SILICON GRAPHICS INC
Form 10-Q
May 10, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 26, 2004.

or

o **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	**94-2789662**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1500 Crittenden Lane, Mountain View, California 94043-1351
(Address of principal executive offices) (Zip Code)

(650) 960-1980
(Registrant s telephone number, including area code)

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 ý No o

As of April 30, 2004 there were 261,040,072 shares of Common Stock outstanding.

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

Yes ý No o

SILICON GRAPHICS, INC.

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

		Page No.
PART I-FINANCIAL INFORMATION		
Item 1.	Financial Statements (Unaudited):	
	Condensed Consolidated Statements of Operations	3
	Condensed Consolidated Balance Sheets	4
	Condensed Consolidated Statements of Cash Flows	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Results of Operations and Financial Condition	16
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	26
Item 4.	Controls and Procedures	26
PART II-OTHER INFORMATION		
Item 1.	Legal Proceedings	27
Item 6.	Exhibits and Reports on Form 8-K	27
Signatures		28

Trademarks used in this Form 10-Q: Silicon Graphics, Altix, O2, Octane, Onyx, Origin, Reality Center, IRIX, Silicon Graphics Fuel and SGI are registered trademarks, and Tezro, and CXFS are trademarks of Silicon Graphics, Inc. in the U.S. and/or other countries worldwide. MIPS is a registered trademark of MIPS Technologies, Inc. used under license by Silicon Graphics, Inc. UNIX is a registered trademark of The Open Group, in the U. S. and other countries. Intel and Itanium are trademarks or registered trademarks of Intel Corporation or its subsidiaries in the U. S. and other countries. Linux is a registered trademark of Linus Torvalds.

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		Nine Months Ended	
	March 26, 2004	March 28, 2003	March 26, 2004	March 28, 2003
Product and other revenue	$ 132,025	$ 113,233	$ 398,774	$ 403,593
Service revenue	98,138	103,894	287,329	317,990
Total revenue	230,163	217,127	686,103	721,583
Costs and expenses:				
Cost of product and other revenue	70,115	75,528	219,583	246,534
Cost of service revenue	55,532	61,118	156,413	182,929
Research and development	30,287	44,911	95,862	130,474
Selling, general and administrative	72,275	80,247	220,719	241,110
Other operating expense (1)	8,643	3,200	45,865	17,461
Total costs and expenses	236,852	265,004	738,442	818,508
Operating loss	(6,689)	(47,877)	(52,339)	(96,925)
Interest and other income (expense), net	538	(2,395)	(11,070)	(10,403)
Loss on extinguishment of tendered debt			(30,915)	
Loss before benefit for income taxes	(6,151)	(50,272)	(94,324)	(107,328)
Income tax benefit	(2,060)	(15,285)	(4,936)	(14,272)
Net loss	$ (4,091)	$ (34,987)	$ (89,388)	$ (93,056)
Net loss per share - basic and diluted	$ (0.02)	$ (0.17)	$ (0.41)	$ (0.46)
Common shares outstanding - basic and diluted	229,743	201,990	216,782	200,805

(1) Represents charges for estimated restructuring costs and asset impairments in each of the three and nine-month periods ended March 26, 2004 and March 28, 2003.

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

SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 26, 2004 (unaudited)	June 27, 2003 (1)
Assets:		
Current assets:		
Cash and cash equivalents	$ 144,786	$ 140,836
Short-term marketable investments	1,285	440
Short-term restricted investments	33,117	35,298
Accounts receivable, net	128,336	133,166
Inventories	71,515	71,426
Prepaid expenses and other current assets	39,790	51,727
Total current assets	418,829	432,893
Restricted investments	905	1,430
Property and equipment, net	84,454	108,062
Other assets	103,367	107,469
	$ 607,555	$ 649,854
Liabilities and Stockholders Deficit:		
Current liabilities:		
Accounts payable	$ 71,848	$ 76,507
Accrued compensation	39,791	38,916
Income taxes payable	19,464	22,666
Deferred revenue	156,215	149,434
Other current liabilities	90,380	109,147
Current portion of restructuring charge	23,535	17,840
Current portion of long-term debt	22,666	16,894
Total current liabilities	423,899	431,404
Long-term debt	265,280	291,956
Other liabilities	82,824	91,385
Total liabilities	772,003	814,745
Stockholders deficit:		
Common stock and additional paid-in-capital	1,550,409	1,467,798
Accumulated deficit	(1,689,589)	(1,606,049)
Treasury stock	(6,771)	(6,715)
Accumulated other comprehensive loss	(18,497)	(19,925)
Total stockholders deficit	(164,448)	(164,891)
	$ 607,555	$ 649,854

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

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

SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(In thousands)	**Nine Months Ended March 26, 2004**	**March 28, 2003**
Cash Flows From Operating Activities:		
Net loss	$ (89,388)	$ (93,056)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	63,847	72,630
Amortization of premium on 6.50% Senior Secured Convertible Notes	(5,975)	
Loss on sale of real estate		4,687
Non-cash loss on extinguishment of tendered debt	30,915	
Non-cash asset impairment charges	3,009	1,051
Non-cash interest expense on induced conversion of debt	3,089	
Other	1,954	(464)
Changes in operating assets and liabilities:		
Accounts receivable	4,830	55,744
Inventories	(3,056)	15,009
Accounts payable	(4,659)	(6,603)
Accrued compensation	875	(18,305)
Deferred revenue	6,781	(17,537)
Other assets and liabilities	(24,945)	(51,060)
Total adjustments	76,665	55,152
Net cash used in operating activities	(12,723)	(37,904)
Cash Flows From Investing Activities:		
Proceeds from sale of real estate and fixed assets	10,615	6,432
Purchases of marketable investments	(883)	(449)
Proceeds from the maturities of marketable investments	38	4,857
Purchases of restricted investments	(76,410)	(165,704)
Proceeds from the maturities of restricted investments	79,365	159,413
Capital expenditures	(15,413)	(14,163)
Increase in other assets	(13,538)	(19,929)
Net cash used in investing activities	(16,226)	(29,543)
Cash Flows From Financing Activities:		
Payments of debt principal	(13,335)	(6,615)
Payments of debt issuance costs	(3,618)	
Sale of SGI common stock	2,582	1,607
Net proceeds from sale of SGI common stock through private placement	47,270	
Net cash provided (used in) financing activities	32,899	(5,008)

Net increase (decrease) in cash and cash equivalents		3,950		(72,455)
Cash and cash equivalents at beginning of period		140,836		213,302
Cash and cash equivalents at end of period	$	144,786	$	140,847

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

SILICON GRAPHICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation.

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

We have incurred net losses and negative cash flows from operations during each of the past four fiscal years. Our unrestricted cash and marketable investments at March 26, 2004 were $146 million, up from $141 million at June 27, 2003. While a forecast of future events is inherently uncertain, we believe that the combination of our current resources and cash expected to be generated from operations will be sufficient to meet our financial obligations through at least the next twelve months.

2. Stock-Based Compensation.

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

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

	Three Months Ended		Nine Months Ended	
(In thousands, except per share amounts)	**March 26, 2004**	**March 28, 2003**	**March 26, 2004**	**March 28, 2003**
Net loss-as reported	$ (4,091)	$ (34,987)	$ (89,388)	$ (93,056)
Additions:				
	48	58	184	208

Stock-based employee compensation expense included in net loss above								
Deductions:								
Stock-based employee compensation expense determined under fair value method for all awards		(1,144)		(1,683)		(3,442)		(6,777)
Pro forma net loss	$	(5,187)	$	(36,612)	$	(92,646)	$	(99,625)
Net loss per share basic and diluted as reported	$	(0.02)	$	(0.17)	$	(0.41)	$	(0.46)
Net loss per share basic and diluted pro forma	$	(0.02)	$	(0.18)	$	(0.43)	$	(0.50)

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

3. Other Operating Expense.

We have substantially completed our execution of the fiscal 2000, fiscal 2001 and fiscal 2003 restructuring plans, with the exception of certain vacated leased facilities that have lease terms expiring through the end of fiscal 2010. Our obligations associated with these leases as of March 26, 2004 were approximately $7 million, $5 million and $2 million, respectively, net of aggregated estimated sublease income of approximately $3 million between the fiscal 2000 and fiscal 2001 plans. Estimated sublease income associated with the fiscal 2003 plan is negligible.

During the fourth quarter of fiscal 2003, we announced and began to implement additional restructuring activities (fiscal 2004 restructuring plan). These actions resulted in aggregate charges of $10 million and the elimination of approximately 320 positions across all levels and functions.

Severance payments and related charges of $9 million consisted primarily of salary and expected payroll taxes, medical benefits, statutory legal obligations and outplacement services. The remaining $1 million in charges was comprised of costs associated with third party contract cancellations, outside consulting services and vacating approximately 6,400 square feet of administrative facilities overseas, with lease terms expiring through fiscal 2004. Estimated sublease income associated with these vacated facilities is negligible.

During the first nine months of fiscal 2004, we continued restructuring activities under the fiscal 2004 restructuring plan. These actions resulted in aggregate charges of $24 million and the elimination of approximately 475 positions across all levels and functions in the first quarter of fiscal 2004, aggregate charges of $13 million and the elimination of approximately 45 positions in the second quarter of fiscal 2004 and aggregate charges of $9 million in the third quarter of fiscal 2004. Severance payments and related charges of $15 million and $4 million in the first and second quarter of fiscal 2004, respectively, consisted primarily of salary and expected payroll taxes, medical benefits, statutory legal obligations and outplacement services. Severance payments and related charges in the third quarter of fiscal 2004 were negligible. In the third quarter of fiscal 2004, we adjusted our estimate of severance payments and related charges under the fiscal 2004 restructuring plan by approximately $0.3 million, due to lower than originally estimated severance and related costs and reduced our estimate of facilities related payments by approximately $0.4 million due to the reassessment of tax obligations. As a result of fiscal 2004 restructuring activities and moving our headquarters as described below, we also wrote down approximately $3 million of fixed assets during the first nine months of fiscal 2004. These write-downs included charges against leasehold improvements and associated furniture and fixtures held for disposal in the vacated buildings.

In the first quarter of fiscal 2004, we agreed to sublease our Amphitheatre Technology Center campus in Mountain View, California and relocate our headquarters to our nearby Crittenden Technology Center campus. This relocation was substantially completed during the third quarter of fiscal 2004. Under this sublease arrangement, we recorded charges of $27 million through the first nine months of fiscal 2004 of which $21 million represented the fair value of the future net sublease loss component and $6 million represented other facility costs directly associated with this arrangement. Pursuant to SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities , we are required to determine the fair value of future contractual obligations using our credit-adjusted risk-free interest rate at the point we cease to use the respective buildings. As such, we have discounted the future remaining obligations for each building, which approximate $18 million. We are also required to accrete this discounted estimated net sublease loss up to its undiscounted value of $70 million from the respective cease-use dates to the end of the lease terms ending in fiscal 2013. During the second and third quarters of fiscal 2004, we increased the fiscal 2004 restructuring accrual related to our headquarters relocation by $22 million and $14 million, respectively, by reclassifying to restructuring a previously recorded deferred gain associated with our old Amphitheatre Technology Center campus headquarters that was included in other liabilities.

The relocation of our Mountain View, California headquarters, which is now substantially completed, is expected to result in a net reduction in our facilities occupancy costs of approximately $14 million to $17 million per year beginning in fiscal 2005. Beginning in fiscal 2004, we began to record annual accretion expense, as noted above, which will approximate $1 million to $8 million through fiscal 2013. The cash impact of these charges will be spread over the term of the sublease and we expect that the restructuring of these facilities will result in approximately $75 million in cash savings over that same period.

The remaining restructuring accrual balance of approximately $66 million at March 26, 2004 includes $1 million in severance obligations, $1 million of other restructuring related liabilities and $64 million of facility-related liabilities, net of estimated sublease income of $95 million. Approximately $1 million for severance and related charges and $1 million for other restructuring-related charges will be paid in the fourth quarter of fiscal 2004 and approximately $64 million, net, will be paid through fiscal 2013 for vacated facilities related expenditures.

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

Category	Severance and Related Charges	Canceled Contracts	Vacated Facilities	Other	Impairment Charges	Total
Balance at June 27, 2003	$ 7,191	$ 13	$ 24,648	$	$	$ 31,852
Additions fiscal 2004 restructuring and impairment	14,640	234	4,134	4,014	1,714	24,736
Adjustments:						
Decrease non-cash	(500)					(500)
Expenditures:						
Cash	(10,645)	(247)	(3,604)	(467)		(14,963)
Non-cash					(1,714)	(1,714)
Balance at September 26, 2003	$ 10,686	$	$ 25,178	$ 3,547	$	$ 39,411
Additions fiscal 2004 restructuring and impairment	3,596	407	9,416	1,143	827	15,389
Adjustments:						
Decrease non-cash	(303)		(2,100)			(2,403)
Reclassification non-cash			22,403			22,403
Expenditures:						
Cash	(10,137)	(407)	(5,062)	(613)		(16,219)
Non-cash					(827)	(827)
Balance at December 26, 2003	$ 3,842	$	$ 49,835	$ 4,077	$	$ 57,754
Additions fiscal 2004 restructuring and impairment	292		8,182	433	467	9,374
Adjustments:						
Decrease non-cash	(374)		(357)			(731)
Reclassification non-cash			14,058			14,058
Expenditures:						
Cash	(2,721)		(7,452)	(3,373)		(13,546)
Non-cash					(467)	(467)
Balance at March 26, 2004	$ 1,039	$	$ 64,266	$ 1,137	$	$ 66,442

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

Category	Servers	Workstations	Global Services	Total
Fiscal 2003 restructuring:				
Costs incurred to date: (1)				
Severance and Related Charges	$ 5,287	$ 2,212	$ 5,623	$ 13,122
Canceled Contracts	69	28	73	170
Vacated Facilities	77	32	81	190
Total fiscal 2003	$ 5,433	$ 2,272	$ 5,777	$ 13,482

(1) Cost incurred to date closely approximate total costs expected to be incurred

Category	Servers	Workstations	Global Services	Total
Fiscal 2004 restructuring:				
Costs incurred to date:				
Severance and Related Charges	$ 7,893	$ 1,874	$ 7,758	$ 17,525
Canceled Contracts	291	75	275	641
Vacated Facilities	9,942	2,339	9,452	21,733
Other	2,524	595	2,472	5,591
Impairment Charges	1,363	322	1,323	3,008
Total first nine months of fiscal 2004	$ 22,013	$ 5,205	$ 21,280	$ 48,498
Cumulative at March 26, 2004	$ 27,446	$ 7,477	$ 27,057	$ 61,980
Estimated future costs to be incurred under the 2004 restructuring plan:				
Severance and Related Charges	$ 439	$ 86	$ 425	$ 950
Vacated Facilities	21,995	5,940	20,136	48,071
Total costs to be incurred in future periods	$ 22,434	$ 6,026	$ 20,561	$ 49,021
Total costs expected to be incurred	$ 49,880	$ 13,503	$ 47,618	$ 111,001

4. Inventories.

(In thousands)	March 26, 2004	June 27, 2003
Components and subassemblies	$ 29,194	$ 39,939
Work-in-process	14,092	8,897
Finished goods	13,047	12,000
Demonstration systems	15,182	10,590

Total inventories	$	71,515	$	71,426

5. Property and Equipment.

(In thousands)		March 26, 2004		June 27, 2003
Property and equipment, at cost	$	507,462	$	576,330
Accumulated depreciation and amortization		(423,008)		(468,268)
Property and equipment, net	$	84,454	$	108,062

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

6. **Other Assets.**

(In thousands)	March 26, 2004	June 27, 2003
Spare parts	$ 35,764	$ 44,505
Investments	19,704	20,655
Software licenses, goodwill and other	47,899	42,309
	$ 103,367	$ 107,469

7. **Financing Arrangement.**

We currently have an asset-based credit facility that matures in April 2005. This facility is also subject to acceleration upon various events of default. The facility is secured by our U.S. and Canadian accounts receivable, U.S. inventory and equipment, the pledge of certain intellectual property and a $10 million cash deposit. Available credit under our asset-based credit facility is determined monthly based on 85% of eligible accounts receivable and an inventory collateral calculation based on the terms of the agreement. Generally, we do not use this facility for cash borrowings, but rather to support letters of credit, including letters of credit we are required to provide as security under certain lease obligations. We are currently using our full borrowing capacity under this line to secure $49 million in outstanding letters of credit. This obligation bears interest payable monthly at the prime rate plus 0.25% (4.25% at March 26, 2004) for cash advances and at 2.0% for letters of credit. We deposit additional cash collateral when the eligible accounts receivable and other collateral, which fluctuate within the quarter, are below the level needed to secure our outstanding letters of credit. At March 26, 2004, the credit facility was secured by a total of $23 million cash collateral, which is included as a component of Short-term Restricted Investments. The credit facility contains financial and other covenants. During the third quarter of fiscal 2004 we violated the minimum $50 million cash requirement covenant for which we received a waiver of compliance. During the second quarter of fiscal 2004 we had one violation of a covenant that was administrative in nature for which we received a waiver of compliance. We also obtained a waiver of compliance with the covenants of the predecessor to this facility from the lender in the first, third and fourth quarters of fiscal 2003. In the event we are not able to comply with the financial and other covenants of this facility in the future, or there is a material adverse change affecting our ability to repay the outstanding balance, the facility may be declared to be in default. If a default is declared and not waived it could have a significant impact on our working capital position.

8. **Equity Issuances**

On February 17, 2004, we sold 18,181,818 shares of our common stock, par value $0.001 per share, for an aggregate purchase price of $50 million ($2.75 per share) to certain institutional investors in a private placement transaction. The proceeds, net of associated costs of approximately $3 million, are expected to be used for general working capital purposes.

On February 19, 2004, we also issued 959,520 shares of our common stock to certain of these institutional investors in connection with their conversion of $24 million aggregate principal amount of our 6.50% Senior Secured Convertible Notes due June 2009 into 19,190,400 common shares. In accordance with FAS 84, Induced Conversion of Convertible Debt , we recorded approximately $3 million in non-cash interest expense representing the fair market value of the additional 959,520 shares of common stock issued.

9. Debt

(In thousands)	March 26, 2004	June 27, 2003
Senior Secured Convertible Notes due June 1, 2009 at 6.50%, including unamortized premium of $24,458	$ 213,609	$
Convertible Subordinated Debentures due February 1, 2011 at 6.125%, net of unamortized discount of $7,509 ($8,097 at June 27, 2003)	49,267	48,679
Japanese Yen fixed rate loan due in quarterly installments through December 31, 2004 at 10.00%	18,817	29,563
Senior Convertible Notes due September 1, 2004 at 5.25%	3,849	230,591
Senior Secured Notes due June 1, 2009 at 11.75%	2,386	
Other	18	17
	287,946	308,850
Less amounts due within one year	(22,666)	(16,894)
Amounts due after one year	$ 265,280	$ 291,956

In December 2003, we exchanged $224 million of newly issued 6.50% Senior Secured Convertible Notes due 2009 (the Senior Secured Convertible Notes) and $2 million of 11.75% Senior Secured Notes due 2009 (the Senior Secured Notes) for 98% of our existing 5.25% Senior Convertible Notes due in September 2004 (the 2004 Senior Notes). The Senior Secured Convertible Notes are convertible at the holders option into shares of common stock at a conversion price equal to $1.25 per share. The earliest our Senior Secured Convertible Notes are redeemable at our option is the beginning of December 2005. During calendar 2006, the Senior Secured Convertible Notes may be redeemed at our option at 100% of the principal amount if the closing price of our common stock has been at least 150% of the conversion price for the 20 consecutive trading days ending two trading days prior to the notice of redemption. Thereafter, the Senior Secured Convertible Notes may be redeemed at our option at 100% of the principal amount. The Senior Secured Notes are not convertible and are redeemable at our option at varying prices based on the year of redemption beginning in June 2004 at 104% of the principal amount. Both the Senior Secured Convertible Notes and the Senior Secured Notes are redeemable at the option of the holder in the event of the sale of all, or substantially all, of our common stock for consideration other than common stock traded on a U.S. exchange or approved for quotation on the Nasdaq National Market. Both the Senior Secured Convertible Notes and the Senior Secured Notes are also secured by a junior priority security interest in those assets in which the lenders under our secured credit facility currently hold a senior priority security interest. See Note 7 to the Condensed Consolidated Financial Statements for further information regarding our secured credit facility.

The debt exchange was accounted for as an extinguishment of the tendered debt and resulted in a non-cash loss of approximately $31 million, recorded in the second quarter of fiscal 2004 primarily representing the difference between the fair value of the new debt instruments and the net carrying value of the extinguished debt. The difference is treated as a premium on the new Senior Secured Convertible Notes and is being amortized as an offset to interest expense over the term of the Notes. Also included in the $31 million loss was a write-off of $0.4 million in debt issuance costs associated with the extinguished debt.

In the third quarter of fiscal 2004, approximately $35 million of our principal amount Senior Secured Convertible Notes were converted, resulting in the issuance of approximately 28 million shares of common stock, including approximately 19 million shares related to our induced conversion transaction further described in Note 8. The unamortized premium on our Senior Secured Convertible Notes was also reduced by $6 million, of which approximately $1 million was due to regular amortization and $5 million resulted from debt conversions.

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

In connection with the fiscal 1996 acquisition of Cray Research Inc., we assumed the 6.125% Convertible Subordinated Debentures due 2011. These debentures are convertible into shares of our common stock at a conversion price of $39.17 per share at any time prior to maturity and may be redeemed at our option at a price of 100% of the principal amount. Prior to our acquisition of Cray, Cray repurchased a portion of the debentures with a face value of $33 million. The repurchase satisfied the first six required annual sinking fund payments of approximately $6 million originally scheduled for fiscal years 1997 through 2002. In fiscal 2000 and fiscal 1999, we repurchased additional portions of the debentures with face values of $11 million and $15 million, respectively. These repurchases satisfied the next four required annual sinking fund payments of approximately $6 million originally scheduled for fiscal years 2003 through 2006. Remaining annual sinking fund payments of approximately $5 million in fiscal 2007 and approximately $6 million each from fiscal 2008 to 2010 are scheduled, with a final maturity payment of approximately $35 million in 2011.

10. Guarantees.

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

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

Performance guarantees include contracts that contingently require us to make payments to the beneficiary of the guarantee based on another entity s failure to perform under an obligating agreement. We had no outstanding performance guarantees at March 26, 2004 that are subject to the disclosure requirements of FIN 45.

Indemnifications include agreements that contingently require us to make payments to an indemnified party based on changes in an underlying variable (e.g. a specified interest rate, security price or other variable) that is related to an asset, liability, or an equity security of the indemnified party. Indemnifications include agreements to indemnify the guaranteed party for an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law. Indemnifications for this purpose do not include

agreements in favor of customers with respect to potential intellectual property or other liabilities. Currently, we have issued indemnifications to cover potential exposure related to the payment of additional taxes. The term of an indemnification is based on the length of time required to settle the dispute.

The following table discloses our maximum potential obligations under guarantees as of March 26, 2004:

(In thousands)	Maximum Potential Amount of Future Payments	Assets Held as Collateral
Financial guarantees	$ 52,653	$ 52,653
Indemnifications	647	632
Total	$ 53,300	$ 53,285

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

(In thousands)	2004	2003
Product warranty beginning balance	$ 6,711	$ 8,958
New warranties issued	7,500	7,758
Warranties paid	(8,159)	(10,232)
Changes in warranty rate estimates	(1,310)	
Product warranty ending balance	$ 4,742	$ 6,484

11. Loss Per Share.

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

(In thousands, except per share amounts)	Three Months Ended March 26, 2004	Three Months Ended March 28, 2003	Nine Months Ended March 26, 2004	Nine Months Ended March 28, 2003
Net loss available to common stockholders	$ (4,091)	$ (34,987)	$ (89,388)	$ (93,056)
Weighted average shares outstanding - basic and diluted (1)	229,743	201,990	216,782	200,805
Net loss per share - basic and diluted	$ (0.02)	$ (0.17)	$ (0.41)	$ (0.46)
	165,822	18,545	90,070	17,264

Potentially dilutive weighted securities excluded from computations because they are anti-dilutive (2)

(1) The increase in weighted average shares outstanding in the three- and nine-month periods ended March 26, 2004 is primarily the result of approximately 47 million non-weighted shares issued in conjunction with our private placement transaction (18 million shares), the conversion of our 2009 6.50% Senior Notes and related stock consideration (20 million shares) and other conversions of these same 2009 6.50% Senior Notes (9 million shares). The weighting of these shares is based on the timing of these transactions within the quarter.

(2) The increase in potentially dilutive securities in the three- and nine-month periods ended March 26, 2004 is primarily the result of approximately 151.3 and 81.5 million weighted shares, respectively, (151.3 million shares non-weighted) associated with the convertible feature of our new 6.50% Senior Secured Convertible Notes.

12. Comprehensive Loss.

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

	Three Months Ended		Nine Months Ended	
(In thousands)	**March 26, 2004**	**March 28, 2003**	**March 26, 2004**	**March 28, 2003**
Net loss	$ (4,091)	$ (34,987)	$ (89,388)	$ (93,056)
Change in unrealized gain on derivative instruments designated and qualifying as cash flow hedges	434	155	184	1,431
Foreign currency translation gain adjustments	103	176	1,244	17
Comprehensive loss	$ (3,554)	$ (34,656)	$ (87,960)	$ (91,608)

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

(In thousands)	**March 26, 2004**	**June 27, 2003**
Unrealized loss on derivative instruments designated and qualifying as cash flow hedges	$ (197)	$ (381)
Foreign currency translation adjustments	(18,300)	(19,544)
Accumulated other comprehensive loss	$ (18,497)	$ (19,925)

13. Segment Information.

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

SGI has three reportable segments: Servers, Workstations and Global Services. Based on how our Chief Executive Officer reviews the business, reportable segments were derived based on factors such as customer base, homogenuity of products, technology, delivery channels and other factors. Effective for fiscal 2004, we removed our prior generations of workstations, graphics systems and high-performance servers included in the Remarketed Products Group from the Server and Workstations segments after reassessment of factors such as economic characteristics, homogeneity of products, technology and other factors. The Remarketed Products Group does not meet the quantitative thresholds required for separate disclosure and is included in Other in the reconciliation of reported revenue and operating profit. Prior year amounts have been reclassified to conform to current year presentation.

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

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

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

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

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

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

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

	Three Months Ended			Nine Months Ended		
	Servers	Workstations	Global Services	Servers	Workstations	Global Services
March 26, 2004:						
Revenue from external customers	$ 92,832	$ 18,244	$ 89,883	$ 272,969	$ 63,606	$ 261,788
Segment (loss) profit	$ (10,339)	$ (16,336)	$ 25,521	$ (44,766)	$ (47,143)	$ 77,104
March 28, 2003:						
Revenue from external customers	$ 64,853	$ 28,536	$ 95,857	$ 225,907	$ 105,643	$ 294,725
Segment (loss) profit	$ (46,939)	$ (24,680)	$ 24,131	$ (114,924)	$ (56,423)	$ 80,035

Reconciliation to SGI as reported (in thousands):

	Three Months Ended		Nine Months Ended	
	March 26, 2004	March 28, 2003	March 26, 2004	March 28, 2003
Revenue:				
Total reportable segments	$ 200,959	$ 189,246	$ 598,363	$ 626,275
Other	29,204	27,881	87,740	95,308
Total SGI consolidated	$ 230,163	$ 217,127	$ 686,103	$ 721,583
Operating loss:				
Total reportable segments	$ (1,154)	$ (47,488)	$ (14,805)	$ (91,312)
Other	3,108	2,811	8,332	11,848
Other operating (expense) income	(8,643)	(3,200)	(45,866)	(17,461)
Total SGI consolidated	$ (6,689)	$ (47,877)	$ (52,339)	$ (96,925)

14. Recent Accounting Pronouncements.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 . The Interpretation establishes accounting guidance for consolidation of variable interest entities that function to support the activities of the primary beneficiary. Interpretation 46 applies to any business enterprise, both public and private, that has a controlling interest, contractual relationship or other business relationship with a variable interest entity. Originally the provisions of Interpretation No. 46 were effective immediately for all variable interests in variable interest entities created before February 1, 2003 and no later than the first fiscal period beginning after June 15, 2003 for all variable interests in variable interest entities created before February 1, 2003. In October 2003, the FASB agreed to a broad-based

deferral of Interpretation 46 for public companies until the end of periods ending after December 15, 2003. In December 2003, the FASB again deferred the effective date of the Interpretation s provisions and agreed to a revised model for adoption allowing differing effective dates based on certain factors. The adoption of Interpretation 46 (as revised in December 2003) did not have a material impact on our consolidated financial position, results of operations, cash flows or financial statement disclosures. If we enter into any such arrangement with a variable interest entity in the future, and we are the primary beneficiary, our consolidated financial position or results of operations could be impacted.

15. Legal Proceedings.

In June 2002, we reached an agreement to resolve the claims asserted in a lawsuit originally filed as *Collette Sweeney v. Silicon Graphics, Inc. and Does 1-50, inclusive, CV 790199,* on June 5, 2000 in the Superior Court for the County of Santa Clara, State of California, and later dismissed by the plaintiffs but refiled as a representative action under California Business and Professions Code section 17200 by the plaintiffs original counsel. The lawsuit asserts claims for violations of provisions of the California Labor Code and California Wage Orders. The settlement agreement outlines a process for identifying and resolving claims from members of the represented class. This process was essentially completed in the third quarter of fiscal 2004 and we expect the complaint will be dismissed in the fourth quarter.

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

1999 and proposed certain adjustments. In February 2004, we reached agreement regarding these adjustments and believe that adequate amounts have been provided for the agreed adjustments.

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

On September 30, 2003, a lawsuit captioned *FuzzySharp Technologies Incorporated v. Silicon Graphics, Inc.* alleging patent infringement by an SGI workstation product was filed by FuzzySharp in the United States District Court for the Northern District of California, Civil Action No. C 03-4404 JCS. The parties have agreed in principle on a resolution to this litigation and expect it to be dismissed in the fourth quarter of fiscal 2004. This resolution is not expected to have a material impact on our financial condition, results of operations or liquidity.

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

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

16. Subsequent Event.

On April 15, 2004, we announced that we had reached a definitive agreement for the sale of our Alias graphics software business to Accel-KKR, a technology-focused private equity investment firm for a purchase price of $57.5 million in cash, subject to closing adjustments. The transaction is subject to customary closing conditions and is expected to close during the fourth quarter of fiscal 2004. We currently expect to realize approximately $50 million in pre-tax net proceeds after taking into account working capital requirements of the Alias business as well as transaction costs. As a result of this transaction, all employees of Alias, approximately 430, will transfer to the new independent Alias business at closing. Given the likely sale of Alias, our operating results for all periods presented in our 2004 Annual Report on Form 10-K will reflect the results of the Alias business, up to the closing date, as a discontinued operation. Subsequent to the closing of this transaction Alias will be a fully independent company and will not be reflected in our financial results.

Following is a summary of the estimated assets and liabilities held for sale at March 26, 2004, adjusted as specified in the purchase agreement:

(in millions)

Cash and short-term investments	$	6.9
Accounts receivable, net		16.7
Other current assets		2.1
Property and equipment, net		3.9
Other assets		0.7
Short-term deferred revenue		(15.9)
Other accrued liabilities		(10.5)
	$	3.9

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

MANAGEMENT S DISCUSSION AND ANALYSIS

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

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

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

Overview

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

We have incurred net losses and negative cash flows from operations for the past several years. During this time we have been engaged in a multifaceted turnaround process including the following key elements:

Repositioning SGI as a leader in supplying high performance systems based on the Intel Itanium processor and Linux operating system, while managing a long-term decline in sales of our traditional MIPS processor and IRIX operating system-based products. While our target markets have not changed, this has required a refocusing of our research and development investments. Our Altix product family of Intel/Linux based systems, introduced in January 2003, currently has revenues approximately equal to those from our traditional Origin server family. It is important to our success that our Altix revenues grow more rapidly than the expected continued decline of our MIPS/IRIX revenues.

Reducing our expenses to levels commensurate with our current revenues. We have reduced our total costs and expenses from $334 million in the quarter ended March 29, 2002 to $265 million in the quarter ended March 28, 2003 and further to $237 million in the quarter ended March 26, 2004, as a result of restructuring actions including headcount reductions and facility closures. These actions as well as improved business processes have also enabled us to retain relatively high gross margins for our industry (45.4% for the quarter ended March 26, 2004).

Eliminating non-core assets and businesses. We have focused our investments on the core elements of our business and have sought to generate cash from the sale of non-core businesses, fixed assets and intellectual property. On February 11, 2004, for example, we announced that we were considering the sale of our Alias graphics application software business and on April 15, 2004, we announced that we had reached a definitive agreement to sell this business in a transaction that we expect will yield approximately $50 million in pre-tax cash proceeds.

Strengthening our balance sheet and liquidity. During the quarter ended December 26, 2003 we completed an exchange offer under which we issued $226 million principal amount in senior secured notes due 2009 in exchange for notes that would otherwise have matured in September 2004. During the quarter ended March 26, 2004 we completed a private placement of common stock yielding net proceeds of $47 million. At March 26, 2004 we had cash and equivalents and unrestricted marketable investments of $146 million.

Results of Operations

(Numbers may not add due to rounding) (In millions, except per share amounts)	Three Months Ended		Nine Months Ended	
	March 26, 2004	March 28, 2003	March 26, 2004	March 28, 2003
Total revenue	$ 230	$ 217	$ 686	$ 722
Cost of revenue	126	137	376	429
Gross profit	105	80	310	292
Gross profit margin	45.4%	37.1%	45.2%	40.5%
Total operating expenses	111	128	362	389
Operating loss	(7)	(48)	(52)	(97)
Interest and other income (expense), net	1	(2)	(11)	(10)
Loss on extinguishment of tendered debt			(31)	
Loss before benefit for income taxes	(6)	(50)	(94)	(107)
Net loss	$ (4)	$		