6<sup>1</sup> Agreement between the Company and Gary Francis, dated August 19, 1997 (previously filed as Exhibit 10.25 to the Company's Annual Report on Form 10-K for the fiscal year ended December 26, 1997, filed on March 6, 1998, and incorporated herein by reference)
  - 10.7<sup>1</sup> Severance Agreement, dated as of July 1, 2001, between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
  - 10.8<sup>1</sup> Restricted Stock Award Agreement, dated as of September 27, 2001, by and between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002, and incorporated herein by reference)
  - 10.9<sup>1</sup> Offer Letter, dated May 10, 2001, from the Company to Michael McLay (previously filed as Exhibit 10.17 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
  - 10.10<sup>1</sup> Offer Letter, dated February 9, 2001, from the Company to Jill F. Kenney (previously filed as Exhibit 10.19 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)

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- 10.11<sup>1</sup> Offer Letter, dated February 9, 2001, from the Company to Roger Gaston (previously filed as Exhibit 10.20 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.12<sup>1</sup> Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$390,000 (previously filed as Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.13<sup>1</sup> Promissory Note, dated May 11, 2001, from Michael McLay to the Company, in the principal amount of \$160,000 (previously filed as Exhibit 10.24 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)

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- 10.14<sup>1</sup> Form of LEAP Participation Agreement, dated April 30, 2001 (previously filed as Exhibit 10.25 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.15<sup>1</sup> Offer Letter, dated July 16, 2001, from the Company to Roy Perry (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.16<sup>1</sup> Offer Letter, dated June 27, 2001, from the Company to Angel Garcia (previously filed as Exhibit 10.29 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.17 Credit Agreement, dated as of October 10, 2001, among the Company, the several financial institutions thereto, Bank of America, N.A., as letter of credit issuing bank and sole administrative agent for the Banks, Key Corporate Capital, Inc. as Documentation Agent, Fleet National Bank as Syndication Agent, and Banc of America Securities LLC as sole lead arranger and sole book manager (previously filed as Exhibit 10.13 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.18 Security Agreement, dated as of October 10, 2001, by and among the Company, Bank of America, N.A., as Collateral Agent for itself and other Secured Parties referred to therein (previously filed as Exhibit 10.14 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.19 Guaranty, dated as of October 10, 2001, by StorageTek Holding Corporation, in favor of the Banks party to a certain Credit Agreement and Bank of America, N.A., as Agent and Issuing Bank and Collateral Agent (previously filed as Exhibit 10.15 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.20<sup>1</sup> Form of Executive Severance Agreement (previously filed as Exhibit 10.32 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.21 Master Services Agreement (MSA), between each of the Company, Electronic Data Systems Corporation, and EDS Information Services L.L.C., dated as of April 1, 2002 (previously filed as Exhibit 10.33 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.22 Authorization Letter #1 pursuant to the MSA, dated April 1, 2002 (previously filed as Exhibit 10.34 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.23 Authorization Letter #2 pursuant to the MSA, dated April 1, 2002 (previously filed as Exhibit 10.35 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)

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- 10.24 Master Secondary Storage Services Agreement, between the Company and Electronic Data Systems Corporation, dated March 29, 2002 (previously filed as Exhibit 10.36 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on

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May 13, 2002, and incorporated herein by reference)

- 10.25<sup>1</sup> Offer Letter, dated June 25, 2002, between the Company and Mark Roellig (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 2002, filed on August 12, 2002, and incorporated herein by reference)
- 10.26<sup>1</sup> Form of Indemnification Agreement, dated as of November 22, 2002, between the Company and each director (previously filed as Exhibit 10.31 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.27<sup>1</sup> Storage Technology Corporation 1993 Non-Statutory Stock Option Plan (previously filed as Exhibit 10.32 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.28<sup>1</sup> Offer Letter, dated November 12, 2002, between the Company and Pierre Cousin (previously filed as Exhibit 10.33 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.29<sup>1</sup> Agreement, dated December 1, 2002, between the Company and Pierre Cousin (previously filed as Exhibit 10.34 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.30<sup>1</sup> Amended and Restated CEO Employment Agreement, dated March 27, 2003, between the Company and Patrick J. Martin (previously filed as Exhibit 10.36 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 28, 2003, filed on May 9, 2003, and incorporated herein by reference)
- 10.31<sup>1</sup> Form of Executive Agreement, dated as of February 12, 2003, between the Company and each executive officer (previously filed as Exhibit 10.37 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 28, 2003, filed on May 9, 2003, and incorporated herein by reference)
- 10.32 Letter, dated July 24, 2003, from the Company to Bank of America, N.A. (previously filed as Exhibit 10.32 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 27, 2003, filed on August 8, 2003, and incorporated herein by reference)
- 31.1<sup>2</sup> Certification Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2<sup>2</sup> Certification Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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32.1<sup>2</sup> Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2<sup>2</sup> Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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1 Contract or compensatory plan or arrangement in which directors and/or officers participate

2 Indicates exhibit filed with his Quarterly Report on Form 10-Q

(b) Reports on Form 8-K.

Current report on Form 8-K, filed on July 23, 2003, relating to an Item 9, Regulation FD Disclosure, regarding the announcement of our results of operations for the fiscal quarter ended June 27, 2003, including a copy of the script of the prepared remarks of the Chief Executive Officer and Chief Financial Officer from a conference call regarding such results of operations.

## 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.

STORAGE TECHNOLOGY CORPORATION  
(Registrant)

November 7, 2003

(Date)

/s/ ROBERT S. KOCOL

Robert S. Kocol  
Corporate Vice President  
and Chief Financial Officer  
(Principal Financial Officer)

November 7, 2003

(Date)

/s/ THOMAS G. ARNOLD

Thomas G. Arnold  
Vice President and Corporate Controller  
(Principal Accounting Officer)