

CRAY INC  
Form 10-Q  
May 09, 2011  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**X    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**

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

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

**Commission File Number: 0-26820**

**CRAY INC.**

**(Exact name of registrant as specified in its charter)**

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**Washington**  
(State or Other Jurisdiction of

**93-0962605**  
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

**901 Fifth Avenue, Suite 1000**

**Seattle, Washington**  
(Address of Principal Executive Office)

**98164**  
(Zip Code)

Registrant's Telephone Number, Including Area Code:

**(206) 701-2000**

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

Indicate by check mark whether the registrant 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

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. (Check one):

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

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

As of May 4, 2011, there were 36,177,512 shares of Common Stock issued and outstanding.

**Table of Contents**

**CRAY INC.**

**TABLE OF CONTENTS**

	<b>Page No.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	3
<u>Item 1. Unaudited Condensed Consolidated Financial Statements:</u>	3
<u>Balance Sheets as of March 31, 2011 and December 31, 2010</u>	3
<u>Statements of Operations for the Three Months Ended March 31, 2011 and 2010</u>	4
<u>Statements of Cash Flows for the Three Months Ended March 31, 2011 and 2010</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	24
<u>Item 4. Controls and Procedures</u>	24
<b><u>PART II. OTHER INFORMATION</u></b>	25
<u>Item 1A. Risk Factors</u>	25
<u>Item 6. Exhibits</u>	33
<b><u>SIGNATURES</u></b>	34
<b>Available Information</b>	

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, amendments to those reports and proxy statements filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act are available free of charge at our website at [www.cray.com](http://www.cray.com) as soon as reasonably practicable after we electronically file such reports with the SEC.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Unaudited Condensed Consolidated Financial Statements  
CRAY INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited and in thousands, except share data)**

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 122,015	\$ 57,381
Restricted cash	3,924	3,914
Accounts and other receivables, net	35,034	106,268
Inventory	52,664	49,241
Prepaid expenses and other current assets	6,195	5,901
Total current assets	219,832	222,705
Property and equipment, net	16,802	17,953
Service inventory, net	1,821	1,887
Deferred tax assets	3,098	3,105
Other non-current assets	12,960	14,978
<b>TOTAL ASSETS</b>	<b>\$ 254,513</b>	<b>\$ 260,628</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 14,149	\$ 20,384
Accrued payroll and related expenses	11,403	20,668
Other accrued liabilities	6,410	6,380
Deferred revenue	62,198	49,896
Total current liabilities	94,160	97,328
Long-term deferred revenue	12,896	14,954
Other non-current liabilities	2,720	2,525
<b>TOTAL LIABILITIES</b>	<b>109,776</b>	<b>114,807</b>
Commitments and contingencies (Note 11)		
Shareholders' equity:		
Preferred stock Authorized and undesignated, 5,000,000 shares; no shares issued or outstanding		
Common stock and additional paid-in capital, par value \$.01 per share Authorized, 75,000,000 shares; issued and outstanding 36,176,186 and 36,068,081 shares, respectively	560,739	559,058
Accumulated other comprehensive income	3,626	4,906
Accumulated deficit	(419,628)	(418,143)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>144,737</b>	<b>145,821</b>

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TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 254,513	\$ 260,628
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See accompanying notes

**Table of Contents**

**CRAY INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited and in thousands, except per share data)

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Revenue:		
Product	\$ 16,696	\$ 9,065
Service	23,171	19,323
Total revenue	39,867	28,388
Cost of revenue:		
Cost of product revenue	11,317	8,006
Cost of service revenue	11,350	13,748
Total cost of revenue	22,667	21,754
Gross profit	17,200	6,634
Operating expenses:		
Research and development, net	6,456	7,694
Sales and marketing	6,356	6,264
General and administrative	4,137	4,287
Restructuring	1,118	
Total operating expenses	18,067	18,245
Loss from operations	(867)	(11,611)
Other income (expense), net	(543)	97
Interest income, net	17	17
Loss before income taxes	(1,393)	(11,497)
Income tax expense	(92)	(100)
Net loss	\$ (1,485)	\$ (11,597)
Basic and diluted net loss per common share	\$ (0.04)	\$ (0.34)
Basic and diluted weighted average shares outstanding	34,781	33,954

See accompanying notes

**Table of Contents****CRAY INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited and in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Operating activities:</b>		
Net loss	\$ (1,485)	\$ (11,597)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,164	2,201
Loss on disposal of fixed assets	115	
Share-based compensation expense	1,121	1,211
Inventory write-down		492
Deferred income taxes	7	(31)
Cash provided by (used in) due to changes in operating assets and liabilities:		
Accounts and other receivables	71,159	(109)
Inventory	(3,456)	(13,377)
Prepaid expenses and other assets	1,688	(642)
Accounts payable	(6,241)	(2,716)
Accrued payroll and related expenses and other accrued liabilities	(10,662)	(4,202)
Other non-current liabilities	195	(143)
Deferred revenue	10,233	20,488
<b>Net cash provided by (used in) operating activities</b>	<b>64,838</b>	<b>(8,425)</b>
<b>Investing activities:</b>		
Purchases of property and equipment	(976)	(1,462)
<b>Net cash used in investing activities</b>	<b>(976)</b>	<b>(1,462)</b>
<b>Financing activities:</b>		
Proceeds from issuance of common stock through employee stock purchase plan	102	147
Proceeds from exercise of options	459	
<b>Net cash provided by financing activities</b>	<b>561</b>	<b>147</b>
Effect of foreign exchange rate changes on cash and cash equivalents	211	(230)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>64,634</b>	<b>(9,970)</b>
<b>Cash and cash equivalents:</b>		
Beginning of period	57,381	105,018
<b>End of period</b>	<b>\$ 122,015</b>	<b>\$ 95,048</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for income taxes	\$ 1,403	\$ 494
<b>Non-cash investing and financing activities:</b>		
Inventory transfers to fixed assets and service inventory	\$ 33	\$ 2,275
Shares issued for 401(k) match	\$	\$ 1,226

See accompanying notes





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**Table of Contents**

**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1 Basis of Presentation and Summary of Significant Accounting Policies**

In these notes, Cray Inc. and its wholly-owned subsidiaries are collectively referred to as the Company. In the opinion of management, the accompanying Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Operations and Statements of Cash Flows have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Management believes that all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010 (the 2010 Form 10-K ).

The Company's revenue, results of operations and cash balances are likely to fluctuate significantly from quarter-to-quarter. These fluctuations are due to such factors as the high average sales prices and limited number of sales of the Company's products, the timing of purchase orders and product deliveries, the revenue recognition accounting policy of generally not recognizing product revenue until customer acceptance and other contractual provisions have been fulfilled and the timing of payments for product sales, maintenance services, government research and development funding and purchases of inventory. Given the nature of the Company's business, its revenue, receivables and other related accounts are likely to be concentrated among a few customers.

During the three months ended March 31, 2011, the Company incurred a net loss of \$1.5 million and was provided with \$64.8 million of cash from operating activities. The Company had \$125.7 million of working capital as of March 31, 2011. Management's plans project that the Company's current cash resources and cash to be generated from operations will be adequate to meet the Company's liquidity needs for at least the next twelve months. These plans assume acceptance and subsequent collections from several large customers, as well as cash receipts on future sales opportunities not yet contracted.

**Principles of Consolidation**

The accompanying condensed consolidated financial statements include the accounts of Cray Inc. and its wholly-owned subsidiaries. All material intercompany accounts and transactions have been eliminated.

**Use of Estimates**

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Company's condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

**Revenue Recognition**

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. Delivery does not occur until the products have been shipped or services provided to the customer, risk of loss has transferred to the customer, and a customer acceptance has been obtained. The sales price is not considered to be fixed or determinable until all material contingencies related to the sales have been resolved. The Company records revenue in the Condensed Consolidated Statements of Operations net of any sales, use, value added or certain excise taxes imposed by governmental authorities on specific sales transactions. In addition to the aforementioned general policy, the following are the Company's statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

*Multiple-Element Arrangements.* The Company commonly enters into revenue arrangements that include multiple deliverables of its product and service offerings due to the needs of its customers. Product may be delivered in phases over time periods which can be as long as five years. Maintenance services generally begin upon acceptance of the first equipment delivery and future deliveries of equipment generally have an

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associated maintenance period. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period and accordingly allocates a portion of the arrangement consideration as a separate deliverable which is recognized as service revenue over the entire service period. Other services such as training and engineering services can be delivered as a discrete delivery or over the term of the contract. A multiple-element arrangement is separated into more than one unit of accounting if the following criteria are met:

The delivered item(s) has value to the customer on a standalone basis; and

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**Table of Contents**

**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company.

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative estimated selling price.

The Company follows a selling price hierarchy in determining the best estimate of the selling price of each deliverable. Certain products and services are sold separately in standalone arrangements for which the Company is sometimes able to determine vendor specific objective evidence, or VSOE. The Company determines VSOE based on normal pricing and discounting practices for the product or service when sold separately.

When the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements, the Company attempts to establish the selling price of each remaining element based on third-party evidence, or TPE. The Company's inability to establish VSOE is often due to a relatively small sample of customer contracts that differ in system size and contract terms which can be due to infrequently selling each element separately, not pricing products within a narrow range, or only having a limited sales history, such as in the case of certain advanced and emerging technologies. TPE is determined based on our prices or competitor prices for similar deliverables when sold separately. On certain transactions the Company is able to obtain competitor prices for comparable bundled arrangements. However, generally, the Company's offerings contain a significant level of customization and differentiation from those of competitors such that the comparable pricing of products with similar functionality cannot be obtained. The Company is also often unable to reliably determine what similar competitor products' selling prices are on a standalone basis as important details of competitive bids are not available. Therefore, the Company is often unable to determine TPE.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses estimated selling price, or ESP, in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a standalone basis. In determining ESP, the Company uses either the list price of the deliverable less a discount or the cost to provide the product or service plus a margin. When using list price less a discount, the Company uses discounts from list price for previous transactions. This approach incorporates several factors, including the size of the transaction and any changes to list prices. The data is collected from prior sales, and although the data may not have the sample size or consistency to establish VSOE, it is sufficiently objective to estimate the selling price. When using cost plus a margin, the Company considers the total cost of the product or service, including customer-specific and geographic factors. The Company also considers the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

*Products.* The Company recognizes revenue from sales of products, other than the Cray CX systems, upon customer acceptance of the system, when the price is fixed or determinable, collection is reasonably assured and no significant unfulfilled obligations exist. Revenue from sales of Cray CX systems is generally recognized upon shipment when title and risk of loss transfers to the customer and collection is reasonably assured.

*Services.* Maintenance services are provided under separate maintenance contracts with customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods, often with prepayments for the term of the contract. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period. When service is part of a multiple element arrangement, the Company allocates a portion of the arrangement consideration to maintenance service revenue based on estimates of selling price. Maintenance revenue is recognized ratably over the term of the maintenance contract. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue.

Revenue from engineering services is recognized as services are performed.

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*Project Revenue.* Revenue from design and build contracts is recognized under the percentage-of-completion, or POC method. Under the POC method, revenue is recognized based on the costs incurred to date as a percentage of the total estimated costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are recorded in income in the period in which the circumstances that gave rise to the revision become known by management. The Company performs ongoing profitability analyses of its contracts accounted for under the POC method in order to determine whether the latest estimates of revenue, costs and extent of progress require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately.

**Table of Contents**

**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

The Company records revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if management believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

It is commensurate with either of the following:

The Company's performance to achieve the milestone; or

The enhancement of value of the delivered item or items as a result of a specific outcome resulting from the Company's performance to achieve the milestone.

It relates solely to past performance.

It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

The individual milestones are determined to be substantive or nonsubstantive in their entirety and milestone consideration is not bifurcated.

Revenue from projects is classified as Product Revenue or Service Revenue, based on the nature of the work performed.

**Note 2 Fair Value Measurement**

Based on the observability of the inputs used in the valuation techniques used to determine the fair value of certain financial assets and liabilities, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values.

In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The following table presents information about the Company's financial assets and liabilities that have been measured at fair value as of March 31, 2011, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands):

Description	Fair Value at March 31, 2011	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)
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Assets:				
Cash, cash equivalents and restricted cash	\$	125,939	\$ 125,939	\$
Assets measured at fair value at March 31, 2011	\$	125,939	\$ 125,939	\$
Liabilities:				
Foreign exchange forward contracts (1)	\$	317	\$	\$ 317
Liabilities measured at fair value at March 31, 2011	\$	317	\$	\$ 317

(1) Included in Other accrued liabilities on the Company's Condensed Consolidated Balance Sheets.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Foreign Currency Derivatives*

The Company may enter into foreign currency derivatives to hedge future cash receipts on certain sales transactions that are payable in foreign currencies.

As of March 31, 2011, the Company had outstanding forward contracts which were designated as cash flow hedges of anticipated future cash receipts on sales contracts payable in foreign currencies. The outstanding notional amounts were 37.8 million Euro and hedged foreign currency exposure of approximately \$52.6 million. Cash receipts associated with the hedged contracts are expected to be received between 2011 and 2014, during which time the revenue on the associated sales contracts are expected to be recognized.

As of December 31, 2010, the outstanding notional amounts were approximately 2.0 million British pound sterling, 37.8 million euro and 53.3 million Swedish krona. As of December 31, 2010 these contracts hedged foreign currency exposure of approximately \$63.0 million.

Fair Values of Derivative Instruments (in thousands):

Hedge Classification	Balance Sheet Location	Fair Value as of March 31, 2011	Fair Value as of December 31, 2010
Foreign currency contracts	Other non-current assets	\$ 0	\$ 2,044
Foreign currency contracts	Other accrued liabilities	\$ (317)	\$ (704)
Total derivatives classified as hedging instruments		\$ (317)	\$ 1,340

As of March 31, 2011 and December 31, 2010, foreign currency losses of \$16,000 and foreign currency gains of \$1.4 million, respectively, were included in Accumulated other comprehensive income on the Company's Condensed Consolidated Balance Sheets. For the three months ended March 31, 2011, the Company recognized approximately \$1.0 million in net reclassification adjustments, which reduced product revenue, as revenue on the associated sales contracts was recognized.

**Note 3 Earnings (Loss) Per Share ( EPS )**

Basic EPS is computed by dividing net income available to common shareholders by the weighted average number of common shares, excluding unvested restricted stock, outstanding during the period. Diluted EPS is computed by dividing net income available to common shareholders by the weighted average number of common and potential common shares outstanding during the period, which includes the additional dilution related to conversion of stock options, unvested restricted stock and restricted stock units as computed under the treasury stock method.

For the three month periods ended March 31, 2011 and 2010, outstanding stock options, unvested restricted stock grants and restricted stock units were antidilutive because of net losses and, as such, their effect has not been included in the calculation of basic or diluted net loss per share. For the three month period ended March 31, 2011, potential gross common shares of 4.7 million were antidilutive and not included in computing diluted EPS. For the three month period ended March 31, 2010, potential gross common shares of 4.5 million were antidilutive and not included in computing diluted EPS.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 4 Comprehensive Loss**

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

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net loss	\$ (1,485)	\$ (11,597)
Unrealized loss on available-for-sale investments		(3)
Cash flow hedges:		
Gain (loss) on cash flow hedges	(2,431)	914
Reclassification adjustment to revenue	1,016	0
	(1,415)	914
Foreign currency translation adjustment	135	195
Comprehensive loss	\$ (2,765)	\$ (10,491)

**Note 5 Accounts and Other Receivables, Net**

Net accounts and other receivables consisted of the following (in thousands):

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Trade accounts receivable	\$ 13,235	\$ 79,891
Unbilled receivables	3,883	1,785
Advance billings	17,852	22,445
Other receivables	184	2,270
	35,154	106,391
Allowance for doubtful accounts	(120)	(123)
Accounts and other receivables, net	\$ 35,034	\$ 106,268

Unbilled receivables represent amounts where the Company has recognized revenue in advance of the contractual billing terms. Advance billings represent billings made based on contractual terms for which revenue has not been recognized.

As of March 31, 2011 and December 31, 2010, accounts receivable included \$17.0 million and \$56.4 million, respectively, due from U.S. government agencies and customers primarily serving the U.S. government. Of this amount, \$2.9 million and \$0.5 million were unbilled as of March 31, 2011 and December 31, 2010, respectively, based upon contractual billing arrangements with these customers. As of March 31, 2011, two non-U.S. government customers accounted for 33% of total accounts and other receivables. As of December 31, 2010, two different non-U.S. government customers accounted for 32% of total accounts and other receivables.



**Note 6 Inventory**

Inventory consisted of the following (in thousands):

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Components and subassemblies	\$ 8,263	\$ 11,481
Work in process	5,158	5,670
Finished goods	39,243	32,090
<b>Total</b>	<b>\$ 52,664</b>	<b>\$ 49,241</b>

As of March 31, 2011, finished goods inventory included \$37.6 million located at customer sites pending acceptance. As of December 31, 2010, finished goods inventory of \$31.5 million was located at customer sites pending acceptance. At March 31, 2011, two customers accounted for \$32.9 million, and at December 31, 2010, two customers accounted for \$29.4 million of finished goods inventory.

During the three months ended March 31, 2010, the Company wrote off \$0.5 million of inventory, primarily related to the SeaStar interconnect of the Cray XT product line, which the Company has phased out. No write-off was recorded during the three months ended March 31, 2011. The Company has a remaining net exposure of \$0.2 million on SeaStar interconnects of the Cray XT product line.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 7 Deferred Revenue**

Deferred revenue consisted of the following (in thousands):

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Deferred product revenue	\$ 34,325	\$ 19,959
Deferred service revenue	40,769	44,891
Total deferred revenue	75,094	64,850
Less long-term deferred revenue	(12,896)	(14,954)
Deferred revenue in current liabilities	\$ 62,198	\$ 49,896

As of March 31, 2011, two customers accounted for 35% of total deferred revenue. At December 31, 2010, one customer accounted for 28% of total deferred revenue.

**Note 8 Share-Based Compensation**

The Company accounts for its share-based compensation based on an estimate of fair value of the grant on the date of grant.

The fair value of unvested restricted stock and restricted stock units is based on the market price of a share of the Company's common stock on the date of grant and is amortized over the vesting period.

In determining fair value of stock options, the Company uses the Black-Scholes option pricing model. As no options were granted in the three month period ended March 31, 2011, no calculation was performed. The following key weighted average assumptions were employed in the calculation for the three month period ended March 31, 2010:

Risk-free interest rate	2.2%
Expected dividend yield	0%
Volatility	77%
Expected life	4.0 years
Weighted average Black-Scholes value of options granted	\$3.72

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Volatility is based on historical data. The expected life of an option is based on the assumption that options will be exercised, on average, about two years after vesting occurs. The Company recognizes compensation expense for only the portion of options or stock units that are expected to vest. Therefore, management applies an estimated forfeiture rate that is derived from historical employee termination data and adjusted for expected future employee turnover rates. The estimated forfeiture rate for stock option grants during the three month period ended March 31, 2010 was 10%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods. The Company's stock price volatility, option lives and expected forfeiture rates involve management's best estimates at the time of such determination, which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the vesting period or requisite service

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period of the option. The Company typically issues stock options with a four-year vesting period (the requisite service period) and amortizes the fair value of stock options (stock compensation cost) ratably over the requisite service period.

The Company also has an employee stock purchase plan ( ESPP ) which allows employees to purchase shares of the Company's common stock at 95% of fair market value on the fourth business day after the end of each offering period. The ESPP is deemed non-compensatory and therefore is not subject to the fair value provisions.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table sets forth the gross share-based compensation cost resulting from stock options and unvested restricted stock grants and restricted stock units (before consideration of any offsets for research and development co-funding) that was recorded in the Company's Condensed Consolidated Statements of Operations for the three months ended March 31, 2011 and 2010 (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Cost of product revenue	\$ 52	\$ 48
Cost of service revenue	108	92
Research and development, net	336	387
Sales and marketing	141	195
General and administrative	484	489
Total	\$ 1,121	\$ 1,211

A summary of the Company's year-to-date stock option activity and related information follows:

	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>
Outstanding at December 31, 2010	3,445,710	\$ 6.20	
Grants			
Exercises	(91,271)	\$ 5.02	
Cancellations	(28,390)	\$ 8.76	
Outstanding at March 31, 2011	3,326,049	\$ 6.21	7.2 years
Exercisable at March 31, 2011	1,749,416	\$ 7.21	6.0 years
Available for grant at March 31, 2011	3,267,400		

As of March 31, 2011, there was \$3.9 million of aggregate intrinsic value of outstanding stock options, including \$1.6 million of aggregate intrinsic value of exercisable stock options. Intrinsic value represents the total pretax intrinsic value for all in-the-money options (i.e., the difference between the Company's closing stock price on the last trading day of its first quarter of 2011 and the exercise price, multiplied by the number of shares of common stock underlying the stock options) that would have been received by the option holders had all option holders exercised their options on March 31, 2011. During the three months ended March 31, 2011, stock options covering 91,271 shares of common stock, with a total intrinsic value of \$0.2 million were exercised. During the three months ended March 31, 2010, no options were exercised.

A summary of the Company's unvested restricted stock grants and restricted stock units and changes during the period ended March 31, 2011 is as follows:

	Shares	Weighted Average Grant date Fair Value
Outstanding at December 31, 2010	1,380,491	\$ 4.77
Granted		
Forfeited		
Vested		
Outstanding at March 31, 2011	1,380,491	\$ 4.77

As of March 31, 2011, the Company had \$6.8 million of total unrecognized compensation cost related to unvested stock options and unvested restricted stock and restricted stock units, which is expected to be recognized over a weighted average period of 1.95 years.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 9 Income Taxes**

The Company recorded income tax expense of \$0.1 million for the three months ended March 31, 2011 and 2010. The expense recorded was primarily related to foreign income taxes payable.

The Company continues to provide a full valuation allowance against its net operating losses and other net deferred taxes arising in certain jurisdictions, primarily in the United States, as the realization of such assets is not considered to be more likely than not. If in a future period the Company is able to conclude that it is more likely than not that additional deferred tax assets will be realized, the adjustment of the valuation allowance would increase net income in that period.

**Note 10 Segment Information**

The Company has three operating segments: Cray Products, Custom Engineering, and Maintenance and Support. The segments represent components of the Company for which separate financial information is available that is utilized on a regular basis by the Chief Executive Officer, who is the Chief Operating Decision Maker, in determining how to allocate the Company's resources and evaluate performance. The segments are determined based on several factors, including the Company's internal operating structure, the manner in which the Company's operations are managed, client base, similar economic characteristics and the availability of separate financial information.

*Cray Products*

Cray Products include a suite of highly advanced systems, including the Cray XE6, Cray XE6m, Cray CX1000 and Cray CX1, which are used by single users all the way up through large research centers.

*Custom Engineering*

Custom Engineering designs, builds and implements custom high performance computing and data management solutions. Custom Engineering is structured into three practices: Special Purpose Systems, Knowledge Management, and Data Management Solutions.

*Maintenance and Support*

Maintenance and Support provides ongoing maintenance of Cray systems and systems analysts to help customers achieve their mission objectives.

The following table presents revenues and gross margin for the Company's operating segments for the three months ended March 31 (in thousands):

	<b>Three Months Ended</b>	
	<b>March 31, 2011</b>	<b>2010</b>
Revenue:		
Cray Products	\$ 15,953	\$ 6,161
Custom Engineering	8,554	8,363
Maintenance and Support	15,360	13,864

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Total revenue	\$ 39,867	\$ 28,388
Cost of Revenue:		
Cray Products	\$ 10,722	\$ 5,467
Custom Engineering	4,061	8,137
Maintenance and Support	7,884	8,150
Total cost of revenue	\$ 22,667	\$ 21,754
Gross Profit:		
Cray Products	\$ 5,231	\$ 694
Custom Engineering	4,493	226
Maintenance and Support	7,476	5,714
Total gross profit	\$ 17,200	\$ 6,634

Revenue and cost of revenue is the only discrete financial information the Company prepares for its segments. Other financial results or assets are not separated by segment.

**Table of Contents****CRAY INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Operating segments do not sell products to each other, and accordingly, there is no inter-segment revenue to be reported.

The Company's geographic operations outside the United States include sales and service offices in Canada, Brazil, Europe, the Middle East, Japan, Australia, India, Korea and Taiwan. The following data represents the Company's revenue for the United States and all other countries, which is determined based upon a customer's geographic location (in thousands):

	<b>United States</b>		<b>Other Countries</b>		<b>Total</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Three months ended March 31,						
Product revenue	\$ 7,480	\$ 8,697	\$ 9,216	\$ 368	\$ 16,696	\$ 9,065
Service revenue	17,351	14,310	5,820	5,013	23,171	19,323
Total revenue	\$ 24,831	\$ 23,007	\$ 15,036	\$ 5,381	\$ 39,867	\$ 28,388

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately \$22.2 million for the three months ended March 31, 2011, compared to approximately \$19.4 million for the three months ended March 31, 2010. For the three months ended March 31, 2011, revenue in Sweden accounted for 16% of total revenue.

**Note 11 Commitments and Contingencies***Litigation*

In 2009 a complaint, and then later in the year an amended complaint, were filed against Cray and Mellon Investor Services, LLC (Cray's stock transfer agent) claiming damages relating to the participation of an individual in a 1999 financing of the predecessor of Cray. The plaintiff is the receiver that has been appointed for certain entities related to the individual and the claims brought by the plaintiff arise from, among other things, plaintiff's assertion that there has been an inappropriate delay in receiving a replacement for a lost stock certificate allegedly owed to the receiver. The Company continues to defend and evaluate the claim but does not expect the outcome to have a material impact on the financial position of Cray.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Preliminary Note Regarding Forward-Looking Statements**

This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or if they prove incorrect, could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements are based on our management's beliefs and assumptions and on information currently available to them. In some cases you can identify forward-looking statements by terms such as may, will, should, could, would, expect, anticipates, believes, estimates, projects, predicts and potential and similar expressions, but the absence of these words does not mean a statement is not forward-looking. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, and examples of forward-looking statements include any projections of earnings, revenue or other results of operations or financial results; any statements of the plans, strategies, objectives and beliefs of management of the Company; any statements concerning proposed new products, technologies or services; any statements regarding future research and development or co-funding for such efforts; any statements regarding future economic conditions; and any statements of assumptions underlying any of the foregoing. These forward-looking statements are subject to the safe harbor created by Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons,



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including the risks faced by us and described in Item 1A. Risk Factors in Part II and other sections of this report and our other filings with the U.S. Securities and Exchange Commission, or SEC, or Commission. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. You should read this report completely and with the understanding that our actual future results may be materially different from what we expect. We assume no obligation to update these forward-looking statements, whether as a result of new information, future events, or otherwise.

### **Overview and Executive Summary**

We design, develop, manufacture, market and service high performance computing, or HPC, systems, commonly known as supercomputers, and provide engineering services related to HPC systems and solutions. Our supercomputer systems provide capability and sustained performance far beyond typical server-based computer systems and address challenging scientific, engineering and national security computing problems.

## **Table of Contents**

We believe we are well positioned to meet the HPC market's demanding needs by providing superior supercomputer systems with performance and cost advantages when sustained performance on challenging applications and total cost of ownership are taken into account. We differentiate ourselves from our competitors primarily by concentrating our research and development efforts on the interconnect network, packaging, system software capabilities and processing capabilities that enable our systems to provide efficient and high sustained performance at scale—that is, that enable our systems to continue to increase performance as they grow in size. Purpose-built for the supercomputer market, our high-end systems balance highly capable processors, very dense design, highly scalable system software and very high speed interconnect and communications capabilities. Our current strategy is to gain market share in the high-end supercomputer market segment, extend our technology leadership, maintain our focus on execution and profitability and expand our addressable market including broadening our engineering services offerings, specifically our Custom Engineering practices, and selling our Cray XE6m systems.

We focus our sales and marketing activities on government agencies, academic institutions and commercial entities that purchase HPC systems. We sell our HPC systems and services primarily through a direct sales force that operates throughout the United States and in Canada, Europe, Japan and Asia-Pacific. Our HPC systems are installed at more than 100 sites around the world.

### ***Summary of First Three Months of 2011 Results***

Total revenue increased \$11.5 million for the first three months of 2011 compared to the first three months of 2010, from \$28.4 million to \$39.9 million, primarily due to higher sales of Cray XE6 systems compared to sales of predecessor systems.

Loss from operations decreased \$10.7 million to a loss of \$0.9 million for the first three months of 2011 compared to the first three months of 2010, due to increased revenue and higher gross margins. Total gross margins increased from 23% to 43% for the first three months of 2011. The increase in total gross margin was due to a number of factors, including the following:

abnormally low total profit margin in the first quarter of 2010, principally due to low volume as customers deferred purchases until the release of the Cray XE6 system later in 2010,

higher margins from our maintenance services in the first quarter of 2011 as we begin to service the large systems that were accepted in the fourth quarter of 2010

an additional \$2.3 million in revenue recorded on a Custom Engineering contract in the first quarter of 2011 where revenue is being recorded on the cash basis as the Company's ability to collect payment is not reasonably assured.

Net cash provided from operations was \$64.8 million for the first three months of 2011 compared to net cash used in operations of \$8.4 million for the first three months of 2010. Cash provided from operations in the first three months of 2011 was driven by large cash collections from multiple customers that accepted large systems in the fourth quarter of 2010. Cash balances, including restricted cash balances, were \$125.9 million as of March 31, 2011 compared to \$61.3 million as of December 31, 2010.

### ***Market Overview and Challenges***

Significant trends in the HPC industry include:

The commoditization of HPC hardware, particularly processors and interconnect systems;

The growing commoditization of software, including plentiful building blocks and more capable open source software;

Supercomputing with many-core commodity processors driving increasing scalability requirements;

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Electrical power requirements becoming a design constraint and driver in total cost of ownership determinations;

Increased micro-architectural diversity, including many-core processors and growing experimentation with accelerators, as the rate of per-core performance increases slows; and

Data needs growing faster than computational needs.

Several of these trends have resulted in the expansion and acceptance of lower-bandwidth cluster systems using processors manufactured by Intel, AMD and others combined with commercially available commodity networking and other components, particularly in the middle and lower segments of the HPC market. These systems may offer higher theoretical peak performance for equivalent cost, and price/peak performance is often the dominant factor in HPC procurements outside of the high-end supercomputer market segment. Vendors of such systems often put pricing pressure on us in competitive procurements.

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**Table of Contents**

In the markets for the largest systems, those costing significantly in excess of \$3 million, the use of commodity processors and networking components can result in increasing data transfer bottlenecks as these components do not balance processor power with network communication capability. With the arrival of increasing processor core counts due to new many-core processors, these unbalanced systems will typically have even lower productivity, especially in larger systems running more complex applications. We and other vendors have also begun to augment standard microprocessors with other processor types, such as field programmable gate arrays and graphics processing units, in order to increase computational power, further complicating programming models. In addition, with increasing scale, bandwidth and processor core counts, large computer systems use progressively higher amounts of power to operate and require special cooling capabilities.

To position ourselves to meet the market's demanding needs, we concentrate our research and development efforts on the interconnect, system and programming environment software and packaging capabilities that enable our supercomputers to perform at scale—that is, to continue to increase actual performance as systems grow ever larger in size. We also have demonstrated expertise in several processor technologies. Further, we offer unique capabilities in high-speed, high bandwidth system interconnect design, compiler technology, system software and packaging capabilities. We believe our experience and capabilities across each of these fronts are becoming ever more important, especially in larger procurements. We expect to be in a comparatively advantageous position as larger many-core processors become available and as multiple processing technologies become integrated into single systems in heterogeneous environments. In addition, we intend to expand our addressable market by leveraging our technologies and customer base, the Cray brand and industry trends by introducing complementary products and services to new and existing customers, as demonstrated by our emphasis on Custom Engineering projects and the introduction of our Cray XE6m system in 2010.

**Key Performance Indicators**

Our management monitors and analyzes several key performance indicators in order to manage our business and evaluate our financial and operating performance, including:

*Revenue.* Product revenue generally constitutes the major portion of our revenue in any reporting period and, for the reasons discussed elsewhere in this quarterly report on Form 10-Q, is subject to significant variability from period to period. In the short term, we closely review the status of product shipments, installations and acceptances in order to forecast revenue and cash receipts; longer-term, we monitor the status of the pipeline of product sales opportunities and product development cycles. Product revenue growth is an indicator of whether we are achieving our objective of increased market share in the supercomputing market. The introduction of the Cray XE family and our longer-term product roadmap are efforts to increase product revenue. We also plan to increase our engineering services offerings, specifically with our Custom Engineering initiative, and market new products, such as the Cray XE6m and successor systems, to increase revenue. Maintenance service revenue is more constant in the short term and assists, in part, to offset the impact that the variability in product revenue has on total revenue.

*Gross profit margin.* Our total gross profit margin increased from 23% in the first three months of 2010 to 43% in the first three months of 2011. Our product gross profit margin increased from 12% for the three months ended March 31, 2010 to 32% during the same period in 2011 as the product gross profit margin in 2010 was abnormally low principally due to low volume as customers deferred purchases until the release of the Cray XE6 system later in 2010. Service gross profit margin increased from 29% for the three months ended March 31, 2010 to 51% for the three months ended March 31, 2011. The increase in service gross profit margin is due to higher margins from our maintenance services as we begin to service the large systems that were accepted in the fourth quarter of 2010 and an additional \$2.3 million in revenue recorded on a Custom Engineering contract in the first quarter of 2011 where revenue is being recorded on the cash basis as the Company's ability to collect payment is not reasonably assured.

*Operating expenses.* Our operating expenses are driven largely by headcount, the level of recognized co-funding for research and development and contracted third-party research and development services. Operating expenses for the three months ended March 31, 2011 were \$0.2 million less than for the same period in 2010. The decrease in operating expenses was caused by a \$1.2 million decrease in net research and development expenses, due primarily to lower outside services, partially offset by a restructuring charge of \$1.1 million. In our restructuring, we eliminated approximately 52 positions. The restructuring is designed to rebalance our headcount to areas of more need in the future such as software development, custom engineering and customer service, and in select international geographies. The elimination of these positions is expected to be substantially offset by planned increases of personnel and, as a result, we currently expect to end 2011 with approximately the same number of employees that we employed at the beginning of 2011.

*Liquidity and cash flows.* Due to the variability in product revenue and new contracts, our cash position also varies significantly from quarter-to-quarter and within a quarter. We closely monitor our expected cash levels, particularly in light of increased inventory purchases for large system installations and the risk of delays in product shipments and acceptances and, longer-term, in product development. Sustained profitability over annual periods is our primary objective and should improve our cash position.



## **Table of Contents**

### **Critical Accounting Policies and Estimates**

This discussion, as well as disclosures included elsewhere in this quarterly report on Form 10-Q, are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingencies. In preparing our financial statements in accordance with GAAP, there are certain accounting policies that are particularly important. These include revenue recognition, inventory valuation, accounting for income taxes, research and development expenses and share-based compensation. Our significant accounting policies are set forth in Note 2 to the Consolidated Financial Statements included in our 2010 Form 10-K and should be reviewed in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto as of March 31, 2011 in this quarterly report on Form 10-Q, as they are integral to understanding our results of operations and financial condition in this interim period. In some cases, these policies represent required accounting. In other cases, they may represent a choice between acceptable accounting methods or may require substantial judgment or estimation.

Additionally, we consider certain judgments and estimates to be significant, including those relating to the fair value and selling price determination used in revenue recognition, percentage of completion accounting, estimates of proportional performance on co-funded engineering contracts and prepaid engineering services, realization of accounts receivable, determination of inventory at the lower of cost or market, useful lives for depreciation and amortization, determination of future cash flows associated with impairment testing of long-lived assets, determination of the fair value of stock options and other assessments of fair value, realization of deferred income tax assets, including our ability to utilize such assets, potential income tax assessments and other contingencies. We base our estimates on historical experience, current conditions and on other assumptions that we believe to be reasonable under the circumstances. Actual results may differ materially from these estimates and assumptions.

Our management has discussed the selection of significant accounting policies and the effect of judgments and estimates with the Audit Committee of our Board of Directors.

### ***Revenue Recognition***

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. Delivery does not occur until the products have been shipped or services provided to the customer, risk of loss has transferred to the customer, and a customer acceptance has been obtained. The sales price is not considered to be fixed or determinable until all material contingencies related to the sales have been resolved. The Company records revenue in the Condensed Consolidated Statements of Operations net of any sales, use, value added or certain excise taxes imposed by governmental authorities on specific sales transactions. In addition to the aforementioned general policy, the following are the Company's statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

*Multiple-Element Arrangements.* The Company commonly enters into revenue arrangements that include multiple deliverables of its product and service offerings due to the needs of its customers. Product may be delivered in phases over time periods which can be as long as five years. Maintenance services generally begin upon acceptance of the first equipment delivery and future deliveries of equipment generally have an associated maintenance period. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period and accordingly allocates a portion of the arrangement consideration as a separate deliverable which is recognized as service revenue over the entire service period. Other services such as training and engineering services can be delivered as a discrete delivery or over the term of the contract. A multiple-element arrangement is separated into more than one unit of accounting if the following criteria are met:

The delivered item(s) has value to the customer on a standalone basis; and

If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company.

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative estimated selling price.

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The Company follows a selling price hierarchy in determining the best estimate of the selling price of each deliverable. Certain products and services are sold separately in standalone arrangements for which the Company is sometimes able to determine vendor specific objective evidence, or VSOE. The Company determines VSOE based on normal pricing and discounting practices for the product or service when sold separately.

## **Table of Contents**

When the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements, the Company attempts to establish the selling price of each remaining element based on third-party evidence, or TPE. The Company's inability to establish VSOE is often due to a relatively small sample of customer contracts that differ in system size and contract terms which can be due to infrequently selling each element separately, not pricing products within a narrow range, or only having a limited sales history, such as in the case of certain advanced and emerging technologies. TPE is determined based on our prices or competitor prices for similar deliverables when sold separately. On certain transactions the Company is able to obtain competitor prices for comparable bundled arrangements. However, generally, the Company's offerings contain a significant level of customization and differentiation from those of competitors such that the comparable pricing of products with similar functionality cannot be obtained. The Company is also often unable to reliably determine what similar competitor products' selling prices are on a standalone basis as important details of competitive bids are not available. Therefore, the Company is often unable to determine TPE.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses estimated selling price, or ESP, in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a standalone basis. In determining ESP, the Company uses either the list price of the deliverable less a discount or the cost to provide the product or service plus a margin. When using list price less a discount, the Company uses discounts from list price for previous transactions. This approach incorporates several factors, including the size of the transaction and any changes to list prices. The data is collected from prior sales, and although the data may not have the sample size or consistency to establish VSOE, it is sufficiently objective to estimate the selling price. When using cost plus a margin, the Company considers the total cost of the product or service, including customer-specific and geographic factors. The Company also considers the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

*Products.* The Company recognizes revenue from sales of products, other than the Cray CX systems, upon customer acceptance of the system, when the price is fixed or determinable, collection is reasonably assured and no significant unfulfilled obligations exist. Revenue from sales of Cray CX systems is generally recognized upon shipment when title and risk of loss transfers to the customer and collection is reasonably assured.

*Services.* Maintenance services are provided under separate maintenance contracts with customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods, often with prepayments for the term of the contract. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period. When service is part of a multiple element arrangement, the Company allocates a portion of the arrangement consideration to maintenance service revenue based on estimates of selling price. Maintenance revenue is recognized ratably over the term of the maintenance contract. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue.

Revenue from engineering services is recognized as services are performed.

*Project Revenue.* Revenue from design and build contracts is recognized under the percentage-of-completion, or POC method. Under the POC method, revenue is recognized based on the costs incurred to date as a percentage of the total estimated costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are recorded in income in the period in which the circumstances that gave rise to the revision become known by management. The Company performs ongoing profitability analyses of its contracts accounted for under the POC method in order to determine whether the latest estimates of revenue, costs and extent of progress require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately.

The Company records revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if management believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

It is commensurate with either of the following:

The Company's performance to achieve the milestone; or



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The enhancement of value of the delivered item or items as a result of a specific outcome resulting from the Company's performance to achieve the milestone.

It relates solely to past performance.

It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

## **Table of Contents**

The individual milestones are determined to be substantive or nonsubstantive in their entirety and milestone consideration is not bifurcated.

Revenue from projects is classified as Product Revenue or Service Revenue, based on the nature of the work performed.

### ***Inventory Valuation***

We record our inventory at the lower of cost or market. We regularly evaluate the technological usefulness and anticipated future demand for our inventory components. Due to rapid changes in technology and the increasing demands of our customers, we are continually developing new products. Additionally, during periods of product or inventory component upgrades or transitions, we may acquire significant quantities of inventory to support estimated current and future production and service requirements. As a result, it is possible that older inventory items we have purchased may become obsolete, be sold below cost or be deemed in excess of quantities required for production or service requirements. When we determine it is not likely we will recover the cost of inventory items through future sales, we write-down the related inventory to our estimate of its market value.

Because the products we sell have high average sales prices and because a high number of our prospective customers receive funding from U.S. or foreign governments, it is difficult to estimate future sales of our products and the timing of such sales. It also is difficult to determine whether the cost of our inventories will ultimately be recovered through future sales. While we believe our inventory is stated at the lower of cost or market and that our estimates and assumptions to determine any adjustments to the cost of our inventories are reasonable, our estimates may prove to be inaccurate. We have sold inventory previously reduced in part or in whole to zero, and we may have future sales of previously written-down inventory. We also may have additional expense to write-down inventory to its estimated market value. Adjustments to these estimates in the future may materially impact our operating results.

### ***Accounting for Income Taxes***

Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and operating loss and tax credit carryforwards and are measured using the enacted tax rates and laws that will be in effect when the differences and carryforwards are expected to be recovered or settled. A valuation allowance for deferred tax assets is provided when we estimate that it is more likely than not that all or a portion of the deferred tax assets may not be realized through future operations. This assessment is based upon consideration of available positive and negative evidence, which includes, among other things, our recent results of operations and expected future profitability. We consider our actual historical results over several years to have stronger weight than other more subjective indicators, including forecasts, when considering whether to establish or reduce a valuation allowance on deferred tax assets. Estimated interest and penalties are recorded as a component of interest expense and other expense, respectively.

As of March 31, 2011, we had approximately \$131.3 million of net deferred tax assets, against which we provided a \$128.2 million valuation allowance, resulting in a net deferred tax asset of \$3.1 million. Our net deferred tax assets relate primarily to certain foreign jurisdictions where we believe it is more likely than not that such assets will be realized. We continue to provide a full valuation allowance against net operating losses and other net deferred tax assets arising in certain jurisdictions, primarily in the United States and Canada, as the realization of such assets is not considered to be more likely than not at this time. We reported income before income taxes for the year ended December 31, 2010. If we continue to generate income before income taxes in future periods, our conclusion about the realizability of our deferred tax assets and therefore the appropriateness of the valuation allowance could change in a future period and we could record a substantial gain in our condensed consolidated statement of operations when that occurs.

### ***Research and Development Expenses***

Research and development expenses include costs incurred in the development and production of our hardware and software, costs incurred to enhance and support existing product features, costs incurred to support and improve our development processes, and costs related to future product development. Research and development costs are expensed as incurred, and may be offset by co-funding from third parties. We may also enter into arrangements whereby we make advance, non-refundable payments to a vendor to perform certain research and development services. These payments are deferred and recognized over the vendor's estimated performance period.

Amounts to be received under co-funding arrangements with the U.S. government are based on either contractual milestones or costs incurred. These co-funding milestone payments are recognized in operations as performance is estimated to be completed and are measured as milestone achievements occur or as costs are incurred. These estimates are reviewed on a periodic basis and are subject to change, including in the near term. If an estimate is changed, net research and development expense could be impacted significantly.



**Table of Contents**

We do not record a receivable from the U.S. government prior to completing the requirements necessary to bill for a milestone or cost reimbursement. Funding from the U.S. government is subject to certain budget restrictions and milestones may be subject to completion risk, and as such, there may be periods in which research and development costs are expensed as incurred for which no reimbursement is recorded, as milestones have not been completed or the U.S. government has not funded an agreement.

We classify amounts to be received from funded research and development projects as either revenue or a reduction to research and development expense based on the specific facts and circumstances of the contractual arrangement, considering total costs expected to be incurred compared to total expected funding and the nature of the research and development contractual arrangement. In the event that a particular arrangement is determined to represent revenue, the corresponding research and development costs are classified as cost of revenue.

***Share-based Compensation***

We measure compensation cost for share-based payment awards at fair value and recognize it as compensation expense over the service period for awards expected to vest. We recognize share-based compensation expense for all share-based payment awards, net of an estimated forfeiture rate. We recognize compensation cost for only those shares expected to vest on a straight-line basis over the requisite service period of the award.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. We utilize the Black-Scholes options pricing model to value the stock options granted under our options plans. In this model, we utilize assumptions related to stock price volatility, stock option term and forfeiture rates that are based upon both historical factors as well as management's judgment.

The fair value of restricted stock and restricted stock units is determined based on the number of shares or units granted and the quoted price of our common stock at the date of grant.

**Results of Operations*****Revenue and Gross Profit Margins***

Our revenue, cost of revenue and gross profit margin for the three months ended March 31, 2011 and 2010, respectively, were (in thousands, except for percentages):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Product revenue	\$ 16,696	\$ 9,065
Less: Cost of product revenue	11,317	8,006
Product gross profit	\$ 5,379	\$ 1,059
Product gross profit margin	32%	12%
Service revenue	\$ 23,171	\$ 19,323
Less: Cost of service revenue	11,350	13,748
Service gross profit	\$ 11,821	\$ 5,575
Service gross profit margin	51%	29%
Total revenue	\$ 39,867	\$ 28,388
Less: Total cost of revenue	22,667	21,754
Gross profit	\$ 17,200	\$ 6,634

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Gross profit margin	43%	23%
<i>Product Revenue</i>		

Product revenue for the three months ended March 31, 2011 was \$16.7 million, primarily from sales of Cray XE6 systems. Product revenue for the three months ended March 31, 2010 was \$9.1 million, primarily from sales of Cray XT5 systems. Product revenues for the three months ended March 31, 2011 increased by \$7.6 million over the same prior year period as product revenue for the first quarter of 2010 was abnormally low as customers deferred purchases until the release of the Cray XE6 system later in 2010.

**Table of Contents***Service Revenue*

Service revenue for the three months ended March 31, 2011 was \$23.2 million compared to \$19.3 million for the same period in 2010. The increase in service revenue is due to the beginning of maintenance services on the large systems that were accepted in the fourth quarter of 2010 and an additional \$2.3 million in revenue recorded on a Custom Engineering contract where revenue is being recorded on the cash basis as the Company's ability to collect payment is not reasonably assured.

*Cost of Product Revenue and Product Gross Profit*

For the three months ended March 31, 2011, product gross profit increased \$4.3 million, while product gross profit margin increased 20 percentage points to 32% compared to the same period in 2010. The increase in product gross profit margin was due to an abnormally low product gross profit margin in the first quarter of 2010 principally due to low volume as customers deferred purchases until the release of the Cray XE6 system later in 2010.

*Cost of Service Revenue and Service Gross Profit*

Cost of service revenue decreased \$2.4 million during the three months ended March 31, 2011 compared to the same period in 2010, principally due to lower outside services costs on certain Custom Engineering contracts. Service gross profit margin increased by 22 percentage points for the three month period ended March 31, 2011 to 51% as compared to the same period in 2010. The increase in service gross profit margin is due to higher margins from maintenance on the large systems that were accepted in the fourth quarter of 2010 and an additional \$2.3 million in revenue recorded on a Custom Engineering contract where revenue is being recorded on a cash basis as the Company's ability to collect payment is not reasonably assured.

*Research and Development Expenses*

Research and development expenses for the three months ended March 31, 2011 and 2010, respectively, were (in thousands, except for percentages):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Gross research and development expenses	\$ 19,218	\$ 20,194
Less: Amounts included in cost of revenue	(108)	
Less: Reimbursed research and development (excludes amounts in cost of revenue)	(12,654)	(12,500)
Net research and development expenses	\$ 6,456	\$ 7,694
Percentage of total revenue	16%	27%

Gross research and development expenses in the table above reflect all research and development expenditures. Research and development expenses include personnel expenses, depreciation, allocations for certain overhead expenses, software, prototype materials and outside contracted engineering expenses.

For the three months ended March 31, 2011, gross research and development expenses decreased \$1.0 million from the same period in 2010, due to lower expenditures on outside services. Reimbursed research and development amounts included in cost of revenue were \$0.1 million for the first three months of 2011. There were no reimbursed research and development amounts included in cost of revenue in the first three months of 2010.

In February 2010, the Company and the Defense Advanced Research Project Agency (DARPA) amended the Phase III agreement. As with the previous contract, we expect to receive reimbursement after the achievement of a series of pre-defined milestones culminating in the delivery of a prototype system in 2012. Consistent with this change, certain deliverables have been eliminated from the contract, reducing the overall scope and cost of the project. Pursuant to the amended contract, we are required to spend \$285 million on our DARPA Phase III project in order to receive the full \$190 million of co-funding. As of March 31, 2011, we had received \$146 million of reimbursement under the DARPA Phase III agreement.



**Table of Contents*****Sales and Marketing and General and Administrative Expenses***

Our sales and marketing and general and administrative expenses for the three months ended March 31, 2011 and 2010, respectively, were (in thousands, except for percentages):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Sales and marketing	\$ 6,356	\$ 6,264
Percentage of total revenue	16%	22%
General and administrative	\$ 4,137	\$ 4,287
Percentage of total revenue	10%	15%

***Sales and Marketing.*** Sales and marketing expense for the three months ended March 31, 2011 increased slightly from the same period in 2010, primarily due to higher salaries and benefits related to Custom Engineering personnel additions as well as increased expenses in our foreign locations.

***General and Administrative.*** General and administrative expenses for the three months ended March 31, 2011 decreased slightly from the same period in 2010, primarily due to lower salaries and benefits.

***Restructuring***

We eliminated 52 positions late in the first quarter of 2011 and recorded a restructuring charge of \$1.1 million. The restructuring is designed to rebalance our headcount to areas of more need in the future such as software development, custom engineering and customer service, and in select international geographies. The elimination of these positions is expected to be substantially offset by planned increases of personnel and, as a result, we currently expect to end 2011 with approximately the same number of employees that we employed at the beginning of 2011.

***Other Income (Expense), net***

For the three months ended March 31, 2011, we recognized net other expense of \$0.5 million compared to net other income of \$0.1 million for the same period in 2010. Net other expense for the three months ended March 31, 2011 was principally the result of foreign currency transaction losses. Net other income for the three months ended March 31, 2010 was principally the result of foreign currency transaction gains.

***Interest Income (Expense)***

Our interest income and interest expense for the three months ended March 31, 2011 and 2010, respectively, were (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Interest income	\$ 36	\$ 41
Interest expense	(19)	(24)
Net interest income	\$ 17	\$ 17

Interest income and interest expense for the three months ended March 31, 2011 was consistent with the same period in 2010.

***Taxes***

We recorded an income tax expense of \$0.1 million for the three months ended March 31, 2011 and 2010 principally from our foreign operations.





**Table of Contents****Liquidity and Capital Resources**

The Company generates cash from operations predominantly from the sale of high performance computer systems and related services. The Company typically has a small number of significant contracts that make up the majority of total revenue. The material changes in certain of the Company's balance sheet accounts are due to the timing of product deliveries, customer acceptances, contractually determined billings and cash collections. Working capital requirements, including inventory purchases and normal capital expenditures, are generally funded with cash from operations.

The Company received acceptances on a large number of systems in the fourth quarter of 2010. The final payments for many of these systems were received in the first quarter of 2011, which resulted in an increase in cash and cash equivalents and restricted cash of \$64.6 million from December 31, 2010 to March 31, 2011. These cash collections decreased accounts and other receivables from \$106.3 million at December 31, 2010 to \$35.0 million at March 31, 2011. Inventory increased modestly from \$49.2 million at December 31, 2010 to \$52.7 million at March 31, 2011. The current portion of deferred revenues increased to \$62.2 million as of March 31, 2011 from \$49.9 million at December 31, 2010, resulting principally from contractual rights to bill certain customers for part of the contract before full customer acceptance and related revenue recognition.

Cash and cash equivalents, restricted cash and short-term investments totaled \$125.9 million at March 31, 2011 compared to \$61.3 million at December 31, 2010. As of March 31, 2011, we had working capital of \$125.7 million compared to \$125.4 million as of December 31, 2010.

Cash flow information includes the following (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Cash provided by (used in):		
Operating Activities	\$ 64,838	\$ (8,425)
Investing Activities	\$ (976)	\$ (1,462)
Financing Activities	\$ 561	\$ 147

*Operating Activities.* Net cash provided by operating activities was \$64.8 million in the quarter ended March 31, 2011. Net cash used in operating activities was \$8.4 million in the same quarter in 2010. For the quarter ended March 31, 2011, cash provided by operating activities was principally the result of a large decrease in accounts receivable due to the receipt of final payments related to fourth quarter 2010 acceptances of multiple large systems. For the quarter ended March 31, 2010, net cash used in operating activities was principally the result of our net loss as changes in operating assets and liabilities offset each other.

*Investing Activities.* Net cash used in investing activities was \$1.0 million in the first quarter of 2011. Net cash used in investing activities was \$1.5 million in the same quarter in 2010. For the three months ended March 31, 2011 and March 31, 2010, net cash used in investing activities was due to purchases of property and equipment.

*Financing Activities.* Net cash provided by financing activities was \$0.6 million in the quarter ending March 31, 2011. Net cash provided by financing activities was \$0.1 million in the same quarter in 2010. For the quarter ended March 31, 2011, cash provided by financing activities related to proceeds from stock option exercises and stock purchases from our employee stock purchase plan. Net cash provided by financing activities for the three months ended March 31, 2010 resulted from the issuance of common stock through our employee stock purchase plan.

Over the next twelve months, we expect our significant cash requirements will relate to operational expenses, consisting primarily of personnel costs, costs of inventory associated with certain large-scale product deliveries, spare parts, outside engineering expenses, and the acquisition of property and equipment. In addition, we lease certain equipment and facilities used in our operations under operating leases in the normal course of business. The following table summarizes our contractual cash obligations as of March 31, 2011 (in thousands):

		<b>Amounts Committed by Year</b>			
		<b>2011</b>			
		<b>(Less than</b>	<b>2012 -</b>	<b>2014 -</b>	
		<b>1 Year)</b>	<b>2013</b>	<b>2015</b>	<b>Thereafter</b>
<b>Contractual Obligations</b>	<b>Total</b>				

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Development agreements	\$ 15,440	\$ 10,361	\$ 5,079	\$	\$
Operating leases	29,146	3,254	8,170	7,370	10,352
Unrecognized income tax benefits	13	13			
Total contractual cash obligations	\$ 44,599	\$ 13,628	\$ 13,249	\$ 7,370	\$ 10,352

## **Table of Contents**

We have a line of credit with Wells Fargo Bank of \$3.5 million and a maturity date of June 1, 2011. In September 2010, we entered into a secured line of credit with Silicon Valley Bank in the amount of \$25 million. The first \$15 million is available at any time and the additional \$10 million is available if certain minimum financial ratios are exceeded. Our line of credit with Silicon Valley Bank has a maturity date of September 13, 2012. In connection with this line of credit, a blanket lien has been granted in substantially all assets. We have made no draws and had no outstanding borrowings on either line of credit as of March 31, 2011.

In our normal course of operations, we have development arrangements under which we engage outside engineering resources to work on our research and development projects. For the three months ended March 31, 2011, we incurred \$1.5 million for such arrangements.

At any particular time, our cash position is affected by the timing of cash receipts for product sales, maintenance contracts, government co-funding for research and development activities and our payments for inventory, resulting in significant fluctuations in our cash balance from quarter-to-quarter and within a quarter. Our principal sources of liquidity are our cash and cash equivalents, short-term investments and cash from operations. We expect our cash resources to be adequate for at least the next twelve months.

The adequacy of our cash resources is dependent on the amount and timing of government funding as well as our ability to sell our products and to engage in Custom Engineering projects, with adequate gross profit. Beyond the next twelve months, the adequacy of our cash resources will largely depend on our success in achieving profitable operations and positive operating cash flows on a sustained basis.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to financial market risks, including changes in interest rates and equity price fluctuations.

*Interest Rate Risk:* We invest our available cash in money market mutual funds whose underlying investments include investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. government and its agencies. We do not have any derivative instruments or auction rate securities in our investment portfolio. We protect and preserve invested funds by limiting default, market and reinvestment risk. Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. Fixed-rate securities may have their fair market value adversely affected due to a rise in interest rates, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. Although we have the above noted risks, a 0.5% change in interest rates would not be significant.

*Foreign Currency Risk:* We sell our products primarily in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our products are generally priced based on U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we often sell products with payments in U.S. dollars, our product sales contracts may call for payment in foreign currencies and to the extent we do so, or engage with our foreign subsidiaries in transactions deemed to be short-term in nature, we are subject to foreign currency exchange risks. As of March 31, 2011, we had entered into forward exchange contracts that hedge approximately \$52.6 million of anticipated cash receipts on specific foreign currency denominated sales contracts. These forward contracts hedge the risk of foreign exchange rate changes between the time that the related contracts were signed and when the cash receipts are expected to be received. Our foreign maintenance contracts are typically paid in local currencies and provide a partial natural hedge against foreign exchange exposure. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks. As of March 31, 2011, a 10% change in foreign exchange rates could impact our annual earnings and cash flows by approximately \$1.7 million.

### **Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this quarterly report. Based on this evaluation, our chief executive officer and chief financial officer concluded as of March 31, 2011 that our disclosure controls and procedures were effective such that the information required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.



## **Table of Contents**

*Changes in internal control over financial reporting.* There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2011 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

*Limitations on effectiveness of control.* Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected.

## ***Part II. OTHER INFORMATION***

### **Item 1A. Risk Factors**

You should carefully consider the risks described below together with all of the other information included in this quarterly report on Form 10-Q and in our 2010 annual report on Form 10-K. If any of these risks actually occur, our business, financial condition or operating results could be materially adversely affected and the trading price of our common stock could decline.

**Our operating results fluctuate significantly and we may not achieve profitability in any given period.** Our operating results are subject to significant fluctuations which make estimating revenue and operating results for any specific period very difficult, particularly as a material portion of product revenue recognized in any given quarter and year typically depends on a very limited number of system sales expected for that quarter and year and the product revenue may depend on the timing of product acceptances by customers and contractual provisions affecting revenue recognition. Delays in recognizing revenue from a product transaction or transactions due to development or product delivery delays, not receiving needed components timely or with anticipated quality and performance, not achieving customer acceptances of installed systems, contractual provisions or for other reasons, could have a material adverse effect on our operating results in any specific quarter or year, and could shift associated revenue, gross profit and cash receipts from one quarter into another, including from one year to another in the case of revenue expected to be realized in the fourth quarter of any year. The amount and timing of research and development co-funding (such as from our DARPA HPCS program) can also materially affect our expenses for any given quarter or year. In addition, because our revenue is often concentrated in particular quarters rather than evenly spread throughout a year, as it is expected to be again in the fourth quarter this year, we generally do not expect to sustain profitability over successive quarters even if we are profitable for the year.

Although we recorded positive net income in 2010, we have experienced net losses in recent periods and, prior to 2010, had last recorded positive annual net income in 2003. For example, we recorded a net loss of \$10.6 million in 2007, a net loss of \$40.7 million in 2008, that included a non-cash goodwill impairment charge of approximately \$54.5 million, a net loss of \$0.6 million in 2009, and a net loss of \$1.5 million for the three months ended March 31, 2011.

Whether we will be able to increase our revenue and achieve and sustain profitability on a quarterly and annual basis depends on a number of factors, including:

our ability to secure orders for our Cray XE6/Cray XE6m and successor systems, particularly orders that could be accepted in 2011, including a large opportunity the Company is pursuing that could account for over \$50 million;

the successful continued expansion of our Custom Engineering strategic initiative;

our expense levels, including research and development expense net of government funding, which are affected by the amount and timing of such funding and the meeting of contractual development milestones, including the milestones under our DARPA HPCS program;

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our ability to successfully and timely design, integrate and secure competitive processors for our systems, including for successors to our Cray XE6 systems;

**Table of Contents**

successfully delivering and obtaining customer acceptances of our Cray XE6 and Cray XE6m systems and successfully selling upgrades and successor components and systems;

the level of product gross profit contribution in any given period due to volume or product mix, competitive factors, strategic transactions, product life cycle, currency fluctuations and component costs;

our ability to secure additional government funding for future development projects;

the level of revenue recognized in any given period, which is affected by the very high average sales prices and limited number of system sales in any quarter, the timing of product acceptances by customers and contractual provisions affecting the timing and amount of revenue recognition;

the competitiveness of our products;

maintaining our product development projects on schedule and within budgetary limitations;

the level and timing of maintenance contract renewals with existing customers;

the level and timing of our engineering services contract closures, including the amount of non-billable time incurred;

revenue delays or losses due to customers postponing purchases to wait for future upgraded or new systems, delays in delivery of upgraded or new systems, longer than expected customer acceptance cycles or penalties resulting from system acceptance issues; and

the terms and conditions of sale or lease for our products and services.

The receipt of orders and the timing of shipments and acceptances impact our quarterly and annual results, including cash flows, and are affected by events outside our control, such as:

the timely availability of acceptable components in sufficient quantities to meet customer delivery schedules;

the timing and level of government funding for research and development contracts and product acquisitions, which may be adversely affected by the current economic and fiscal situation and governmental budgetary limitations;

the availability of adequate customer facilities to install and operate new Cray systems;

price fluctuations in the commodity electronics, processor and memory markets;

general economic trends, including changes in levels of customer capital spending;



the introduction or announcement of competitive or key industry supplier products;

currency fluctuations, international conflicts or economic crises; and

the receipt and timing of necessary export licenses.

Because of the numerous factors affecting our revenue and results of operations, we may not have net income on a quarterly or annual basis in the future. We anticipate that our quarterly results will fluctuate significantly, and include losses, even in years where we expect or achieve positive annual net income. Delays in component availability, product development, receipt of orders, level and timing of approved government fiscal budgets, product acceptances, reductions in outside funding for our research and development efforts and achieving contractual development milestones have had a substantial adverse effect on our past results and could continue to have such an effect on our results in 2011 and in future years.

**If the Defense Advanced Research Projects Agency (DARPA) terminates our DARPA High Productivity Computing Systems (HPCS) program in whole or in part or if we are unable to achieve and obtain acceptance of key DARPA milestones when or as expected or at all, our net research and development expenditures and capital requirements would increase significantly and our ability to conduct research and development would decrease.** The DARPA HPCS program calls for the delivery of prototype systems in 2012, and currently provides for a contribution by DARPA to us of up to \$190 million assuming we meet certain milestones, \$146 million of which we had already earned as of March 31, 2011. In February of 2010, we completed negotiations with DARPA to change the scope and schedule of this program, including changes to milestones and payments allocated to individual milestones, and that resulted in a reduction in the total possible contribution from DARPA over the term of the HPCS program from \$250 million to \$190 million. If the completion of any development milestone is delayed, our reported net research and development expenses, and our operating results, would be adversely affected. If we are unable to complete the remaining milestones, or one or more milestone payments are delayed, reduced and/or eliminated or the program is terminated, our cash flows and expenses would be adversely impacted and our product development programs would be put at risk. If we do not achieve and have accepted a milestone in the period we had originally estimated, we may incur research and development expense without offsetting co-funding by DARPA, resulting in increased net research and development expense during the period. We incurred some delays in payments for program milestones by DARPA in 2007 and 2008; in addition, as a result of our discussions with DARPA on the changes in scope

## Table of Contents

and program schedule, results for the third and fourth quarters of 2009 and full-year 2009 were adversely impacted by delays in completing development milestones. The amount of DARPA funds we can recognize as an offset to our periodic research and development expenses depends on our estimates of the total costs and the time to complete the program; changes in our estimates may decrease the amount of funding recognized in any period, which may increase the amount of net research and development expense recognized in that quarter. By the project's completion, we must spend at least \$285 million on the project for us to receive all of the DARPA \$190 million reimbursements; failure to do so would result in a lower level of DARPA contribution and could result in a termination of the funding contract. DARPA's future financial commitments are subject to subsequent Congressional and federal inter-agency action, and our development efforts and the level of reported research and development expenses would be adversely impacted if DARPA does not receive expected funding, which could result in a delay in payment for completed milestones, a delay in the timing of milestones or a decision to terminate all or part of the program before completion.

**If our current and future strategic initiatives targeting markets outside of our traditional markets, primarily our Custom Engineering initiative, are not successful, our ability to grow our revenues and achieve and sustain profitability will be adversely affected.** Our ability to materially grow our revenues and achieve and sustain profitability will be adversely affected if we are unable to generate sufficient revenue from strategic initiatives targeting markets outside of our traditional market, particularly if those market segments do not grow significantly. We currently have two such new strategic initiatives: Custom Engineering and selling our Cray XE6m systems. Our Custom Engineering initiative has demonstrated the most growth to date, and we believe it represents the best opportunity for us to diversify our revenue. To grow our revenue from Custom Engineering, we must continue to win awards for new contracts, timely perform on existing contracts and develop our capability for business development, notwithstanding that this is a relatively new initiative and we do not have significant experience targeting the markets relevant to our Custom Engineering practices. In addition, many of the new Custom Engineering projects will be for the U.S. government and likely will require us to enter into agreements that are subject to new or additional Federal Acquisition Regulations, including costing and pricing requirements to which we have not previously been subject. These regulations are complex and subject to audit to ensure compliance. We may need to enhance existing financial and costing systems to accommodate these new requirements. Errors made in interpreting and complying with these regulations could result in significant penalties. The Cray XE6m and successor systems require successful sales in a lower priced segment of the supercomputer market. These efforts require monetary investments ahead of revenue, including adding experienced personnel and initiating new marketing and sales efforts.

**If the U.S. government purchases fewer supercomputers or delays such purchases, our revenue would be reduced and our operating results would be adversely affected.** Historically, sales to the U.S. government and customers primarily serving the U.S. government have represented the largest single market segment for supercomputer sales worldwide, including our products and services. In 2008, 2009 and 2010 and the first three months of 2011, approximately 81%, 72%, 62% and 56% respectively, of our revenue was derived from such sales. Our plans for 2011 and the foreseeable future contemplate significant sales to U.S. government agencies. Sales to government agencies, including further sales pursuant to existing contracts, may be adversely affected by factors outside our control, such as the current economic uncertainty and related political focus on cutting or limiting budgets and their effect on government budgets, changes in procurement policies, budgetary considerations including Congressional delays in completing appropriation bills as occurred in 2011, domestic crises, and international political developments. If agencies and departments of the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue and operating results would be adversely affected.

**Our reliance on third-party suppliers poses significant risks to our operating results, business and prospects.** We rely upon third-party vendors to supply processors for our systems and storage subsystems and use service providers to co-develop key technologies, including integrated circuit design and verification. We subcontract the manufacture of a majority of the hardware components for our high-end products, including integrated circuits, printed circuit boards, connectors, cables, power supplies and memory parts, on a sole or limited source basis to third-party suppliers. We use contract manufacturers to assemble certain important components for all of our systems. We also rely on third parties to supply key software and hardware capabilities, such as file systems, solution-specific servers and storage subsystems. In addition, we use original equipment manufacturers to deliver complete Cray CX systems. Because specific processors must be designed into our systems well in advance of initial deliveries of those systems, we are particularly reliant on our processor vendors to deliver on the capabilities and pricing expected at the time we design the processor into the system. We are subject to substantial risks because of our reliance on these and other limited or sole source suppliers, including the following risks:

We rely on components that are manufactured in whole or in part in Japan and if we are unable to obtain these components in sufficient quantities on time as a result of effects of the natural and nuclear disasters in Japan, then production and sales of our systems could be delayed;

If a supplier does not provide components that meet our specifications in sufficient quantities on time, then production and sales of our systems could be delayed;



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**Table of Contents**

If an interruption of supply of our components, services or capabilities occurs because a supplier changes its technology roadmap, decides to no longer provide those products or services, increases the price of those products or services significantly or imposes reduced delivery allocations on its customers, it could take us a considerable period of time to identify and qualify alternative suppliers, to redesign our products as necessary and to begin to manufacture the redesigned components or otherwise obtain those services or capabilities. In some cases, such as with key integrated circuits and memory parts or processors, we may not be able to redesign such components or find alternate sources that we could use in any realistic timeframe;

If a supplier of a component is subject to a claim that the component infringes a third party's intellectual property rights, as has recently happened with one of our suppliers, our ability to obtain necessary components could be adversely affected or our cost to obtain such components could increase significantly;

If a supplier providing us with key research and development and design services or core technology components with respect to integrated circuit design, network communication capabilities or software is late, fails to provide us with effective functionality or loses key internal talent, our development programs may be delayed or prove to be impossible to complete;

If a supplier cannot provide a competitive key component (for example, due to inadequate performance or a prohibitive price) or eliminates key features from components, such as with the processors we design into our systems, our systems may be less competitive than systems using components with greater capabilities;

If a supplier provides us with hardware or software that contains bugs or other errors or is different from what we expected, our development projects and production systems may be adversely affected through reduced performance or capabilities, additional design testing and verification efforts, re-spins of integrated circuits and/or development of replacement components, and the production and sales of our systems could be delayed and systems installed at customer sites could require significant, expensive field component replacements or result in penalties;

Some of our key component and service suppliers are small companies with limited financial and other resources, and consequently may be more likely to experience financial and operational difficulties than larger, well-established companies, which increases the risk that they will be unable to deliver products as needed; and

If a key supplier is acquired or has a significant business change, such as the acquisition of our file system software provider by our competitor Sun Microsystems and the subsequent acquisition of Sun by Oracle, the production and sales of our systems and services may be delayed or adversely affected, or our development programs may be delayed or may be impossible to complete.

For example, our DARPA HPCS project was adversely affected by changes by a major microprocessor supplier in its high performance technology roadmap that affected our ability to complete that program successfully and resulted in a reduction in the amount of funding we could receive from DARPA by \$60 million. In addition, our Cray XE6 and Cray XE6m systems are based on certain AMD Opteron processors. Delays in the availability of certain acceptable reliable components, including processors and memory parts, and increases in order lead times for certain components, adversely affected our revenue and operating results in prior periods, and could adversely affect results for 2011 and in subsequent periods. In addition, planned upgrades to our Cray XE6 and Cray XE6m systems in 2011 are dependent upon third party processors not yet commercially available. Delays of or issues with these future processors could adversely affect revenue in 2011 and in subsequent periods.

**If we are unable to compete successfully in the highly competitive HPC market, our business will not be successful.** The market for HPC systems is very competitive. An increase in competitive pressures in our market or our failure to compete effectively may result in pricing reductions, reduced gross margins and loss of market share and revenue. Many of our competitors are established companies well known in the HPC market, including IBM, NEC, Hewlett-Packard, Fujitsu, Hitachi, Silicon Graphics International, Bull S.A. and Sun Microsystems (now Oracle). Most of these competitors have substantially greater research, engineering, manufacturing, marketing and financial resources than we do. We also compete with systems builders and resellers of systems that are constructed from commodity components using processors manufactured by Intel, AMD and others. These competitors include the companies named above and Dell, with IBM using both third-party processors and its own proprietary processors, as well as smaller firms that benefit from the low research and development costs needed to assemble systems from commercially available commodity products. Such companies, because they can offer high peak performance per dollar,

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can put pricing pressure on us in certain competitive procurements. In addition, to the extent that Intel, IBM and other processor suppliers develop processors with greater capabilities or at a lower cost than the processors we currently use from AMD or design, our Cray XT6, Cray XT6m, Cray XE6, Cray XE6m and successor systems may be at a competitive disadvantage to systems utilizing such other processors until we can design in, integrate and secure competitive processors, if at all. Although our April 2008 collaboration with Intel was intended to help mitigate this risk, Intel processors are not expected to be delivered in our supercomputers targeted at the high-end of the supercomputer market segment until 2013.

## **Table of Contents**

Periodic announcements by our competitors of new HPC systems or plans for future systems and price adjustments may reduce customer demand for our products. Many of our potential customers already own or lease high performance computer systems. Some of our competitors may offer substantial discounts to potential customers. We have in the past and may again be required to provide substantial discounts to make strategic sales, which may reduce or eliminate any gross profit on such transactions, or to provide lease financing for our products, which could result in a deferral of our receipt of cash and revenue for these systems. These developments limit our revenue and resources and reduce our ability to be profitable.

**If we are unable to secure additional government research and development funding, our desired strategy would be adversely affected and our ability to conduct research and development would decrease.** The significant government research and development funding we receive from the DARPA HPCS program is scheduled to end in 2012. If we are unable to secure sufficient additional government research and development funding beyond 2012, in particular funding targeted for exascale computing initiatives, our desired strategy would be adversely affected and our ability to continue research and development efforts on next-generation systems would decrease.

**If we are unable to successfully sell and deliver our Cray XE6 systems and develop, sell and deliver successor systems, our operating results will be adversely affected.** We expect that a significant portion of our revenue in the foreseeable future will come from sales and deliveries of Cray XE6 and successor systems, and upgrades such as integration of GPU accelerators or future processors. Because of the long technology development cycles required to compete effectively in this market, we must begin development of products years ahead of our ability to sell such systems. With procurements for large systems that require that we link together multiple cabinets containing powerful processors and other components into an integrated system, our Cray XE6 and successor systems must also scale to unprecedented levels of performance. During our internal testing and the customer acceptance processes, we may discover that we cannot achieve acceptable system stability or scalability across these large systems without incurring significant additional delays and expense. Any additional delays in receiving acceptable components or in product development, assembly, final testing and obtaining large system stability would delay delivery, installation and acceptance of Cray XE6 and successor systems.

Many factors affect our ability to successfully develop and sell these systems, including the following:

The level of product differentiation in our Cray XE6 and successor systems. We need to compete successfully against HPC systems from large established companies and lower bandwidth, commodity cluster systems from both large, established companies and smaller firms and demonstrate the value of our balanced high bandwidth systems.

Our ability to meet all customer requirements for acceptance. Even once a system has been delivered, we sometimes do not meet all of the contract requirements for customer acceptance and ongoing reliability of our systems within the provided-for acceptance period, which has resulted in contract penalties and delays in our ability to recognize revenue from system deliveries. Most often these penalties adversely affect gross profit through the provision of additional equipment and services and/or service credits to satisfy delivery delays and performance shortfalls. The risk of contract penalties is increased when we bid for new business prior to completing development of new products when we must estimate future system performance, such as was required with our new Cray XE6 systems.

Our ability to source competitive, key components in appropriate quantities, in a timely fashion and on acceptable terms and conditions. For example, in March 2008, we placed a last-time buy for a key component for our Cray XT4, Cray XT5, Cray XT6 and Cray XMT systems prior to it becoming unavailable, which had to be placed before we could know all the possible sales prospects for these products or when the key component could be made obsolete by a successor component. If we underestimated our needs, we could limit the number of possible sales of these products and reduce potential revenue, or if we overestimated, we could incur inventory obsolescence charges and reduce our gross profit. Beginning in 2009 through March 31, 2011, we have written off approximately \$5.0 million of estimated excess inventory primarily related to this key component, and we may be required to write off some of the \$0.2 million remaining inventory in the future.

Whether potential customers delay purchases of our products because they decide to wait for successor systems or upgrades that we have announced or they believe will be available in the future.

Failure to successfully sell our Cray XE6 systems and develop and sell upgrades and successor systems into the high-end of the HPC market will adversely affect our operating results.

**Customers and other third parties may make statements speculating about or announcing an intention to complete purchases of Cray products before such purchases are substantially certain, and these proposed purchases may not be completed when or as expected, if at all.** From time to time, customers and other third parties may make statements speculating about or announcing a potential purchase of Cray products before Cray has obtained an order for such purchases or completed negotiations and signed a contract for the purchase of such products. In some instances, government and government-funded customers may announce possible purchases even before they have obtained the necessary budget to procure the products. As a result, these statements or announcements do not mean that Cray will ultimately be able to secure the sale when or as expected or at all as it is not certain that the contract or order negotiations will be completed successfully or as expected or that the customer will be able to obtain the budget they hope for or expect.

**The continuing commoditization of HPC hardware and software has resulted in pricing pressure and may adversely affect our operating results.** The continuing commoditization of HPC hardware, particularly processors and interconnect systems, and the growing commoditization of software, including plentiful building blocks and more capable open source software, has resulted in the expansion and acceptance of lower-bandwidth cluster systems using processors manufactured by Intel, AMD and others combined with commercially available commodity networking and other components, particularly in the middle and lower segments of the HPC market. These systems may offer higher theoretical peak performance for equivalent cost than equivalent Cray systems, and price/peak performance is often the dominant factor in HPC procurements outside of the high-end HPC or supercomputer market segment. Vendors of such systems often put pricing pressure on us in competitive procurements, even at times in larger procurements, and this pricing pressure may cause us to reduce our pricing in order to remain competitive which can negatively impact our gross margins and adversely affect our operating results.

## **Table of Contents**

**Failure to overcome the technical challenges of developing competitive supercomputer systems well in advance of when they can be sold would adversely affect our revenue and operating results in subsequent years.** We continue to develop successor systems to the Cray XE6 systems and incorporate Intel technologies into our products as part of our DARPA HPCS program. We are also planning to incorporate GPU accelerators into our Cray XE6 products. The incorporation of graphic processing units into our systems designed for the supercomputing segment of the market poses unique challenges in both hardware and software integration.

These development efforts are lengthy and technically challenging processes, and require a significant investment of capital, engineering and other resources often years ahead of the time when we can be assured they will result in competitive products. We may invest significant resources in alternatives that prove ultimately unfruitful. Unanticipated performance and/or development issues may require more engineers, time or testing resources than are currently available. In the past several years, directing engineering resources to solving current issues has adversely affected the timely development of successor products required for our longer-term product roadmap. Given the breadth of our engineering challenges and our limited engineering and technical personnel resources, we periodically review the anticipated contributions and expense of our product programs to determine their long-term viability, and we may substantially modify or terminate one or more development programs. We may not be successful in meeting our development schedules for technical reasons and/or because of insufficient engineering resources, which could result in an uncompetitive product or cause a lack of confidence in our capabilities among our key customers. To the extent we incur delays in completing the design, development and production of hardware components, delays in development of requisite system software, cancellation of programs due to technical or economic infeasibility or invest in unproductive development efforts, our revenue, results of operations and cash flows, and the reputation of such systems in the market, could be adversely affected.

**We are subject to increasing government regulations and other requirements due to the nature of our business, which may adversely affect our business operations.** In 2008, 2009 and 2010 and the first three months of 2011, 81%, 72%, 62% and 56% respectively, of our revenue were derived from the U.S. government or customers primarily serving the U.S. government. Our growth in custom engineering is also currently primarily directed at the government market. In addition to normal business risks, our contracts with the U.S. government are subject to unique risks, some of which are beyond our control. Our contracts with the U.S. government are subject to particular risks, including:

*The funding of U.S. government programs is subject to congressional appropriations.* Many of the U.S. government programs in which we participate may extend for several years; however, these programs are normally funded annually. Changes in U.S. strategy and priorities may affect our future procurement opportunities and existing programs. Long-term government contracts and related orders are subject to cancellation, or delay, if appropriations for subsequent performance periods are not made. The termination of funding for existing or new U.S. government programs could result in a material adverse effect on our results of operations and financial condition.

*The U.S. government may modify, curtail or terminate its contracts with us.* The U.S. government may modify, curtail or terminate its contracts and subcontracts with us, without prior notice at its convenience upon payment for work done and commitments made at the time of termination. Modification, curtailment or termination of our major programs or contracts could have a material adverse effect on our results of operations and financial condition.

*Our U.S. government contract costs are subject to audits by U.S. government agencies.* U.S. government representatives may audit the costs we incur on our U.S. government contracts, including allocated indirect costs. Such audits could result in adjustments to our contract costs. Any costs found to be improperly allocated to a specific contract will not be reimbursed, and such costs already reimbursed must be refunded. If any audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government.

*Our business is subject to potential U.S. government inquiries and investigations.* We may be subject to U.S. government inquiries and investigations of our business practices due to our participation in government contracts. Any such inquiry or investigation could potentially result in a material adverse effect on our results of operations and financial condition.

*Our U.S. government business is also subject to specific procurement regulations and other requirements.* These requirements, although customary in U.S. government contracts, increase our performance and compliance costs. These costs might increase in the future, reducing our margins, which could have a negative effect on our financial condition. Failure to comply with these regulations and requirements could lead to suspension or debarment, for cause, from U.S. government contracting or subcontracting for a period of time and could have a negative effect on our reputation and ability to secure future U.S. government contracts.



## **Table of Contents**

*U.S. export controls could hinder our ability to make sales to foreign customers and our future prospects.* The U.S. government regulates the export of HPC systems such as our products. Occasionally we have experienced delays for up to several months in receiving appropriate approvals necessary for certain sales, which have delayed the shipment of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to foreign customers, eliminating an important source of potential revenue. Our ability to have certain components manufactured in foreign countries for a lower cost has also been adversely affected by export restrictions covering information necessary to allow such foreign manufacturers to manufacture components for us.

**If we cannot retain, attract and motivate key personnel, we may be unable to effectively implement our business plan.** Our success depends in large part upon our ability to retain, attract and motivate highly skilled management, development, marketing, sales and service personnel. The loss of and failure to replace key engineering management and personnel could adversely affect multiple development efforts. Recruitment and retention of senior management and skilled technical, sales and other personnel is very competitive, and we may not be successful in either attracting or retaining such personnel. From time to time, we have lost key personnel to other high technology companies. As part of our strategy to attract and retain key personnel, we may offer equity compensation through stock options and restricted stock grants. Potential employees, however, may not perceive our equity incentives as attractive, and current employees who have significant options with exercise prices significantly above current market values for our common stock may seek other employment. In addition, due to the intense competition for qualified employees, we may be required to increase the level of compensation paid to existing and new employees, which could materially increase our operating expenses.

**Our stock price is volatile.** The trading price of our common stock is subject to significant fluctuations in response to many factors, including our quarterly operating results, changes in analysts' estimates or our outlook, our capital raising activities, announcements of technological innovations and customer contracts by us or our competitors, a significant aggressive seller or buyer, general economic conditions and conditions in our industry.

**We may infringe or be subject to claims that we infringe the intellectual property rights of others.** Third parties in the past have asserted, and may in the future assert intellectual property infringement claims against us. As a result of such intellectual property infringement claims, we could be required or otherwise decide that it is appropriate to:

pay third-party infringement claims;

discontinue manufacturing, using, or selling particular products subject to infringement claims;

discontinue using the technology or processes subject to infringement claims;

develop other technology not subject to infringement claims, which could be time-consuming and costly or may not be possible; or

license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms.

Regardless of the merits, any intellectual property infringement claim would require management attention and could be expensive to defend.

**We incorporate software licensed from third parties into the operating systems for our products as well as in our tools to design products and any significant interruption in the availability of these third-party software products or defects in these products could reduce the demand for our products or cause delay in development.** The operating system software we develop for our HPC systems contains components that are licensed to us under open source software licenses. Our business could be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case we would be required to redesign our operating system software to function with alternative third-party software, or develop these components ourselves, which would result in increased costs and could result in delays in product shipments. Our Cray CX, Cray XT, Cray XE and successor systems utilize software system variants that incorporate Linux technology. The open source licenses under which we have obtained certain components of our operating system software may not be enforceable. Any ruling by a court that these licenses are not enforceable, or that Linux-based operating systems, or significant portions of them, may not be copied, modified or distributed as provided in those licenses, would

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adversely affect our ability to sell our systems. In addition, as a result of concerns about the risks of litigation and open source software generally, we may be forced to protect our customers from potential claims of infringement. In any such event, our financial condition and results of operations may be adversely affected.

We also incorporate proprietary incidental software from third parties, such as for file systems, job scheduling and storage subsystems. We have experienced some functional issues in the past with implementing such software with our supercomputer systems. In addition, we may not be able to secure needed software systems on acceptable terms, which may make our systems less attractive to potential customers. These issues may result in lost revenue, additional expense by us and/or loss of customer confidence.

## **Table of Contents**

**We are required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 at the end of each fiscal year, and any adverse results from such future evaluations could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.** Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we are required to furnish a report by our management and a report by our independent registered public accounting firm on our internal control over financial reporting in our annual reports on Form 10-K as to whether we have any material weaknesses in our internal controls over financial reporting. Depending on their nature and severity, any future material weaknesses could result in our having to restate financial statements, could make it difficult or impossible for us to obtain an audit of our annual financial statements or could result in a qualification of any such audit. In such events, we could experience a number of adverse consequences, including our inability to comply with applicable reporting and listing requirements, a loss of market confidence in our publicly available information, delisting from the NASDAQ Global Market, an inability to complete a financing, loss of other financing sources such as our line of credit, and litigation based on the events themselves or their consequences.

**We may not be able to protect our proprietary information and rights adequately.** We rely on a combination of patent, copyright and trade secret protection, nondisclosure agreements and licensing arrangements to establish, protect and enforce our proprietary information and rights. We have a number of patents and have additional applications pending. There can be no assurance, however, that patents will be issued from the pending applications or that any issued patents will protect adequately those aspects of our technology to which such patents will relate. Despite our efforts to safeguard and maintain our proprietary rights, we cannot be certain that we will succeed in doing so or that our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technologies. The laws of some countries do not protect intellectual property rights to the same extent or in the same manner as do the laws of the United States. Additionally, under certain conditions, the U.S. government might obtain non-exclusive rights to certain of our intellectual property. Although we continue to implement protective measures and intend to defend our proprietary rights vigorously, these efforts may not be successful.

**Provisions of our Restated Articles of Incorporation and Bylaws could make a proposed acquisition of Cray that is not approved by our Board of Directors more difficult.** Provisions of our Restated Articles of Incorporation and Bylaws could make it more difficult for a third party to acquire us. These provisions could limit the price that investors might be willing to pay in the future for our common stock. For example, our Restated Articles of Incorporation and Bylaws provide for:

removal of a director only in limited circumstances and only upon the affirmative vote of not less than two-thirds of the shares entitled to vote to elect directors;

the ability of our Board of Directors to issue up to 5,000,000 shares of preferred stock, without shareholder approval, with rights senior to those of the common stock;

no cumulative voting of shares;

the right of shareholders to call a special meeting of the shareholders only upon demand by the holders of not less than 30% of the shares entitled to vote at such a meeting;

the affirmative vote of not less than two-thirds of the outstanding shares entitled to vote on an amendment, unless the amendment was approved by a majority of our continuing directors, who are defined as directors who have either served as a director since August 31, 1995, or were nominated to be a director by the continuing directors;

special voting requirements for mergers and other business combinations, unless the proposed transaction was approved by a majority of continuing directors;

special procedures to bring matters before our shareholders at our annual shareholders meeting; and

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special procedures to nominate members for election to our Board of Directors.

These provisions could delay, defer or prevent a merger, consolidation, takeover or other business transaction between us and a third-party that is not approved by our Board of Directors.

**Table of Contents**

**Item 6. Exhibits**

- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certificate pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**Table of Contents**

**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.

Date: May 9, 2011

**CRAY INC.**

/s/ PETER J. UNGARO

**Peter J. Ungaro**  
**President and Chief Executive Officer**

/s/ BRIAN C. HENRY

**Brian C. Henry**  
**Executive Vice President and Chief Financial Officer**

/s/ CHARLES D. FAIRCHILD

**Charles D. Fairchild**  
**Vice President, Corporate Controller and Chief Accounting Officer**