

SILICON GRAPHICS INC /CA/
Form 10-Q
November 13, 2001

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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 September 28, 2001.

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.)

1600 Amphitheatre Pkwy., Mountain View, California 94043-1351

(Address of principal executive offices) (Zip Code)

(650) 960-1980

(Registrant's telephone number, including area code)

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 November 2, 2001 there were 194,161,436 shares of Common Stock outstanding.

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 | |
|-----------------------------------|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| Product and other revenue | \$ 245,744 | \$ 279,999 |
| Service revenue | 133,648 | 146,337 |
| Total revenue | 379,392 | 426,336 |
| Costs and expenses: | | |
| Cost of product and other revenue | 114,875 | 166,907 |
| Cost of service revenue | 90,762 | 116,218 |
| Research and development | 47,620 | 57,349 |

| | Three Months Ended | |
|---|--------------------|-------------|
| Selling, general and administrative | 140,598 | 185,663 |
| Other operating expense (recovery)(1) | 32,112 | (6,221) |
| Total costs and expenses | 425,967 | 519,916 |
| Operating loss | (46,575) | (93,580) |
| Interest and other income (expense), net | (7,519) | (2,450) |
| Other non-recurring income (expense), net | (13,136) | 50,558 |
| Loss before provision for income taxes | (67,230) | (45,472) |
| Provision for income taxes | 2,052 | 3,516 |
| Net loss | (69,282) | (48,988) |
| Preferred stock dividend requirement | | (131) |
| Net loss available to common stockholders | \$ (69,282) | \$ (49,119) |
| Net loss per share basic and diluted | \$ (0.36) | \$ (0.26) |
| Common shares outstanding basic and diluted | 192,094 | 187,872 |

(1) Represents a charge for estimated restructuring and impairment costs in the three-month period ended September 28, 2001 and a change in previously estimated restructuring costs in the three-month period ended September 30, 2000.

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

SILICON GRAPHICS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

| | September 28, 2001 | June 30, 2001(1) |
|-----------------------------------|-----------------------|---------------------|
| | (unaudited) | |
| Assets: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 118,282 | \$ 123,129 |
| Short-term marketable investments | 3,510 | 2,978 |
| Short-term restricted investments | 58,281 | 74,036 |
| Accounts receivable, net | 299,843 | 354,026 |
| Inventories | 204,239 | 205,152 |

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| | September 28, 2001 | June 30, 2001(1) |
|---|-----------------------|---------------------|
| Prepaid expenses and other current assets | 107,579 | 94,387 |
| Total current assets | 791,734 | 853,708 |
| Restricted investments | 2,821 | 2,817 |
| Property and equipment, net | 217,138 | 268,944 |
| Other assets | 150,133 | 157,560 |
| | \$ 1,161,826 | \$ 1,283,029 |
| Liabilities and Stockholders' Deficit: | | |
| Current liabilities: | | |
| Accounts payable | \$ 137,272 | \$ 167,053 |
| Accrued compensation | 108,105 | 114,162 |
| Income taxes payable | 26,202 | 30,561 |
| Deferred revenue | 234,979 | 265,246 |
| Other current liabilities | 286,854 | 267,876 |
| Current portion of long-term debt | 54,631 | 50,694 |
| Total current liabilities | 848,043 | 895,592 |
| Long-term debt | 291,141 | 289,289 |
| Other liabilities | 115,530 | 123,431 |
| Stockholders' deficit: | | |
| Common stock and additional paid-in-capital | 1,440,845 | 1,442,867 |
| Accumulated deficit | (1,409,034) | (1,340,085) |
| Treasury stock | (105,190) | (105,190) |
| Accumulated other comprehensive loss | (19,509) | (22,875) |
| Total stockholders' deficit | (92,888) | (25,283) |
| | \$ 1,161,826 | \$ 1,283,029 |

(1) The balance sheet at June 30, 2001 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 financial statements.

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| | Three Months Ended | |
|--|--------------------|-------------------|
| | Sept 28, 2001 | Sept. 30, 2000 |
| Cash Flows From Operating Activities: | | |
| Net loss | \$ (69,282) | \$ (48,988) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 51,896 | 31,558 |
| Loss on sale of real estate | 3,816 | |
| Loss (gain) on sale of marketable investments | 1,320 | (38,805) |
| Gain on sale of Cray® product line | | (11,753) |
| Restructuring charge (recovery) | 31,642 | (6,221) |
| Other | (753) | (4,543) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 54,183 | 37,848 |
| Inventories | (11,461) | 13,156 |
| Accounts payable | (29,782) | (23,108) |
| Other assets and liabilities | (65,260) | (24,419) |
| Total adjustments | 35,601 | (26,287) |
| Net cash used in operating activities | (33,681) | (75,275) |
| Cash Flows From Investing Activities: | | |
| Proceeds from sale of real estate and fixed assets | 26,147 | |
| Purchase of marketable investments | (532) | (1,177) |
| Purchases of restricted investments | (142,535) | (38,878) |
| Proceeds from the maturities of restricted investments | 158,285 | 60,906 |
| Capital expenditures | (9,273) | (41,397) |
| (Increase) decrease in other assets | (2,290) | 37,672 |
| Net cash provided by investing activities | 29,802 | 17,126 |
| Cash Flows From Financing Activities: | | |
| Issuance of debt | 44 | |
| Payments of debt principal | (1,012) | (1,822) |
| Sale of SGI common stock | | 1,148 |
| Cash dividends-preferred stock | | (131) |
| Net cash used in financing activities | (968) | (805) |
| Net decrease in cash and cash equivalents | (4,847) | (58,954) |
| Cash and cash equivalents at beginning of period | 123,129 | 251,811 |
| Cash and cash equivalents at end of period | \$ 118,282 | \$ 192,857 |

The accompanying notes are an integral part of these financial statements

1. Consolidated Financial Statements.

The 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 30, 2001 filed with the Securities and Exchange Commission.

We have incurred net losses and negative cash flows from operations during each of the past two fiscal years. Unrestricted cash and marketable investments declined from \$126 million at June 30, 2001, to \$122 million at September 28, 2001. We have working capital deficiency of \$56 million and a stockholders' deficit of \$93 million at September 28, 2001. Because our cash levels fluctuate significantly during the quarter, and especially given the uncertainties of the current business climate, we have been actively working to improve our liquidity situation (See Note 13 Subsequent Events). Actions that have been taken include cutting our operating expense levels to reduce cash consumed in operations, and raising cash through licensing and sales transactions involving real estate, intellectual property and other assets not deemed core to our business. Of course, re-establishing profitable operations is our ultimate goal. While a forecast of future events is inherently uncertain, we believe that the combination of our current resources and cash generated from our fiscal 2002 operating plan and licensing and sales transactions will provide sufficient funding to enable the Company to meet its obligations through at least June 30, 2002. We are committed to the successful execution of our operating plan and business turnaround, and will take steps if necessary to further restructure our business operations to reduce expenses.

2. Inventories.

| | <u>September 28, 2001</u> | <u>June 30, 2001</u> |
|------------------------------|-----------------------------|-----------------------------|
| | (In thousands) | |
| Components and subassemblies | \$ 61,848 | \$ 85,383 |
| Work-in-process | 71,637 | 32,171 |
| Finished goods | 54,146 | 40,092 |
| Demonstration systems | 16,608 | 47,506 |
| | <u> </u> | <u> </u> |
| Total inventories | <u>\$ 204,239</u> | <u>\$ 205,152</u> |

3. Restricted Investments.

Restricted investments consist of short- and long-term investments held under a security agreement or pledged as collateral against letters of credit. Restricted investments pledged as collateral are held in the Company's name by major financial institutions.

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4. Property and Equipment.

| | <u>September 28, 2001</u> | <u>June 30, 2001</u> |
|---|-----------------------------|-----------------------------|
| | (In thousands) | |
| Property and equipment, at cost | \$ 727,469 | \$ 755,362 |
| Accumulated depreciation and amortization | (510,331) | (486,418) |
| | <u> </u> | <u> </u> |
| Property and equipment, net | <u>\$ 217,138</u> | <u>\$ 268,944</u> |

5. Other Assets.

| | <u>September 28, 2001</u> | <u>June 30, 2001</u> |
|--|---------------------------|----------------------|
|--|---------------------------|----------------------|

| | September 28, 2001 | June 30, 2001 |
|---------------------------------------|--------------------|-------------------|
| | (In thousands) | |
| Spare parts | \$ 75,936 | \$ 80,044 |
| Investments | 9,268 | 12,841 |
| Software licenses, goodwill and other | 64,929 | 64,675 |
| | <u>\$ 150,133</u> | <u>\$ 157,560</u> |

6. Financing Arrangement

During the fourth quarter of fiscal 2001, we obtained an asset-based credit facility. Available credit is determined monthly based on 85% of eligible accounts receivable, up to a maximum of \$75 million. To date, we have used \$43 million of this line to secure a letter of credit required under terms of our building sale-leaseback arrangement. This obligation bears interest payable monthly at the prime rate plus 0.25% (6.25% at September 28, 2001) and the principal amount is due in April 2003. The facility is currently secured by U.S. accounts receivable and inventory, the pledge of certain intellectual property and a \$7 million cash deposit. The credit facility also contains financial and other covenants. During the first quarter of fiscal 2002, we were not in compliance with the financial covenants relating to EBITDA for the fourth quarter of fiscal 2001 and the \$50 million minimum daily unrestricted cash balance and have obtained a waiver from the lender of these defaults. 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 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, it would have a significant impact on our working capital.

7. Other Operating Expense.

Restructuring During the first quarter of fiscal 2000, we announced and began to implement a restructuring program aimed at bringing our expenses more in line with the current revenue levels and restoring long-term profitability to SGI. These actions resulted in aggregate charges of \$145 million (before the effect of the adjustments noted below) and included a reevaluation of our core competencies, technology roadmap and business model. The restructuring program was broad-based and covered virtually all aspects of our products, operations and processes. The fiscal 2000 restructuring actions resulted in the elimination of approximately 1,100 positions across essentially all of our functions and locations for a charge of \$65.8 million, writing down certain operating assets, vacating certain leased facilities and canceling certain contracts.

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Fiscal 2000 restructuring and impairment actions included operating asset write downs of \$27 million for fixed assets and evaluation units, prepaid license agreements and other intangible assets associated with the end of life of our Silicon Graphics® 320 and Silicon Graphics® 540 visual workstations and certain high-end graphics development projects that were canceled. Third party contract cancellation charges associated with the fiscal 2000 actions totaled \$8 million. We planned to vacate approximately 1,500,000 square feet of leased sales and administrative facilities throughout the world, with lease terms expiring through fiscal 2004. We estimated this would require ongoing lease payments of \$26 million until subleases could be arranged and incurred \$7 million in exit costs, including costs to restore facilities to original condition. In addition, an impairment charge of \$11 million was recorded for the abandonment of leasehold and other fixed assets associated with the facility closures.

During the second through fourth quarters of fiscal 2000 and the first quarter of fiscal 2001, we lowered our estimate of the total costs associated with the fiscal 2000 restructuring activities described above. As a result, a cumulative adjustment of approximately \$35 million and \$6 million, respectively, has been recorded in fiscal 2000 and fiscal 2001, respectively. The adjustment primarily reflects far more favorable settlements of lease obligations attributable to extremely high demand for facilities in Mountain View, California. It also reflected our new approach to structuring our field organization. The adjustment further reflects lower than estimated severance and related charges attributable to higher than expected attrition and lower per person costs. Estimated costs of contract cancellations were also adjusted due to favorable settlements. As of March 31, 2001, all estimated positions were eliminated and all severance-related charges were paid. The remaining facilities related accrual balance of approximately \$1 million at September 28, 2001 is expected to result in cash expenditures through fiscal 2004.

During the fourth quarter of fiscal 2001, we announced and began to implement additional restructuring actions with the objective of further reducing our operating expenses and restoring long-term profitability to SGI. These actions resulted in aggregate charges of \$88 million and were broad-based and covered virtually all aspects of our products, operations and processes. Fiscal 2001 restructuring actions resulted in the elimination of approximately 1,000 positions, across all levels and functions, of which roughly 800 of the positions have been eliminated as of September 28, 2001. Severance payments and related charges of \$45 million consist primarily of salary and expected payroll taxes, extended medical benefits, statutory legal obligations and outplacement services. Third party contract cancellation charges associated with the fiscal 2001

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actions totaled \$2 million. Our plans include vacating approximately 3,000,000 square feet of leased sales and administrative facilities throughout the world, with lease terms expiring through April 2010. We estimate this will require ongoing lease payments of \$32 million and \$9 million in exit costs, including costs to restore facilities to their original condition. The remaining fiscal 2001 accrual balance of approximately \$55 million at September 28, 2001 is expected to result in cash expenditures through fiscal 2002 for severance and related charges and canceled contracts and through fiscal 2010 for facilities related expenditures.

During the first quarter of fiscal 2002, we announced and began to implement additional restructuring actions consistent with the objective of the fiscal 2001 restructuring. These actions resulted in aggregate charges of \$30 million and are expected to result in the elimination of approximately 700 positions across all levels and functions, of which roughly 400 of the positions have been eliminated as of September 28, 2001. Severance payments and related charges of \$27 million consist primarily of salary and expected payroll taxes, extended medical benefits, statutory legal obligations and outplacement services. Third party contract cancellation charges associated with the fiscal 2002 actions totaled \$1 million. Our plans include vacating approximately 114,000 square feet of administrative

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facilities throughout the world, with lease terms expiring through fiscal 2006. We estimate this will require ongoing lease payments of \$2 million. Our plans also include consolidating our manufacturing activity in Wisconsin and closing our manufacturing facility in Switzerland by the end of December 2001. Our plan is to sell the Switzerland facility and we estimate this closure will require approximately \$1 million in exit costs. The remaining fiscal 2002 accrual balance of approximately \$26 million at September 28, 2001 is expected to result in cash expenditures through fiscal 2002 for severance and related charges and canceled contracts and through fiscal 2006 for facilities related expenditures.

Impairment As a result of the fiscal 2001 restructuring activities described above, we wrote down approximately \$10 million of fixed assets, primarily associated with leasehold improvements and associated furniture and fixtures held for disposal. We wrote down approximately \$6 million related to canceled projects and demonstration units as a result of the decision to discontinue the IA32 product line. In addition, we also recorded approximately \$4 million in impairments for internally developed software projects discontinued as a result of the functionality provided by the new Enterprise Resource Planning ("ERP") system. The fair value and remaining carrying value of these assets at September 28, 2001 was immaterial.

As a result of the fiscal 2002 restructuring activities described above, we wrote down approximately \$1 million of fixed assets held for disposal and approximately \$1 million of demonstration units. The fair value and remaining carrying value of these assets at September 28, 2001 was immaterial.

The following table depicts the restructuring activity and impairment charges during the first three months of fiscal 2002: (in thousands):

| Category | Severance and Related Charges | Canceled Contracts | Vacated Facilities | Impairment Charges | Total |
|---|----------------------------------|-----------------------|-----------------------|-----------------------|-----------|
| Balance at June 30, 2001 | \$ 36,150 | \$ 1,217 | \$ 43,282 | \$ | \$ 80,649 |
| Additions fiscal 2002 restructuring and Impairment | 26,648 | 1,130 | 2,127 | 2,207 | 32,112 |
| Expenditures: | | | | | |
| Cash | (25,418) | (1,420) | (2,291) | | (29,129) |
| Non-cash | | | (576) | (2,207) | (2,783) |
| Balance at Sept. 28, 2001 | \$ 37,380 | \$ 927 | \$ 42,542 | \$ 0 | \$ 80,849 |

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8. Loss Per Share.

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

Three Months Ended

| | Three Months Ended | |
|---|--|--------------------|
| | September 28, 2001 | September 30, 2000 |
| | (In thousands, except per share amounts) | |
| Net loss | \$ (69,282) | \$ (48,988) |
| Less preferred stock dividends | | (131) |
| Net loss available to common stockholders | \$ (69,282) | \$ (49,119) |
| Weighted average shares outstanding basic and diluted | 192,094 | 187,872 |
| Net loss per share basic and diluted | \$ (0.36) | \$ (0.26) |
| Potentially dilutive securities excluded from Computations because they are anti-dilutive | 7,688 | 13,563 |

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9. Comprehensive Loss.

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

| | Three Months Ended | |
|--|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| | (In thousands) | |
| Net loss | \$ (69,282) | \$ (48,988) |
| Change in unrealized loss on available-for-sale Investments | (165) | (753) |
| Reclassification adjustment of accumulated unrealized loss (gain) related to the sale of investments | 1,302 | (24,450) |
| Change in unrealized (loss) gain on derivative instruments designated and qualifying as cash flow hedges | (135) | 4,347 |
| Foreign currency translation adjustments | 2,364 | (3,868) |
| Comprehensive loss | \$ (65,916) | \$ (73,712) |

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

| | September 28, 2001 | June 30, 2001 |
|---|-----------------------|------------------|
| | | (In thousands) |
| Unrealized loss on available-for-sale investments | \$ (1,335) | \$ (2,472) |
| Unrealized gain on derivative instruments designated and qualifying as cash flow hedges | 587 | 722 |
| Foreign currency translation adjustments | (18,761) | (21,125) |
| Accumulated other comprehensive loss | \$ (19,509) | \$ (22,875) |

10. Segment Information.

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SGI is a leader in high-performance computing and advanced graphics solutions, offering powerful servers and visual workstations. We have three reportable segments: Servers, Visual Workstations and Global Services. Reportable segments are determined based on several factors including customer base, homogeneity of products, technology, delivery channels and other factors. The Server segment's current products include Silicon Graphics® Onyx2® and the next generation Onyx® 3000 family of graphics systems, the SGI Origim™ 200 family of servers, the SGI 1000 family of servers and the Origim™ 2000 and Origin 3000 family of high-performance servers. The Visual Workstation segment's current products include the Silicon Graphics® O2®, the Silicon Graphics® Octane®, and the Silicon Graphics® Octane2™ visual workstations based upon the MIPS® microprocessor and the IRIX® operating system. During the fourth quarter of fiscal 2001, a decision was made to end of life the Silicon Graphics 230, Silicon Graphics 330, Silicon Graphics 550, and the Silicon Graphics Zx10 visual workstations based upon the Intel® microprocessor and the Windows NT® and Red Hat® Linux® operating systems. These products were shipped through the first quarter of fiscal 2002. 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, communication and entertainment services. Effective for fiscal 2002, we reorganized our Global Services segment and removed the remanufactured systems sales from this segment. The remanufactured systems sales operating unit does not meet the quantitative thresholds required for separate disclosure and is included in "Other" in the reconciliation of reported revenue and operating profit. We evaluate performance for each of these segments based on profit or loss from operations before interest and taxes.

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In addition to the aforementioned reportable segments, expenses of the research and development, sales and marketing, manufacturing, finance and administration groups are allocated to the operating units and are included in the results reported. The revenue and related expenses of our remanufactured systems sales organization and our wholly-owned software subsidiary Alias/Wavefront, as well as certain corporate-level revenue and expenses are not allocated to operating units 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 units 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 | | |
|---------------------------------|---------------------------|----------------------------|------------------------|
| | Servers | Visual Workstations | Global Services |
| September 28, 2001: | | | |
| Revenue from external customers | \$ 97,517 | \$ 56,852 | \$ 124,825 |
| Segment (loss) profit | \$ (65,365) | \$ (34,321) | \$ 13,420 |
| September 30, 2000: | | | |
| Revenue from external customers | \$ 145,792 | \$ 96,142 | \$ 138,251 |
| Segment (loss) profit | \$ (72,019) | \$ (30,727) | \$ (5,754) |

Reconciliation to SGI as reported (in thousands):

| | Three Months Ended | |
|-------------------------------|---------------------------|-----------------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| Revenue: | | |
| Total reportable segments | \$ 279,194 | \$ 380,185 |
| Other | 100,198 | 46,151 |
| Total SGI consolidated | \$ 379,392 | \$ 426,336 |
| Operating loss: | | |
| Total reportable segments | \$ (86,266) | \$ (108,500) |
| Other | 71,803 | 8,699 |

| | Three Months Ended | |
|----------------------------------|--------------------|--------------------|
| Other operating (expense) income | (32,112) | 6,221 |
| Total SGI consolidated | \$ (46,575) | \$ (93,580) |

11. Recent Accounting Pronouncements.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations", or "SFAS 141", and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", or "SFAS 142". SFAS 141 requires the use of the purchase method for all business combinations initiated after June 30, 2001, and provides new criteria for determining whether an acquired intangible asset should be recognized separately from goodwill. SFAS 142 eliminates the amortization of goodwill and replaces it with an impairment only model. Upon adoption, goodwill related to acquisitions completed before the date of adoption would be subject to the new provisions of SFAS 141; amortization of any remaining book value of goodwill would cease and the new impairment-only approach would apply. The impairment-only approach does not apply to the treatment of other intangible assets. The provisions of SFAS 141 and SFAS 142 will be effective for fiscal years beginning after December 15, 2001. We adopted SFAS 141 as of July 1, 2001 and will adopt SFAS 142

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as of July 1, 2002, and do not believe such adoption will have a material impact on our results of operations, financial position, or cash flows.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" or "SFAS 144" that is applicable to financial statements issued for fiscal years beginning after December 15, 2001, with transition provisions for certain matters. The FASB's new rules on asset impairment supersede FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of", and provides a single accounting model for long-lived assets to be disposed of. Although retaining many of the fundamental recognition and measurement provisions of Statement 121, the new rules significantly change the criteria that would have to be met to classify an asset as held-for-sale. The new rules also will supersede the provisions of APB Opinion 30 with regard to reporting the effects of a disposal of a segment of a business and will require expected future operating losses from discontinued operations to be displayed in discontinued operations in the period(s) in which the losses are incurred (rather than as of the measurement date as presently required).

12. Contingencies.

We are defending the lawsuits described below. We believe we have good defenses to the claims in each of these lawsuits and we are defending each of them vigorously.

We are defending putative securities class action lawsuits filed in the U.S. District Court for the Northern District of California and in California Superior Court for the County of Santa Clara in December 1997 and January 1998 alleging that SGI and certain of its officers made material misrepresentations and omissions during the period from July to October 1997. In September 2001, we reached a settlement of both the federal and state class actions which includes a payment of \$4 million in cash and the issuance of 8 million shares of SGI common stock to the settlement class. The settlement is subject to preliminary and final approval from the federal court.

We also have been defending a securities class action lawsuit involving Alias Research Inc., which was pending when we acquired Alias in June 1995. The Alias case, which was filed in 1991 in the U.S. District Court for the District of Connecticut, alleges that Alias and a former officer and director made material misrepresentations and omissions during the period from May 1991 to April 1992. In April 2001, plaintiffs and defendant reached an understanding that resolves this litigation, subject to final court approval.

We are also defending a claim for violation of provisions of the California Labor Code and a claim for violation of the Federal Fair Labor Standards Act (FLSA). After Defendant removed the case to federal court based on the existence of a federal question, plaintiff dismissed the FLSA claim and the matter was remanded to state court. In April 2001, plaintiff filed a further amended complaint adding a representative action under California Business and Professions Code section 17200.

The U.S. Departments of Commerce and Justice are currently conducting civil and criminal investigations into SGI's compliance with export regulations in connection with several export sales to Tier 3 countries. See "Risks That Affect Our Business Export Regulation."

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 we may seek to obtain a license. 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 SGI's financial condition, results of operations or liquidity. However, our evaluation of the likely impact of these pending disputes could change in the future.

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13. Subsequent Events.

On November 9, 2001, NEC Corporation and its publicly held affiliate, NEC Soft, acquired 40% and 20% respectively of SGI Japan, Ltd. for approximately \$95 million. SGI expects its net proceeds to be approximately \$70 million after settlement of inter-company accounts, deal expenses and customary closing adjustments. SGI Japan, which will be jointly owned by SGI, NEC and NEC Soft, has entered into a long-term exclusive distribution agreement with SGI to supply SGI equipment, services and solutions in Japan. Following the closing, SGI will no longer consolidate SGI Japan's results in its financial statements but will instead record its proportionate share of SGI Japan's earnings as non-operating income.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

This Quarterly Report on 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, and future profitability, our business transition objectives, headcount reductions and the expected impact on our business of legal proceedings and government regulatory 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," "predicts," "potential" or "continue" or the negative of such terms or other comparable terminology. These statements are only predictions.

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; ability to achieve profitable operations; 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; inability to effectively implement our visual workstation and server strategy, including the development of appropriate distribution, marketing and customer support models; risks related to dependence on our partners and suppliers; risks related to foreign operations (including the downturn of economic trends, unfavorable currency movements, and export compliance issues); risks associated with implementation of our new business practices, processes and information systems; litigation involving export compliance, intellectual property or other issues; 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.

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Results of Operations

| | Three Months Ended | |
|---|---|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| | (Numbers may not add due to rounding) | |
| | (In millions, except per share amounts) | |
| Total revenue | \$ 379 | \$ 426 |
| Cost of revenue | 206 | 283 |
| Gross profit | 174 | 143 |
| Gross profit margin | 45.8% | 33.6% |
| Total operating expenses | 220 | 237 |
| Operating loss | (47) | (94) |
| Interest and other income (expense), net | (8) | (2) |
| Other non-recurring income (expense), net | (13) | 51 |
| Loss before provision for income taxes | (67) | (45) |
| Net loss | \$ (69) | \$ (49) |
| Net loss per share basic and diluted | \$ (0.36) | \$ (0.26) |

Revenue

The following discussion of revenue is based on the results of our reportable segments as described in Note 9 to the Condensed Consolidated Financial Statements. Total revenue is principally derived from three reportable segments: Servers, Visual Workstations and Global Services. These segments were determined based on factors such as customer base, homogeneity of products, technology, delivery channels and other factors. Effective for fiscal 2002, we reorganized our Global Services segment and removed the remanufactured systems sales from this segment. The remanufactured systems sales operating unit does not meet the quantitative thresholds for separate disclosure and is included in "Other" in the reconciliation of reported revenue. Prior year amounts have been restated to conform to current year presentation.

Revenue for the first quarter of fiscal 2002 included a one-time receipt of \$62.5 million from Microsoft Corporation resulting from an agreement involving a patent cross-license and the transfer of certain of SGI's non-core intellectual property rights. Revenue for the first quarter of fiscal 2002 without the Microsoft revenue was \$317 million, substantially lower compared with the corresponding period of fiscal 2001. This decline reflects a general economic slowdown, strong competition from much larger companies and other factors discussed below that affected particular product families.

The following table presents total revenue by reportable segment with prior year segments restated to reflect current year presentation:

| | Three Months Ended | |
|---------|---------------------------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| | (Numbers may not add due to rounding) | |
| | \$ in millions | |
| Servers | \$ 97 | \$ 146 |

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| | Three Months Ended | |
|---------------------|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| % of total revenue | 26% | 34% |
| Visual Workstations | \$ 57 | \$ 96 |
| % of total revenue | 15% | 23% |
| Global Services | \$ 125 | \$ 138 |
| % of total revenue | 33% | 32% |
| Other | \$ 100 | \$ 46 |
| % of total revenue | 26% | 11% |

Server revenue for the first quarter of fiscal 2002 decreased \$49 million or 34% compared with the corresponding period of fiscal 2001.

Visual Workstation revenue for the first quarter fiscal 2002 decreased \$39 million, or 41% compared with the corresponding period of fiscal 2001. The decrease is primarily attributable to the continuing decline in our UNIX® workstation market.

Global Services revenue is comprised of hardware and software support and maintenance and professional services. Global Services revenue for the first quarter of fiscal 2002 decreased \$13 million, or 10% compared with the corresponding period of fiscal 2001. The decrease primarily reflects a decline in our professional services revenue, coupled with a decline in our traditional customer support revenue.

Other revenue is generally comprised of our operating units that are not reportable segments, including the product and service revenue of our software subsidiary, Alias/Wavefront, and remanufactured system sales. The Microsoft revenue is also included in other revenue in the first quarter of fiscal 2002.

Adjusted to exclude the Microsoft revenue, revenue by reportable segment as a percentage of total revenue for the first quarter of fiscal 2002 was: Servers 31%, Visual Workstations 18%, Global Services 39% and Other 12%.

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

| Area | Three Months Ended | |
|---------------|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| Americas | \$ 249 | \$ 246 |
| Europe | 69 | 97 |
| Rest of World | 61 | 83 |
| Total revenue | \$ 379 | \$ 426 |

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

| Area | Three Months Ended | |
|---------------|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| Americas | 66% | 58% |
| Europe | 18% | 23% |
| Rest of World | 16% | 19% |

Adjusted to exclude the Microsoft revenue, geographic revenue in absolute dollars and as a percentage of total revenue for the first quarter of fiscal 2002 is as follows: Americas \$187 million or 59%; Europe \$69 million or 22%; and Rest of World \$61million or 19%. The geographic revenue mix in the first quarter of fiscal 2002, as adjusted, did not shift significantly when compared with the corresponding period in fiscal 2001. In terms of absolute dollars, decreases in revenue were experienced across all regions primarily due to lower volumes.

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Our consolidated backlog at September 28, 2001 was \$231 million compared with \$209 million at June 30, 2001.

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. Costs associated with non-recurring engineering revenue are included in research and development expense. 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 first quarter of fiscal 2002 increased to 45.8% compared with gross margin of 33.6% in the corresponding period of fiscal 2001. Excluding the \$62.5 million in revenue recognized from the Microsoft agreement, gross margin was 35.1% in the first quarter of fiscal 2002. Gross margin in the first quarter of fiscal 2002 was negatively impacted by an unfavorable product mix and inventory charges related to the 400 to 500 megahertz chip transition and a significant reduction in the market value of memory, partially offset by gross margin improvements attained as a result of ending the Pentium® III-based product lines. Gross margin in the first quarter of fiscal 2001 reflects the effect of component shortages on high-end, high profit margin systems, particularly on the products within our Origin scalable server and Onyx graphics systems businesses. These component shortages affected shipping patterns and were a factor in causing a higher percentage of our revenue to come from lower margin products.

Operating Expenses

| | Three Months Ended | |
|-------------------------------------|--------------------|----------------|
| | Sept. 28, 2001 | Sept. 30, 2000 |
| | \$ in millions | |
| Research and development | \$ 48 | \$ 57 |
| % of total revenue | 12.6% | 13.4% |
| Selling, general and administrative | \$ 141 | \$ 186 |
| % of total revenue | 37.1% | 43.5% |
| Other | \$ 32 | \$ (6) |
| % of total revenue | 8.5% | (1.5)% |

Operating Expenses (excluding Other Operating Expense). Operating expenses for the first quarter of fiscal 2002 declined 23% in absolute dollars from the same period of fiscal 2001. This decrease

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resulted primarily from lower headcount as a result of restructuring activities and attrition, a reduction in outside service expenses and the impact of our overall expense control measures aimed at bringing operating expenses more in line with revenues. However, excluding revenue associated with the Microsoft agreement, research and development expense for the first quarter of fiscal 2002 rose to 15% as a percentage of revenue, while selling, general and administrative expense were relatively flat at 44% of total revenue. First quarter fiscal 2002 operating expenses also includes \$12 million of charges associated with the implementation of an ERP system that were not incurred in the corresponding period of fiscal 2001.

Other Operating Expense. Other operating expense for the first quarter of fiscal 2002 represents a \$32 million charge for estimated restructuring costs associated with the fiscal 2002 restructuring plan. Other operating expense for the first quarter of fiscal 2001 represents a \$6 million reduction to the restructuring costs we estimated during the first quarter of fiscal 2000. See Note 6 to the Condensed Consolidated Financial Statements, "Other Operating Expense," for further information regarding these activities.

Interest and Other

Interest Income and Other, Net Interest income and other, net includes interest on our cash investments, interest expense, gains and losses on other investments, and other non-operating items. Interest income and other, net for the first quarter of fiscal 2002 declined in comparison to the corresponding period of fiscal 2001 mainly due to lower interest income as a result of lower cash balances.

Other Non-recurring income (expense) Other non-recurring expense of \$13 million for the first quarter of fiscal 2002 includes a charge for the settlement of a securities class action lawsuit involving a payment of \$4 million in cash and the issuance of 8 million additional shares of common stock and a loss on the sale of corporate real estate. Other non-recurring income for the first quarter of fiscal 2001 includes a \$39 million gain on the sale of marketable investments and a \$12 million gain related to the sale of the Cray product line.

Taxes Our provision for income taxes for the first quarter of fiscal 2002 and fiscal 2001 arose principally from taxes currently payable in foreign jurisdictions.

Financial Condition

At September 28, 2001, cash and cash equivalents and marketable investments totaled \$122 million compared with \$126 million at June 30, 2001. Also, included in the balance sheet at September 28, 2001 and June 30, 2001 is approximately \$61 million and \$77 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 \$34 million during the first three months of fiscal 2002 compared with using \$75 million during the first quarter of fiscal 2001. Operating cash flows for the first quarter of 2002 also benefitted from \$62.5 million in one-time revenue from the Microsoft intellectual property agreement. To present cash flows from operating activities, net loss for the first quarter of fiscal year 2002 was adjusted for certain significant items. The first quarter of fiscal year 2002 net loss is adjusted to remove the impact of the \$32 million restructuring charge. The first quarter of fiscal 2001 net loss is adjusted to remove the impact of the \$39 million gain on sale of marketable investments, which is reflected as a cash flow from investing activity.

Negative operating cash flow in the first quarter of fiscal 2002 was partially due to approximately \$29 million in cash payments for severance, contractual obligations, and vacated facilities related to our restructuring plans. These restructuring plans are expected to result in future cash outlays of

approximately \$81million, the majority of which will occur in fiscal 2002 and will be funded through cash and cash equivalents. The negative operating cash flows were partially offset by a decrease in accounts receivable attributable to lower revenue levels coupled with increased focus on customer cash collections.

Investing activities, other than changes in available-for-sale and restricted investments, provided \$15 million in cash during the first quarter of fiscal 2002 compared with consuming \$4 million in cash during the first quarter of fiscal 2001. The principal source of cash during the first quarter of fiscal 2002 was the \$26 million net cash proceeds received as a result of the sale of corporate real estate and fixed assets. Investing activities in the first quarter of fiscal 2001 consisted of capital expenditures of \$41 million, offset in part by the proceeds received from the sale of marketable investments.

Financing activities used \$1 million during the first quarter of fiscal 2002 and 2001. The principal financing activity in the first three months of fiscal 2002 was the use of \$1 million for debt payments. The principal financing activities during the first quarter of fiscal 2001 included the use of \$2 million for debt payments, offset in part by proceeds from the issuance of stock.

At September 28, 2001, our principal sources of liquidity included cash and cash equivalents and unrestricted marketable investments of \$122 million. Because our cash levels fluctuate significantly during the quarter, and especially given the uncertainties of the current business climate, we have been actively working to improve our liquidity situation.

On November 9, 2001, NEC Corporation and its publicly held affiliate, NEC Soft, acquired 40% and 20% respectively of SGI Japan, Ltd. for approximately \$95 million. SGI expects its net proceeds to be approximately \$70 million after settlement of inter-company accounts, deal expenses and customary closing adjustments. SGI Japan has entered into a long-term exclusive distribution agreement with SGI Japan to supply SGI equipment, services and solutions in Japan. This transaction also involves the restructuring of SGI's 6 billion Japanese yen loan incurred through SGI Japan. On an inter-company basis, SGI's obligation to SGI Japan has been restructured to mature in quarterly installments beginning in calendar 2002 and ending December 2004. As a result of the new ownership structure of SGI Japan, SGI also expects the underlying bank debt, currently guaranteed to SGI and due to mature in December 2001, to be restructured by SGI Japan through extended repayment terms or reduced through additional equity investments.

Other actions that have been taken and as to which discussions are in progress include cutting our operating expense levels to reduce cash consumed in operations, and raising cash through licensing and sales transactions involving real estate, intellectual property and other assets not deemed core to our business. Of course, re-establishing profitable operations is our ultimate goal. While a forecast of future events is inherently

uncertain, we believe that the combination of our current resources and cash generated from our planned licensing and sales transactions and our fiscal 2002 operating plan, will provide sufficient funding to enable the Company to meet its obligations through at least June 30, 2002. We are committed to the successful execution of our business turnaround, and will take steps if necessary to further restructure our business operations to reduce expenses. The failure to execute successfully on this program, if combined with a failure to achieve our planned-for operating results, inability to restructure our debt or significant changes in the terms of our relationships with key suppliers, could result in our not having adequate liquidity to manage our business.

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. This discussion highlights some of these risks.

Working Capital Requirements. Primarily as a result of net losses, our operating activities consumed \$34 million in cash during the first quarter of fiscal 2002. Unrestricted cash and marketable investments

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declined from \$126 million at June 30, 2001, to \$122 million at September 28, 2001. Because our cash levels fluctuate significantly during the quarter, and especially given the uncertainties of the current business climate, we have been actively working to improve our liquidity situation. Actions that have been taken and as to which discussions are in progress include cutting our operating expense levels to reduce cash consumed in operations, and raising cash through licensing and sales transactions involving real estate, intellectual property and other assets not deemed core to our business. The failure to execute successfully on this program, if combined with a failure to achieve our planned-for operating results or significant changes in the terms of our relationships with key suppliers, could result in our not having adequate liquidity to manage our business.

Given our credit rating, if we should need to obtain short-term borrowings, there can be no assurance that such borrowings would be available or could be obtained at reasonable rates. The inability to obtain such borrowings could have a material adverse impact on our operations, financial condition and liquidity.

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. The facility is currently secured by U. S. accounts receivable and inventory, the pledge of certain intellectual property and a \$7 million cash deposit. The credit facility also contains financial and other covenants. During the first quarter of fiscal 2002, we were not in compliance with the financial covenants relating to EBITDA for the fourth quarter of fiscal 2001 and the \$50 million daily unrestricted cash balances requirement and have obtained a waiver from the lender of these defaults. In the event we are not able to comply with the financial and other covenants of this facility in the future, or there is 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, it would have a significant impact on our working capital.

Impact of Business Climate and Recent Developments. SGI's business was hampered throughout fiscal 2001 by a weakening business climate that affected the willingness of customers globally to make substantial investments in information technology. It is too early to assess the extent to which the events of September 11, 2001 have exacerbated these trends, except that some adverse impact on SGI's results for the quarter ended September 28, 2001 was experienced. If the medium-term effect is to further depress the business climate, and if shortfalls in sales to private sector customers are not offset by increased sales to government customers, especially in the national defense and intelligence areas, then SGI would fail to achieve its planned-for operating results, which will further weaken SGI's financial condition.

Expense Reduction Program. SGI has had declining revenue and has been unprofitable on an operating basis for each of the past four fiscal years. While our operating expenses, excluding other operating expenses, have declined substantially over the last two years on a pro forma basis, they have declined at a slower rate than revenues. During the fourth quarter of fiscal 2001, we announced and began to implement restructuring actions with the objective of reducing our operating expenses and restoring long-term profitability to SGI. These actions resulted in aggregate charges of \$88 million and were broad-based, covering virtually all aspects of our products, operations and processes. During the first quarter of fiscal 2002, we announced and began to implement further restructuring actions in order to align our expenses with the reduced levels of business experienced during fiscal 2001. These actions resulted in aggregate charges of \$30 million. We have also taken steps to begin the shut-down of our manufacturing facility in Switzerland if the transition of all manufacturing to our facility in Chippewa Falls is not completed in an expeditious and efficient manner, we could experience problems shipping systems to our customers. While our objective is to reduce our costs in a manner that will not have a material impact on revenue levels, there is no assurance that this will be achieved or that we will successfully reduce our operating expenses in a timely manner and to a level sufficient to become breakeven or cash flow positive in fiscal 2002.

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Implementation of Global IT System. SGI implemented a global system for ERP at the start of fiscal 2002. During the first quarter of fiscal 2002, we experienced delays and inefficiencies in order entry, product shipment, customer billing and financial reporting. While the functioning of the system has continuously improved during this period, our operations have been affected by the transition to the new system and disruption to our business activity and cash flows could occur if the system does not perform as expected.

New Products. Our ability to meet our objectives for fiscal 2002 and beyond is highly dependent on the success of new products. We operate in a highly competitive, quickly changing environment, and our future depends on our ability to develop and introduce new products in a timely fashion. If we are unable to develop new products that our customers will buy, our business and operating results will be adversely affected. Any extended failure to meet these objectives could affect not only our ability to ship our backlog but to continue to attract new orders.

Dependence 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 longer-term addition of the Intel 64-bit architecture and additional outsourcing of manufacturing, 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 such as those that have existed during the 2001 fiscal year, 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, in the future, to Linux, is a key factor to our business success.

Employees. Our success depends on our ability to continue to attract, retain and motivate highly qualified technical, marketing and management personnel, who are in great demand. The uncertainties surrounding SGI's business prospects have increased the challenges of retaining world-class talent. We recently announced our plans to implement further restructuring actions that occurred during the first quarter of fiscal 2002. As we work through this process, there is no guarantee that we will not lose highly qualified employees.

Product Development and Introduction. Our continued success depends on our ability to develop and rapidly bring to market technologically complex and innovative 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 and external manufacturing teams, outside suppliers of key components such as semiconductor and storage products and outsourced manufacturing partners. The failure of any one of these elements could cause our new products to fail to meet specifications or to miss the aggressive timetables that we establish. There is no assurance that acceptance of our new systems will not be affected by delays in this process. As noted above, our ability to successfully attract and retain key technical, marketing and management personnel in a competitive hiring environment has a direct impact on our ability to maintain our product development timetables.

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.

Dual Platform Strategy. We have announced product roadmaps for both the server and workstation businesses that will, over the next five years, supplement our products based on the MIPS processor architecture with products based on the Intel processor architecture, and from the IRIX operating system to Linux and Windows NT. This process will involve our supporting both architectures indefinitely in order to provide flexibility and support to our customers. Risks associated with this strategy include uncertainty among employees, customers and partners, potential customer defection and higher operating expenses. There can be no assurance that we will introduce the new products required for these transitions as planned, successfully support our customer and partner base as they adopt these new products or otherwise manage this process in a way that will allow us to recover from this uncertainty.

Period To Period Fluctuations. Our operating results may fluctuate for a number of reasons. Delivery cycles are typically short, other than for large-scale server products. A little 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, the California energy situation or natural disasters. Demand can also be adversely affected 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 mix considerations, including geographic concentrations, the mix of product and service revenue, and the mix of server and desktop product revenue including the mix of configurations within these product categories.

Our results have typically followed a seasonal pattern, with stronger sequential growth in the second and fourth fiscal quarters, reflecting the buying patterns of our customers.

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

Our stock price, like that of other technology companies, is subject to significant volatility. If revenue or earnings in any quarter fail to meet the investment community's expectations, there could be an immediate impact on our stock price. The stock price may also be affected by broader market trends unrelated to our performance.

Competition. 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 and, in some segments, a larger installed base of customers and a wider range of available applications software. Competition may result in significant discounting and lower gross margins.

Impact Of Government Customers. 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 and the government's reservation of the right to cancel contracts for its convenience.

A portion of our business requires security clearances from the United States government. We have implemented measures to maintain our clearances in light of the fact that our CEO, Robert Bishop, is not a United States citizen. However, these arrangements are subject to customer review and approval and periodic review by the Defense Security Service of the Department of Defense. Any disruption or limitation in our ability to do business with the United States government could have an adverse impact on SGI.

Export Regulation. 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. The U.S. Departments of Commerce and Justice and the Swiss authorities are currently conducting civil and criminal investigations into SGI's compliance with the export regulations in connection with several export sales to Tier 3 countries. We believe that these matters will be resolved without a significant adverse effect on our business. However, there is no assurance that these matters will not have an unforeseen outcome that could impair the conduct of our business with the U.S. government or our sales outside the United States.

Our international sales would also be adversely affected if such regulations were tightened, or if they are not modified over time to reflect the increasing performance of our products.

Intellectual Property. 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. 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.

New York Stock Exchange Listing. The listing rules of the New York Stock Exchange generally require that listed securities trade at a minimum share price of \$1.00 per share when averaged over a 30 trading day period. On August 1, 2001, SGI was notified by the exchange that it was not in compliance with this criterion and required that this failure to meet the listing standards on February 14, 2002. If the Common Stock price fails to rise above this minimum threshold and if SGI fails to take action, such as a reverse stock split, to address this issue, the

Common Stock could be delisted from the exchange, which would impair the liquidity available to holders of the Common Stock.

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 Market Risk.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

We are defending putative securities class action lawsuits filed in the U.S. District Court for the Northern District of California and in California Superior Court for the County of Santa Clara in December 1997 and January 1998 alleging that SGI and certain of its officers made material misrepresentations and omissions during the period from July to October 1997. In September 2001, we reached a settlement of both the federal and state class actions which includes the payment of \$4 million in cash and the issuance of 8 million shares of SGI common stock to the settlement class. The settlement is subject to preliminary and final approval from the federal court.

We also have been defending a securities class action lawsuit involving Alias Research Inc., which was pending when we acquired Alias in June 1995. The Alias case, which was filed in 1991 in the U.S. District Court for the District of Connecticut, alleges that Alias and a former officer and director made material misrepresentations and omissions during the period from May 1991 to April 1992. In April 2001, plaintiffs and defendant reached an understanding that resolves this litigation, subject to final court approval.

We are also defending a claim for violation of provisions of the California Labor Code and a claim for violation of the Federal Fair Labor Standards Act (FLSA). After Defendant removed the case to federal court based on the existence of a federal question, plaintiff dismissed the FLSA claim and the matter was remanded to state court. In April 2001, plaintiff filed a further amended complaint adding a representative action under California Business and Professions Code section 17200.

The U.S. Departments of Commerce and Justice are currently conducting civil and criminal investigations into SGI's compliance with export regulations in connection with several export sales to Tier 3 countries. See "Risks That Affect Our Business Export Regulation."

Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits
- 10.27 Loan Agreement dated as of November 9, 2001 between SGI and SGI Japan, Ltd.

- (b) Reports on Form 8-K.

None

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SIGNATURES

