PHH CORP
Form 10-Q
May 04, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from to

Commission File No. 1-7797

PHH CORPORATION
(Exact name of registrant as specified in its charter)

MARYLAND	**52-0551284**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
3000 LEADENHALL ROAD MT. LAUREL, NEW JERSEY	**08054**
(Address of principal executive offices)	*(Zip Code)*

856-917-1744
(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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes o No þ

As of April 25, 2011, 56,255,467 shares of PHH Common stock were outstanding.

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Except as expressly indicated or unless the context otherwise requires, the Company, PHH, we, our or us means Corporation, a Maryland corporation, and its subsidiaries.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may also be made in other documents filed or furnished with the SEC or may be made orally to analysts, investors, representatives of the media and others. Generally, forward-looking statements are not based on historical facts but instead represent only our current beliefs regarding future events. All forward-looking statements are, by their nature, subject to risks, uncertainties and other factors. Investors are cautioned not to place undue reliance on these forward-looking statements. Such statements may be identified by words such as expects, anticipates, intends, projects, estimates, plans, may increase, may similar expressions or future or conditional verbs such as will, should, would, may and could . Forward-looking statements contained in this Form 10-Q include, but are not limited to, statements concerning the following:

- § the impact of the adoption of recently issued accounting pronouncements on our financial statements;
- § the impact of the risk retention requirements and other provisions of the Dodd-Frank Act;
- § future origination volumes and loan margins in the mortgage industry;
- § actuarial estimate of total reinsurance losses and expected future reinsurance premiums; and
- § mortgage repurchase and indemnification claims and associated reserves and provisions.

Actual results, performance or achievements may differ materially from those expressed or implied in forward-looking statements due to a variety of factors, including but not limited to the factors listed and discussed in Part I Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010 and those factors described below:

- § the effects of continued market volatility or continued economic decline on the availability and cost of our financing arrangements and the value of our assets;
- § the effects of a continued decline in the volume of U.S. home sales and home prices, due to adverse economic changes or otherwise, on our Mortgage Production and Mortgage Servicing segments;
- § the effects of changes in current interest rates on our business and our financing costs;
- § our decisions regarding the use of derivatives related to mortgage servicing rights, if any, and the resulting potential volatility of the results of operations of our Mortgage Servicing segment;
- § the effects of increases in our actual and projected repurchases of, indemnification given in respect of, or related losses associated with, sold mortgage loans for which we have provided representations and warranties or other contractual recourse to purchasers and insurers of such loans, including increases in our loss severity and reserves associated with such loans;
- § the effects of reinsurance claims in excess of projected levels and in excess of reinsurance premiums we are entitled to receive or amounts currently held in trust to pay such claims;
- § the effects of any significant adverse changes in the underwriting criteria or existence or programs of government-sponsored entities, including Fannie Mae and Freddie Mac, including any changes caused by the Dodd-Frank Wall Street Reform and Consumer Protection Act;
- § the effects of any inquiries and investigations of foreclosure procedures or other servicing activities by attorney generals of certain states and the U.S. Department of Justice, or any litigation related to our mortgage servicing activities;

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- § the ability to maintain our status as a government sponsored entity-approved seller and servicer, including the ability to continue to comply with the respective selling and servicing guides, including any changes caused by the Dodd-Frank Act;
- § the effects of any changes to the servicing compensation structure for mortgage servicers pursuant to the programs of government sponsored-entities;
- § changes in laws and regulations, including changes in mortgage- and real estate-related laws and regulations (including changes caused by the Dodd-Frank Act), status of government sponsored-entities and state, federal and foreign tax laws and accounting standards;
- § the effects of the insolvency of any of the counterparties to our significant customer contracts or financing arrangements or the inability or unwillingness of such counterparties to perform their respective obligations under, or to renew on terms favorable to us, such contracts, or our ability to continue to comply with the terms of our significant customer contracts, including service level agreements;
- § the effects of competition in our existing and potential future lines of business, including the impact of consolidation within the industries in which we operate and competitors with greater financial resources and broader product lines;
- § the ability to obtain financing (including refinancing existing indebtedness) on acceptable terms, if at all, to finance our operations or growth strategy, to operate within the limitations imposed by our financing arrangements and to maintain the amount of cash required to service our indebtedness;
- § the ability to maintain our relationships with our existing clients and to establish relationships with new clients;
- § the ability to attract and retain key employees;
- § a deterioration in the performance of assets held as collateral for secured borrowings;
- § the impact of the failure to maintain our credit ratings;
- § any failure to comply with covenants under our financing arrangements;
- § the effects of the consolidation of financial institutions and the related impact on the availability of credit; and
- § the impact of actions taken or to be taken by the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System on the credit markets and the U.S. economy.

Forward-looking statements speak only as of the date on which they are made. Factors and assumptions discussed above, and other factors not identified above, may have an impact on the continued accuracy of any forward-looking statements that we make. Except for our ongoing obligations to disclose material information under the federal securities laws, we undertake no obligation to release publicly any revisions to any forward-looking statements. For any forward-looking statements contained in any document, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In millions, except per share data)

	Three Months Ended March 31, 2011	2010
Revenues		
Mortgage fees	$ 86	$ 52
Fleet management fees	42	38
Net fee income	128	90
Fleet lease income	337	339
Gain on mortgage loans, net	59	105
Mortgage interest income	35	18
Mortgage interest expense	(54)	(38)
Mortgage net finance expense	(19)	(20)
Loan servicing income	108	101
Change in fair value of mortgage servicing rights	(32)	(52)
Net loan servicing income	76	49
Other income	84	14
Net revenues	665	577
Expenses		
Salaries and related expenses	134	114
Occupancy and other office expenses	15	15
Depreciation on operating leases	306	308
Fleet interest expense	20	23
Other depreciation and amortization	6	6
Other operating expenses	99	92
Total expenses	580	558
Income before income taxes	85	19
Income tax expense	33	11

Net income	52	8
Less: net income attributable to noncontrolling interest	3	
Net income attributable to PHH Corporation	$ 49	$ 8
Basic earnings per share attributable to PHH Corporation	$ 0.87	$ 0.15
Diluted earnings per share attributable to PHH Corporation	$ 0.84	$ 0.15

See Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In millions, except share data)

	March 31, 2011	December 31, 2010
ASSETS		
Cash and cash equivalents	$ 325	$ 195
Restricted cash, cash equivalents and investments (including $248 and $254 of available-for-sale securities at fair value)	558	531
Mortgage loans held for sale	1,338	4,329
Accounts receivable, net	606	573
Net investment in fleet leases	3,501	3,492
Mortgage servicing rights	1,590	1,442
Property, plant and equipment, net	45	46
Goodwill	25	25
Other assets	570	637
Total assets (1)	$ 8,558	$ 11,270
LIABILITIES AND EQUITY		
Accounts payable and accrued expenses	$ 488	$ 521
Debt	5,395	8,085
Deferred taxes	758	728
Other liabilities	280	358
Total liabilities (1)	6,921	9,692
Commitments and contingencies (Note 11)		
EQUITY		
Preferred stock, $0.01 par value; 1,090,000 shares authorized; none issued or outstanding		
Common stock, $0.01 par value; 273,910,000 shares authorized; 56,209,782 shares issued and outstanding at March 31, 2011; 55,699,218 shares issued and outstanding at December 31, 2010	1	1
Additional paid-in capital	1,077	1,069
Retained earnings	514	465
Accumulated other comprehensive income	33	29
Total PHH Corporation stockholders equity	1,625	1,564
Noncontrolling interest	12	14
Total equity	1,637	1,578
Total liabilities and equity	$ 8,558	$ 11,270

Continued.

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CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)
(Unaudited)
(In millions)

(1) The Condensed Consolidated Balance Sheets include assets of variable interest entities which can be used only to settle their obligations and liabilities of variable interest entities which creditors or beneficial interest holders do not have recourse to PHH Corporation and subsidiaries as follows:

	March 31, 2011	December 31, 2010
ASSETS		
Cash and cash equivalents	$ 52	$ 47
Restricted cash, cash equivalents and investments	278	241
Mortgage loans held for sale	225	389
Accounts receivable, net	57	64
Net investment in fleet leases	3,241	3,356
Property, plant and equipment, net	1	1
Other assets	59	82
Total assets	$ 3,913	$ 4,180
LIABILITIES		
Accounts payable and accrued expenses	$ 20	$ 38
Debt	3,159	3,367
Other liabilities	5	5
Total liabilities	$ 3,184	$ 3,410

See Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(Unaudited)
(In millions, except share data)

Three Months Ended March 31, 2011

	PHH Corporation Stockholders						
	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Noncontrolling Interest	Total Equity
Balance at December 31, 2010	55,699,218	$ 1	$ 1,069	$ 465	$ 29	$ 14	$ 1,578
Comprehensive income:							
Net income				49		3	
Currency translation adjustment					4		
Total comprehensive income				49	4	3	56
Distributions to noncontrolling interest						(5)	(5)
Stock compensation expense			2				2
Stock options exercised, including excess tax benefit of $0	350,762		7				7
Restricted stock award vesting, net of excess tax benefit of $0	159,802		(1)				(1)
Balance at March 31, 2011	56,209,782	$ 1	$ 1,077	$ 514	$ 33	$ 12	$ 1,637

Three Months Ended March 31, 2010

	PHH Corporation Stockholders						
	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Noncontrolling Interest	Total Equity
Balance at December 31, 2009	54,774,639	$ 1	$ 1,056	$ 416	$ 19	$ 12	$ 1,504
Comprehensive income:							

Net income				8			
Currency translation adjustment					6		
Total comprehensive income				8	6		14
Stock compensation expense			4				4
Stock options exercised, including excess tax benefit of $0	333,610		5				5
Restricted stock award vesting, net of excess tax benefit of $0	225,607		(3)				(3)
Balance at March 31, 2010	55,333,856	$ 1	$ 1,062	$ 424	$ 25	$ 12	$ 1,524

See Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In millions)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Cash flows from operating activities:		
Net income	$ 52	$ 8
Adjustments to reconcile Net income to net cash provided by operating activities:		
Capitalization of originated mortgage servicing rights	(180)	(97)
Net unrealized loss on mortgage servicing rights	32	52
Vehicle depreciation	306	308
Other depreciation and amortization	6	6
Origination of mortgage loans held for sale	(9,488)	(5,866)
Proceeds on sale of and payments from mortgage loans held for sale	12,648	6,010
Net loss (gain) on interest rate lock commitments, mortgage loans held for sale and related derivatives	13	(165)
Deferred income tax expense	30	1
Other adjustments and changes in other assets and liabilities, net	(265)	50
Net cash provided by operating activities	3,154	307
Cash flows from investing activities:		
Investment in vehicles	(381)	(376)
Proceeds on sale of investment vehicles	82	87
Proceeds on sale of mortgage servicing rights		3
Purchases of property, plant and equipment	(4)	(3)
Purchases of restricted investments	(35)	
Proceeds from sales and maturities of restricted investments	41	
(Increase) decrease in Restricted cash and cash equivalents	(32)	49
Other, net	21	4
Net cash used in investing activities	(308)	(236)
Cash flows from financing activities:		
Proceeds from borrowings	16,272	7,371
Principal payments on borrowings	(18,984)	(7,449)
Issuances of Company Common Stock	7	5
Cash paid for debt issuance costs	(4)	(7)
Other, net	(5)	(2)
Net cash used in financing activities	(2,714)	(82)
Effect of changes in exchange rates on Cash and cash equivalents	(2)	(2)
Net increase (decrease) in Cash and cash equivalents	130	(13)
Cash and cash equivalents at beginning of period	195	150

Cash and cash equivalents at end of period	$	325	$	137

See Notes to Condensed Consolidated Financial Statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

PHH Corporation and subsidiaries (collectively, PHH or the Company) is a leading outsource provider of mortgage and fleet management services operating in the following business segments:

- § **Mortgage Production** provides mortgage loan origination services and sells mortgage loans.
- § **Mortgage Servicing** performs servicing activities for originated and purchased loans.
- § **Fleet Management Services** provides commercial fleet management services.

The Condensed Consolidated Financial Statements include the accounts and transactions of PHH and its subsidiaries, as well as entities in which the Company directly or indirectly has a controlling interest and variable interest entities of which the Company is the primary beneficiary. PHH Home Loans, LLC and its subsidiaries are consolidated within the Condensed Consolidated Financial Statements, and Realogy Corporation s ownership interest is presented as a noncontrolling interest.

The Condensed Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States, which is commonly referred to as GAAP, for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and disclosures required by GAAP for complete financial statements. In management s opinion, the unaudited Condensed Consolidated Financial Statements contain all adjustments, which include normal and recurring adjustments necessary for a fair presentation of the financial position and results of operations for the interim periods presented. The results of operations reported for interim periods are not necessarily indicative of the results of operations for the entire year or any subsequent interim period. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

On March 31, 2011, the Company sold 50.1% of the equity interest in its appraisal services business, Speedy Title and Appraisal Review Services, (STARS) to CoreLogic, Inc. for a total purchase price of $35 million. The total purchase price consisted of an initial $20 million cash payment that was received on March 31, 2011, and three future $5 million installment payments to be received on March 31, 2012, 2014 and 2016. Upon the occurrence of certain events prior to September 30, 2017, the Company may have the right or obligation to purchase CoreLogic s interests. The Company deconsolidated STARS and retained a 49.9% equity interest, which is accounted for under the equity method and is recorded within Other assets with an initial fair value of $34 million as of March 31, 2011. The net assets of STARS were not significant. A $68 million gain on the sale of the 50.1% equity interest was recorded within Other income, which consisted of the net present value of the purchase price paid by CoreLogic plus the initial fair value of the remaining equity method investment in STARS. Subsequent to March 31, 2011, the Company will still participate in the appraisal services business through its interest in STARS, and will be entitled to its proportionate share of STARS earnings based on its 49.9% ownership interest.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions include, but are not limited to, those related to the valuation of mortgage servicing rights, mortgage loans held for sale, other financial instruments and goodwill, the estimation of liabilities for mortgage loan repurchases and indemnifications and reinsurance losses, and the determination of certain income tax assets and liabilities and associated valuation allowances. Actual results could differ from those estimates.

Unless otherwise noted and except for share and per share data, dollar amounts presented within these Notes to Condensed Consolidated Financial Statements are in millions.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Changes In Accounting Policies

Goodwill. In December 2010, the FASB issued new accounting guidance on performing tests of goodwill impairment, ASU No. 2010-28, When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts . This new accounting guidance requires that entities perform a two-step test when evaluating goodwill impairment by first assessing whether the carrying value of the reporting unit exceeds the fair value (Step 1) and, if it does, perform additional procedures to determine if goodwill has been impaired (Step 2). This guidance require entities performing the goodwill impairment test to perform Step 2 of the test for reporting units with zero or negative carrying amounts if it is more likely than not that a goodwill impairment exists based on qualitative considerations. The Company adopted the updates to goodwill impairment guidance effective January 1, 2011. The adoption did not impact the Company s financial statements.

Business Combinations. In December 2010, the FASB issued new accounting guidance on business combinations, ASU No. 2010-29, Disclosure of Supplementary Pro Forma Information for Business Combinations . This new accounting guidance requires a public entity that presents comparative financial statements to disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. This new accounting guidance also expands the supplemental pro-forma disclosures for Business Combinations to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The Company adopted the new business combination guidance effective January 1, 2011. The adoption did not have an impact on the Company s financial statements.

Revenue Recognition. In October 2009, the FASB issued new accounting guidance on revenue recognition, ASU No. 2009-13, Multiple Deliverable Arrangements . This new accounting guidance addresses how to determine whether an arrangement involving multiple deliverables (i) contains more than one unit of accounting and (ii) how the arrangement consideration should be measured and allocated to the separate units of accounting. The Company adopted the updates revenue recognition guidance effective January 1, 2011. The adoption did not have an impact on the Company s financial statements.

Recently Issued Accounting Pronouncements

Receivables. In April 2011, the FASB issued ASU 2011-02, A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring . This new guidance requires a creditor performing an evaluation of whether a restructuring constitutes a troubled debt restructuring, to separately conclude that both (i) the restructuring constitutes a concession and (ii) the debtor is experiencing financial difficulties. This standard clarifies the guidance on a creditor s evaluation of whether it has granted a concession as well as the guidance on a creditor s evaluation of whether a debtor is experiencing financial difficulties. The update also requires entities to disclose additional quantitative activity regarding troubled debt restructurings of finance receivables that occurred during the period, as well as additional information regarding troubled debt restructurings that occurred within the previous twelve months and for which there was a payment default during the current period. The new accounting guidance is effective beginning July 1, 2011, and should be applied retrospectively to January 1, 2011. The Company does not anticipate the adoption of this update to have a material impact on the Company s financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

2. Earnings Per Share

Basic earnings per share attributable to PHH Corporation was computed by dividing Net income attributable to PHH Corporation during the period by the weighted-average number of shares outstanding during the period. Diluted earnings per share attributable to PHH Corporation was computed by dividing Net income attributable to PHH Corporation by the weighted-average number of shares outstanding, assuming all potentially dilutive common shares were issued.

For the three months ended March 31, 2011 and 2010, the weighted-average computation of the dilutive effect of potentially issuable shares of Common stock under the treasury stock method excludes: (i) approximately 0.3 million and 1.2 million, respectively, of outstanding stock-based compensation awards as their inclusion would be anti-dilutive; (ii) purchased options and sold warrants related to the assumed conversion of the 2012 Convertible notes as their inclusion would be anti-dilutive; (iii) sold warrants related to the Company s 2014 Convertible notes as their inclusion would be anti-dilutive; and (iv) the 2014 Convertible notes and related purchased options as they are currently to be settled only in cash.

The following table summarizes the calculations of basic and diluted earnings per share attributable to PHH Corporation for the periods indicated:

	Three Months Ended March 31,	
	2011	2010
	(In millions, except share and per share data)	
Net income attributable to PHH Corporation	$ 49	$ 8
Weighted-average common shares outstanding basic	56,108,525	55,035,745
Effect of potentially dilutive securities:		
Stock options	235,128	133,102
Restricted stock units	699,602	779,681
Assumed conversion of the 2012 Convertible notes	1,583,917	
Weighted-average common shares outstanding diluted	58,627,172	55,948,528
Basic earnings per share attributable to PHH Corporation	$ 0.87	$ 0.15
Diluted earnings per share attributable to PHH Corporation	$ 0.84	$ 0.15

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

3. Restricted Cash, Cash Equivalents and Investments

The following table summarizes Restricted cash, cash equivalents and investment balances:

	March 31, 2011	December 31, 2010
	(In millions)	
Restricted cash and cash equivalents	$ 310	$ 277
Restricted investments, at fair value	248	254
Restricted cash, cash equivalents and investments	$ 558	$ 531

The restricted cash related to our reinsurance activities was invested in certain debt securities as permitted under the reinsurance agreements. These investments remain in trust for capital fund requirements and potential reinsurance losses, as summarized in the following tables:

	March 31, 2011				
	Amortized Cost	Fair Value	Unrealized Gains (In millions)	Unrealized Losses	Weighted-average remaining maturity
Restricted investments classified as available-for-sale:					
Corporate securities	$ 69	$ 69	$	$	27 mos.
Agency securities [1]	100	101	1		23 mos.
Government securities	78	78			25 mos.
Total available-for-sale securities	$ 247	$ 248	$ 1	$	25 mos.

	December 31, 2010				
	Amortized Cost	Fair Value	Unrealized Gains (In millions)	Unrealized Losses	Weighted-average remaining maturity
Restricted investments classified as available-for-sale:					
Corporate securities	$ 71	$ 71	$	$	30 mos.
Agency securities [1]	106	107	1		26 mos.
Government securities	76	76			28 mos.
Total available-for-sale securities	$ 253	$ 254	$ 1	$	27 mos.

(1)

Represents bonds and notes issued by various agencies including, but not limited to, Fannie Mae, Freddie Mac and Federal Home Loan Banks.

During the three months ended March 31, 2011, the amount of realized gains and losses from the sale of available-for-sale securities was not significant. There were no available-for-sale securities outstanding during the three months ended March 31, 2010.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

4. Mortgage Servicing Rights

The total servicing portfolio consists of loans associated with capitalized mortgage servicing rights, loans held for sale, and the servicing portfolio associated with loans subserviced for others. The total servicing portfolio, including loans subserviced for others was $170.7 billion and $166.1 billion as of March 31, 2011 and December 31, 2010, respectively. Mortgage servicing rights (MSRs) recorded in the Condensed Consolidated Balance Sheets are related to the capitalized servicing portfolio, and are created either through the direct purchase of servicing from a third party, or through the sale of an originated loan.

The activity in the loan servicing portfolio associated with capitalized servicing rights consisted of:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
Balance, beginning of period	$ 134,753	$ 127,700
Additions	12,347	5,688
Payoffs, sales and curtailments	(6,023)	(4,844)
Balance, end of period	$ 141,077	$ 128,544

The activity in capitalized MSRs consisted of:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
Mortgage Servicing Rights:		
Balance, beginning of period	$ 1,442	$ 1,413
Additions	180	97
Changes in fair value due to:		
Realization of expected cash flows	(60)	(63)
Changes in market inputs or assumptions used in the valuation model	28	11
Balance, end of period	$ 1,590	$ 1,458

Contractually specified servicing fees, late fees and other ancillary servicing revenue were recorded within Loan servicing income as follows:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
Net service fee revenue	$106	$97
Late fees	6	5
Other ancillary servicing revenue	11	10

As of March 31, 2011 and December 31, 2010, the MSRs had a weighted-average life of approximately 6.0 years and 5.7 years, respectively. The following summarizes certain information regarding the initial and ending capitalization rates of the MSRs:

	Three Months Ended March 31,	
	2011	2010
Initial capitalization rate of additions to MSRs	1.46%	1.70%
Weighted-average servicing fee of additions to MSRs (in basis points)	28	30

	As of March 31,	
	2011	2010
Capitalized servicing rate	1.13%	1.13%
Capitalized servicing multiple	3.7	3.7
Weighted-average servicing fee (in basis points)	30	30

See Note 13, Fair Value Measurements for additional information regarding the valuation of MSRs.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

5. Mortgage Loan Sales

Residential mortgage loans are sold through one of the following methods: (i) sales to Fannie Mae and Freddie Mac and loan sales to other investors guaranteed by Ginnie Mae (collectively GSEs), or (ii) sales to private investors. The Company may have continuing involvement in mortgage loans sold by retaining one or more of the following: servicing rights and servicing obligations, recourse obligations and/or beneficial interests (such as interest-only strips, principal-only strips, or subordinated interests). During the three months ended March 31, 2011, the Company did not retain any interests from sales or securitizations other than mortgage servicing rights. See Note 10, Credit Risk for a further description of recourse obligations.

The following table sets forth information regarding cash flows relating to loan sales in which the Company has continuing involvement:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
Proceeds from new loan sales or securitizations	$12,306	$5,763
Servicing fees received [1]	106	97
Purchases of delinquent or foreclosed loans [2]	(9)	(12)
Servicing advances [3]	(436)	(344)
Repayment of servicing advances	426	338

(1) Excludes late fees and other ancillary servicing revenue.

(2) Excludes indemnification payments to investors and insurers of the related mortgage loans.

(3) As of March 31, 2011 and December 31, 2010, outstanding servicing advance receivables of $194 million and $187 million, respectively, were included in Accounts receivable, net.

During the three months ended March 31, 2011 and 2010, pre-tax gains of $178 million and $102 million, respectively, related to the sale or securitization of residential mortgage loans were recognized in Gain on mortgage loans, net in the Condensed Consolidated Statements of Operations.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

6. Derivatives

The Company did not have any derivative instruments designated as hedging instruments as of and during the three months ended March 31, 2011 or as of and during the year ended December 31, 2010. Derivative instruments are recorded in Other assets and Other liabilities in the Condensed Consolidated Balance Sheets, except for certain instruments related to the Convertible notes due in 2012 which are recorded in equity. Derivative instruments and the risks they manage are as follows:

Forward delivery commitments Related to interest rate and price risk for Mortgage loans held for sale and interest rate lock commitments

Option contracts Related to interest rate and price risk for interest rate lock commitments

Interest rate contracts Related to interest rate risk for variable-rate debt arrangements and fixed-rate leases

Convertible note-related agreements Related to the issuance of the Convertible notes due in 2014

Foreign exchange contracts Related to exposure to currency fluctuations that would impact our investment in, or borrowings related to, our Canadian operations

The following table presents the balances of outstanding derivative amounts on a gross basis prior to the application of counterparty and collateral netting:

	March 31, 2011			December 31, 2010		
	Asset Derivatives	Liability Derivatives	Notional	Asset Derivatives	Liability Derivatives	Notional
	(In millions)					
Interest rate lock commitments	$ 51	$ 2	$ 3,765	$ 42	$ 46	$ 7,328
Forward delivery commitments: [1]						
Not subject to master netting arrangements	10	11	4,325	61	14	4,703
Subject to master netting arrangements[2]	10	24	5,999	248	68	16,438
Interest rate contracts	3		592	4		653
Option contracts	1		600			
Convertible note-related agreements [3]	44	44		54	54	
Foreign exchange contracts		1	108			30
Gross derivative assets and liabilities	119	82		409	182	
Netting adjustments:						
Offsetting receivables/ payables	(12)	(12)		(241)	(241)	
Cash collateral paid / received	5	(8)			190	
Net fair value of derivative instruments	$ 112	$ 62		$ 168	$ 131	

(1) The net notional amount of Forward delivery commitments was $4.1 billion and $10.3 billion as of March 31, 2011 and December 31, 2010, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(2) Represents derivative instruments that are executed with the same counterparties and subject to master netting arrangements. Forward delivery commitments subject to netting shown above were presented in the Balance sheets as follows:

	March 31, 2011		December 31, 2010	
	Asset Derivatives	Liability Derivatives	Asset Derivatives	Liability Derivatives
	(In millions)			
Other Assets	$ 4	$ 6	$ 10	$ 3
Other Liabilities	6	18	238	65
Total	$ 10	$ 24	$ 248	$ 68

(3) The notional amount of the derivative instruments related to the issuance of the 2014 Convertible notes represents 9.6881 million shares of the Company s Common stock as of March 31, 2011 and December 31, 2010.

The following table summarizes the gains (losses) recorded in the Condensed Consolidated Statements of Operations for derivative instruments:

	Statement of Operations Presentation	Three Months Ended March 31,	
		2011	2010
		(In millions)	
Interest rate lock commitments	Gain on mortgage loans, net	$ 184	$ 202
Option contracts	Gain on mortgage loans, net	(3)	
Forward delivery commitments	Gain on mortgage loans, net	10	(57)
Interest rate contracts	Fleet interest expense		(3)
Foreign exchange contracts	Fleet interest expense	(2)	(1)
Total derivative instruments		$ 189	$ 141

7. Vehicle Leasing Activities

The components of Net investment in fleet leases were as follows:

	March 31, 2011	December 31, 2010
	(In millions)	
Operating Leases:		
Vehicles under open-end operating leases	$ 7,702	$ 7,601
Vehicles under closed-end operating leases	194	208
Vehicles under operating leases	7,896	7,809
Less: Accumulated depreciation	(4,725)	(4,671)
Net investment in operating leases	3,171	3,138

Direct Financing Leases:		
Lease payments receivable	98	106
Less: Unearned income	(3)	(3)
Net investment in direct financing leases	95	103
Off-Lease Vehicles:		
Vehicles not yet subject to a lease	225	248
Vehicles held for sale	21	7
Less: Accumulated depreciation	(11)	(4)
Net investment in off-lease vehicles	235	251
Net investment in fleet leases	$ 3,501	$ 3,492

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8. Debt and Borrowing Arrangements

The following table summarizes the components of indebtedness:

	March 31, 2011		December 31, 2010	
	Balance	Weighted-Average Interest Rate[1]	Balance	Weighted-Average Interest Rate[1]
	(In millions)			
Term notes, in amortization	$ 1,898	2.1%	$ 1,167	2.2%
Term notes, in revolving period	85	2.3%	989	2.0%
Variable-funding notes	974	1.8%	871	1.9%
Other	38	5.1%	39	5.1%
Total Vehicle Management Asset-Backed Debt	2,995		3,066	
Committed warehouse facilities	1,081	2.2%	2,419	2.1%
Uncommitted warehouse facilities			1,290	1.2%
Servicing advance facility	71	2.8%	68	2.8%
Total Mortgage Asset-Backed Debt	1,152		3,777	
Term notes	782	8.1%	782	8.1%
Convertible notes	438	4.0%	430	4.0%
Credit facilities				
Total Unsecured Debt	1,220		1,212	
Mortgage Loan Securitization Debt Certificates, at Fair Value [2]	28	7.0%	30	7.0%
Total Debt	$ 5,395		$ 8,085	

(1) Represents the weighted-average stated interest rate of the facilities as of the respective date. Facilities are variable-rate, except for the Term notes, Convertible notes, and Mortgage Loan Securitization Debt Certificates which are fixed-rate.

(2) Cash flows of securitized mortgage loans support payment of the debt certificates and creditors of the securitization trust do not have recourse to the Company.

Assets held as collateral that are not available to pay the Company s general obligations as of March 31, 2011 consisted of:

	Vehicle Asset-Backed Debt	Mortgage Asset-Backed Debt
	(In millions)	
Restricted cash and cash equivalents	$ 278	$
Accounts receivable	48	83
Mortgage loans held for sale		1,131
Net investment in fleet leases	3,237	
Total	$ 3,563	$ 1,214

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table provides the contractual debt maturities as of March 31, 2011:

	Vehicle Asset-Backed Debt (1)	Mortgage Asset-Backed Debt	Unsecured Debt	Mortgage Loan Securitization Debt Certificates	Total
			(In millions)		
Within one year	$ 1,125	$ 1,152	$	$ 8	$ 2,285
Between one and two years	900		671	7	1,578
Between two and three years	623			6	629
Between three and four years	336		250	5	591
Between four and five years	16		350	4	370
Thereafter			8		8
	$ 3,000	$ 1,152	$ 1,279	$ 30	$ 5,461

(1) Maturities of vehicle management asset-backed notes, a portion of which are amortizing in accordance with their terms, represent estimated payments based on the expected cash inflows related to the securitized vehicle leases and related assets.

Capacity under all borrowing agreements is dependent upon maintaining compliance with, or obtaining waivers of, the terms, conditions and covenants of the respective agreements. Available capacity under asset-backed funding arrangements may be further limited by asset eligibility requirements. Available capacity under committed asset-backed debt arrangements and unsecured credit facilities as of March 31, 2011 consisted of:

	Capacity	Utilized Capacity	Available Capacity
		(In millions)	
Vehicle Management Asset-Backed Debt:			
Term notes, in revolving period	$ 85	$ 85	$
Variable-funding notes	1,309	974	335
Mortgage Asset-Backed Debt:			
Committed warehouse facilities	2,835	1,081	1,754
Servicing advance facility	120	71	49
Unsecured Committed Credit Facilities(1)	530	16	514

(1) Utilized capacity reflects $16 million of letters of credit issued under the Amended Credit Facility, which are not included in Debt in the Condensed Consolidated Balance Sheet.

Capacity for Mortgage asset-backed debt shown above excludes $2.0 billion not drawn under uncommitted facilities.

The fair value of debt was $5.5 billion and $8.2 billion as of March 31, 2011 and December 31, 2010, respectively.

Vehicle Management Asset-Backed Debt

Vehicle management asset-backed debt primarily represents variable-rate debt issued by a wholly owned subsidiary, Chesapeake Funding LLC, to support the acquisition of vehicles by the Fleet Management Services segment s U.S. leasing operations and debt issued by the consolidated special purpose trust, Fleet Leasing Receivables Trust (FLRT), the Canadian special purpose trust, used to finance leases originated by the Canadian fleet operation.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Vehicle management asset-backed debt includes term notes, which provide a fixed funding amount at the time of issuance, or Variable-funding notes under which the committed capacity may be drawn upon as needed during a commitment period, which is typically 364 days in duration. The available capacity under Variable-funding notes may be used to fund future amortization of other Vehicle management asset-backed debt or to fund growth in Net investment in fleet leases during the term of the commitment.

As with the Variable-funding notes, certain Term notes may contain provisions that allow the outstanding debt to revolve for specified periods of time. During these revolving periods, the monthly collection of lease payments allocable to each outstanding series is available to fund the acquisition of vehicles and/or equipment to be leased to customers. Upon expiration of the revolving period, the repayment of principal commences, and the monthly allocated lease payments are applied to the notes until they are paid in full.

Term Notes

As of March 31, 2011, Term notes outstanding that are revolving in accordance with their terms are Chesapeake Series 2009-3 and 2010-1 Note B. Expiration dates of Term notes in their revolving period range from May 31, 2011 to October 20, 2011.

As of March 31, 2011, Term notes outstanding that are amortizing in accordance with their terms are Chesapeake Series 2009-1, 2009-2 and 2009-4 and the FLRT Series 2010-1. Final repayment dates of Term notes in their amortization period range from October 2012 to October 2014.

Variable-funding Notes

As of March 31, 2011, Variable-funding notes outstanding include the FLRT Series 2010-2 and Chesapeake Series 2010-1 Note A and commitments are scheduled to expire August 30, 2011 and May 31, 2011, respectively, but are renewable subject to agreement by the parties.

Mortgage Asset-Backed Debt

Mortgage asset-backed debt primarily represents variable-rate warehouse facilities to support the origination of mortgage loans, which provide creditors a collateralized interest in specific mortgage loans that meet the eligibility requirements under the terms of the facility during the warehouse period. The source of repayment of the facilities is typically from the sale or securitization of the underlying loans into the secondary mortgage market. These facilities are typically 364-day facilities, and as of March 31, 2011, the range of maturity dates for committed facilities is May 25, 2011 to December 16, 2011.

Committed Facilities

As of March 31, 2011, the Company has outstanding committed mortgage warehouse facilities with the Royal Bank of Scotland, plc, Credit Suisse First Boston Capital LLC, Ally Bank, Bank of America, and Fannie Mae.

On March 3, 2011, the variable-rate committed facility of PHH Home Loans with Ally Bank was amended to extend the maturity date from March 31, 2011 to the earliest of (i) July 31, 2011 or (ii) 90 days after either the Company or Ally Bank gives notice of termination.

Uncommitted Facilities

As of March 31, 2011, the Company has an outstanding uncommitted mortgage repurchase facility with Fannie Mae. The variable-rate uncommitted facility has total capacity of up to $3.0 billion as of March 31, 2011, less certain amounts outstanding under the $1.0 billion committed Fannie Mae facility.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Servicing Advance Facility

As of March 31, 2011, the Company has a committed facility with Fannie Mae that provides for the early reimbursement of certain servicing advances made on behalf of Fannie Mae.

Unsecured Debt

Term Notes

Term notes include $350 million of 9 1/4% Senior notes due in 2016 that have been registered under a public registration statement and $424 million of Medium-term notes. The effective interest rate of the term notes, which includes the accretion of the discount and issuance costs, was 9.9% as of March 31, 2011.

Credit Facilities

Credit facilities primarily represents an Amended and Restated Competitive Advance and Revolving Credit Agreement, dated as of January 6, 2006, among PHH, a group of lenders and JPMorgan Chase Bank, N.A., as administrative agent. The facility has $525 million of commitments which are scheduled to terminate on February 29, 2012. Provided certain conditions are met, the Company may extend the commitments for an additional year at its request.

As of March 31, 2011, there were no outstanding amounts borrowed under the Amended Credit Facility and the interest rate of commitments of the facility ranged from 3.9% to 5.5%.

Convertible Notes

Convertible notes include a private offering of $250 million of 4.0% Convertible senior notes with a maturity date of April 15, 2012 and a private offering of $250 million of 4.0% Convertible senior notes with a maturity date of September 1, 2014.

As of March 31, 2011 and December 31, 2010, the carrying amount of the convertible notes is net of an unamortized discount of $62 million and $70 million, respectively. The effective interest rate of the convertible notes, which includes the accretion of the discount and issuance costs, was 12.7% as of March 31, 2011. There have been no conversions of the convertible notes since issuance.

Debt Covenants

Certain debt arrangements require the maintenance of certain financial ratios and contain affirmative and negative covenants, including, but not limited to, material adverse change, liquidity maintenance, restrictions on indebtedness of the Company and its material subsidiaries, mergers, liens, liquidations, sale and leaseback transactions, and restrictions on certain types of payments.

There were no significant amendments to the terms of our debt covenants during the three months ended March 31, 2011. At March 31, 2011, the Company was in compliance with all of its financial covenants related to its debt arrangements.

Under certain of the Company s financing, servicing, hedging and related agreements and instruments, the lenders or trustees have the right to notify the Company if they believe it has breached a covenant under the operative documents and may declare an event of default. If one or more notices of default were to be given, the Company believes it would have various periods in which to cure certain of such events of default. If it does not cure the events of default or obtain necessary waivers within the required time periods, the maturity of some of its debt could be accelerated and its ability to incur additional indebtedness could be restricted. In addition, an event of default or acceleration under certain agreements and instruments would trigger cross-default provisions under certain of its other agreements and instruments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Income Taxes

Interim income tax expense or benefit is recorded by applying a projected full-year effective income tax rate to the quarterly Income before income taxes for results that are deemed to be reliably estimable. Certain results dependent on fair value adjustments of the Mortgage Production and Mortgage Servicing segments are considered not to be reliably estimable and therefore discrete year-to-date income tax provisions are recorded on those results.

Income tax expense was significantly impacted by the following items that increased (decreased) the effective tax rate:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
State and local income taxes, net of federal tax benefits	$ 5	1
Liabilities for income tax contingencies	(8)	1
Changes in valuation allowance	4	2

State and local income taxes, net of federal tax benefits. The impact to the effective tax rate from State and local income taxes primarily represents the volatility in the pre-tax income or loss, as well as the mix of income and loss from the operations by entity and state income tax jurisdiction. The effective state tax rate has stayed consistent for the three months ended March 31, 2011 and 2010.

Liabilities for income tax contingencies. The impact to the effective tax rate from changes in the liabilities for income tax contingencies primarily represents decreases in liabilities associated with the resolution and settlement with various taxing authorities, partially offset by increases in liabilities associated with new uncertain tax positions taken during the quarter. During the three months ended March 31, 2011, the IRS concluded its examination and review of the Company s taxable years 2006 through 2009.

Changes in valuation allowance. The impact to the effective tax rate from Changes in valuation allowance primarily represents loss carryforwards generated during the period for which the Company believes it is more likely than not that the amounts will not be realized. For the three months ended March 31, 2011 and 2010, the increases were primarily driven by tax losses generated by our mortgage business in each period.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

10. Credit Risk

The Company is subject to the following forms of credit risk:

- **Consumer credit risk** through mortgage banking activities as a result of originating and servicing residential mortgage loans
- **Commercial credit risk** through fleet management and leasing activities
- **Counterparty credit risk** through derivative transactions, sales agreements and various mortgage loan origination and servicing agreements

Consumer Credit Risk

The Company is not subject to the majority of the risks inherent in maintaining a mortgage loan portfolio because loans are not held for investment purposes and are generally sold to investors within 60 days of origination. The majority of mortgage loans sales are on a non-recourse basis; however, the Company has exposure in certain circumstances in its capacity as a loan originator and servicer to loan repurchases and indemnifications through representation and warranty provisions. Additionally, the Company has exposure through its reinsurance agreements that are inactive and in runoff.

Loan performance is an indicator of the inherent risk associated with our origination and servicing activities. In limited circumstances, the Company has exposure to possible losses on loans within the servicing portfolio due to loan repurchases and indemnifications, as further discussed below. The following tables summarize certain information regarding the total loan servicing portfolio, which includes loans associated with the capitalized Mortgage servicing rights as well as loans subserviced for others:

	March 31, 2011	December 31, 2010
	(In millions)	
Loan Servicing Portfolio Composition:		
Owned	$ 143,028	$ 140,160
Subserviced	27,683	25,915
Total servicing portfolio	$ 170,711	$ 166,075
Conventional loans	$ 139,092	$ 136,261
Government loans	24,969	23,100
Home equity lines of credit	6,650	6,714
Total servicing portfolio	$ 170,711	$ 166,075
Weighted-average interest rate	4.8%	4.9%

	March 31, 2011		December 31, 2010	
	Number of Loans	Unpaid Balance	Number of Loans	Unpaid Balance
Portfolio Delinquency[1]				
30 days	1.99%	1.70%	2.36%	2.01%
60 days	0.48%	0.45%	0.67%	0.60%
90 or more days	0.98%	1.00%	1.21%	1.27%

Total delinquency	3.45%	3.15%	4.24%	3.88%
Foreclosure/real estate owned [2]	2.19%	2.26%	2.30%	2.37%

(1) Represents the loan servicing portfolio delinquencies as a percentage of the total number of loans and the total unpaid balance of the portfolio.

(2) As of March 31, 2011 and December 31, 2010, there were 18,143 and 18,554 of loans in foreclosure with unpaid principal balances of $3.2 billion and $3.3 billion, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Foreclosure-Related Reserves

Representations and warranties are provided to purchasers and insurers on a significant portion of loans sold and are assumed on purchased mortgage servicing rights. In the event of a breach of these representations and warranties, the Company may be required to repurchase a mortgage loan or indemnify the purchaser, and any loss on the mortgage loan may be borne by the Company. If there is no breach of a representation and warranty provision, there is no obligation to repurchase the loan or indemnify the investor against loss. In limited circumstances, the full risk of loss on loans sold is retained to the extent the liquidation of the underlying collateral is insufficient. In some instances where the Company has purchased loans from third parties, it may have the ability to recover the loss from the third party.

Foreclosure-related reserves are maintained for the liabilities for probable losses related to repurchase and indemnification obligations and on-balance sheet loans in foreclosure and real estate owned. A summary of the activity in foreclosure-related reserves is as follows:

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
	(In millions)	
Balance, beginning of period	$ 111	$ 86
Realized foreclosure losses	(16)	(16)
Increase in reserves due to:		
Changes in assumptions	15	24
New loan sales	5	2
Balance, end of period	$ 115	$ 96

Foreclosure-related reserves consist of the following:

Loan Repurchases and Indemnifications

The maximum exposure to representation and warranty provisions exceeds the amount of loans in the capitalized portfolio of $141.1 billion; however, the range of total possible losses cannot be estimated because the Company does not service all of the loans for which it has provided representations or warranties. As of March 31, 2011, approximately $205 million of loans have been identified in which the Company has full risk of loss or has identified a breach of representation and warranty provisions; 15% of which were at least 90 days delinquent (calculated based upon the unpaid principal balance of the loans).

As of March 31, 2011 and December 31, 2010, liabilities for probable losses related to repurchase and indemnification obligations of $78 million and $74 million, respectively, are included in Other liabilities in the Condensed Consolidated Balance Sheets.

Mortgage Loans in Foreclosure and Real Estate Owned

Mortgage loans in foreclosure represent the unpaid principal balance of mortgage loans for which foreclosure proceedings have been initiated, plus recoverable advances made on those loans. These amounts are recorded net of an allowance for probable losses on such mortgage loans and related advances.

Real estate owned, which are acquired from mortgagors in default, are recorded at the lower of the adjusted carrying amount at the time the property is acquired or fair value. Fair value is determined based upon the estimated net realizable value of the underlying collateral less the estimated costs to sell.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The carrying values of the mortgage loans in foreclosure and real estate owned are recorded within Other Assets on the Condensed Consolidated Balance Sheets as follows:

	March 31, 2011	December 31, 2010
	(In millions)	
Mortgage loans in foreclosure	$ 131	$ 128
Allowance for probable losses	(22)	(22)
Mortgage loans in foreclosure, net	$ 109	$ 106
Real Estate Owned	$ 50	$ 54
Adjustment to estimated net realizable value	(15)	(15)
Real Estate Owned, net	$ 35	$ 39

Mortgage Reinsurance

The Company has exposure to consumer credit risk through losses from two contracts with primary mortgage insurance companies, that are inactive and in runoff. The Company s exposure to losses through these reinsurance contracts is based on mortgage loans pooled by year of origination.

As of March 31, 2011, the contractual reinsurance period for each pool was 10 years and the weighted-average reinsurance period was 4.7 years. Loss rates on these pools are determined based on the unpaid principal balance of the underlying loans. The Company indemnifies the primary mortgage insurers for losses that fall between a stated minimum and maximum loss rate on each annual pool. In return for absorbing this loss exposure, the Company is contractually entitled to a portion of the insurance premium from the primary mortgage insurers.

The Company is required to hold securities in trust related to this potential obligation, which were $255 million, included in Restricted cash, cash equivalents and investments in the Condensed Consolidated Balance Sheet as of March 31, 2011. The amount of securities held in trust is contractually specified in the reinsurance agreements and is based on the original risk assumed under the contracts and the incurred losses to date.

The unpaid reinsurance losses outstanding as of March 31, 2011 were $7 million. As of March 31, 2011, $110 million was included in Other liabilities in the Condensed Consolidated Balance Sheet for incurred and incurred but not reported losses associated with mortgage reinsurance activities, which was determined on an undiscounted basis.

A summary of the activity in reinsurance-related reserves is as follows:

	Three Months Ended March 31,	
	2011	2010
	(In millions)	
Balance, beginning of period	$ 113	$ 108
Realized reinsurance losses	(16)	(2)
Increase in liability for reinsurance losses	13	11
Balance, end of period	$ 110	$ 117

Commercial Credit Risk

Vehicle leases are primarily classified as operating leases; however, certain leases are classified as direct financing leases and recorded within Net investment in fleet leases in the Condensed Consolidated Balance Sheets.

As of March 31, 2011 and December 31, 2010, direct financing leases greater than 90 days past due total $21 million and $19 million, respectively. As of March 31, 2011 and December 31, 2010, direct financing leases greater than 90 days that are still accruing interest are $19 million and $16 million, respectively and the allowance for credit losses was $3 million as of both periods.

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11. Commitments and Contingencies

Legal Contingencies

The Company is party to various claims and legal proceedings from time to time related to contract disputes and other commercial, employment and tax matters.

PHH Mortgage Corporation, a wholly-owned subsidiary of the Company, is the defendant in a lawsuit initiated in 2009 in the United States District Court, Middle District of Georgia, by a borrower with a loan that has been serviced by the Company. The borrower alleged breach of contract, negligent servicing and violations of the Real Estate Settlement Procedures Act. On March 21, 2011, the jury issued a verdict in favor of the borrower, awarding compensatory damages of $1 million and punitive damages of $20 million, resulting in an exposure of $21 million. The Company intends to seek further judicial review of the case including appeal as necessary. The recorded liability for probable losses related to this matter as of March 31, 2011 was not significant.

12. Accumulated Other Comprehensive Income

The after-tax components of Accumulated other comprehensive income were as follows:

Three Months Ended March 31, 2011

	Currency Translation Adjustment	Unrealized Gains on Available-for-Sale Securities	Pension Adjustment	Total
		(In millions)		
Balance at December 31, 2010	$ 36	$ 1	$ (8)	$ 29
Change during 2011	4			4
Balance at March 31, 2011	$ 40	$ 1	$ (8)	$ 33

Three Months Ended March 31, 2010

	Currency Translation Adjustment	Pension Adjustment	Total
		(In millions)	
Balance at December 31, 2009	$ 27	$ (8)	$ 19
Change during 2010	6		6
Balance at March 31, 2010	$ 33	$ (8)	$ 25

All components of Accumulated other comprehensive income presented above are net of income taxes; however the currency translation adjustment presented above excludes income taxes on undistributed earnings of foreign subsidiaries, which are considered to be indefinitely invested.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

13. Fair Value Measurements

Recurring Fair Value Measurements

For assets and liabilities measured at fair value on a recurring basis, there has been no change in the valuation methodologies and classification pursuant to the valuation hierarchy during the three months ended March 31, 2011. The incorporation of counterparty credit risk did not have a significant impact on the valuation of assets and liabilities recorded at fair value as of March 31, 2011 or December 31, 2010. Significant inputs to the measurement of fair value on a recurring basis and further information on the assets and liabilities measured at fair value on a recurring basis are as follows:

Mortgage Loans Held for Sale. For Level Three mortgage loans held for sale, fair value is estimated utilizing either a discounted cash flow model or underlying collateral values. The assumptions used to measure fair value using a discounted cash flow valuation methodology are as follows:

	March 31, 2011	December 31, 2010
Prepayment speed	10%	13%
Discount Rate	7-10%	7-10%
Yield	3-8%	3-8%
Credit Loss (annualized)	6-32%	5-31%

The following table reflects the difference between the carrying amount of Mortgage loans held for sale measured at fair value, and the aggregate unpaid principal amount that the Company is contractually entitled to receive at maturity:

	March 31, 2011		December 31, 2010	
	Total	Loans 90 or more days past due and on non-accrual status	Total	Loans 90 or more days past due and on non-accrual status
	(In millions)			
Mortgage loans held for sale:				
Carrying amount	$ 1,338	$ 11	$ 4,329	$ 14
Aggregate unpaid principal balance	1,352	21	4,356	21
Difference	$ (14)	$ (10)	$ (27)	$ (7)

The following table summarizes the components of Mortgage loans held for sale:

	March 31, 2011	December 31, 2010
	(In millions)	
First mortgages:		
Conforming[(1)]	$ 1,165	$ 4,123
Non-conforming	118	138
Construction loans	8	11
Total first mortgages	1,291	4,272

Second lien	10	11
Scratch and Dent[2]	35	40
Other	2	6
Total	$ 1,338	$ 4,329

(1) Represents mortgage loans that conform to the standards of the government-sponsored entities.

(2) Represents mortgage loans with origination flaws or performance issues.

Derivative Instruments. The average pullthrough percentage used in measuring the fair value of interest rate lock commitments was 77% and 78% as of March 31, 2011 and December 31, 2010, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Mortgage Servicing Rights. The significant assumptions used in estimating the fair value of Mortgage servicing rights were as follows (in annual rates):

	March 31, 2011	December 31, 2010
Weighted-average prepayment speed (CPR)	11%	12%
Option adjusted spread, in basis points	846	844
Volatility	27%	29%

The following table summarizes the estimated change in the fair value of MSRs from adverse changes in the significant assumptions:

	March 31, 2011		
	Weighted-Average Prepayment Speed	Option Adjusted Spread	Volatility
		(In millions)	
Impact on fair value of 10% adverse change	$ (71)	$ (73)	$(23)
Impact on fair value of 20% adverse change	(136)	(141)	(47)

These sensitivities are hypothetical and presented for illustrative purposes only. Changes in fair value based on a 10% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption is calculated without changing any other assumption; in reality, changes in one assumption may result in changes in another, which may magnify or counteract the sensitivities. Further, this analysis does not assume any impact resulting from management s intervention to mitigate these variations.

Assets and liabilities measured at fair value on a recurring basis were included in the Condensed Consolidated Balance Sheets as follows:

	March 31, 2011				
	Level One	Level Two	Level Three	Cash Collateral and Netting[(1)]	Total
			(In millions)		
Assets:					
Restricted investments	$	$ 248	$	$	$ 248
Mortgage loans held for sale		1,181	157		1,338
Mortgage servicing rights			1,590		1,590
Other assets:					
Derivative assets:					
Interest rate lock commitments			51		51
Forward delivery commitments		20		(7)	13
Interest rate contracts		3			3
Option contracts		1			1
Convertible note-related agreements			44		44
Securitized mortgage loans			37		37
Liabilities:					

Other liabilities:					
Derivative liabilities:					
Interest rate lock commitments	$	$	$ 2	$	$ 2
Forward delivery commitments		35		(20)	15
Foreign exchange contracts		1			1
Convertible note-related agreements			44		44
Debt:					
Mortgage loan securitization debt certificates			28		28

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2010				
	Level One	Level Two	Level Three	Cash Collateral and Netting[1]	Total
			(In millions)		
Assets:					
Restricted investments	$	$ 254	$	$	$ 254
Mortgage loans held for sale		4,157	172		4,329
Mortgage servicing rights			1,442		1,442
Other assets:					
Derivative assets:					
Interest rate lock commitments			42		42
Forward delivery commitments		309		(241)	68
Interest rate contracts		4			4
Convertible note-related agreements			54		54
Securitized mortgage loans			42		42
Liabilities:					
Other liabilities:					
Derivative liabilities:					
Interest rate lock commitments			46		46
Forward delivery commitments		82		(51)	31
Convertible note-related agreements			54		54
Debt:					
Mortgage loan securitization debt certificates			30		30

(1) Adjustments to arrive at the carrying amounts of assets and liabilities presented in the Condensed Consolidated Balance Sheets which represent the effect of netting the payable or receivable and cash collateral held or placed with the same counterparties under master netting arrangements.

The activity in assets and liabilities classified within Level Three of the valuation hierarchy consisted of:

	Three Months Ended March 31, 2011				
			Other Assets		Debt
	Mortgage Loans Held for Sale	Mortgage Servicing Rights	Interest Rate Lock Commitments, Net	Securitized Mortgage Loans	Mortgage Loan Securitization Debt Certificates
			(In millions)		
Balance, January 1, 2011	$ 172	$ 1,442	$ (4)	$ 42	$ 30
Realized and unrealized gains (losses) for assets	(12)	(32)	184		
Realized and unrealized (gains) losses for liabilities				(1)	1

Purchases	12				
Issuances	177	180			
Settlements	(173)		(131)	(4)	(3)
Transfers into level three [1]	48				
Transfers out of level three [2]	(67)				
Balance, March 31, 2011	$ 157	$ 1,590	$ 49	$ 37	$ 28

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended March 31, 2010					
				Other Assets		Debt
	Mortgage Loans Held for Sale	Mortgage Servicing Rights	Investment Securities	Interest Rate Lock Commitments, Net	Securitized Mortgage Loans	Mortgage Loan securitization debt certificates
			(In millions)			
Balance, January 1, 2010	$ 111	$ 1,413	$ 12	$ 26	$	$
Realized and unrealized gains (losses) for assets	(2)	(52)		202	2	
Realized and unrealized losses for liabilities						1
Purchases, issuances and settlements, net	(19)	97		(177)	(4)	(4)
Transfers into level three [(1)]	18					
Transfers out of level three [(2)]	(16)					
Transition adjustment [(3)]			(11)		51	40
Balance, March 31, 2010	$ 92	$ 1,458	$ 1	$ 51	$ 49	$ 37

(1) Represents transfers to Scratch and Dent and Non-Conforming loans from conforming loans. Loans that transfer into Level Three represent mortgage loans with origination flaws, performance issues, or characteristics that would make them not currently saleable through the Agency mortgage-backed security market.

(2) Represents Scratch and Dent and construction loans that were foreclosed upon, construction loans that converted to first mortgages and Scratch and Dent or Non-Conforming loans with origination flaws, performance issues or characteristics that were corrected. Mortgage loans in foreclosure are measured at fair value on a non-recurring basis, as discussed in further detail below.

(3) Represents the transition adjustment related to the adoption of updates to Consolidation and Transfers and Servicing accounting guidance resulting in the consolidation of a mortgage loan securitization trust.

For assets and liabilities classified within Level Three of the valuation hierarchy, the following table summarizes the amounts included in the Condensed Consolidated Statements of Operations for: (i) realized and unrealized gains and losses and (ii) unrealized gains and losses related to assets and liabilities that are included in the Condensed Consolidated Balance Sheets as of the end of the respective period:

	Three Months Ended March 31, 2011					
	Mortgage	Mortgage Servicing	Interest Rate Lock	Securitized Mortgage	Mortgage Loan Securitization Debt	Related to Assets and Liabilities Held at March 31,

	Loans Held for Sale	Rights	Commitments	Loans	Certificates	2011
				(In millions)		
Gain on mortgage loans, net	$(15)	$	$ 184	$	$	$ 33
Change in fair value of mortgage servicing rights		(32)				(28)
Mortgage interest income	3			1		
Mortgage interest expense					(1)	
Other income				(3)		(3)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended March 31, 2010					
	Mortgage Loans Held for Sale	Mortgage Servicing Rights	Interest Rate Lock Commitments	Securitized Mortgage Loans	Mortgage Loan Securitization Debt Certificates	Related to Assets and Liabilities Held at March 31, 2010
	(In millions)					
Gain on mortgage loans, net	$ (4)	$	$ 202	$	$	$ 44
Change in fair value of mortgage servicing rights		(52)				11
Mortgage interest income	3			1		1
Mortgage interest expense					(1)	
Other income				1		1

Non-Recurring Fair Value Measurements

Other Assets. The allowance for probable losses associated with mortgage loans in foreclosure and the adjustment to record REO at their estimated net realizable value were based upon fair value measurements from Level Two of the valuation hierarchy. During the three months ended March 31, 2011 and 2010, total foreclosure-related charges of $15 million and $23 million, respectively, were recorded in Other operating expenses, which include changes in the estimate of losses related to off-balance sheet exposure to loan repurchases and indemnifications in addition to the provision for valuation adjustments for mortgage loans in foreclosure and REO. See Note 10, Credit Risk for further discussion regarding the balances of mortgage loans in foreclosure, REO, and the off-balance sheet exposure to loan repurchases and indemnifications.

14. Variable Interest Entities

Significant variable interest entities included in the Condensed Consolidated Balance Sheets are as follows:

	March 31, 2011			
	PHH Home Loans	Chesapeake and D.L Peterson Trust	FLRT and PHH Lease Receivables LP	Mortgage Securitization Trust
	(In millions)			
ASSETS				
Cash	$ 43	$ 6	$	$
Restricted cash[1]		237	40	
Mortgage loans held for sale	220			
Accounts receivable, net	9	48		
Net investment in fleet leases		2,785	456	
Property, plant and equipment, net	1			
Other assets	10	10	3	37
Total assets	$ 283	$ 3,086	$ 499	$ 37

Assets held as collateral[(2)]	$	184	$	3,070	$	463	$	
LIABILITIES								
Accounts payable and accrued expenses	$	15	$	3	$	2	$	
Debt		169		2,547		410		28
Other liabilities		5						
Total liabilities[(3)]	$	189	$	2,550	$	412	$	28

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2010			
	PHH Home Loans	Chesapeake and D.L Peterson Trust	FLRT and PHH Lease Receivables LP	Mortgage Securitization Trust
	(In millions)			
ASSETS				
Cash	$ 40	$ 4	$	$
Restricted cash[1]		202	39	
Mortgage loans held for sale	384			
Accounts receivable, net	14	50		
Net investment in fleet leases		2,854	502	
Property, plant and equipment, net	1			
Other assets	10	12	18	42
Total assets	$ 449	$ 3,122	$ 559	$ 42
Assets held as collateral[2]	$ 331	$ 3,106	$ 506	$
LIABILITIES				
Accounts payable and accrued expenses	$ 20	$ 3	$ 16	$
Debt	304	2,577	450	30
Other liabilities	5			
Total liabilities[3]	$ 329	$ 2,580	$ 466	$ 30

(1) Restricted cash of Chesapeake Funding and FLRT primarily relates to amounts collected for lease payments and related receivables specifically designated to purchase assets, to repay debt and/or to provide over-collateralization related to vehicle management asset-backed debt arrangements.

(2) Assets held as collateral relate to the entity s borrowing arrangements and are not available to pay the Company s general obligations. See Note 8, Debt and Borrowing Arrangements for further information.

(3) Total liabilities exclude intercompany payables.

PHH Home Loans

For the three months ended March 31, 2011, approximately 17% of the mortgage loans originated by the Company were derived from Realogy Corporation s affiliates, of which approximately 83% were originated by PHH Home Loans.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

15. Segment Information

Operations are conducted through three business segments: Mortgage Production, Mortgage Servicing and Fleet Management Services.

Mortgage Production provides mortgage loan origination services and sells mortgage loans.

Mortgage Servicing performs servicing activities for originated and purchased loans.

Fleet Management Services provides commercial fleet management services.

Certain income and expenses not allocated to the three reportable segments and intersegment eliminations are reported under the heading Other. The Company s operations are substantially located in the U.S.

Management evaluates the operating results of each of the reportable segments based upon Net revenues and segment profit or loss, which is presented as the income or loss before income tax expense or benefit and after net income or loss attributable to noncontrolling interest. The Mortgage Production segment profit or loss excludes Realogy Corporation s noncontrolling interest in the profit or loss of PHH Home Loans.

Segment results were as follows:

	Net Revenues Three Months Ended March 31,		Segment Profit (Loss) [1] Three Months Ended March 31,	
	2011	2010	2011	2010
	(In millions)			
Mortgage Production segment [2]	$ 214	$ 152	$ 52	$ 25
Mortgage Servicing segment	57	36	14	(13)
Fleet Management Services segment	395	390	16	8
Total reportable segments	666	578	82	20
Other	(1)	(1)		(1)
Total Company	$ 665	$ 577	$ 82	$ 19

	Total Assets	
	As of March 31, 2011	As of December 31, 2010
	(In millions)	
Mortgage Production segment	$ 1,591	$ 4,605
Mortgage Servicing segment	2,441	2,291
Fleet Management Services segment	4,259	4,216
Other	267	158
Total Company	$ 8,558	$ 11,270

(1) The following is a reconciliation of Income before income taxes to segment profit:

Three Months Ended March 31,

	2011	2010
	(In millions)	
Income before income taxes	$ 85	$ 19
Less: net income attributable to noncontrolling interest	3	
Segment profit	$ 82	$ 19

(2) For the three months ended March 31, 2011, Net revenues and segment profit for the Mortgage Production segment includes a $68 million gain on the 50.1% sale of the equity interests in the Company s appraisal services business.

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

The following discussion should be read in conjunction with the Cautionary Note Regarding Forward-Looking Statements and our Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q and Item 1. Business , Item 1A. Risk Factors , Item 7. Management s Discussion and Analysis of Financial Conditions and Results of Operations and our Consolidated Financial Statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010.

Our Management s Discussion and Analysis of Financial Condition and Results of Operations is presented in sections as follows:

- § Overview
- § Results of Operations
- § Risk Management
- § Liquidity and Capital Resources
- § Off-Balance Sheet Arrangements and Guarantees
- § Critical Accounting Policies
- § Recently Issued Accounting Pronouncements

Overview

We are a leading outsource provider of mortgage and fleet management services. We conduct our business through three operating segments: a Mortgage Production segment, a Mortgage Servicing segment and a Fleet Management Services segment. Our Mortgage Production segment originates, purchases and sells mortgage loans through PHH Mortgage Corporation. Our Mortgage Servicing segment services mortgage loans originated by PHH Mortgage and PHH Home Loans. Our Mortgage Servicing segment also purchases mortgage servicing rights and acts as a subservicer for certain clients that own the underlying servicing rights. Our Fleet Management Services segment provides commercial fleet management services to corporate clients and government agencies throughout the United States and Canada.

Although our Fleet Management Services segment has historically generated a larger portion of our Net revenues, our Mortgage Production and Mortgage Servicing segments have historically contributed a significantly larger portion of our Net income (loss). Our Mortgage Production and Mortgage Servicing segments have experienced, and may continue to experience, high degrees of earnings volatility due to significant exposure to interest rates and the real estate markets, which impacts our loan origination volumes, valuation of our mortgage servicing rights, and foreclosure-related charges.

Executive Summary

In our mortgage business, an environment of higher interest rates and seasonally lower home purchase volumes resulted in lower volumes of interest rate lock commitments and gain on sale margins. Although the Company closed $13.8 billion of loans in the first quarter of 2011, the closings did not have a significant contribution to the results of operations as the interest rate lock commitments were recognized in prior periods at fair value.

On March 31, 2011, we sold 50.1% of the equity interests in our appraisal services business (Speedy Title and Appraisal Review Services, or STARS) to CoreLogic, Inc. and retained the remaining 49.9% of the interests. STARS provides appraisal services, credit research, flood certification, and tax services. We believe this new partnership will enable us to leverage the technology and product expertise of CoreLogic to enhance the customer experience and, ultimately, drive earnings growth. We received a $20 million cash payment in March 2011, with three $5 million installment payments to be received on March 31, 2012, 2014 and 2016. The sale resulted in a total gain of $68 million during the first quarter of 2011 which was inclusive of a $34 million non-cash gain from the initial valuation of our equity method investment upon deconsolidation of STARS.

Our Fleet Management Services segment continued the positive momentum from 2010 with strong earnings from fee-based services.

The following table presents summarized results for PHH Corporation for the first quarters of 2011 and 2010:

	Three Months Ended March 31,	
	2011	2010
	(In millions, except per share data)	
PHH Corporation Consolidated:		
Net income attributable to PHH Corporation	$ 49	$ 8
Basic earnings per share attributable to PHH Corporation	0.87	0.15
Diluted earnings per share attributable to PHH Corporation	0.84	0.15
Reportable Segments Profit (Loss):[(1)]		
Mortgage Production segment	$ 52	$ 25
Mortgage Servicing segment	14	(13)
Fleet Management Services segment	16	8

(1) Segment Profit (Loss) is described in Note 15, Segment Information in the accompanying Notes to Condensed Consolidated Financial Statements.

The following summarizes the key highlights that drove our operating performance and segment profit (loss) for our reportable segments during the first quarter of 2011 in comparison to 2010:

Mortgage Production Segment

- § Segment profit in the first quarter of 2011 was $27 million higher than the same period in 2010 due to a $68 million gain on the sale of 50.1% of the equity interests in STARS, that was partially offset by lower gain on sale margins and lower interest rate lock commitments.
- § Total mortgage closing volumes for the first quarter of 2011 were $13.8 billion of which approximately 70% were retail and 30% were wholesale/correspondent. Closing volumes were 77% higher than the first quarter of 2010 due to the closing of interest rate lock commitments that were entered into during the second half of 2010.
- § Higher interest rates and seasonally low purchase volumes resulted in a 21% decline in interest rate lock commitments expected to close to $5.0 billion in the first quarter of 2011 from $6.4 billion in the same period of 2010. Gain on sale margins were down significantly from the first quarter of 2010 reflecting a more normalized level of industry originations.

Mortgage Servicing Segment

- § Segment profit benefitted in the first quarter of 2011 from a $25 million increase in the fair value of our mortgage servicing rights driven primarily by higher long-term interest rates and improved portfolio delinquencies, as compared to a $7 million decrease during the first quarter of 2010. Additionally, there was a $12 million unfavorable change in fair value due to prepayments and recurring cash flows during the first quarter of 2011 compared to the same period in the prior year, reflecting a higher level of payoffs in the first quarter of 2011.
- § Loan servicing income increased by $7 million reflecting the continued growth in our loan servicing portfolio. Our average loan servicing portfolio increased by 11% from $152.3 billion in the first quarter of 2010 to $168.8 billion in the first quarter of 2011.

§ Foreclosure-related charges remain elevated at $15 million during the first quarter of 2011 reflecting a continued higher level of repurchase demands and loss severities.

Fleet Management Services Segment

§ Fleet segment generated $16 million of segment profit in the first quarter of 2011 and continued to benefit from strong fee-based revenues and lower costs as compared to the first quarter of 2010.

§ Maintenance service, fuel, and accident management average units all increased in the first quarter of 2011 compared to the same period in 2010 despite a 6% decline in the number of leased vehicles.

See Results of Operations First Quarter 2011 Compared With First Quarter 2010 for additional information regarding our consolidated results and the results of each of our reportable segments.

Industry Trends

Regulatory Trends

Financial Regulatory Reform

Six federal agencies, including the SEC, have proposed a rule providing sponsors of securitizations with various options for meeting the risk-retention requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among other things, the options include retaining risk of the securitization transactions equal to 5 percent of each class of asset-backed security, 5 percent of par value of all asset-backed security interests issued, 5 percent of a representative pool of assets, or a combination of these options.

As required by the Dodd-Frank Act, the proposal includes descriptions of loans that would not be subject to these requirements, including asset-backed securities that are collateralized exclusively by residential mortgages that qualify as qualified residential mortgages (or QRMs). Proposed criteria to qualify for an exemption from the risk retention requirements include, but are not limited to: (i) loan-to-value ratios for purchases and refinances of 80% and 75%, respectively; (ii) mortgage payment to gross income and debt payment to gross income ratios of 28% and 36%, respectively; (iii) borrower credit requirements including no current delinquencies, 60-day plus delinquencies in the past 2 years, or bankruptcies / foreclosures in the past 3 years; and (iv) loan-type requirements including no interest only, negative amortization, balloon payments, or prepayment penalties.

The proposed rule would also recognize that the 100 percent guarantee of principal and interest provided by Fannie Mae and Freddie Mac meets their risk-retention requirements as sponsors of mortgage-backed securities for as long as they are in conservatorship or receivership with capital support from the U.S. government.

Substantially all of the loans that we originated during 2010 were sold to Fannie Mae, Freddie Mac, or Ginnie Mae and would therefore be exempt from the risk-retention requirements under the current proposal. For our lease securitizations, we believe we currently retain a subordinate position relative to the issued asset-backed securities in excess of the proposed 5% requirement, and we are continuing to monitor the potential impact to the Company under the proposed rules.

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Focus on Foreclosure Practices

During the first quarter of 2011, various federal regulators completed a review of 14 entities involved in the mortgage servicing process and noted weaknesses in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third-party vendors, including foreclosure attorneys. These regulators took formal actions against each of the 14 entities subject to this review to address those weaknesses and risks. These actions require each entity, among other things, to conduct a more complete review of certain aspects of foreclosure actions that occurred between January 1, 2009, and December 31, 2010.

While we were not included in these reviews, we have received inquiries and requests for information from regulators and attorneys general of certain states as well as from the Committee on Oversight and Government Reform of the U.S. House of Representatives, requesting information as to our foreclosure processes and procedures, among other things. We have not received any formal notice of investigation or been assessed any material penalties resulting from our foreclosure practices to date.

Mortgage Production Trends

An increase in interest rates, renue that is being affected by lower selling prices for new contracts compared with existing contracts, coupled with a decline in the overall installed base reflecting both a decline in our existing installed base as older systems are removed from the base as well as the impact to the installed base from lower system sales volumes in recent periods. A non-recurring adjustment to deferred service revenue that reduced service revenue by $2 million also contributed to the decline noted during the first nine months of fiscal 2005. Also contributing to the decline in overall global services revenue was a decrease in our Professional Services revenue in the third quarter of fiscal 2005 compared with the corresponding period in fiscal 2004 primarily due to a reduction in professional services contracted with third parties. Professional services revenue includes revenue generated from the sale of SGI and third party product and SGI consulting and managed services.

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

	Three Months Ended				Nine Months Ended			
Area	**March 25, 2005**		**March 26, 2004**		**March 25, 2005**		**March 26, 2004**	
Americas	$ 93	59%	$ 133	63%	$ 334	60%	$ 409	65%
Europe	46	29%	56	26%	137	24%	159	25%
Rest of world	20	12%	24	11%	87	16%	66	10%
Total revenue	$ 159		$ 213		$ 558		$ 634	

The fluctuation in geographic revenue as a percentage of total revenue in the third quarter of fiscal 2005 compared with the corresponding period of fiscal 2004 is primarily due to several large U.S federal government orders that failed to close within the third quarter resulting in lower revenue within the Americas. The fluctuation in geographic revenue as a percentage of total revenue in the first nine months of fiscal 2005 compared with the corresponding period in fiscal 2004 is primarily a result of two large transactions to a single customer in Japan, namely SGI Japan, a related party that is also our exclusive distributor in Japan, that accounted for 5% of total revenue in the first nine months of fiscal 2005.

Our consolidated backlog at March 25, 2005 was $103 million, up from $88 million at March 26, 2004. Backlog is comprised of committed purchase orders for products and professional services deliverable within three to nine months, depending on the product family. Increases in backlog primarily in the Americas and to a lesser extent in Rest of World, were offset in part by a backlog decline in Europe. From a segment standpoint, backlog improved principally within the Products segment, specifically within our Altix and Prism product families and to a lesser extent within our Storage solutions offerings and Origin product family. Increases were offset in part by backlog declines within workstations as well as our remarketed products group.

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Gross Profit Margin

Cost of product and other revenue includes costs related to product shipments, including materials, labor, overhead, and other direct or allocated costs involved in their manufacture or delivery. Costs associated with engineering service revenue are included in cost of service revenue, unless the engineering service effort meets the criteria for government funded research, as outlined in SFAS 2, *Accounting for Research and Development Costs*. If the contract meets the criteria for a government funded research arrangement, the costs to deliver the contract are included in research and development expense. Cost of service revenue includes all costs incurred in the support and maintenance of our products, as well as costs to deliver professional services, including the costs associated with third-party products.

Overall gross profit margin for the third quarter and the first nine months of fiscal 2005 decreased from 42.1% to 34.5% and from 41.9% to 36.2%, respectively, compared with the corresponding periods of fiscal 2004. Product and other gross profit margin for the third quarter and first nine months of fiscal 2005 decreased 13.3 percentage points and 7.6 percentage points, respectively, compared with the corresponding periods in fiscal 2004. As a result of fixed costs in our manufacturing cost structure, cost of sales did not decline in proportion to our lower sales volumes for both the third quarter and first nine months of fiscal 2005 compared with the corresponding periods in fiscal 2004. Also, we continue to see a shift in mix from our MIPS/IRIX-based systems which typically carry a higher gross margin to our Intel/Linux-based systems whose gross margins are lower. These negative impacts on gross margin were offset slightly by favorable manufacturing variances resulting from manufacturing efficiencies and procurement cost controls. Our results for the first nine months of fiscal 2005 also reflected a higher percentage of revenue from a relatively small number of large transactions, especially in the Altix product family. These transactions typically are negotiated with high discount rates due to very competitive bidding processes, resulting in lower gross margins, offset to some extent by favorable component pricing applicable to these transactions. Increasing competitive pressures from commodity cluster systems also contributed to the decline in gross profit margin. We expect to continue to generate a portion of our revenue from large, high visibility transactions, which are typically very complex, tend to carry lower gross margins and represent unpredictable sales cycles. We also plan to continue to work with suppliers such as Intel to structure favorable component pricing to support these types of anticipated sales.

Service gross profit margin for the third quarter and first nine months of fiscal 2005 decreased 0.5 percentage points and 3.1 percentage points, respectively, compared with the corresponding periods in fiscal 2004. Due to fixed elements in the service cost structure, service costs did not decline in proportion to the revenue decline, leading to a reduction in service gross margin. Specifically, fixed costs associated with our professional services business coupled with lower margins on sales of third party product were the primary causes for the decline. A non-recurring adjustment to deferred service revenue which negatively impacted service gross margin by 1.1 percentage points in the first nine months of fiscal 2005 coupled with a large sales transaction involving a significant portion of professional services at lower than average gross margin also contributed to the overall decline in service gross profit margins during the first nine months of fiscal 2005 compared with the corresponding period in fiscal 2004.

Operating Expenses

Operating expenses were as follows (dollars in millions):

	Three Months Ended		Nine Months Ended	
	March 25, 2005	**March 26, 2004**	**March 25, 2005**	**March 26, 2004**
Research and development	$ 24	$ 27	$ 72	$ 85
% of total revenue	15%	13%	13%	13%

Selling, general, and administrative	$ 61	$ 63	$ 187	$ 192
% of total revenue	38%	29%	33%	30%
Other	$ 14	$ 9	$ 23	$ 46
% of total revenue	9%	4%	4%	7%

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Operating Expenses (excluding Other Operating Expenses). Operating expenses, excluding other operating expenses, for the third quarter of fiscal 2005 decreased by 4% from the corresponding period of fiscal 2004, but increased as a percentage of total revenue from 42% to 54%. Operating expenses, excluding other operating expenses, for the first nine months of fiscal 2005 decreased by 7% from the corresponding period of fiscal 2004, but increased as a percentage of total revenue from 44% to 46%.

As a result of restructuring actions and attrition, total headcount associated with our research and development, selling, general, and administrative activities at the end of the third quarter of fiscal 2005 declined by 144, or 6%, from the corresponding headcount at the end of the third quarter of fiscal 2004.

Research and development expense decreased by $3 million from the third quarter of fiscal 2004 to the third quarter of fiscal 2005 and by $13 million from the first nine months of fiscal 2004 to the first nine months of fiscal 2005. Headcount and occupancy-related cost savings were the primary contributors to the decline.

Selling, general, and administrative expenses decreased by $2 million from the third quarter of fiscal 2004 to the third quarter of fiscal 2005 and by $5 million from the first nine months of fiscal 2004 to the first nine months of fiscal 2005 primarily due to headcount and occupancy-related cost savings. Included in the third quarter and first nine months of fiscal 2004 was a $5 million release of an estimated legal liability to reflect completion of the settlement process which did not recur in the corresponding periods of fiscal 2005. In addition, the first nine months of fiscal 2004 included a $5 million reduction in estimated employee benefit liabilities due to a modification in a benefit plan which also did not recur in the corresponding period of fiscal 2005.

Other Operating Expenses. Other operating expenses of $14 million and $9 million for the third quarters of fiscal 2005 and 2004, respectively, represented costs of our restructuring plans and asset impairment activities. Specifically, during the third quarter of fiscal 2005, we recorded $7 million of expense related to the termination of approximately 150 employees, $5 million for costs associated with vacating leased facilities, and accretion expense of $2 million related to the relocation of our Mountain View, California headquarters. During the third quarter of fiscal 2004, we recorded $9 million in restructuring costs, which were primarily associated with our headquarters relocation.

Other operating expense was $23 million and $46 million for the first nine months of fiscal 2005 and 2004, respectively. During the first nine months of fiscal 2005, we recorded non-cash accretion expense of $8 million related to the relocation of our Mountain View, California headquarters, $7 million of costs related to the termination of employees, $3 million of costs related to the relocation of our facility in the United Kingdom, and $5 million of costs related to vacating other leased facilities. During the first nine months of fiscal 2004, we recorded $18 million in severance and related costs, $1 million related to vacating other leased facilities, and $27 million in costs associated with our headquarters relocation. See Note 3 to the Condensed Consolidated Financial Statements for further information about these activities.

Because of our continuing losses and declining cash position, we have announced our intention to implement further expense reductions in the fourth quarter of fiscal 2005 to supplement those initiated in the third quarter of fiscal 2005. Due to the timing for initiating these actions, we do not expect to achieve significant costs savings from these actions in the fourth quarter of fiscal 2005.

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Interest and Other

Interest and other income (expense) were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	March 25, 2005	March 26, 2004	March 25, 2005	March 26, 2004
Interest expense	$ (3,706)	$ (3,832)	$ (12,698)	$ (15,904)
Investment gain	$ 132	$ 193	$ 162	$ 193
Foreign exchange gain (loss)	312	(190)	1,650	1,151
Miscellaneous income (expense)	1,393	3,985	(781)	2,326
Interest income	508	426	1,180	1,400
Interest and other income (expense), net	$ 2,345	$ 4,414	$ 2,211	$ 5,070
Loss on extinguishment of tendered debt	$	$	$	$ (30,915)

Interest Expense. Interest expense was unchanged at $4 million for the third quarters of fiscal 2004 and 2005 and decreased from $16 million for the first nine months of fiscal 2004 to $13 million in the first nine months of fiscal 2005 primarily as a result of the decrease in our long-term debt.

Interest and Other Income (Expense), Net. Interest and other income (expense), net includes interest on our cash investments, gains and losses on other investments, and other non-operating items. Miscellaneous income (expense) decreased from the third quarter of fiscal 2004 to the same quarter in fiscal 2005 primarily because of receipt of a nonrecurring $2 million settlement for terminating a contractual arrangement during the third quarter of fiscal 2004.

Loss on Extinguishment of Tendered Debt. During the second quarter of fiscal 2004, we completed an exchange offer for 98.3% of our 5.25% Senior Convertible Notes due to mature in September 2004. The exchange offer was accounted for as a debt extinguishment and resulted in a non-cash loss of approximately $31 million, primarily representing the difference between the fair value of the new debt instruments and the net carrying value of the extinguished debt. The difference is treated as a premium on the new Senior Secured Convertible Notes and is being amortized as an offset to interest expense over the term of the notes. Also included in the $31 million loss was a write-off of $400 thousand in debt issuance costs associated with the extinguished debt.

Income Taxes

Our net benefit for income taxes of $7 million for the first nine months of fiscal 2005 arose principally from a refund of U.S. income taxes paid in prior years and a reduction of foreign tax exposures, partially offset by net income taxes payable in foreign jurisdictions. Our net benefit for income taxes of $7 million for the first nine months of fiscal 2004 arose principally from the reassessment of our global tax exposures and refunds associated with certain U.S. and state income taxes paid in prior years, partially offset by net income taxes payable in foreign jurisdictions.

Financial Condition

At March 25, 2005, unrestricted cash and cash equivalents and marketable investments totaled $84 million, compared with $106 million at December 24, 2004 and $157 million at June 25, 2004. At March 25, 2005, December 24, 2004 and June 25, 2004, we also held $32 million, $29 million and $24 million, respectively, of restricted investments. Restricted investments consist of short- and long-term investments held under a security agreement or pledged as collateral against letters of credit. Our working capital of $37 million at March 25, 2005 decreased from $65 million at December 24, 2004 and from $76 million at June 25, 2004.

Primarily as a result of net losses, operating activities from continuing operations used $41 million during the first nine months of fiscal 2005, compared with using $13 million during the same period in fiscal 2004. The negative operating cash flows from continuing operations in the first nine months of fiscal 2005 were primarily the result of payments related to restructuring actions and higher operating losses. Cash payments for severance and facilities obligations related to restructuring actions initiated in the current and prior years totaled $28 million. Furthermore, we expect these restructuring actions to result in additional future net cash outlays of $100 million, of which we project that

$10 million will occur in the fourth quarter of fiscal 2005, $17 million in fiscal 2006 and the remainder to occur through fiscal 2014. Regarding our cash invested in working capital, our increased investment in inventories used $34 million of cash during the first nine months of fiscal 2005. Inventories increased primarily due to seasonality and because several large transactions failed to close within the quarter. In addition, we manufacture complex products for which the linearity is concentrated near the end of our quarters. Small variations in the timing of our production processes can also affect whether sales occur before or after quarter end and can, therefore, affect our quarter end inventory balances.

The cash impact of the increase in our inventories was partially offset by a $25 million decrease in our accounts receivable. The decrease in accounts receivable is attributable to decreased revenue levels, our continued focus on cash collections, with specific focus on aged receivables. Our days sales outstanding increased from an average of 47 days at March 26, 2004 to 50 days at March 25, 2005.

Investing activities, other than changes in available-for-sale and restricted investments, used $14 million in cash during the first nine months of fiscal 2005, compared with using $18 million in cash during the same period of fiscal 2004. Principal investing activities in the first nine months of fiscal 2005 was primarily attributable to capital expenditures of $12 million primarily for leasehold improvements, manufacturing equipment, and information technology equipment. Principal investing activities in the first nine months of fiscal 2004 included $15 million for capital expenditures, and increases in prepaid expenses associated with our new corporate headquarters, purchases of spares inventory to support new and existing products, and other asset activity in the ordinary course of business, which were partially offset by $11 million in net cash proceeds received from the sale of our facility in Cortaillod, Switzerland. Capital expenditures were higher in the first nine months of fiscal 2004 than during the first nine months of 2005 primarily because of spending in 2004 related to the relocation of our corporate headquarters to the Crittenden Technology Center campus in Mountain View, California. During the first nine months of fiscal 2005, we conducted an inventory of fixed assets and, as a result, recorded disposals of fixed assets with a cost basis of $58 million and no significant remaining net book value. This activity had no significant effect on our results of operations or cash flows.

The principal use of cash for financing activities during the first nine months of fiscal 2005 and 2004 included $18 million and $13 million, respectively, in debt principal payments. We repaid $13 million of our Japanese yen fixed rate loan during the first nine months of fiscal 2004, and we repaid the remaining $14 million during the same period of fiscal 2005. Also, we repaid the $4 million outstanding principal amount of our 5.25% Senior Convertible Notes during the first nine months of fiscal 2005. During the first nine months of fiscal 2004, we sold approximately 18 million shares of our common stock to certain institutional investors in a private placement transaction. The aggregate purchase price of the common stock was $50 million, and we received $47 million in net proceeds.

At March 25, 2005, our principal sources of liquidity included cash and cash equivalents and unrestricted marketable investments of $84 million. Based on our revenue outlook for the fourth quarter ending June 24, 2005 and the timing of various future payments, we expect to continue to consume cash during the fourth quarter of fiscal 2005. We also experience significant intra-quarter fluctuations in our cash levels due to timing differences between our payments to vendors and our collections from customers, with the result that our cash balances are generally at their highest point at the end of each quarter and significantly lower at other times. As a result, we continue to focus on spending controls and working capital efficiencies to maintain adequate levels of unrestricted cash within each quarter. If we fail to reduce the cash consumption from operations and to generate cash from other sources on a timely basis, or if the cash requirements of our business change as the result of changes in terms from vendors or other causes, we might no longer have the cash resources required to run our business.

The terms of our existing indebtedness may affect our operating flexibility, including our ability to raise additional capital if needed. At March 25, 2005, we had an asset-based credit facility that we used for the purpose of issuing letters of credit supporting certain lease obligations. The facility was secured by our U.S. and Canadian accounts receivable, U.S. inventory and equipment, certain intellectual property and $10 million cash collateral. We also deposit additional cash whenever eligible accounts receivable and other collateral fluctuate below the level needed to secure our letters of credit. At March 25, 2005, this facility was secured by a total of $10 million cash collateral.

The asset-based credit facility matured in April 2005. Upon maturity, we renewed the facility, with improved terms, for a two-year period expiring in April 2007. These improved terms, some of which we received the benefit of

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through amendments to the prior credit line, include increasing availability under the facility by expanding the existing borrowing base to add categories of collateral that tend to remain relatively fixed throughout each quarter, including our intellectual property and eligible real property, and adjusting the calculation of inventory reserves and eligible accounts receivable. In addition, the renewed facility provides for less restrictive financial covenants than those of the prior line, including reduction of the minimum cash covenant from $50 million to $25 million. The credit facility also contains restrictions that currently limit the facility to $50 million and require the deposit of a minimum of $20 million in cash collateral with the lender. We expect to continue to use the credit facility principally for letters of credit, including the rent deposit for our headquarters facility.

Covenants in the credit facility require us to maintain minimum levels of earnings before interest, taxes, depreciation, and amortization (EBITDA), and minimum cash and cash equivalents levels and set maximum capital expenditure levels. The credit facility and the indentures governing the secured notes also contain covenants that, among other things, limit our ability to incur additional indebtedness, dispose of certain assets, issue or pay dividends on capital stock, repurchase capital stock, or prepay or repurchase subordinated debt. A failure to comply with these covenants could entitle the debt holders to accelerate the underlying obligations. On several occasions during fiscal 2004 and during the first three quarters of fiscal 2005, we were in violation of financial and administrative covenants in the credit facility. In each case we received a waiver of compliance from the lender.

We also had outstanding $191 million aggregate principal amount of senior secured convertible notes and senior secured notes, both due in 2009, at both March 25, 2005 and June 25, 2004, and $57 million aggregate principal amount of convertible subordinated debentures, due in 2011, at both March 25, 2005 and June 25, 2004.

We have incurred net losses and negative cash flows from operations during each of the past several fiscal years and had working capital of $37 million at March 25, 2005, down from $76 million at June 25, 2004. Our unrestricted cash and marketable investments at March 25, 2005 were $84 million, down from $157 million at June 25, 2004. On March 30, 2005, subsequent to the end of our third fiscal quarter, we completed the sale of a portion of our investment in SGI Japan and received net cash proceeds of $29 million. We believe that our current resources and expected operating results, combined with the renewal of our credit facility on April 12, 2005, will provide us with sufficient liquidity to meet our financial obligations through the end of fiscal 2005.

Beyond fiscal 2005, the adequacy of our resources will depend largely on our success in re-establishing profitable operations and positive operating cash flows. Because of our continuing losses and declining cash position, we announced a restructuring program in the third quarter with the goal of reducing expenses. The actions taken in the third quarter will begin to affect our operating expenses in the fourth quarter, and continuing actions in the fourth quarter will not begin to be reflected in our operating expenses until early in fiscal 2006. Any forecast of operating results is inherently uncertain, and although we will seek to implement these actions in a manner that does not materially reduce revenue, we cannot be certain that we will achieve our goal of re-establishing profitable operations and positive cash flow.

Contractual Obligations

During the first nine months of fiscal 2005, there were no material changes outside the ordinary course of our business in long-term debt obligations, capital lease obligations, operating lease obligations, purchase obligations, or any other long-term liabilities reflected in our condensed consolidated balance sheet.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an on-going basis, we evaluate these critical accounting policies and estimates, including those related to customer programs and incentives, bad debts, inventory, lease residual values, warranty obligations, restructuring, incomes taxes, and contingencies. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

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Management has discussed the development and selection of the following critical accounting policies and estimates with the audit committee of our board of directors and the audit committee has reviewed our disclosures relating to them.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. For all of these policies, we caution that future events often do not develop exactly as forecasted, and that even the best estimates routinely require adjustment.

Revenue Recognition. A majority of our revenue is derived from sales that are recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable and collectibility is reasonably assured. Certain revenue is generated from contracts where we are obligated to deliver multiple products and/or services. In these instances, we must assess the arrangement to determine whether the elements of the arrangement should be treated as separate units of accounting for revenue recognition purposes and if so, how the total contract price should be allocated among the elements and when revenue should be recognized for each element. We recognize revenue for delivered elements only when there is objective and reliable evidence of the fair value of the undelivered items and customer acceptance, if applicable, has been obtained. Allocation of the total contract price between each element of the arrangement may impact the timing of revenue recognition, but will not change the total revenue recognized on the contract.

Certain contracts involving multiple elements may be delivered over a longer duration of time. In these instances, we typically recognize revenue using the proportional performance method. In applying the proportional performance method, we recognize revenue as work progresses, based on the percentage that incurred costs to date bear to estimated total costs. We apply this method when we can obtain reasonably reliable estimates of contract costs. As work progresses on these contracts we adjust our cost estimates as the facts warrant. The profit on the contracts is subject to revision over the life of the contract. The impact of these revisions is recorded to revenue and cost of goods sold in the period in which the facts that give rise to the revision become known.

Product Warranties. We provide for the estimated cost to warrant our products against defects in materials and workmanship at the time revenue is recognized. We estimate our warranty obligation based on factors such as product lifecycle analysis and historical experience, and our estimate is affected by data such as product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required. On a quarterly basis, these estimates are reviewed and adjusted as considered necessary based on the factors noted above. Over the past three years, changes in product warranties estimates have decreased the reserve by approximately $1 million in both fiscal 2002 and 2004 while increasing the reserve by approximately $0.3 million in fiscal 2003.

Manufacturing Inventory and Spare Parts. We write down our manufacturing inventory for estimated excess, obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value. At the end of each quarter, we perform an in depth excess and obsolete analysis of all manufacturing inventory parts on order and on hand based upon assumptions about future demand and current market conditions. For all spare parts on hand, our analysis is based on assumptions about product life cycles, historical usage, current production status and installed base. Additional adjustments to manufacturing inventory and parts may be required if actual market conditions are less favorable than those projected by us during the analyses.

Lease Residual Values. Effective beginning in the second half of fiscal 2004, we now retain a residual interest in the products sold under certain lease arrangements, representing the estimated fair market value of the equipment at the end of the lease term. The residual value is derived for each significant product family based upon the following factors: historical data regarding recovery of residual values; current assessment of market conditions for used equipment; and any forward-looking projections deemed significant, particularly those relating to upcoming technology or changing market conditions. Residual values are evaluated periodically to determine if other-than-temporary declines in estimated residual values are indicated. Any anticipated increase in future residual values is not recognized until the used equipment is remarketed. Factors that could cause actual results to differ materially from the estimates include severe changes in the used equipment market and unforeseen changes in technology.

Bad Debts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When we become aware of a specific customer s inability to pay their outstanding obligation for reasons such as deterioration in their operating results or financial position or bankruptcy proceedings, we record a specific reserve for bad debt to reduce their receivable to an amount we reasonably believe is collectible. If the financial condition of specific customers were to change, our estimates of the recoverability of receivables could be further adjusted. We also record allowances for doubtful accounts for all other customers based on a variety of factors including the length of time the receivables are past due and historical experience. On a quarterly basis, these estimates are reviewed and adjusted as considered necessary based on the criteria noted above.

Valuation of Goodwill. We review goodwill for impairment in the fourth quarter of each year, or more frequently if events or circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 142 *Goodwill and Other Intangible Assets*. The provisions of SFAS No. 142 require that a two-step impairment test be performed on goodwill. In the first step, we compare the fair value of each reporting unit to its carrying value. Our reporting units are consistent with the reportable segments identified in Note 18 of the Condensed Consolidated Financial Statements. We determine the fair value of our reporting units based on an income approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit s goodwill. If the carrying value of a reporting unit s goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference.

The process of evaluating the potential impairment of goodwill is subjective and requires significant estimates and assumptions at many points during the analysis. In determining the fair value of a reporting unit we make estimates and assumptions about these reporting units. Our estimated future cash flows are based on assumptions that are consistent with our routine annual planning process and include revenue growth rates and operating margins, risk-adjusted discount rates and future economic and market conditions. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. In addition, we make certain judgments and assumptions in allocating shared assets and liabilities to determine the carrying values for each of our reporting units. Actual future results may differ from those estimates.

Restructuring. In recent fiscal years, we have recorded significant accruals in connection with our restructuring programs. These accruals include estimates of employee separation costs and the settlements of contractual obligations, including lease terminations resulting from our actions. Accruals associated with vacated facilities and related asset impairments are estimated in accordance with SFAS No. 5, *Accounting for Contingencies* and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* respectively. Estimates may be adjusted upward or downward upon occurrence of a future triggering event. Triggering events may include, but are not limited to, changes in estimated time to sublease, sublease terms and sublease rates. Due to the extended contractual obligations of certain of these leases and the inherent volatility of commercial real estate markets, we expect to make future adjustments to these vacated facilities accruals. Over the past three years, various triggering events have caused our estimates to decrease by $4 million, $2 million and $13 million in fiscal 2004, 2003 and 2002, respectively.

Income Taxes. Estimates and judgments occur in the calculation of certain tax liabilities and in the determination of the recoverability of certain deferred tax assets, which arise from temporary differences and carryforwards. We regularly assess the likelihood that our deferred tax assets will be realized from recoverable income taxes or recovered from future taxable income based on the realization criteria set forth under SFAS 109, *Accounting for Income Taxes*, and we record a valuation allowance to reduce our deferred tax assets to the amount that we believe to be more likely than not realizable. In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

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Loss Contingencies. We record an obligation for loss contingencies when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Contingent liabilities are often resolved over long time periods and there is a reasonable probability that the ultimate loss will differ from and perhaps exceed the recorded provision. Estimating probable losses requires analysis of multiple factors that often depend on judgments about the outcome of pending lawsuits and potential actions by third parties including government agencies. Over the past two years, we have resolved lawsuits whereby the ultimate outcome caused us to partially reverse previously recorded contingent liabilities in the amount of $5 million and $9 million in fiscal 2004 and 2003, respectively.

Other Significant Accounting Policies. Other significant accounting policies not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. Policies regarding financial instruments, stock-based compensation and consolidation require difficult judgments on complex matters that are often subject to multiple sources of authoritative guidance. Certain of these matters are among topics currently under reexamination by accounting standards setters and regulators. Specific conclusions reached by these standards setters may cause a material change in our accounting policies.

Risks That Affect Our Business

SGI operates in a rapidly changing environment that involves a number of risks, some of which are beyond our control.

Our success will require continued revenue growth from newer product families. The SGI Altix family of servers and superclusters based on the Intel Itanium 2 processor and the Linux operating system was introduced in January 2003 and additional products in this line were added during fiscal 2004. In October 2004, we expanded our advanced graphics product line with the introduction of Silicon Graphics Prism, visualization systems based on Linux, Itanium 2, and our scalable graphics technology. Risks associated with these newer product families include dependence on Intel in terms of price, supply, performance, product roadmaps and timely access to design specifications; the availability of Linux applications optimized for the 64-bit Itanium platform or our scalable systems architecture; acceptance of the Linux operating system in demanding environments; and competition from other suppliers of Intel-based servers, including clusters of low-end servers.

Future revenue growth from our newer product families is especially important because revenues from our traditional MIPS and IRIX products and maintenance business are expected to continue to decline. Our ability to achieve future revenue growth will depend significantly on the market success of these newer product families in servers, storage and visualization. If one or more of the product lines were to fail in the market, it could have an adverse effect on our business.

We have been incurring losses and consuming cash in our operations and must reverse these trends. We have incurred net losses and negative cash flows from operations during each of the past several fiscal years. At March 25, 2005, our principal source of liquidity was unrestricted cash and marketable investments of $84 million, down from $106 million at December 24, 2004. We expect to continue to consume cash from operations in the fourth quarter of fiscal 2005. Due to the significant intra-quarter fluctuations in our cash levels that result from timing differences between our payments to vendors and our collections from customers, our cash levels tend to be at their highest at the end of the quarter. As a result, we continue to focus on expense controls and working capital efficiencies to maintain adequate cash levels. See Financial Condition. If we fail to reduce the cash consumption from operations and to generate cash from these other sources on a timely basis, or if the cash requirements of our business change as the result of changes in payment terms from vendors or other causes, we could no longer have the cash resources required to run our business. The uncertainty related to such a circumstance could adversely affect our relationships with customers, vendors and partners.

Our on-going restructuring activities may not reduce our losses and cash consumption. In the third quarter of fiscal 2005, we initiated previously announced restructuring actions with a goal to reduce expenses by at least 10% from then projected third quarter levels. These restructuring actions, which primarily include the elimination of approximately 200 positions worldwide and exiting a portion of certain facilities, were commenced in February 2005 and will continue in the fourth quarter of fiscal 2005 as we complete notifications to employees outside the U.S. Although we will seek to implement these actions in a manner that does not materially reduce revenue or impair our ability to compete successfully, we cannot be certain that these outcomes will not occur or that these actions will accomplish its intended objective of reducing our losses and cash consumption. The third quarter restructuring charge of approximately $14 million was incurred primarily in connection with this

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restructuring and is comprised primarily of U.S. severance costs and future lease payments relating to vacated facilities. Substantially all of the restructuring charges has required or will require the outlay of cash, although the timing of payments relating to leased facilities is unchanged by the restructuring.

The terms of our debt obligations may limit our ability to raise additional capital and may adversely affect our business. We have an asset-based credit facility, renewed in April 2005, and two series of outstanding secured notes that may be in default and accelerated if we fail to meet certain financial and other covenants. Our asset-based credit facility also permits the lender to decline future extensions of credit if a material adverse change occurs. See Financial Condition. During the first, second, and third quarters of fiscal 2005 and on several occasions during fiscal 2003 and 2004, we were in violation of financial or administrative covenants under the prior credit facility for which, in each case, we received a waiver from the lender. However, there can be no assurance that a waiver will be available on acceptable terms in the event of a future default. If we were unable to obtain a necessary waiver, we would be required to deposit an amount equal to the difference between our then current unrestricted cash deposits and the full amount of the letters of credit secured by the facility. If a default is not waived, we may not be able to obtain alternative financing on acceptable terms. The need to comply with the terms of our debt obligations may also limit our ability to obtain additional financing and our flexibility in planning for or reacting to changes in our business and the industry.

If we continue to consume cash in operations and restructuring, we may need to obtain additional financing to fund our business or repay our debt, and we cannot assure you that financing will be available in amounts or on terms acceptable to us. In addition, if funds are raised by incurring further debt, our operations and finances may become subject to further restrictions and we may be required to limit our service or product development activities or other operations, or otherwise modify our business strategy. If we obtain additional funds by selling any of our equity securities or if we issue equity derivative securities in connection with obtaining debt financing, the percentage ownership of our stockholders will be reduced, stockholders may experience additional dilution, or the equity securities may have rights, preferences or privileges senior to the common stock.

Our common stock may be delisted. The New York Stock Exchange (NYSE) requires that listed securities trade at a minimum per share price of $1.00 averaged over a thirty day trading period. Based on the recent trend in our stock price and discussions with the NYSE, we expect to receive a notice of non-compliance in the near future, as we did in 2002 and 2001. If we fail or are unable to take action, such as a reverse stock split, to raise our stock price above this minimum threshold within a time frame acceptable to the NYSE, the NYSE could terminate the listing of our common stock. Delisting would adversely affect the liquidity and market price of our common stock.

Our disclosure controls and procedures need improvement. Our independent registered public accounting firm, Ernst & Young LLP, advised us in connection with the completion of their audit for fiscal 2004 that they had identified certain matters involving the operation of our internal controls that they consider to be a material weakness. See Item 4. Controls and Procedures elsewhere in this Form 10-Q. Although we are making progress implementing changes to respond to these matters, we have continued to identify deficiencies in our internal controls during the second and third quarters of fiscal 2005 and have taken steps to address these deficiencies. See Item 4. Controls and Procedures elsewhere in this Form 10-Q. Despite the steps we have taken to effectively correct the identified deficiencies, there could still be a risk of accounting errors, which could have an adverse affect on our operations or consolidated financial results. There is no guarantee that the changes we have implemented will be effective. In addition, we are evaluating, documenting and testing our internal controls in anticipation of our required compliance at June 24, 2005 with Section 404 of the Sarbanes-Oxley Act of 2002. If we are unable to complete the required assessment as to the adequacy of our internal control reporting and remediate any deficiencies identified through the process, or if our independent registered public accounting firm is unable to provide us with an unqualified report as to the effectiveness of our internal controls over financial reporting as of June 24, 2005, investors could lose confidence in the reliability of our internal controls over financial reporting.

We are concentrating our R&D and marketing investments. As an increasing percentage of our R&D and marketing budget is devoted to potential growth areas, including the SGI Altix and Prism families, visualization and storage, a declining amount both in percentage and absolute terms is being devoted to the traditional MIPS and IRIX products, which continue to supply a significant portion of our revenue. Managing this transition without unduly compromising the competitiveness of the MIPS and IRIX families and the quality of support received by customers will be key to our success. There can be no assurance that this transition will not impair our customer relationships and our competitive position.

We may become involved in intellectual property disputes. We routinely receive communications from third parties asserting patent or other rights covering our products and technologies. Based upon our evaluation, we may take no action or may seek to obtain a license. We are in discussions with several parties that have asserted intellectual property infringement claims. In any given case there is a risk that a license will not be available on terms that we consider reasonable, or that litigation will ensue. We expect that, as the number of hardware and software patents issued continues to increase, and as competition in the markets we address intensifies, the volume of these intellectual property claims will also increase.

In addition, our growing visibility as a supplier of Linux-based systems and as a participant in the open source software community increases our risk of becoming embroiled in the intellectual property disputes concerning these subjects, such as the current widely reported litigations between SCO Group on the one hand and IBM and Red Hat on the other. We received a notice from SCO Group purporting to terminate as of October 14, 2003 our fully paid license to certain UNIX operating system-related code, under which we distribute our IRIX operating system, on the basis that we have breached the terms of such license. We believe that the SCO Group s allegations are without merit and that our fully paid license is non-terminable. Nonetheless, there can be no assurance that this dispute with SCO Group will not escalate into litigation, which could have a material adverse effect on SGI, or that SCO Group s intellectual property claims will not impair the market acceptance of the Linux operating system.

We are increasingly dependent on our partners. Our strategy of developing system products based on industry-standard technologies has increased our dependence on Intel and other partners. It is important that we receive appropriate technical cooperation from Intel and other partners, and that the products from these partners continue to evolve in ways that support the differentiation that we seek to bring to our products. In particular, our Altix and Prism families depend on the continued availability, performance and price/performance of the Intel Itanium 2 processor family. Our financial performance and business prospects would be adversely affected if Intel were to reduce its support for the Itanium 2 line, including its willingness to supply components on terms that enable us to compete effectively for sales with substantial price sensitivity.

The competitiveness of our system products, particularly our servers, is also significantly affected by the availability on our platform of third-party software applications that are important to customers in our target markets. The success of our Linux-based products and services depends on, among other things, the growth of the Linux market, the acceptance of Linux solutions by customers in demanding environments, the availability of Linux applications optimized for the 64-bit Itanium 2 platform or our scalable systems architecture and our dependence on acceptance of SGI-developed code by the open source community and by Linux distributors with whom we partner.

Our dependence on third party partners and suppliers, including sole source suppliers, may prevent us from delivering an acceptable product on a timely basis. We rely on both single source and sole source suppliers for many of the components we use in our products. We utilize the Intel Itanium 2 processors in our Altix family of servers and superclusters and our Prism graphics system and have designed our system architecture to optimize performance using this processor. The Itanium 2 processor family is available only from Intel. If we were to utilize an alternative microprocessor, the transition would require an alternative design, which would be costly and cause significant delays in the development of future products, adversely affecting our business and operating results.

Our business is dependent on our ability to anticipate our needs for components and products and our suppliers ability to deliver such components and products in time to meet critical manufacturing and distribution schedules. In addition, we have benefited from favorable discounts on certain components from key suppliers for selected transactions. Our business could be adversely affected, for example, if suppliers fail to meet product release schedules, if we experience supply constraints, if we fail to negotiate favorable pricing or if we experience any other interruption or delay in the supply chain which interferes with our ability to manufacture our products or manage our inventory levels. Risks also include limited bargaining flexibility and the possibility of charges for excess and obsolete inventory. We are currently focused on maximizing our working capital by working closely with our suppliers and tightly managing our overall supply chain.

In addition, we have used IBM as a key foundry supplier of our integrated circuits. IBM has informed us that it will no longer act as our foundry supplier on a long-term basis, although it will continue production of our current products for a limited time. We are in the process of negotiating an orderly termination of the relationship with IBM and completing contracts with an alternate supplier to act as our foundry for certain key integrated circuits for new products planned for 2007 and later. There can be no assurance that we will be to complete agreements with IBM and/or the alternate supplier on reasonable terms.

We are dependent on sales to the U.S. government. A significant portion of our revenue is derived from sales to the U.S. government, either directly by us or through system integrators and other resellers. Sales to the government present risks in addition to those involved in sales to commercial customers, including potential disruptions due to changes in appropriation and spending patterns. Our U.S. government business is also highly sensitive to changes in the U.S. government s national and international priorities and budgeting. Events like Operation Iraqi Freedom and the continuing war on terrorism may affect funding for our programs or result in changes in government programs or spending priorities that may adversely affect our business. In addition, the U.S. government can typically terminate or modify its contracts with us at any time for its convenience. Any disruption or limitation in our ability to do business with the U.S. government could have an adverse impact on SGI.

A portion of our business requires security clearances from the U.S. government. We have implemented measures to maintain our clearances in light of the fact that our Chairman and Chief Executive Officer, Robert Bishop, is an Australian citizen. These arrangements are subject to periodic review by customer agencies and the Defense Security Service of the Department of Defense.

We expect our operating results to fluctuate for a variety of reasons. Our revenue and operating results may fluctuate for a number of reasons from period to period. Decreases in revenue can arise from any number of factors, including decreased demand, supply constraints, delays in the availability of new products, transit interruptions, overall economic conditions, competitive factors, military or terrorist actions, or natural disasters. Demand can also be adversely affected by concerns specifically associated with our financial health and by product and technology transition announcements by us or our competitors. The timing of customer acceptance of certain large-scale server products may also have a significant effect on periodic operating results. Margins are heavily influenced by revenue levels, mix considerations, including geographic concentrations, the mix of product and service revenue, industry price trends, competitive pricing pressures (particularly for high visibility accounts) and the mix of server and desktop product revenue as well as the mix of configurations within these product categories. As a result of the concentration of sales in the third month of each quarter, developments late in a quarter can have a significant impact on that period s results.

We operate in a highly competitive industry with increasing market share being gained by cluster systems. The computer industry is highly competitive, with rapid technological advances and constantly improving price/performance. Most of our competitors have substantially greater technical, marketing and financial resources. They also generally have a larger installed base of customers and a wider range of available applications software. Competition may result in significant discounting and lower gross margins. In addition, as our Linux-based systems business grows, the number of our competitors may grow commensurate with the increased market opportunity. Specifically, PC vendors such as Dell Computer have achieved meaningful penetration in the high performance computing market with commodity products that can be clustered together to produce systems that compete with our mid-range products. These clustered systems may not be subject to U.S. export regulations, which may make them more attractive to certain international customers. See Many of our international sales require export licenses.

Our typical concentration of sales at the end of our fiscal quarters makes period-to-period financial results less predictable. Over half of each quarter s product revenue results from orders booked and shipped during the third month, and disproportionately in the latter half of that month. This makes the forecasting of revenue inherently uncertain and can produce pressure on the Company s internal infrastructure during the third month of a quarter. Because we plan our operating expenses, many of which are relatively fixed in the short term, on expected revenue, even a relatively small revenue shortfall may cause a period s results to be substantially below expectations.

We are subject to the risks of international operations. We generate a large portion of our revenue outside the United States, and as a result, our business is subject to the risks associated with doing business internationally. International transactions frequently involve increased financial and legal risks arising from stringent contractual terms and conditions and the widely differing legal systems and customs in foreign countries. War, terrorism or public health issues in the regions of the world in which we do business have caused and may continue to cause damage or disruption to commerce by creating economic and political uncertainties. Such events could adversely affect our business in any number of ways, such as decreasing demand for our products, increasing our costs of operations, making it difficult to deliver products to customers, and causing delays and other problems in our supply chain. Our future revenue, gross

margin, expenses and financial condition could also suffer due to other international factors, including but not limited to: changes in a country s economic and labor conditions; currency fluctuations; compliance with a variety of foreign laws, as well as U.S. laws affecting the activities of U.S. companies abroad; changes in tax laws; changes in the regulatory or legal environment; difficulties associated with repatriating cash generated abroad; fluctuations in transportation costs; natural and medical disasters; and trade protection measures.

Many of our international sales require export licenses. Our sales to customers outside the United States are subject to U.S. export regulations. Sales of many of our high-end products require clearance and export licenses from the U.S. Department of Commerce under these regulations. Our international sales would be adversely affected if such regulations were tightened, or if they are not modified over time to reflect the increasing performance of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to foreign customers. In addition, we could be subject to regulations, fines and penalties for violations of import and export regulations such as our products being shipped directly or through a third-party to certain countries. Such violations could result in penalties, including prohibiting us from exporting our products to one or more countries, and could materially and adversely affect our business.

We may not be able to develop and introduce new products on a timely basis. Meeting our objectives for the future will require that our recently introduced products achieve success in the marketplace and that we succeed in the timely development and introduction of more successful new products. Product transitions are a recurring part of our business. A number of risks are inherent in this process.

The development of new technology and products is increasingly complex and uncertain, which increases the risk of delays. The introduction of new computer systems requires close collaboration and continued technological advancement involving multiple hardware and software design teams, internal manufacturing teams, outside suppliers of key components such as semiconductors and outsource manufacturing partners. The failure of any one of these elements could cause our products under development to fail to meet specifications or to miss the aggressive timetables that we establish. There is no assurance that development or acceptance of our new systems will not be affected by delays in this process.

Short product life cycles place a premium on our ability to manage the transition to new products. We often announce new products in the early part of a quarter while the product is in the final stages of development and testing, and seek to manufacture and ship the product in volume during the same quarter. Our results could be adversely affected by such factors as development delays, the release of products to manufacturing late in any quarter, quality or yield problems experienced by suppliers, variations in product costs and excess inventories of older products and components. In addition, some customers may delay purchasing existing products in anticipation of new product introductions.

Most products are upgraded during their product life cycle. The ability to upgrade products in a timely fashion is necessary to compete in the computer industry. Delay in introducing updates and upgrades can adversely affect acceptance and demand for product.

We may not be able to retain and attract qualified employees. Our success depends on our ability to continue to attract, retain and motivate highly qualified technical, sales and marketing and management personnel. The uncertainties surrounding our business prospects and our continuing restructuring actions have increased the challenges of retaining world-class talent. There is no guarantee that we will not lose highly qualified employees or that we will be able to hire highly qualified candidates as new skills are needed.

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We may not be able to utilize a significant portion of our net operating loss and credit carryforwards. We have generated a significant amount of U.S. net operating loss carryforwards due to prior period losses. U.S. and state income tax laws limit the amount of these carryforwards a company can utilize upon a greater than 50% cumulative shift of stock ownership over a three year period. The issuance of additional common stock, in financing transactions or on conversion of our outstanding convertible bonds such as the 2009 Senior Convertible Notes issued in December 2003, will count towards this cumulative ownership shift. There is a risk that our ability to use our existing carryforwards in the future could be limited and not available to offset income tax liabilities from future profits. This would have an effect on our cash balances and liquidity and would reduce our income after taxes. This would not affect our future effective tax rate since any affected loss and credit carryforwards have been subjected to a valuation allowance in prior periods.

Unforeseen environmental costs could impact our future net earnings. Certain of our operations involve the use of substances regulated under various federal, state and international laws governing the environment. While we endeavor to be in compliance with environmental laws at all times, any failure to so comply can subject us to material liability. Production and marketing of products in certain states and countries may subject us to environmental and other regulations including, in some instances, the requirement that we finance the costs of environmentally safe recycling, recovery or disposal of products imported into the EU. Such laws and regulations have recently been passed in several jurisdictions in which our products are sold, including various European Union member states, Japan and California. These and other environmental laws may become stricter over time and require us to incur substantial costs for compliance. Environmental costs are presently not material to our operations or financial position. Although we do not anticipate any material adverse effects in the future based on the nature of our operations and the thrust of such laws, there is no assurance that such existing laws or future laws will not have a material adverse affect on us.

Our business is subject to market risk. In the normal course of business, our financial position is routinely subjected to a variety of risks, including market risk associated with interest rate movements and currency rate movements on non-U.S. dollar denominated assets and liabilities, as well as collectibility of accounts receivable. We regularly assess these risks and have established policies and business practices to protect against the adverse effects of these and other potential exposures. As a result, we do not anticipate material losses in these areas.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The information required under this Item 3 is included in the section above entitled Our Business is Subject to Market Risk and should be read in connection with the information on market risk related to changes in interest rates and non-U.S. currency exchange rates in Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk , in our Annual Report on Form 10-K for the year ended June 25, 2004.

Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* Company management, including our chief executive officer and chief financial officer, has evaluated our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this Form 10-Q (the Evaluation Date). Based on that evaluation, our chief executive officer and chief financial officer have concluded that the Company s disclosure controls and procedures are effective, except as discussed below, to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time period specified in SEC rules and forms. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including cost limitations, the possibility of human error, judgments and assumptions regarding the likelihood of future events, and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can provide only reasonable assurance of achieving their control objectives.

Our independent registered public accounting firm, (Ernst & Young LLP), advised us in connection with the completion of their audit for fiscal 2004 that they had identified certain matters involving the operation of our internal controls that they consider to be a material weakness. A material weakness is a reportable

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condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Ernst & Young s fiscal 2004 conclusion that we need to reassess our existing finance organization resource requirements and re-evaluate the design and operating effectiveness of certain controls surrounding the financial statement close process was based on several adjustments that were made in the course of the audit process that, in their view, should have been identified and resolved by the Company as part of the internal accounting close process. The adjustments involved accruals for accounts payable, calculation errors relating to certain items of interest and depreciation expense, and the choice of accounting methods for a complex transaction involving hardware and services revenue. The adjustments were made prior to the public release of our results for fiscal 2004 and do not affect previously announced results.

The matters identified in the Ernst & Young letter have been reviewed with management and the Audit Committee. Management believes that the material weakness identified in the Ernst & Young letter is attributable in significant part to the substantial headcount reductions that we have implemented over the past several years, which have had a disproportionate impact on administrative functions.

We have an ongoing process of analyzing and attempting to improve our internal controls, including those related to the matters identified in the Ernst & Young letter. We are in the process of implementing changes to respond to these matters on an immediate and a longer-term basis. During the first nine months of fiscal 2005 we implemented enhanced control procedures to mitigate several of the items noted by Ernst & Young.

Specifically, we:

- developed and began to deliver training programs for our finance personnel, including programs specifically targeted at revenue recognition;
- strengthened our staffing in revenue recognition accounting and SEC Reporting;
- implemented additional procedures to identify the existence of liabilities and review their accuracy;
- added additional review procedures over critical spreadsheets that are used to directly determine financial statement amounts or balances; and
- strengthened our internal review procedures in conjunction with our ongoing work to enhance our internal controls, enabling us to identify and adjust items as part of our normal close process during our quarter ended March 25, 2005.

Through the third fiscal quarter we continued to address and correct internal control deficiencies. In the second fiscal quarter, we had one item that was identified by Ernst & Young during the course of their quarterly review that resulted in an adjustment being recorded in that quarter. In conjunction with our enhanced review procedures, the Company also identified a small number of items that resulted in adjustments being recorded in the second and third quarters of fiscal 2005 that should have more appropriately been recorded in other periods. These adjustments did not have a material impact on results reported in previous periods. We have evaluated all such control deficiencies related to these adjustments, both individually, and in the aggregate, whether identified by the Company or by Ernst & Young, and have determined that two such control deficiencies would be categorized as significant deficiencies in our internal controls over financial reporting. We have discussed these matters with both Ernst & Young and our Audit Committee. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Company s annual or interim financial statements that is more than inconsequential will not be prevented or detected. The adjustments were made prior to the public release of our results for the third quarter of fiscal 2005 and therefore do not affect previously announced results for the third quarter of fiscal 2005. We are continuing our efforts to enhance our internal review procedures.

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In addition, we have been engaged in an ongoing process of identifying, documenting and testing our internal controls in anticipation of our required compliance with Section 404 of the Sarbanes-Oxley Act at the end of fiscal 2005. Changes have been made and will be made to our internal controls as a result of these efforts. However, the process has not yet been completed and we cannot provide any assurance that we will be able to complete the required assessment as to the adequacy of our internal control reporting or that Ernst & Young will be able to provide us with an unqualified report as to the effectiveness of our internal controls over financial reporting as of June 24, 2005. In addition, other issues not currently identified could arise prior to the end of this fiscal year that we would not be able to remediate prior to June 24, 2005.

Other than as described above, there have been no changes in the Company s internal control over financial reporting during the quarter ended March 25, 2005 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

(b) *Changes in internal controls.* There were no significant changes in our internal controls or, to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

In June 2002, we reached an agreement to resolve the claims asserted in a lawsuit originally filed as *Collette Sweeney v. Silicon Graphics, Inc. and Does 1-50, inclusive, CV 790199* on June 5, 2000 in the Superior Court for the County of Santa Clara, State of California and later dismissed by the plaintiffs but refiled as a representative action under California Business and Professions Code section 17200 by the plaintiffs original counsel. The lawsuit asserts claims for violations of provisions of the California Labor Code and California Wage Orders. The settlement agreement outlined a process for identifying and resolving claims from members of the represented class. This process was completed in the third quarter of fiscal 2004 and we expect the complaint will be dismissed in the fourth quarter of fiscal 2005.

Our U.S. tax returns for fiscal years 2002 to 2004 are open and no adjustments have been proposed. In addition, we have open income tax, VAT and sales tax audits for years 1995 through 2004 in various foreign jurisdictions. We believe that we have made adequate provisions for any adjustments that have resulted or may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. Should any issues addressed in our tax audits be resolved in a manner not consistent with our expectations, we could be required to adjust our provision for income tax in the period such resolution occurs.

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

In May 2001, a Brazilian court entered a judgment against our Brazilian subsidiary, Silicon Graphics Comercio e Serviços Limitada, with regard to a claim by Cargill Prolease against a third party for breach of an April 1997 lease agreement to which SGI s subsidiary was a guarantor. We have appealed the judgment, which totaled $1.3 million, including interest as of March 25, 2005, and expect the appeal to be heard in 2006.

We are currently involved in a dispute with a systems integrator regarding whether acceptance criteria were met with regard to an SGI system delivered in the spring of 2003. We are seeking full payment for the system in an amount equal to EUR 4.6 million ($6 million based on the conversion rate as of March 25, 2005). The other party has contested our claim and has alleged damages of up to EUR 10 million ($13 million based on the conversion rate as of March 25, 2005) which exceed our contractual limit of liability of EUR 1.8 million ($2 million based on the conversion rate as of March 25, 2005). We are currently in discussions with the other party regarding the possible settlement of the dispute; however we cannot currently predict the outcome and the dispute may result in litigation.

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

We are not aware of any pending disputes, including those disputes and settlements described above, that would be likely to have a material adverse effect on our financial condition, results of operations, or liquidity. However, litigation is subject to inherent uncertainties, and unfavorable outcomes could occur. An unfavorable outcome could include the payment of monetary damages, a cash or other settlement or an injunction prohibiting us from selling one or more products. If an unfavorable resolution were to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the resolution occurs or on future periods.

Item 6. Exhibits

The following Exhibits are filed as part of this Report:

10.1	Second Amended and Restated Credit Agreement, dated as of April 12, 2005, between the Company and Wells Fargo Foothill, Inc. (incorporated by reference to Exhibit 10.1 of Registrant s Form 8-K filed on April 14, 2005).
10.2	Security Agreement, dated as of April 12, 2005, between the Company and Wells Fargo Foothill, Inc. (incorporated by reference to Exhibit 10.1 of Registrant s Form 8-K filed on April 14, 2005).
10.3	Amended and Restated Intellectual Property Security Agreement, dated as of March 21, 2005, between the Company and Wells Fargo Foothill, Inc. (incorporated by reference to Exhibit 10.1 of Registrant s Form 8-K filed on March 25, 2005).
10.4	Form of Employment Continuation Agreement entered into between the Company and its executive officers, as amended and restated as of April 25, 2001.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Robert R. Bishop and Jeffrey V. Zellmer.

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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.

Dated: May 4, 2005	SILICON GRAPHICS, INC.	
	a Delaware corporation	
	By:	/s/ Jeffrey Zellmer
		Jeffrey Zellmer
		Senior Vice President and Chief Financial Officer
		(Principal Financial Officer)
	By:	/s/ Kathy Lanterman
		Kathy Lanterman
		Vice President and Corporate Controller
		(Principal Accounting Officer)