

STORAGE TECHNOLOGY CORP  
Form 10-Q  
August 03, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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

For the quarterly period ended June 25, 2004

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-7534

**STORAGE TECHNOLOGY CORPORATION**

(Exact name of registrant as specified in its charter)

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

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

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

**80028-4309**  
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

The registrant had 111,137,989 shares of common stock outstanding as of July 30, 2004.

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**STORAGE TECHNOLOGY CORPORATION**  
**INDEX TO FORM 10-Q**  
**June 25, 2004**

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

	<u>06/25/04</u>	<u>12/26/03</u>
	<u>(Unaudited)</u>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,062,060	\$ 1,001,629
Short-term investments	3,549	14,650
Accounts receivable	452,469	539,334
Inventories	105,637	109,988
Deferred income tax assets	133,429	139,446
Other current assets	9,752	123

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	06/25/04	12/26/03
	<u>                    </u>	<u>                    </u>
Total current assets	1,766,896	1,805,170
Long-term investments	45,049	43,501
Property, plant, and equipment	186,354	201,647
Spare parts for maintenance	47,222	44,695
Deferred income tax assets	93,532	93,521
Other assets	130,360	116,712
	<u>                    </u>	<u>                    </u>
Total assets	\$ 2,269,413	\$ 2,305,246
	<u>                    </u>	<u>                    </u>
<b>LIABILITIES</b>		
Current liabilities:		
Current portion of long-term debt	\$ 1,238	\$ 1,090
Accounts payable	97,466	132,404
Accrued liabilities	459,319	483,672
Income taxes payable	242,659	250,818
Other current liabilities	28,552	64,674
	<u>                    </u>	<u>                    </u>
Total current liabilities	829,234	932,658
Long-term debt	10,369	11,150
	<u>                    </u>	<u>                    </u>
Total liabilities	839,603	943,808
	<u>                    </u>	<u>                    </u>
Commitments and contingencies (Notes 4 and 7)		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$0.10 par value, 300,000,000 shares authorized; 113,620,235 shares issued at June 25, 2004, and 111,135,483 shares issued at December 26, 2003	11,362	11,114
Capital in excess of par value	1,046,058	991,273
Retained earnings	468,048	409,072
Accumulated other comprehensive loss	(21,510)	(30,436)
Treasury stock, 2,000,000 shares at June 25, 2004, and 299,677 shares at December 26, 2003, at cost	(56,155)	(5,919)
Unearned compensation	(17,993)	(13,666)
	<u>                    </u>	<u>                    </u>
Total stockholders' equity	1,429,810	1,361,438
	<u>                    </u>	<u>                    </u>
Total liabilities and stockholders' equity	\$ 2,269,413	\$ 2,305,246
	<u>                    </u>	<u>                    </u>

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

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

Quarter Ended

Six Months Ended

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	<u>06/25/04</u>	<u>06/27/03</u>	<u>06/25/04</u>	<u>06/27/03</u>
<b>Revenue:</b>				
Storage products	\$ 289,048	\$ 313,150	\$ 583,654	\$ 594,409
Storage services	227,567	214,113	448,033	412,809
<b>Total revenue</b>	<b>516,615</b>	<b>527,263</b>	<b>1,031,687</b>	<b>1,007,218</b>
<b>Cost of revenue:</b>				
Storage products	152,096	169,154	301,715	322,489
Storage services	126,687	120,443	253,937	234,304
<b>Total cost of revenue</b>	<b>278,783</b>	<b>289,597</b>	<b>555,652</b>	<b>556,793</b>
<b>Gross profit</b>	<b>237,832</b>	<b>237,666</b>	<b>476,035</b>	<b>450,425</b>
Research and development costs	47,046	50,522	95,548	100,983
Selling, general, and administrative expense	148,287	146,206	310,972	287,023
<b>Operating profit</b>	<b>42,499</b>	<b>40,938</b>	<b>69,515</b>	<b>62,419</b>
Interest income	3,319	2,566	6,500	5,008
Interest expense	(318)	(398)	(695)	(867)
<b>Income before income taxes</b>	<b>45,500</b>	<b>43,106</b>	<b>75,320</b>	<b>66,560</b>
Provision for income taxes	(9,873)	(13,000)	(16,344)	(20,000)
<b>Net income</b>	<b>\$ 35,627</b>	<b>\$ 30,106</b>	<b>\$ 58,976</b>	<b>\$ 46,560</b>
<b>EARNINGS PER COMMON SHARE</b>				
Basic earnings per share	\$ 0.32	\$ 0.28	\$ 0.53	\$ 0.43
Weighted-average shares	110,675	107,653	110,613	107,172
Diluted earnings per share	\$ 0.32	\$ 0.27	\$ 0.52	\$ 0.42
Weighted-average and dilutive potential shares	112,726	110,193	113,040	109,659

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

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

Six Months Ended

06/25/04

06/27/03

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	Six Months Ended	
	_____	_____
<b>OPERATING ACTIVITIES</b>		
Cash received from customers	\$ 1,115,656	\$ 1,105,851
Cash paid to suppliers and employees	(962,099)	(969,659)
Interest received	5,861	4,583
Interest paid	(555)	(675)
Income taxes paid	(15,602)	(7,360)
	_____	_____
Net cash provided by operating activities	143,261	132,740
	_____	_____
<b>INVESTING ACTIVITIES</b>		
Proceeds from sale of investments	23,715	--
Purchases of investments	(14,258)	--
Purchases of property, plant, and equipment	(27,961)	(20,643)
Proceeds from sale of property, plant, and equipment	13	3,706
Other assets	(23,854)	(774)
	_____	_____
Net cash used in investing activities	(42,345)	(17,711)
	_____	_____
<b>FINANCING ACTIVITIES</b>		
Repurchases of common stock	(56,155)	--
Proceeds from employee stock plans	45,068	32,456
Proceeds from other debt	428	650
Repayments of other debt	(815)	(1,122)
	_____	_____
Net cash provided by (used in) financing activities	(11,474)	31,984
	_____	_____
Effect of exchange rate changes on cash	(29,011)	1,541
	_____	_____
Increase in cash and cash equivalents	60,431	148,554
Cash and cash equivalents - beginning of the period	1,001,629	657,599
	_____	_____
Cash and cash equivalents - end of the period	\$ 1,062,060	\$ 806,153
	_____	_____
<b>RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES</b>		
Net income	\$ 58,976	\$ 46,560
Depreciation and amortization expense	40,549	42,639
Inventory writedowns	10,259	11,204
Translation loss	18,684	11,070
Other non-cash adjustments to income	33,567	(10,978)
Decrease in accounts receivable	83,969	98,633
Increase in other current assets	(13,053)	(1,189)
(Increase) decrease in inventories	4,407	(3,763)
Increase in spare parts	(10,837)	(7,433)
Increase in deferred income tax assets	(850)	(3,352)
Decrease in accounts payable	(34,723)	(37,126)
Decrease in accrued liabilities	(23,509)	(15,925)
Decrease in other current liabilities	(16,870)	(8,242)
Increase (decrease) in income taxes payable	(7,308)	10,642
	_____	_____
Net cash provided by operating activities	\$ 143,261	\$ 132,740
	_____	_____

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

**STORAGE TECHNOLOGY CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
(Unaudited)  
(In Thousands)

	Common Shares Issued	Common Stock	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Unearned Compensation	Total
Balances, December 26, 2003	111,135	\$ 11,114	\$ 991,273	\$ 409,072	\$ (30,436)	\$ (5,919)	\$ (13,666)	\$ 1,361,438
Components of comprehensive income:								
Net income	--	--	--	58,976	--	--	--	58,976
Other comprehensive income	--	--	--	--	8,926	--	--	8,926
Total comprehensive income	--	--	--	58,976	8,926	--	--	67,902
Shares issued upon exercise of								
stock options	2,179	218	36,827	--	--	--	--	37,045
Shares issued under employee stock purchase plan	408	41	8,083	--	--	--	--	8,124
Shares repurchased under stock repurchase program	--	--	--	--	--	(56,155)	--	(56,155)
Restricted stock activity	231	22	7,612	--	--	--	(4,327)	3,307
Other	(333)	(33)	2,263	--	--	5,919	--	8,149
Balances, June 25, 2004	113,620	\$ 11,362	\$ 1,046,058	\$ 468,048	\$ (21,510)	\$ (56,155)	\$ (17,993)	\$ 1,429,810

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

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

	Quarter Ended		Six Months Ended	
	06/25/04	06/27/03	06/25/04	06/27/03
Net income	\$ 35,627	\$ 30,106	\$ 58,976	\$ 46,560

Other comprehensive income (loss):

Foreign currency hedging contracts:

Net gain (loss) on foreign currency cash flow hedges, net of tax expense (benefit) of \$(121),

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	Quarter Ended		Six Months Ended	
\$(5,626), \$462, and \$(8,662)	(192)	(9,025)	735	(13,895)
Reclassification adjustment for net losses included in net income, net of tax benefit of \$3,010, \$2,974, \$6,467, and \$4,389	4,788	4,771	10,287	7,041
Unrealized gain (loss) on marketable securities:				
Holding gain (loss), net of tax expense (benefit) of \$(276), \$152, \$(134), and \$565	(461)	354	(160)	1,317
Reclassification adjustment for net gains included in net income, net of tax expense of \$508, \$534, \$830, and \$534	(1,186)	(1,245)	(1,936)	(1,245)
Other comprehensive income (loss)	2,949	(5,145)	8,926	(6,782)
Comprehensive income	\$ 38,576	\$ 24,961	\$ 67,902	\$ 39,778

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

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

**NOTE 1 BASIS OF PREPARATION**

The accompanying interim consolidated financial statements of Storage Technology Corporation and its wholly owned subsidiaries (StorageTek or the Company) have been prepared on substantially the same basis as the Company's annual consolidated financial statements and should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 26, 2003. In the opinion of management, the interim consolidated financial statements reflect all adjustments necessary for the fair presentation of results for the periods presented, and such adjustments are of a normal, recurring nature. Certain prior year amounts have been reclassified to conform to the current year presentation.

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

**NOTE 2 STOCK-BASED COMPENSATION PLANS**

The Company accounts for stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Stock-based compensation reflected in net income is related to restricted stock.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based compensation (in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	06/25/04	06/27/03	06/25/04	06/27/03
Net income, as reported	\$ 35,627	\$ 30,106	\$ 58,976	\$ 46,560
Add: Stock-based compensation expense included in reported net income, net of related tax effects	1,260	1,158	2,515	1,918

**NOTE 2 STOCK-BASED COMPENSATION PLANS**

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	Quarter Ended		Six Months Ended	
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(6,498)	(6,053)	(12,427)	(10,829)
Pro forma net income	\$ 30,389	\$ 25,211	\$ 49,064	\$ 37,649
Earnings per share:				
Basic, as reported	\$ 0.32	\$ 0.28	\$ 0.53	\$ 0.43
Basic, pro forma	\$ 0.27	\$ 0.23	\$ 0.44	\$ 0.35
Diluted, as reported	\$ 0.32	\$ 0.27	\$ 0.52	\$ 0.42
Diluted, pro forma	\$ 0.27	\$ 0.23	\$ 0.44	\$ 0.35

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**NOTE 3 INVENTORIES**

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

	06/25/04	12/26/03
Raw materials	\$ 19,505	\$ 14,951
Work-in-process	15,578	29,740
Finished goods	70,554	65,297
	\$ 105,637	\$ 109,988

**NOTE 4 LITIGATION**

In August 2002, Ted Marx, a former StorageTek employee who was terminated in 2001, filed suit in California State Superior Court (Los Angeles) against StorageTek. The complaint contained claims for wrongful termination, wrongful termination in violation of the California Labor Code, breach of the covenant not to terminate without good reason, breach of contract, breach of the covenant of good faith and fair dealing, failure to pay wages under the California Labor Code, and intentional infliction of emotional distress. In September 2003, StorageTek filed its motion for summary judgment. In December 2003, the court ruled in favor of StorageTek on the claim of breach of the covenant not to terminate without good reason. The trial commenced in May 2004. In June 2004, the jury awarded approximately \$2.9 million in compensatory damages and \$9.0 million in punitive damages to the plaintiff. The plaintiff is also requesting certain attorney fees from the court. StorageTek intends to vigorously seek to overturn and/or reduce the award. StorageTek has not accrued the damages or the attorney fees for this case, as it does not believe that these amounts represent a loss contingency that meets the definition of probable under SFAS No. 5, Accounting for Contingencies.

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

**NOTE 5 OPERATIONS OF BUSINESS SEGMENTS**

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



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

	Quarter Ended		Six Months Ended	
	06/25/04	06/27/03	06/25/04	06/27/03
<b>Revenue:</b>				
Storage products	\$ 289,048	\$ 313,150	\$ 583,654	\$ 594,409
Storage services	227,567	214,113	448,033	412,809
<b>Total revenue</b>	<b>\$ 516,615</b>	<b>\$ 527,263</b>	<b>\$ 1,031,687</b>	<b>\$ 1,007,218</b>
<b>Gross profit:</b>				
Storage products	\$ 136,952	\$ 143,996	\$ 281,939	\$ 271,920
Storage services	100,880	93,670	194,096	178,505
<b>Total gross profit</b>	<b>\$ 237,832</b>	<b>\$ 237,666</b>	<b>\$ 476,035</b>	<b>\$ 450,425</b>

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

	Quarter Ended		Six Months Ended	
	06/25/04	06/27/03	06/25/04	06/27/03
Tape products	\$ 215,044	\$ 235,685	\$ 438,133	\$ 451,573
Disk products	46,186	42,068	90,404	79,413
Network products	18,595	22,441	35,609	42,077
Other	9,223	12,956	19,508	21,346
<b>Total storage products revenue</b>	<b>\$ 289,048</b>	<b>\$ 313,150</b>	<b>\$ 583,654</b>	<b>\$ 594,409</b>

#### NOTE 6 EARNINGS PER COMMON SHARE

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

	Quarter Ended		Six Months Ended	
	06/25/04	06/27/03	06/25/04	06/27/03
Net income	\$ 35,627	\$ 30,106	\$ 58,976	\$ 46,560
Weighted average common shares outstanding:				
Basic	110,675	107,653	110,613	107,172
Effect of dilutive common stock equivalents	2,051	2,540	2,427	2,487
<b>Diluted</b>	<b>112,726</b>	<b>110,193</b>	<b>113,040</b>	<b>109,659</b>
Earnings per common share:				
Basic	\$ 0.32	\$ 0.28	\$ 0.53	\$ 0.43

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	Quarter Ended		Six Months Ended	
Diluted	\$	0.32	\$	0.27
		10	\$	0.52
			\$	0.42

For the quarters ended June 25, 2004, and June 27, 2003, options to purchase 3,612,443 and 737,281 shares of common stock, respectively, were excluded from the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the Company's common stock, and therefore, the effect would have been antidilutive. For the six months ended June 25, 2004 and June 27, 2003, options to purchase 3,623,196 and 1,518,325 shares of common stock, respectively, were excluded from the computation of diluted earnings per share for the same reason.

**NOTE 7 INDEMNIFICATIONS AND WARRANTIES**

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

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

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

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

	Six Months Ended	
	06/25/04	06/27/03
Balance at beginning of period	\$ 49,374	\$ 41,155
Accruals for warranties issued	21,015	23,916
Adjustments to warranties	(3,737)	380
Amortization	(24,227)	(21,226)
Balance at end of period	\$ 42,425	\$ 44,225

**NOTE 8 SUBSEQUENT EVENT**

In July 2004, the Company's Board of Directors authorized an increased stock repurchase program to acquire up to \$500 million of common stock. The intent of the repurchase program is to reduce dilution created by shares issued under employee stock plans and opportunistically balance the cash returned to shareholders through share repurchases with the cash reinvested in the business for profitable revenue growth. The

repurchase program does not have an expiration date, and it replaces the previous program announced in January 2004. The previous program had allowed for the acquisition of up to 1,000,000 shares of common stock per quarter through 2005.

Purchases under the repurchase program may be made in the open market or through privately negotiated transactions. Purchases may be commenced or suspended at any time without prior notice, and there is no fixed termination date for the repurchase program.

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

### *FORWARD-LOOKING STATEMENTS*

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

### *SECOND QUARTER 2004 FINANCIAL OVERVIEW*

Although the second quarter of 2004 represented the sixteenth consecutive quarter of year-over-year earnings growth, we found the second quarter of 2004 to be a challenging period. Total revenue for the second quarter of 2004 was \$517 million, a decrease of 2% compared to the same period in 2003. Revenue decreased 6% as adjusted to reflect constant foreign currencies. We experienced an unexpected shortfall in order flow during the last two weeks of the quarter. We continue to see a lethargic IT environment. At the beginning of the year, there were expectations that IT spending would pick up in 2004. We have not seen this increase in the first half of the year, but are hopeful that we will see a rebound in spending in the fourth quarter of 2004.

Our Europe, Africa, and Middle East (EAME) region continues to show moderate improvement on a year-over-year basis, but we anticipate EAME is still a few quarters away from returning to its traditional revenue levels. Asia and Latin America continue to perform well, with the exception of Japan. The revenue shortfall for the second quarter of 2004 was particularly pronounced in North America and Japan.

Total gross profit margin continued to improve in the second quarter of 2004, compared to the same period in 2003, primarily due to an increase in storage products gross profit margin as a result of favorable product and channel mixes. Operating expense in the second quarter of 2004 was largely unchanged compared to the same period in 2003, but decreased substantially compared to the first quarter of 2004 due to disciplined expense controls.

We continued to strengthen our balance sheet and cash flows during the second quarter of 2004. Our cash flow from operations was approximately \$73 million, bringing our total cash and investments balance up to \$1.1 billion as of June 25, 2004. Cash flow from operations also funded \$56 million of share repurchases during the six months of 2004. Our operations continue to be self-funded and our debt-to-capitalization ratio remains constant at 1%.

Through our strong balance sheet and cash flows, we believe that we are firmly positioned to exploit future opportunities. Our primary challenge for the future is to increase revenue while maintaining strong cost

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controls. We believe revenue growth can be achieved primarily through the successful execution of our Information Lifecycle Management (ILM) strategy, as well as through various new product launches over the next year. We will continue to focus on improving our sales productivity in all of our geographic regions. A potential risk to successfully growing our revenue and earnings in the future continues to be the weak economic conditions in IT spending.

**SELECTED CONSOLIDATED STATEMENT OF OPERATIONS DATA**

The following table presents Consolidated Statements of Operations data stated as a percentage of total revenue, except for segment gross profit, which is stated as a percentage of the applicable segment revenue. The table also presents the percentage change based on the dollar amounts of each of the items.

	Quarter Ended		Percentage Increase (Decrease) Based on Dollar Amounts
	06/25/04	06/27/03	Q2 2004 vs. Q2 2003
<b>Revenue:</b>			
Storage products	56.0%	59.4%	(7.7)%
Storage services	44.0	40.6	6.3
<b>Total revenue</b>	<b>100.0%</b>	<b>100.0%</b>	<b>(2.0)</b>
<b>Gross profit:</b>			
Storage products	47.4%	46.0%	(4.9)
Storage services	44.3	43.7	7.7
<b>Total gross profit</b>	<b>46.0</b>	<b>45.1</b>	<b>0.1</b>
<b>Operating expenses:</b>			
Research and development costs	9.1	9.6	(6.9)
Selling, general, and administrative expenses	28.7	27.7	1.4
<b>Operating profit</b>	<b>8.2</b>	<b>7.8</b>	<b>3.8</b>
Interest income	0.6	0.5	29.3
Interest expense	(0.1)	(0.1)	(20.1)
<b>Income before income taxes</b>	<b>8.8</b>	<b>8.2</b>	<b>5.6</b>
Provision for income taxes	1.9	2.5	(24.1)
<b>Net income</b>	<b>6.9%</b>	<b>5.7%</b>	<b>(18.3)%</b>

The following table presents supplemental data for storage products revenue stated as a percentage of total storage products revenue, and the percentage change based on the dollar amounts of each of the items.

	Quarter Ended		Percentage Increase (Decrease) Based on Dollar Amounts
	06/25/04	06/27/03	Q2 2004 vs. Q2 2003
<b>Supplemental data - storage products revenue</b>			
Tape products	74.4%	75.3%	(8.8)%
Disk products	16.0	13.4	9.8
Network products	6.4	7.2	(17.1)
Other	3.2	4.1	(28.8)

	100.0%	100.0%	<b>Percentage Increase</b>
Total storage products revenue	100.0%	100.0%	(7.7)%

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**REVENUE AND GROSS PROFIT MARGIN**

**Storage Products**

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

Storage products revenue decreased in the second quarter of 2004, compared to the same period in 2003, primarily due to a shortfall in orders near the end of the quarter. Overall, we experienced weakness in the United States and Asia-Pacific regions. Our worldwide indirect channel sales decreased 12% in the second quarter of 2004 compared to the same period in 2003. We experienced indirect channel weakness throughout the world, but most notably in North America. New product launches planned for the second half of the year are targeted for the channels in the mid-range market, and we anticipate these new products will increase channel sales in late 2004.

We had a decrease in tape product sales during the second quarter of 2004 due primarily to a double-digit decline in open-systems tape revenue. This decline was partially offset by the continued strength in our Virtual Storage Manager (VSM) system revenue. We also saw weakness in our tape automation revenue as customers awaited our new products. Disk product revenue increases were led by a 19% increase in open-systems disk product revenue, and were partially offset by a 6% decrease in enterprise disk products.

We are currently anticipating that revenue for the third quarter of 2004 will be similar to the second quarter of 2004, with the potential for a slight improvement. We expect that normal third quarter seasonal patterns will prevail in Europe and that the favorable impact of currencies on year-over-year comparisons of revenue will diminish late in the year.

Storage products gross profit margin increased in the second quarter and six months of 2004, compared to the same periods in 2003, primarily due to a favorable mix of enterprise product offerings going through the direct channel. Enterprise product sales and direct channel sales both typically carry higher margins. Even though indirect channel sales declined in the second quarter of 2004, we believe this is a temporary condition that will change as the new mid-range products are introduced in the second half of 2004. Indirect channel sales increases could put downward pressure on the gross profit margin. With respect to product mix, continued success in VSM sales has been an important contributor in maintaining the improved product margins we experienced in the first half of 2004. Product mix, channel mix, and further operational efficiencies will be key factors for maintaining storage products gross profit margin.

**Storage Services**

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

Storage services revenue increased in the second quarter and six months of 2004, compared to the same periods in 2003, primarily due to increased maintenance and support services revenue, as well as continued revenue growth from professional service offerings. Professional services revenue accounted for 12% of total storage services revenue in the second quarter of 2004, compared to 11% for the same period in 2003.

Storage services gross profit margin increased slightly in the second quarter of 2004, compared to the same period in 2003, and also increased compared to the first quarter of 2004 due primarily to actions taken to reduce certain inefficiencies in our service operations. We believe that the impact of these actions will be

sustainable throughout the second half of 2004. The increase in storage services gross profit margin may be adversely impacted if professional services continues to become a greater portion of our service revenue, as professional services typically carry lower margins than our

maintenance and support services business.

### ***RESEARCH AND DEVELOPMENT***

Research and development costs continue to decrease, consistent with the trend we have experienced since 2001, although we expect research and development costs to increase in the second half of 2004 due to product launch activities. The continued decreases in research and development costs have been achieved primarily through the implementation of engineering initiatives designed to improve research and development productivity, increase strategic alignment, and reduce non-essential spending.

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

Selling, general, and administrative expense (SG&A) increased slightly during the second quarter of 2004, compared to the same period in 2003. SG&A was significantly higher for the first half of 2004 than for the first half of 2003, primarily due to unfavorable impacts of foreign currency movements on the operating expenses of our international operations.

SG&A expense decreased 9% during the second quarter of 2004, as compared to the first quarter, primarily due to the implementation of expense controls, including a reduction in discretionary spending. We reduced headcount by approximately 250 employees from the first quarter, reflecting a continuation of our efforts on several fronts, including executing on planned outsourcing activities, performance management, and further elimination of non-essential activities. In addition, unfavorable impacts of foreign currencies were smaller in the second quarter of 2004 and provided some of the improvement from the first to the second quarter.

### ***INTEREST INCOME AND EXPENSE***

Net interest income increased approximately 40% for the second quarter and six months of 2004, compared to the same periods in 2003, primarily due to our growing cash and investments balance. Although our cash and investments balance has been steadily increasing, decreasing interest rates have kept our interest income from increasing proportionally. See **LIQUIDITY AND CAPITAL RESOURCES** for further discussion of our debt and financing arrangements.

### ***INCOME TAXES***

Our effective tax rate was approximately 22% for the second quarter and six months of 2004, compared to 30% for the same periods in 2003. We continue to recognize increased tax benefits associated with our manufacturing operations in Puerto Rico and, based on our current estimates, we believe that some of the potential tax contingencies previously identified should be reduced. We anticipate that the effective tax rate in the first half of 2004 will likely be in effect for the full year. Our effective tax rate may be impacted in the future by a variety of factors, including the overall effectiveness of our global manufacturing strategies and changes in our estimates regarding the resolution of open tax matters.

We are subject to regular audits by federal, state, and foreign tax authorities. These audits may result in proposed assessments that may result in additional tax liabilities. Our income taxes payable balance as reported on the Consolidated Balance Sheet is comprised primarily of tax contingencies that we believe are both probable and reasonably estimable.

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Statement of Financial Accounting Standards (SFAS) No. 109 requires that deferred income tax assets be recognized to the extent realization of such assets is more likely than not. Based on the currently available information, we have determined that we will more likely than not realize \$227 million of deferred income tax assets as of June 25, 2004. Our valuation allowance of approximately \$22.8 million as of June 25, 2004, relates principally to foreign net operating loss carryforwards.

### ***CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS***

Our critical accounting estimates and assumptions are disclosed in our Annual Report on Form 10-K for the year ended December 26, 2003. We have made no changes to those policies during the six months ended June 25, 2004.

**LIQUIDITY AND CAPITAL RESOURCES****Sources and Uses of Cash**

The following table summarizes our sources and uses of cash (in thousands):

	Six Months Ended	
	06/25/04	06/27/03
Operating activities	\$ 143,261	\$ 132,740
Investing activities	(42,345)	(17,711)
Financing activities	(11,474)	31,984

Our cash and cash equivalents balance increased \$60.4 million during the first six months of 2004, primarily a result of cash flows generated by our operating activities. Days sales outstanding (DSO) now stands at 80 days, which is 5 days better than the second quarter of 2003. Inventory turns increased to 5.8 times, 5% better than the second quarter of 2003. We continue to focus on improving our operational effectiveness and efficiency.

In the first half of 2004, we used \$56.2 million of cash to purchase shares of the Company's stock under the publicly announced share repurchase program, which was offset by \$45.1 million of proceeds from employee stock plans.

**Future Sources and Uses of Cash**

We expect that cash flows from operations will continue to serve as our principal source of liquidity, and we believe that we have adequate working capital and financing capabilities to meet our anticipated operating and capital requirements for the next 12 months. However, cash flows from operations could be negatively impacted by a decrease in demand for our products and services as a result of rapid technological changes and other risks described under **FACTORS THAT MAY AFFECT FUTURE RESULTS**.

In July 2004, our Board of Directors authorized a share repurchase program to acquire up to \$500 million of common stock. This replaces the program approved in January 2004. We intend to fund the purchases through cash on hand and cash flows from operations. We believe that our financial strength allows us to make these purchases, while still allowing us to expand our presence into new markets and to invest in those areas of the business where we think we can achieve the best returns. We continue to review and evaluate alternative uses for our cash, including potential acquisitions and investments in additional technologies to strengthen our ILM offerings.

Cash flows from operations can be supplemented by our \$75 million revolving credit facility (the Revolver) that expires in October 2004. The interest rates for borrowing under the Revolver are dependent on our Total Debt to rolling four quarter Earnings Before Interest Expense, Taxes, Depreciation, and Amortization (EBITDA) ratio and the term of the outstanding borrowings. The rate ranges from the applicable LIBOR plus 1.75% to 2.50% or the agent bank's base rate plus 0.00% to 0.50%. We pay a 0.50% per annum commitment fee on any unused borrowings. We had no outstanding borrowings under the Revolver as of June 25, 2004. The Revolver is secured by our U.S. accounts receivable and U.S. inventory, and contains certain financial and other covenants, including a prohibition on the payment of cash dividends.

Over the longer term, we may choose to fund our operations through the issuance of additional equity or debt financing. The issuance of equity or convertible debt securities could result in dilution to our stockholders, and we cannot provide any assurance that such additional long-term financing, if required, could be completed on favorable terms.

**FACTORS THAT MAY AFFECT FUTURE RESULTS****We may be materially affected by global economic and political conditions**

Our ability to generate revenue growth during the last several years was adversely affected by the slowdown in the global economy as customers delayed their purchase decisions, reduced their information technology spending budgets, increased their purchase authorization approval requirements, and reduced their capital expenditures by maximizing the current capacities of their data storage equipment. This trend appears to be continuing in 2004. We have implemented various cost-saving measures to help mitigate the adverse effects of the slowdown in the global

economy. We cannot provide any assurance that a prolonged economic downturn will not have additional adverse effects on our financial condition, results of operations, or our ability to generate revenue growth. Furthermore, we cannot provide any assurance that our cost-saving measures will be successful or sufficient to allow us to continue to generate improved operating results in future periods.

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

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

In the first half of 2004, approximately 74% of our storage products revenue was generated by sales of our tape products. Services associated with our tape products also represent a significant portion of our storage services revenue. We experienced a decline in tape product revenue during the second quarter of 2004. We believe this decline may be minimized as we introduce various new tape product offerings in the second half of 2004. For a discussion of risk associated with new products, see *We may be materially affected by risks associated with new product development*, below. If overall demand for tape storage products declines, or if we lose significant market share in tape, our financial condition and results of operations could be materially affected.

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

**We may be materially affected by competition and by our ability to execute our ILM strategy to address competition**

The data storage industry is highly competitive, and customers make their decisions based on a number of competitive factors. We must address each of these factors effectively in order to successfully compete. If we are unable to adapt our products and services to changes in these competitive factors, we may lose market share to our competitors.

Our principal strategy for addressing the competition and growing revenue is our ILM strategy. Our ILM strategy is intended to capitalize on our ability to deliver complete storage solutions that satisfy customer storage requirements, including tape, disk, and network products, together with associated services. We have achieved some initial success in our ILM strategy; however, we must continue to develop and deliver on this strategy in the future in order to grow revenue. We have also seen the adoption of strategies similar to our ILM strategy by our competitors. We cannot provide any assurance that we will successfully execute our ILM strategy or that this strategy will provide us with a competitive advantage in the data storage industry.

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

Services continue to contribute an increasing amount of our total revenue. Growth in services has partially been driven by new service offerings such as storage consulting services, implementation services, and storage management services. The development and delivery of these new services are critical to the success of our plan to deliver complete storage solutions to our customers. We must ensure that storage service professionals have the necessary skill sets, experience, tools, and training to support these new service offerings. Revenue growth from these new service offerings is needed to offset possible future declines in maintenance revenue from our installed service base of products under maintenance contracts as these products are displaced by sales of new StorageTek products under warranty. Any failure to properly develop or deliver our new and existing service offerings could have a material adverse effect on our financial condition and results of operations.

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

In the past, our results have followed a seasonal pattern, which reflects the tendency of customers to make their purchase decisions at the end of a calendar year. During any fiscal quarter, a disproportionately large percentage of total product sales are earned in the last weeks or days of the quarter. We continue to experience these trends in 2004, as we had a shortfall in orders during the last two weeks of the second quarter. It is difficult to predict the extent to which these historical trends will continue in the future. We cannot provide any assurance that we will be able to manage our uneven sales patterns.

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

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

We provide a variety of solutions to meet customer needs, including tape, disk, and network products, along with associated software and services. Our products and services contribute varying gross profit margins, and the gross margin on a customer's total solution is dependent on the amounts and types of products or services involved. Gross profit margins may also be impacted by early start-up manufacturing costs associated with new products. We cannot provide any assurance that our future gross profit margin will be similar to our historical gross profit margin.

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

We sell a number of third-party products, and our gross profit margin may be adversely affected if those products become a larger portion of our total storage solutions. We may also be at a cost disadvantage in acquiring third-party products that are manufactured by competitors.

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

We are continually developing our indirect distribution channels, including original equipment manufacturers (OEMs), value-added distributors (VADs), value-added resellers (VARs), and other distributors. Indirect channel sales contributions are substantially lower in 2004 than they were in 2003, although we believe these contributions will improve in the second half of 2004. Increasing our sales through these indirect channels is critical to expanding our reach into the growing open-systems market. Successfully managing the interaction of our direct and indirect channel efforts to effectively reach all of the potential customer segments for our products and services is a complex process. We cannot provide any assurance that we will be successful in expanding our indirect channel sales. Our ability to forecast future demand for our products may be adversely affected by unforeseen changes in demand from our indirect channel partners. Storage products gross profit margins may be adversely impacted to the extent we continue to receive a larger portion of our sales through our indirect channels in the future. Maintenance revenue may also be adversely affected in future periods to the extent that customers of our indirect channel partners elect to purchase maintenance services from our competitors. Our financial results may also be negatively affected if the financial condition of one or more of our channel partners weakens.

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

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

Name of supplier	Product or service provided
Imation Corporation	T9840 and T9940 series tape media
Sanmina-SCI Corporation	Printed circuit boards and certain other manufacturing and repair services
LSI Logic Storage Systems	D-Series disk products
Fujitsu Electronics America	Application-specific integrated circuits (ASICs) for various tape and disk products
Austria Microsystems	ASICs for various tape products
Herald Datanetics Ltd. (HDL)	Key component used in certain tape products

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

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

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

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

We have reduced our inventory levels over the past two years primarily through our lean manufacturing initiatives. As we continue to move toward a lean manufacturing environment, we will become increasingly dependent on a limited supplier base to deliver quality parts and components in a timely manner. A supplier's inability to deliver parts and components on a timely basis, or our failure to effectively manage inventory levels, could have a material adverse effect on our financial condition and results of operations.

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

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

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

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

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

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

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

We have introduced significant new products in the first half of 2004, including the StreamLine™ SL8500 modular library system, and we plan to introduce a number of other significant new products during the second half of 2004. When we introduce new products, we must effectively manage the transition from our existing products to the new products. If we do not manage the transition effectively, we may be subject to the

following adverse effects:

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

In addition, sales of our new products may replace some of the sales of our existing products, and there may be a decline in sales of existing products in the periods leading up to new product introductions. We cannot provide any assurance that we will be able to successfully manage the development, introduction, or transition of new products in the future.

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

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

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

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

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

#### **We may be materially affected by the risks associated with litigation**

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

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

Our future success depends in large part on our ability to attract and retain our key employees. During 2003 and the first six months of 2004, several changes were made with respect to the executive management team and their organizational responsibilities. We face significant competition for individuals who possess the skills required to sell our products and services, as well as design, develop, manufacture, service, and market those products and services. An inability to successfully attract and retain these employees could have an adverse effect on our future financial condition and results of operations. Furthermore, there may be a delay between when organizational announcements are made and when the organizations are fully effective.

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

International operations accounted for approximately 56% of our revenue in the first half of 2004, respectively, compared to 53% for the same period in 2003. We also sell products through U.S. indirect channel partners that have some of their end-user customers located outside the United States. We expect that we will continue to generate a significant portion of our revenue from international operations.

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

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

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

#### **We may be materially affected by the WEEE directive**

The European Union has finalized the Waste Electrical and Electronic Equipment (WEEE) directive, which regulates the collection, recovery, and recycling of waste from electrical and electronic products, and the Restrictions on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive, which bans the use of certain hazardous materials including lead, mercury, cadmium, chromium, and halogenated flame-retardants. Under WEEE, we will be responsible for financing operations for the collection, treatment, disposal, and recycling of past and future covered products. Because the specific legal requirements have not been finalized, we are presently unable to reasonably estimate the amount of any costs that may be necessary in order to comply with WEEE. We cannot provide any assurance that compliance with WEEE and RoHS will not have a material adverse effect on our financial condition or results of operations.

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

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

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

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

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

#### **Foreign Currency Exchange Rate Risk**

Our primary market risk relates to changes in foreign currency exchange rates. The functional currency for our foreign subsidiaries is the U.S. dollar. A significant portion of our revenue is generated by our international operations. The majority of our international operations involve transactions denominated in the euro, Pound Sterling, and Japanese yen. An increase in the exchange value of the U.S. dollar reduces the value of revenue and profits generated by our international operations. As a result, our financial condition, results of operations, and cash flows can be materially affected by changes in foreign currency exchange rates. We attempt to mitigate this exposure as part of our foreign currency hedging program. The primary goal of our foreign currency hedging program is to reduce the risk of adverse foreign currency movements on the reported financial results of our non-U.S. dollar transactions. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. All foreign currency derivatives are authorized and executed pursuant to our policies. We do not hold or issue derivatives or any other financial instruments for trading or speculative purposes.

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

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A hypothetical 10% adverse movement in foreign exchange rates applied to our foreign currency exchange rate sensitive instruments held as of June 25, 2004, and as of December 26, 2003, would result in a hypothetical loss in fair value of approximately \$45.5 million and \$59.2 million, respectively. The decrease in the hypothetical loss is primarily due to a decrease in net outstanding derivatives. These hypothetical losses do not take our underlying international operations into consideration. We anticipate that any hypothetical loss associated with our foreign currency exchange rate sensitive instruments would be substantially offset by gains associated with our underlying international operations.

### Interest Rate Risk

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

### Credit Risk

We are exposed to credit risk associated with cash equivalents, investments, foreign currency options and forwards, and trade receivables. We do not believe that our cash equivalents, investments, or foreign currency derivatives present significant credit risks, because the counterparties to the instruments consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. Substantially all trade receivable balances are unsecured. The concentration of credit risk with respect to trade receivables is limited by the large number of customers in our customer base and their dispersion across various industries and geographic areas. Although we have a large number of customers who are dispersed across different industries and geographic areas, a prolonged economic

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downturn could increase our exposure to credit risk on our trade receivables. We perform ongoing credit evaluations of our customers and maintain an allowance for potential credit losses.

## ITEM 4 CONTROLS AND PROCEDURES

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures (as defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934) as of June 25, 2004, the end of the period covered by this report. Based on their evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective.

During the fiscal quarter ended June 25, 2004, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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## PART II

### ITEM 1 LEGAL PROCEEDINGS

For information regarding legal proceedings, see Note 4 of NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, included in Part 1, Item 1, of this Form 10-Q, which information is incorporated by reference into this Part II, Item 1.

### ITEM 2 - CHANGES IN SECURITIES, USE OF PROCEEDS, AND ISSUER PURCHASES OF EQUITY SECURITIES

The following table summarizes our purchases of our equity securities during the second quarter of 2004:

Total Number of

Maximum Number of

ITEM 2 - CHANGES IN SECURITIES, USE OF PROCEEDS, AND ISSUER PURCHASES OF EQUITY SECURITIES

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Period	Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (3)
03/27/04 - 04/30/04	235,500	\$ 27.42	235,500	6,764,500
05/01/04 - 05/28/04	656,700	26.61	656,700	6,107,800
05/29/04 - 06/25/04	107,800	28.11	107,800	6,000,000
Total	1,000,000	\$ 26.96	1,000,000	

- (1) Excludes shares withheld to satisfy minimum tax withholding requirements associated with restricted stock lapses.
- (2) In January 2004, our Board of Directors authorized a stock repurchase program to acquire up to 1,000,000 shares of common stock per quarter through 2005.
- (3) As of June 25, 2004, a maximum of 6,000,000 shares could be purchased under the repurchase program announced in January 2004. However, our Board of Directors authorized a new stock repurchase program in July 2004 to acquire up to \$500 million of common stock. This new repurchase program will replace the previous program announced in January 2004.

**ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our Annual Meeting of Stockholders (the Annual Meeting) was held on May 20, 2004. A total of 101,973,111 shares of common stock, par value \$0.10 per share (the Common Stock), were present at the Annual Meeting, either in person or by proxy, constituting a quorum. The matters voted upon at the Annual Meeting by the stockholders consisted of the four proposals set forth in our definitive Proxy Statement, dated April 12, 2004.

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The first proposal related to the election of seven persons to serve on our Board of Directors. The Board's nominees were each elected and received, respectively, the following votes:

Director	For	Withheld
James R. Adams	97,487,609	4,485,502
Charles E. Foster	97,818,473	4,154,638
Mercedes Johnson	98,212,148	3,760,963
William T. Kerr	97,801,839	4,171,272
Robert E. Lee	97,033,192	4,939,919
Patrick J. Martin	98,978,537	2,994,574
Judy C. Odom	98,211,857	3,761,254

The second proposal related to approval of our 2004 Long Term Incentive Plan. The third proposal related to approval of our 2004 Performance-Based Incentive Plan. These two proposals were approved as detailed below.

The fourth proposal was a stockholder proposal regarding cumulative voting. This proposal was rejected as detailed below.

Proposal	For	Against	Abstentions	Broker Non-Votes
Proposal 2	66,490,308	24,806,407	146,165	10,530,231
Proposal 3	87,118,028	4,183,156	142,588	10,529,339
Proposal 4	39,711,152	44,369,191	7,362,562	10,530,206

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

(a) Exhibits:

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

- 3.1 Restated Certificate of Incorporation of Storage Technology Corporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.2 Certificate of Amendment dated May 22, 1989, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.3 Certificate of Second Amendment dated May 28, 1992, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.3 to the Company's Annual Report on Form 10-K for the fiscal year ended December 29, 2000, filed on February 21, 2001, and incorporated herein by reference)
- 3.4 Certificate of Third Amendment dated May 21, 1999, to the Restated Certificate of Incorporation dated July 28, 1987 (previously filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 25, 1999, filed on August 9, 1999, and incorporated herein by reference)

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- 3.5 Restated Bylaws of Storage Technology Corporation, as amended through November 16, 2002 (previously filed as Exhibit 3.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 4.1 Specimen Certificate of Common Stock, \$0.10 par value of Registrant (previously filed as Exhibit (c)(2) to the Company's Current Report on Form 8-K dated June 2, 1989, and incorporated herein by reference)
- 10.1<sup>1</sup> Storage Technology Corporation Amended and Restated 1987 Employee Stock Purchase Plan, as amended through May 21, 2003 (previously filed as Exhibit 4.6 to the Company's Registration Statement on Form S-8 (Registration No. 333-106930) filed on July 10, 2003, and incorporated herein by reference)
- 10.2<sup>1,2</sup> Storage Technology Corporation Amended and Restated 1995 Equity Participation Plan, as amended through May 20, 2004
- 10.3<sup>1,2</sup> Storage Technology Corporation 2004 Long Term Incentive Plan.
- 10.4<sup>1</sup> Storage Technology Corporation Management by Objective Bonus Plan (previously filed as Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.5<sup>1,2</sup> Storage Technology Corporation 2004 Performance-Based Incentive Plan.
- 10.6<sup>1</sup> Storage Technology Corporation Amended and Restated Stock Option Plan for Non-Employee Directors (previously filed as Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 1996, filed on August 12, 1996, and incorporated herein by reference)
- 10.7<sup>1</sup> Storage Technology Corporation Flexible Option Plan, dated December 2001 (previously filed as Exhibit 10.5 to the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2001, filed on March 4, 2002, and incorporated herein by reference)
- 10.8<sup>1</sup> Severance Agreement, dated as of July 1, 2001, between the Company and Robert S. Kocol (previously filed as Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)

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- 10.9<sup>1</sup> Offer Letter, dated May 10, 2001, from the Company to Michael McLay (previously filed as Exhibit 10.17 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 29, 2001, filed on August 9, 2001, and incorporated herein by reference)
- 10.10<sup>1</sup> Offer Letter, dated February 9, 2001, from the Company to Roger Gaston (previously filed as Exhibit 10.20 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 30, 2001, filed on May 14, 2001, and incorporated herein by reference)
- 10.11<sup>1</sup> Offer Letter, dated July 16, 2001, from the Company to Roy Perry (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)

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- 10.12<sup>1</sup> Offer Letter, dated June 27, 2001, from the Company to Angel Garcia (previously filed as Exhibit 10.29 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.13 Credit Agreement, dated as of October 10, 2001, among the Company, the several financial institutions thereto, Bank of America, N.A., as letter of credit issuing bank and sole administrative agent for the Banks, Key Corporate Capital, Inc. as Documentation Agent, Fleet National Bank as Syndication Agent, and Banc of America Securities LLC as sole lead arranger and sole book manager (previously filed as Exhibit 10.13 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.14 Security Agreement, dated as of October 10, 2001, by and among the Company, Bank of America, N.A., as Collateral Agent for itself and other Secured Parties referred to therein (previously filed as Exhibit 10.14 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.15 Guaranty, dated as of October 10, 2001, by StorageTek Holding Corporation, in favor of the Banks party to a certain Credit Agreement and Bank of America, N.A., as Agent and Issuing Bank and Collateral Agent (previously filed as Exhibit 10.15 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 28, 2001, filed on November 8, 2001, and incorporated herein by reference)
- 10.16<sup>1</sup> Form of Executive Severance Agreement (previously filed as Exhibit 10.32 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.17 Master Services Agreement (MSA), between each of the Company, Electronic Data Systems Corporation, and EDS Information Services L.L.C., dated as of April 1, 2002 (previously filed as Exhibit 10.33 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.18 Authorization Letter #1 pursuant to the MSA, dated April 1, 2002 (previously filed as Exhibit 10.34 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.19 Authorization Letter #2 pursuant to the MSA, dated April 1, 2002 (previously filed as Exhibit 10.35 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.20 Master Secondary Storage Services Agreement, between the Company and Electronic Data Systems Corporation, dated March 29, 2002 (previously filed as Exhibit 10.36 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2002, filed on May 13, 2002, and incorporated herein by reference)
- 10.21<sup>1</sup> Offer Letter, dated June 25, 2002, between the Company and Mark Roellig (previously filed as Exhibit 10.28 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 28, 2002, filed on August 12, 2002, and incorporated herein by reference)

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- 10.22<sup>1</sup> Form of Indemnification Agreement, dated as of November 22, 2002, between the Company and each director (previously filed as Exhibit 10.31 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and



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incorporated herein

- 10.23<sup>1</sup> Offer Letter, dated November 12, 2002, between the Company and Pierre Cousin (previously filed as Exhibit 10.33 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.24<sup>1</sup> Agreement, dated December 1, 2002, between the Company and Pierre Cousin (previously filed as Exhibit 10.34 to the Company's Annual Report on Form 10-K for the fiscal year ended December 27, 2002, filed on March 7, 2003, and incorporated herein by reference)
- 10.25<sup>1</sup> Amended and Restated CEO Employment Agreement, dated March 27, 2003, between the Company and Patrick J. Martin (previously filed as Exhibit 10.36 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 28, 2003, filed on May 9, 2003, and incorporated herein by reference)
- 10.26<sup>1</sup> Form of Executive Agreement, dated as of February 12, 2003, between the Company and each executive officer (previously filed as Exhibit 10.37 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 28, 2003, filed on May 9, 2003, and incorporated herein by reference)
- 10.27 Letter, dated July 24, 2003, from the Company to Bank of America, N.A. (previously filed as Exhibit 10.32 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 27, 2003, filed on August 8, 2003, and incorporated herein by reference)
- 10.28<sup>1</sup> Offer Letter, dated December 12, 2003, between the Company and Mark Ward (previously filed as Exhibit 10.30 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 26, 2004, filed on May 5, 2004, and incorporated herein by reference)
- 10.29<sup>1</sup> Offer Letter, dated March 1, 2004, between the Company and Eula Adams (previously filed as Exhibit 10.31 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 26, 2004, filed on May 5, 2004, and incorporated herein by reference)
- 31.1<sup>2</sup> Certification Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2<sup>2</sup> Certification Pursuant to Exchange Act Rules 13a-14 and 15d-14, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1<sup>2</sup> Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2<sup>2</sup> Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

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

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(b) Reports on Form 8-K.

Current report on Form 8-K, filed on May 28, 2004, relating to an Item 5, Other Events and Regulation FD Disclosure, regarding the voting results from Storage Technology Corporation's Annual Meeting of Stockholders held on May 20, 2004.

Current report on Form 8-K, filed on April 21, 2004, relating to an Item 9, Regulation FD Disclosure, regarding the announcement of our results of operations for the fiscal quarter ended March 26, 2004, including a copy of the script of the prepared remarks of the Chief Executive Officer and Chief Financial Officer from a conference call regarding such results of operations.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STORAGE TECHNOLOGY CORPORATION  
(Registrant)

August 2, 2004

(Date)

/s/ ROBERT S. KOCOL

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

August 2, 2004

(Date)

/s/ THOMAS G. ARNOLD

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