SILICON GRAPHICS INC
Form 10-Q
November 09, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005.

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	**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 x No ¨**

As of October 28, 2005, there were 268,402,188 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 x No ¨**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). **Yes ¨ No x**

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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

(in thousands, except per share amounts, unaudited)

	Three Months Ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Revenue:		
Product and other revenue	$ 81,942	$ 92,135
Product revenue from related party	16,826	5,851
Service revenue	70,909	77,421
Total revenue	169,677	175,407
Costs and expenses:		
Cost of product and other revenue	67,360	65,785
Cost of service revenue	38,172	46,692
Research and development	23,365	23,306
Selling, general, and administrative	59,866	62,717
Other operating expenses, net (1)	7,185	3,166
Total costs and expenses	195,948	201,666
Operating loss	(26,271)	(26,259)
Interest expense	(3,475)	(5,136)
Interest and other income (expense), net	(360)	(36)
Loss from equity investment	(1,468)	(230)
Loss from continuing operations before income taxes	(31,574)	(31,661)
Income tax provision (benefit)	497	(3,732)
Net loss from continuing operations	(32,071)	(27,929)
Net loss from discontinued operations, net of tax		(276)
Net loss	$ (32,071)	$ (28,205)
Net loss per common share basic and diluted:		
Continuing operations	$ (0.12)	$ (0.11)
Discontinued operations		(0.00)

Net loss per share basic and diluted	$ (0.12)	$ (0.11)
Weighted-average shares used to compute net loss per share basic and diluted	266,761	262,039

(1) Represents charges for estimated restructuring costs, related accretion expense, and asset impairments in each of the three month periods ended September 30, 2005 and September 24, 2004.

See accompanying notes to these condensed consolidated financial statements.

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SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	Sept. 30, 2005	June 24, 2005
	(unaudited)	(1)
Assets:		
Current assets:		
Cash and cash equivalents	$ 77,163	$ 64,247
Short-term marketable investments	121	39
Short-term restricted investments	40,299	39,757
Accounts receivable, net	69,849	93,335
Inventories	66,462	75,662
Prepaid expenses	8,684	5,666
Other current assets	23,543	37,765
Total current assets	286,121	316,471
Restricted investments	414	413
Property and equipment, net of accumulated depreciation and amortization	50,303	56,257
Other non-current assets	73,124	79,004
	$ 409,962	$ 452,145
Liabilities and Stockholders Deficit:		
Current liabilities:		
Accounts payable	$ 52,930	$ 58,075
Accrued compensation	30,346	34,062
Income taxes payable	2,810	2,689
Other current liabilities	57,459	56,260
Current portion of deferred revenue	82,195	98,305
Current portion of restructuring liability	15,849	16,270
Current portion of long-term debt	3,267	1,820
Total current liabilities	244,856	267,481
Long-term debt	260,719	261,992
Non-current portion of deferred revenue	50,240	36,188
Other non-current liabilities	76,648	77,672
Total liabilities	632,463	643,333
Stockholders deficit:		
Common stock and additional paid-in capital	1,557,825	1,555,033
Accumulated deficit	(1,754,061)	(1,721,981)
Treasury stock	(6,781)	(6,792)
Accumulated other comprehensive loss	(19,484)	(17,448)
Total stockholders deficit	(222,501)	(191,188)

	$ 409,962	$ 452,145

(1) The condensed consolidated balance sheet at June 24, 2005 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.

See accompanying notes to these condensed consolidated financial statements.

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SILICON GRAPHICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Three Months Ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Cash flows from operating activities of continuing operations:		
Net loss	$ (32,071)	$ (28,205)
Loss on disposition of discontinued operations		276
Net loss from continuing operations	(32,071)	(27,929)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	13,536	15,028
Amortization of premium and discount on long-term debt, net	(994)	(965)
Share-based compensation expense	982	
Other	(575)	(1,500)
Changes in operating assets and liabilities:		
Accounts receivable	23,486	37,686
Inventories	6,325	(2,167)
Accounts payable	(5,145)	(5,020)
Accrued compensation	(3,716)	(6,459)
Deferred revenue	(3,357)	(4,262)
Other assets and liabilities	10,876	(12,144)
Total adjustments	41,418	20,197
Net cash provided by (used in) operating activities of continuing operations	9,347	(7,732)
Cash flows from investing activities of continuing operations:		
Purchases of marketable investments	(82)	(128)
Restricted investments:		
Purchases	(3,830)	(33,760)
Maturities	3,284	19,968
Purchases of property and equipment	(1,320)	(3,032)
Decrease (increase) in other assets	2,549	(1,843)
Net cash provided by (used in) investing activities of continuing operations	601	(18,795)
Cash flows from financing activities of continuing operations:		
Payments of debt principal	(167)	(8,491)
Net proceeds from financing arrangements	1,324	1,601
Proceeds from employee stock plans	1,811	1,495
Net cash provided by (used in) financing activities of continuing operations	2,968	(5,395)
Net increase (decrease) in cash and cash equivalents	12,916	(31,922)
Cash and cash equivalents at beginning of year - continuing operations	64,247	154,855

Cash and cash equivalents at end of year - continuing operations	$ 77,163	$ 122,933

See accompanying notes to these condensed consolidated financial statements.

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SILICON GRAPHICS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

These unaudited condensed consolidated financial statements include the accounts of Silicon Graphics, Inc. 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. These condensed consolidated financial statements 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 24, 2005 filed with the Securities and Exchange Commission.

We have incurred operating losses and negative cash flows from operations during each of the past several fiscal years. Our working capital at September 30, 2005 was $41 million, down from $49 million at June 24, 2005. Additionally, we had a stockholders deficit of $223 million at September 30, 2005, compared with $191 million at June 24, 2005. Our unrestricted cash and marketable investments at September 30, 2005 were $77 million, up from $64 million at June 24, 2005. On November 7, 2005, our securities ceased trading on the NYSE and our common stock began trading in the over-the-counter securities market under the symbol SGID. See Note 18 for additional discussion.

During the fourth quarter of fiscal 2005, we retained the turnaround firm AlixPartners LLC. The AlixPartners engagement includes assisting us in developing and implementing a restructuring program aimed at further substantial expense reductions, revenue and margin improvement initiatives and improved cash flow and liquidity.

On August 30, 2005, we approved a restructuring plan and began to implement a reduction in force with notifications to affected employees in North America and certain other locations on September 1, 2005. In addition to the headcount reductions, the restructuring plan includes initiatives to reduce expenses in other areas, including procurement costs for goods and services, consolidation and reorganization of operations in several locations including plans to exit one building at our U.S. corporate headquarters, reducing marketing spending by focusing on the highest priority activities and benefits and other spending controls. The anticipated benefits of this restructuring plan are expected to begin to be realized in the second quarter of fiscal 2006, and anticipated to continue over the remainder of the fiscal year. Although we expect to realize significant long-term cost savings as a result of these actions, the savings reflected in our operating expenses in the second quarter of fiscal 2006 will be partially offset by professional advisory fees incurred in connection with the cost reduction initiatives. See Note 3 for additional discussion related to our restructuring plans.

As our cash position at the end of fiscal 2005 was not sufficient to support our operations, we actively sought to raise additional financing. On October 25, 2005, we announced the completion of a new two-year asset-backed credit facility with Wells Fargo Foothill, Inc. and Ableco Finance LLC. See Note 18 for additional discussion related to this new credit facility. We cannot be certain however, that we will be able to maintain compliance with all of the covenants contained in this new credit facility or that this additional financing will be adequate to achieve our objectives.

Although we secured additional financing on October 25, 2005 as described in Note 18, there are significant risks associated with the achievement of our goals for fiscal 2006. While we are implementing initiatives developed in conjunction with AlixPartners aimed at improving revenue and margins for our core systems products, we expect to continue consuming cash from operations through at least the second quarter of fiscal 2006. The new funds and our current sources of liquidity will only be adequate for our fiscal 2006 operating needs if our restructuring plan yields its anticipated savings and we meet our operating goals for fiscal 2006. Our operating goals include returning to operating profitability in the second half of fiscal 2006, requiring us to achieve significant year-over-year revenue growth in that period while realizing our targeted expense savings and margin improvements. If we fail to achieve these targets, we will likely consume further cash in our operations, which would again impair our liquidity. If we are unable to achieve our targets, we would consider alternatives for ensuring the continued operation of our business. These alternatives could include further reductions in headcount and in the scope of our operations, generating cash from selling or licensing our intellectual property and seeking funding from marketing partners and government customers.

In light of these challenges, our Board of Directors is continuing to evaluate a range of strategic alternatives with the goal of preserving and creating value for the benefit of stockholders and creditors. Alternatives include pursuing our current strategy as an independent public company, seeking a strategic partner or acquirer, seeking a

financial partner to make a substantial equity investment, divesting additional technologies or products, or some combination of the foregoing. We cannot assure that any acquisition or other change in control transaction will occur, or that if such a transaction does occur that it would result in stockholders realizing value equal to or greater than the current trading price of our common stock. If we fail to implement one or more of these alternatives successfully and we have a significant shortfall against our fiscal 2006 operating plan, we could be forced to seek protection under bankruptcy laws.

2. Share-Based Compensation

Share-based Compensation Plans

On September 30, 2005, during the three months then ended, and during the three preceding fiscal years, we had three active share-based compensation plans, which are described below.

Our Amended and Restated 1993 Long-Term Incentive Stock Plan (the 1993 Plan) permits the grant to our employees of up to 3,800,000 restricted shares of our common stock and up to 30,938,808 of share options on our common stock. The 1993 Plan also permits the issuance of stock appreciation rights (SARs). Option awards are generally granted with an exercise price equal to the market price of our common stock at the date of grant; those awards generally vest based on four years of continuous service and have seven-year contractual terms. Restricted share awards generally vest in four annual installments. Vesting would be accelerated if there is a change in control of SGI and the successor corporation does not assume or issue an equivalent share right. Currently, there are no shares of restricted stock subject to repurchase.

Our Amended and Restated 1996 Supplemental Non-Executive Equity Incentive Plan (the 1996 Plan) permits the grant of shares of our common stock or equivalent instruments to our employees (which may be subject to conditions and restrictions) and/or of share options on up to a total of 22,500,000 shares of our common stock. Option awards are generally granted with an exercise price equal to the market price of our common stock at the date of grant; those awards generally vest based on four years of continuous service and have seven-year contractual terms. Restricted share awards generally vest in four annual installments. Vesting would be accelerated if there is a change in control of SGI and the successor corporation does not assume or issue an equivalent share right.

Our Amended and Restated 1998 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase our stock through payroll deductions at 85% of the lower of the closing prices for the stock at the beginning or the end of the six-month purchase period. The purchase periods generally begin in February and August. Purchases are limited to 10% of each employee s compensation and cannot exceed an amount set by the board of directors. Currently this amount is $3,500 per employee per purchase period.

Adoption of SFAS 123(R)

Prior to June 25, 2005, we accounted for our share-based compensation plans under the recognition and measurement provisions of APB Opinion No. (APB) 25, *Accounting for Stock Issued to Employees*, and related guidance, as permitted by SFAS 123, *Accounting for Stock-Based Compensation*. We did not recognize any significant share-based employee compensation costs in our statements of operations prior to fiscal 2006, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective June 25, 2005, we adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified-prospective transition method. Under that transition method, compensation cost recognized in the first quarter of fiscal 2006 includes

the following: (a) compensation cost related to any share-based payments granted through, but not yet vested as of June 24, 2005, and (b) compensation cost for any share-based payments granted subsequent to June 24, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Pro forma results for prior periods as presented below have not been restated.

As a result of adopting SFAS 123(R) using the modified prospective method, our loss from continuing operations before income taxes and net loss for the first quarter of fiscal 2006 includes approximately $1 million of stock-based compensation expense. The effect of recognizing this stock-based compensation expense for the first quarter of fiscal 2006 had no impact on our basic and diluted loss per share.

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The following table presents the pro forma effect on net loss from continuing operations and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to options granted under our share-based compensation arrangements during the first quarter of fiscal 2005 (in thousands, except per share amounts):

Net loss from continuing operations, as reported	$ (27,929)
Add: Share-based employee compensation expense included in reported net income, net of related tax effects	9
Deduct: Total share-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(1,396)
Net loss from continuing operations pro forma	$ (29,316)
Net loss per share from continuing operations:	
Basic and diluted as reported	$ (0.11)
Basic and diluted pro forma	$ (0.11)

For purposes of this pro forma disclosure, we estimated the value of the options using a Black-Scholes-Merton closed-form option pricing formula and amortized that value to expense over the options vesting periods. We allocated this fair value to the pro forma compensation expense of our fiscal periods using the accelerated expense attribution method specified in FASB Interpretation No. (FIN) 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.*

Compensation Cost

The compensation cost that has been charged against our results of operations and the total income tax benefit, if any, that we recognized on our statement of operations for these share-based compensation arrangements was as follows for the first quarter of fiscal 2006 (in thousands):

Share-based compensation cost included in:	
Cost of product and other revenue	$ 54
Cost of service revenue	174
Research and development	300
Selling, general, and administrative	455
Total share-based compensation cost	983
Income tax benefit recognized	
	$ 983

Because the amount of share-based compensation associated with our cost of production is not significant, we did not capitalize any share-based compensation cost as part of inventory and fixed assets during the first quarter of fiscal 2006.

Valuation of Stock Option Awards

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton closed-form option valuation model that uses the assumptions noted in the following table. Expected volatilities are based on historical volatility of our stock and other factors. We use historical data to estimate the options expected term, which represents the period of time that options granted are expected to be outstanding. For purposes of performing our valuation, we separated our employees into two groups, within which the employees have similar historical exercise behavior; the ranges given below result from certain groups of employees exhibiting different behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. We recognize compensation expense for the fair values of these awards, which have graded vesting, on a straight-line basis over the requisite service period of each of these awards.

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	Three months ended	
	Sept. 30, 2005	Sept. 24, 2004
Expected volatility	1.1	1.1
Expected term (in years)	2.43 5.84	2.91
Risk-free rate	3.96% 4.04%	1.69%
Expected dividends	0%	0%

Summary of Stock Options

A summary of options under all of our share-based compensation plans as of September 30, 2005 and changes during the first quarter of fiscal 2006 are as follows (in thousands, except exercise price and contractual term):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding at June 24, 2005	35,441	$ 2.58		
Options granted	287	$ 0.75		
Options exercised	(616)	$ 0.54		
Options forfeited or expired	(2,213)	$ 2.77		
Options outstanding at September 30, 2005	32,899	$ 2.59	5.84	$ 933
Options vested and exercisable at September 30, 2005	24,813	$ 2.96	5.47	$ 923

Aggregate intrinsic value is the sum of the amounts by which the quoted market price of our stock exceeded the exercise price of the options at September 30, 2005, for those options for which the quoted market price was in excess of the exercise price (in-the-money options). The weighted-average grant-date fair value of options granted during the first quarters of fiscal 2006 and fiscal 2005 was $0.62 and $1.08, respectively. The total intrinsic value of options exercised during the first quarters of fiscal 2006 and fiscal 2005, was $0.1 million and $0.2 million, respectively.

As of September 30, 2005, total unrecognized compensation cost related to unvested share-based compensation arrangements granted under our various plans was $3.4 million. We expect that cost to be recognized over a weighted-average period of 2.5 years.

Employee Stock Purchase Plan

As of September 30, 2005, we had issued 25,715,491 shares over the life of the ESPP and its predecessor plans. 2,454,478 and 970,352 shares were issued during the first quarters of fiscal 2006 and fiscal 2005, respectively. We currently have 6,560,531 shares in reserve for future issuance under the plan.

The fair value of each option element of our ESPP is estimated on the date of grant using the Black-Scholes-Merton closed-form option valuation model that uses the assumptions noted in the following table. Expected volatilities are based on historical volatility of our stock and other factors. Expected term represents the six-month offering period for our ESPP. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

	Three months ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Expected volatility	0.72	1.1
Expected term (in years)	0.5	0.5
Risk-free rate	3.79%	1.69%
Expected dividends	0%	0%

Disclosures Pertaining to All Share-Based Compensation Plans

Cash received from option exercises and ESPP contributions under all share-based payment arrangements for the first quarters of fiscal 2006 and fiscal 2005 was $1.1 million and $1.2 million, respectively. Because of our net operating losses, we did not realize any tax benefits for the tax deductions from share-based payment arrangements during the first quarters of fiscal 2006 and fiscal 2005.

3. Other Operating Expenses, Net

Other operating expenses, net represents the costs associated with our restructuring and impairment actions. These actions, by plan, were as follows during the first quarter of fiscal 2006 (in thousands):

	Balance at June 24, 2005	Costs Incurred	Adjustments	Cash Payments	Balance at Sept. 30, 2005
Fiscal 2000 plan:					
Vacated facilities	$ 1,282	$	$ (4)	$ (884)	$ 394
Fiscal 2001 plan:					
Vacated facilities	1,404		(138)	(564)	702
Fiscal 2002 plan:					
Severance and related charges	142				142
Vacated facilities	329		(10)	(54)	265
	471		(10)	(54)	407
Fiscal 2003 plan:					
Severance and related charges	114		(59)	(37)	18
Vacated facilities	127		58	(132)	53
	241		(1)	(169)	71
Fiscal 2004 plan:					
Severance and related charges	258			(10)	248
Vacated facilities	33,489	1,788	2	(2,199)	33,080
	33,747	1,788	2	(2,209)	33,328
Fiscal 2005 plan:					
Severance and related charges	1,891	270		(1,583)	578
Vacated facilities	6,482	190		(830)	5,842
	8,373	460		(2,413)	6,420
Fiscal 2006 plan:					
Severance and related charges		5,053		(1,580)	3,473

Vacated facilities		35		(10)	25
		5,088		(1,590)	3,498
All restructuring plans:					
Severance and related charges	2,405	5,323	(59)	(3,210)	4,459
Vacated facilities	43,113	2,013	(92)	(4,673)	40,361
Total of all restructuring plans	$ 45,518	$ 7,336	$ (151)	$ (7,883)	$ 44,820

During the first quarter of fiscal 2006, we made $8 million in payments related to all of our restructuring plans and actions, $3 million of which was for severance and related charges and $5 million of which was for vacated facilities obligations, primarily rent. We recognized costs of $7 million, of which $5 million was for severance and related charges and $2 million was for accretion and other costs related to our vacated leased facilities. We made minor adjustments to our estimates of severance and related costs and vacated facilities costs associated with the fiscal 2000, fiscal 2001, fiscal 2002, fiscal 2003, and fiscal 2004 restructuring plans. These adjustments primarily reflected net reductions in estimated costs for leased facilities that we vacated under these various restructuring plans.

The restructuring liability balance of $45 million at September 30, 2005 includes $5 million in severance obligations and $40 million of facility-related liabilities. The facility-related liabilities of $40 million represent $174 million in future non-cancelable rental payments due, less estimated sublease income of $96 million, the majority of which is under contract, and less $38 million in accretion expense that will be recognized through fiscal 2014. We expect to pay the majority of the accrued severance and related charges and $13 million of facility-related charges during the 12 months following September 30, 2005, with the remainder of our restructuring obligations to be paid through fiscal 2014.

As of September 30, 2005, we have substantially completed the execution of our fiscal 2000, fiscal 2001, fiscal 2002, fiscal 2003, fiscal 2004, and fiscal 2005 restructuring plans, with the exception of certain severance obligations of our international subsidiaries and payments associated with vacated leased facilities that have lease terms expiring through fiscal 2014. These facilities obligations are presented in these condensed consolidated financial statements net of aggregate estimated sublease income of $96 million. Of this estimated sublease income, $90 million is under contract and $6 million is not under contract.

As part of our fiscal 2004 restructuring plan, we agreed to sublease our Amphitheatre Technology Center campus in Mountain View, California and relocated our headquarters to our nearby Crittenden Technology Center campus. As required by SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, we determined the fair value of our future contractual obligations under these operating leases for this facility using our credit-adjusted risk-free interest rate as of the date we ceased to use the leased properties. As of September 30, 2005, the fair value of our future remaining obligations for the leased properties was $33 million. On a quarterly basis over the periods from the respective cease-use dates to the end of the lease terms (concluding in fiscal 2013), we are required to accrete these discounted future obligations up to their contractually obligated amount of $66 million using the effective interest method. This undiscounted value is net of $89 million of contractual sublease income for this facility. In fiscal 2004, we began recording restructuring accretion expense, which we expect to be between $2 million and $7 million annually through fiscal 2013. During the first quarter of 2006, we recorded $2 million in restructuring accretion expense for the Amphitheatre Technology Center.

As part of our fiscal 2005 restructuring plan, we vacated sales and administrative facilities throughout the world. As required by SFAS 146, we calculated and accrued the fair value of our future contractual obligations under these operating leases using our credit-adjusted risk-free interest rate as of the date we ceased to use the leased properties. As of September 30, 2005, the fair value of our future remaining obligations for the leased properties was $6 million. On a quarterly basis over the periods from the respective cease-use dates to the end of the lease terms (concluding in fiscal 2014), we are required to accrete these discounted future obligations for the leased property up to their contractually obligated amount of $10 million using the effective interest method. This undiscounted value is net of $7 million of non-contractual sublease income. In fiscal 2005, we began to record restructuring accretion expense, which we expect to be $1 million or less annually for this facility through fiscal 2014. Accretion expense was not significant during the first quarter of fiscal 2006.

In an effort to further reduce our operating expenses, we began to implement restructuring activities under the fiscal 2006 restructuring plan during the first quarter of fiscal 2006. We currently estimate that total costs to be incurred under these fiscal 2006 actions will be between $24 and $26 million, of which we estimate that between $10 million and $12 million relates to severance benefits and approximately $14 million represents facilities-related charges. Under this restructuring plan, we recognized costs during the first quarter of fiscal 2006 of $5 million for the elimination of 170 positions across most levels and functions. We expect to eliminate more positions under the fiscal 2006 restructuring plan and expect to complete these actions and make the remaining payments related to this fiscal 2006 action by the end of fiscal 2006. During the first quarter of fiscal 2006, we did not have significant costs related to vacating facilities or terminating contracts under the fiscal 2006 restructuring plan, but we expect to incur such costs under this plan during the remainder of fiscal 2006. Our obligation associated with the fiscal 2006 restructuring plan as of September 30, 2005 consisted primarily of $3 million in severance and related charges.

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The restructuring and relocation costs incurred during the first quarter of fiscal 2006, the cumulative amount incurred through September 30, 2005, and the total amount expected to be incurred for each major type of cost associated with our restructuring plans accounted for in accordance with SFAS 146 (our fiscal 2003, fiscal 2004, fiscal 2005, and fiscal 2006 plans) were as follows (in thousands):

	Products	Global Services	Total
Fiscal 2003 restructuring plan:			
Costs incurred and adjustments during the first quarter of fiscal 2005:			
Severance and related charges	$ (35)	$ (24)	$ (59)
Vacated facilities	34	24	58
Total	$ (1)	$	$ (1)
Cumulative costs incurred as of September 30, 2005 (which closely approximate total amount expected to be incurred):			
Severance and related charges	$ 7,283	$ 5,284	$ 12,567
Canceled contracts	97	73	170
Vacated facilities	309	225	534
Total	$ 7,689	$ 5,582	$ 13,271
Fiscal 2004 restructuring plan:			
Costs incurred and adjustments during the first quarter of fiscal 2005:			
Vacated facilities	$ 1,041	$ 749	$ 1,790
Cumulative costs incurred as of September 30, 2005:			
Severance and related charges	$ 11,406	$ 7,929	$ 19,335
Canceled contracts	377	264	641
Vacated facilities	18,147	12,939	31,086
Other	3,294	2,296	5,590
Impairment charges	1,805	1,257	3,062
Total	$ 35,029	$ 24,685	$ 59,714
Total amount expected to be incurred:			
Severance and related charges	$ 11,406	$ 7,929	$ 19,335
Canceled contracts	377	264	641
Vacated facilities	37,362	26,760	64,122
Other	3,294	2,296	5,590
Impairment charges	1,805	1,257	3,062
Total	$ 54,244	$ 38,506	$ 92,750
Fiscal 2005 restructuring plan:			
Costs incurred and adjustments during the first quarter of fiscal 2005:			
Severance and related charges	$ 157	$ 113	$ 270
Vacated facilities	111	79	190
Total	$ 268	$ 192	$ 460

Cumulative costs incurred as of September 30, 2005:			
Severance and related charges	$ 5,662	$ 4,374	$ 10,036
Vacated facilities	4,985	3,666	8,651
Total	$ 10,647	$ 8,040	$ 18,687
Total amount expected to be incurred:			
Severance and related charges	$ 5,662	$ 4,374	$ 10,036
Vacated facilities	7,593	5,542	13,135
Total	$ 13,255	$ 9,916	$ 23,171

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Fiscal 2006 restructuring plan:

Costs incurred and adjustments during the first quarter of fiscal 2005 (which are also the cumulative costs incurred as of September 30, 2005):

Severance and related charges	$ 2,939	$ 2,114	$ 5,053
Vacated facilities	20	15	35
Total	$ 2,959	$ 2,129	$ 5,088
Total amount expected to be incurred:			
Severance and related charges	$ 6,391	$ 4,597	$ 10,988
Vacated facilities	7,875	5,665	13,540
Total	$ 14,266	$ 10,262	$ 24,528

4. Inventories

Inventories were as follows (in thousands):

	Sept. 30, 2005	June 24, 2005
Components and subassemblies	$ 26,957	$ 25,526
Work-in-process	15,459	23,076
Finished goods	11,898	13,093
Demonstration systems	12,148	13,967
Total inventories	$ 66,462	$ 75,662

5. Other Current Assets

Other current assets were as follows (in thousands):

	Sept. 30, 2005	June 24, 2005
Deferred cost of goods sold	$ 8,806	$ 15,241
Value-added tax receivable	8,713	14,381
Other	6,024	8,143
Total other current assets	$ 23,543	$ 37,765

6. 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 our name by major financial institutions (see Note 9).

7. Property and Equipment

Property and equipment were as follows (in thousands):

	Sept. 30, 2005	June 24, 2005
Property and equipment, at cost	$ 378,207	$ 376,940
Accumulated depreciation and amortization	(327,904)	(320,683)
Property and equipment, net	$ 50,303	$ 56,257

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8. Other Non-Current Assets

Other non-current assets were as follows (in thousands):

	Sept. 30, 2005	June 24, 2005
Spare parts	$ 24,239	$ 25,913
Investments	12,995	16,213
Goodwill	12,901	12,901
Other	22,989	23,977
Total other non-current assets	$ 73,124	$ 79,004

9. Financing Arrangement

On April 12, 2005, we renewed our asset-based credit facility with Wells Fargo Foothill, Inc. for a two-year period expiring in April 2007. On October 25, 2005, we replaced this credit facility with a new two-year asset-backed credit facility with Wells Fargo Foothill, Inc. and Ableco Finance LLC (see Note 18). The following discussion describes the credit facility that existed at September 30, 2005.

The credit facility contains restrictions that limit the facility to $50 million and require the deposit of a minimum of $20 million in cash collateral with the lender. We are using our full capacity under this line to secure $47 million in letters of credit, principally the rent deposits required under our leases for the Amphitheatre and Crittenden Technology Center campuses in Mountain View, California. 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 letters of credit. The credit facility was secured by total cash collateral (including the minimum cash deposit requirement) of $20 million at September 30, 2005, which is included as a component of Short-term Restricted Investments.

Available credit under the credit facility is determined weekly based on the value of inventory reserves, eligible accounts receivable, eligible real estate and intellectual property and is secured by substantially all our assets and the assets of our subsidiary that is responsible for our U.S. federal government business. Maturity of the credit facility is subject to acceleration upon various events of default. This obligation bears interest payable monthly at the prime rate plus 0.25% (7.00% at September 30, 2005) for cash advances and at 2.0% for letters of credit. The credit facility includes financial covenants and other terms and conditions customary to credit facilities of this type and permits the lender to decline future extensions of credit if a material adverse change has occurred. Covenants in the credit facility provide for minimum levels of EBITDA (earnings before interest, taxes, depreciation and amortization), minimum cash and cash equivalents levels and limits on purchases of property and equipment. The credit facility also limits our ability to incur additional indebtedness, dispose of certain assets, pay dividends on capital stock, repurchase capital stock, or prepay or repurchase debt obligations.

On several occasions during the past three fiscal years, we were in violation of financial and administrative covenants in this facility and the predecessor facility. In each case, we received a waiver of compliance from the lender. In addition, we were in violation of the EBITDA covenant under this facility as of September 30, 2005; however, this convenant was amended in conjunction with the new credit facility announced on October 25, 2005 and no waiver was required. In the event that we are not able to comply with the financial covenants and other terms of the new credit facility in the future, and any default is not waived, it could have a significant impact on our working capital.

10. Discontinued Operations

On June 15, 2004, we received $58 million in gross proceeds for the sale of our Alias application software business (Alias) to Accel-KKR, a technology-focused private equity investment firm, and recorded a net gain of $51 million on the transaction. The results of our Alias application software business for periods prior to its sale in June 2004 are reflected as discontinued operations. In the first quarter of fiscal 2006, we incurred an additional $0.3 million in transaction costs associated with this transaction.

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11. Long-Term Debt

Long-term debt was as follows (in thousands):

	Sept. 30, 2005	June 24, 2005
6.50% Senior Secured Convertible Notes due June 1, 2009, including unamortized premium of $17,747 at September 30, 2005 and $18,970 at June 24, 2005	$ 206,325	$ 207,548
6.125% Convertible Subordinated Debentures due February 1, 2011, net of unamortized discount of $6,214 at September 30, 2005 and $6,442 at June 24, 2005	50,563	50,334
11.75% Senior Secured Notes due June 1, 2009	2,386	2,386
Other	4,712	3,544
	263,986	263,812
Less amounts due within one year	(3,267)	(1,820)
Amounts due after one year	$ 260,719	$ 261,992

In December 2003, we exchanged $224 million of newly issued 6.50% Senior Secured Convertible Notes (the Senior Secured Convertible Notes) and $2 million of 11.75% Senior Secured Notes (the Senior Secured Notes) for 98% of our existing 5.25% Senior Convertible Notes (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, and they are redeemable at our option beginning in December 2005. During calendar year 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. In the following years, 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. In addition, the indentures governing the Senior Secured Convertible Notes and the Senior Secured Notes contain covenants that, among other things, limit our ability to incur additional indebtedness, issue capital stock, pay dividends on and redeem or repurchase our capital stock, and prepay or repurchase subordinated debt. 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 9 to these 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. None of our Senior Secured Convertible Notes were converted during the first quarter of fiscal 2006. The unamortized premium on our Senior Secured Convertible Notes was reduced by $1 million during the first quarter of fiscal 2006 due to regular amortization.

In connection with the fiscal 1996 acquisition of Cray Research, Inc. (Cray), we assumed the 6.125% Convertible Subordinated Debentures due in 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 $6 million originally scheduled for fiscal years 1997 through 2002. In fiscal 2000 and fiscal 1999, we repurchased additional portions of the debentures with a face value of $11 million and $15 million, respectively. These repurchases satisfied the next four required annual sinking fund payments of $6 million originally scheduled for fiscal 2003 through fiscal 2006. Remaining annual sinking fund payments of $5 million in fiscal 2007 and $6 million each in fiscal 2008 to 2010 are scheduled, with a final maturity payment of $35 million in 2011. During the fourth quarter of fiscal 2005, we received a notice of default from a purported holder of more than 25% of these 2011 Debentures. For further information regarding this allegation, see Note 17.

Other long-term debt at September 30, 2005 includes $3 million of proceeds received in connection with products sold under certain sales-type lease arrangements, after which we sold the lease receivables to certain financial institutions. These long-term debt amounts represent future revenue streams for customer support contracts on those leased products that we are required under EITF 88-18, *Sales of Future Revenue*, to classify as debt. These future revenue streams will be amortized into revenue over the life of the contracts and will have no future cash-flow impact. Other long-term debt at September 30, 2005 also includes a $1 million loan secured by a receivable. The loan bears interest at a fixed annual rate of 5.22% and is repayable in quarterly installments ending in fiscal 2008.

12. Guarantees

Financial Guarantees

Financial guarantees include contracts that contingently require us to make payments to the beneficiary of the guarantee based on changes in an underlying variable (for example, 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 financial guarantees have terms of one year or less. Our maximum potential obligation under financial guarantees at September 30, 2005 was $49 million for which we had $49 million of assets held as collateral.

Assets held as collateral closely approximate fair value. At September 30, 2005, we did not have any obligations associated with our guarantees that met the criteria to be recorded as liabilities on our statement of financial position.

Product warranty

Product warranty activity was as follows (in thousands):

	Three Months Ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Product warranty beginning balance	$ 6,442	$ 5,203
New warranties issued	2,117	2,499
Warranties paid	(2,214)	(2,401)
Changes in warranty rate estimates	(186)	592
Product warranty ending balance	$ 6,159	$ 5,893

13. Loss Per Share

Set forth below is a reconciliation of basic and diluted loss per share from continuing operations (in thousands, except per share amounts):

	Three Months Ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Net loss from continuing operations	$ (32,071)	$ (27,929)
Weighted average shares outstanding basic and diluted	266,761	262,039
Net loss per share from continuing operations basic and diluted	$ (0.12)	$ (0.11)
Potentially dilutive weighted securities excluded from computations because they are anti-dilutive	154,295	158,345

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14. Comprehensive Loss

The components of comprehensive loss, net of tax, were as follows (in thousands):

	Three Months Ended	
	Sept. 30, 2005	Sept. 24, 2004
Net loss	$ (32,071)	$ (28,205)
Change in net unrealized loss on derivative instruments designated and qualifying as cash flow hedges	(1,611)	(197)
Foreign currency translation adjustments	(424)	(1,275)
Comprehensive loss	$ (34,106)	$ (29,677)

15. Segment Information

SGI has two reportable segments, Products and Global Services. Our reportable segments are determined after assessment of factors such as quantitative thresholds of business components to be included into reportable segments, customer base, economic characteristics, homogeneity of products, technology, delivery channels, and other factors, and it aligns reportable segments with the process by which our Chief Executive Officer makes operating decisions and evaluates performance.

Products

Our Products segment is comprised of our Core Systems based on the Intel® Itanium® 2 microprocessor and Linux® operating system as well as our storage solutions and our Legacy Systems based on the MIPS® RISC microprocessor and IRIX® operating system including the remarketed versions of these workstations, graphics systems, high-performance servers and storage solutions. Our Products are distributed through our direct sales force and through indirect channels, including resellers, distributors, and systems integrators.

Our Core Systems are comprised of our high-performance servers and visualization systems based on Intel Itanium 2 microprocessors and the Linux operating system and storage solutions. Our Core Systems include the SGI® Altix® family of high-performance servers and the SGI® InfiniteStorage line of storage solutions. These are high-performance supercomputing systems designed for technical computing applications, and they are also used as storage management servers for managing very large data repositories that contain critical information and media servers for broadcast television applications. Our Core Systems also include the Silicon Graphics Prism family of visualization systems. These visualization systems are used in a variety of applications, including computer-aided design, medical imaging, 2D and 3D animation, broadcast, modeling, and simulation. Our graphics systems integrate high-performance computing, data management, and high-performance visualization into a single system.

Our Legacy Systems are comprised of our high-performance servers and visualization systems based on MIPS RISC microprocessors and the IRIX operating system. Our Legacy Systems include the SGI® Origin® family of high-performance servers. These are high-performance supercomputing systems designed for technical computing applications, and they are also used as storage management servers for managing very large data repositories that contain critical information and media servers for broadcast television applications. Our Legacy Systems also include the Silicon Graphics® Tezro® and Silicon Graphics Fuel® workstations and the SGI® Onyx® family of graphics systems. These workstations are used in a variety of applications, including computer-aided design, medical imaging, 2D and 3D animation, broadcast, modeling, and simulation. Our graphics systems integrate high-performance computing, data management, and high-performance visualization into a single system. Our Legacy Systems also include the remarketed versions of the MIPS/IRIX-based workstations, graphics systems and high-performance servers as well as remarketed versions of our storage solutions.

Global Services

Our 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, managed services, and third-party products.

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Segment Results

We evaluate our segments based on profit or loss from operations before interest and taxes.

Expenses for research and development, sales and marketing, manufacturing, and finance and administration are allocated to the reportable segments and are included in the results reported. Certain corporate-level revenues 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 products to each other, and accordingly, there is no inter-segment revenue to be reported.

Operating results for our reportable segments were as follows (in thousands):

	Three Months Ended	
	Sept. 30, 2005	**Sept. 24, 2004**
Revenue from external customers:		
Products	$ 98,692	$ 97,669
Global services	70,985	77,738
Total consolidated	$ 169,677	$ 175,407
Operating loss:		
Products	$ (27,715)	$ (28,235)
Global services	8,629	5,142
Total reportable segments	(19,086)	(23,093)
Restructuring	(7,185)	(3,166)