CRAY INC
Form 10-Q
July 31, 2012
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# 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: June 30, 2012**

**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)**

| Washington | 93-0962605 |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| 901 Fifth Avenue, Suite 1000 | |
| Seattle, Washington | 98164 |
| (Address of Principal Executive Office) | (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 x 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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.

| | |
|---|---|
| Large accelerated filer ¨ | Accelerated filer x |
| 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 x

As of July 27, 2012, there were 38,457,538 shares of Common Stock issued and outstanding.

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**CRAY INC.**

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**Available Information**

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 as soon as reasonably practicable after we electronically file such reports with the SEC.

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*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)

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 219,459 | $ 50,411 |
| Restricted cash | 3,500 | 3,776 |
| Accounts and other receivables, net | 101,695 | 72,381 |
| Inventory | 131,537 | 97,881 |
| Prepaid expenses and other current assets | 11,986 | 12,932 |
| Total current assets | 468,177 | 237,381 |
| Property and equipment, net | 16,624 | 16,462 |
| Service inventory, net | 1,506 | 1,611 |
| Deferred tax assets | 13,042 | 13,352 |
| Other non-current assets | 13,014 | 14,293 |
| TOTAL ASSETS | $ 512,363 | $ 283,099 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 37,153 | $ 38,328 |
| Accrued payroll and related expenses | 19,603 | 11,270 |
| Other accrued liabilities | 12,754 | 5,414 |
| Deferred revenue | 83,316 | 44,636 |
| Total current liabilities | 152,826 | 99,648 |
| Long-term deferred revenue | 29,631 | 14,184 |
| Other non-current liabilities | 2,494 | 2,453 |
| TOTAL LIABILITIES | 184,951 | 116,285 |
| Shareholders equity: | | |
| Preferred stock Authorized and undesignated, 5,000,000 shares; no shares issued or outstanding | 0 | 0 |
| Common stock and additional paid-in capital, par value $.01 per share Authorized, 75,000,000 shares; issued and outstanding 38,100,662 and 36,763,379 shares, respectively | 572,672 | 564,148 |
| Accumulated other comprehensive income | 6,168 | 6,480 |
| Accumulated deficit | (251,428) | (403,814) |
| TOTAL SHAREHOLDERS EQUITY | 327,412 | 166,814 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | $ 512,363 | $ 283,099 |

*See accompanying notes*

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CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Revenue: | | | | |
| Product | $ 68,516 | $ 47,654 | $ 164,493 | $ 64,350 |
| Service | 15,667 | 20,266 | 31,997 | 43,437 |
| Total revenue | 84,183 | 67,920 | 196,490 | 107,787 |
| Cost of revenue: | | | | |
| Cost of product revenue | 39,521 | 31,638 | 97,071 | 42,955 |
| Cost of service revenue | 10,167 | 10,528 | 19,768 | 21,878 |
| Total cost of revenue | 49,688 | 42,166 | 116,839 | 64,833 |
| Gross profit | 34,495 | 25,754 | 79,651 | 42,954 |
| Operating expenses: | | | | |
| Research and development, net | 6,893 | 18,464 | 30,643 | 24,920 |
| Sales and marketing | 10,233 | 6,373 | 18,106 | 12,729 |
| General and administrative | 4,971 | 3,777 | 10,101 | 7,914 |
| Restructuring | 0 | 58 | 0 | 1,176 |
| Total operating expenses | 22,097 | 28,672 | 58,850 | 46,739 |
| Net Gain on sale of Interconnect Hardware Development Program | 139,068 | | 139,068 | |
| Income (loss) from operations | 151,466 | (2,918) | 159,869 | (3,785) |
| Other income (expense), net | 245 | 193 | 465 | (350) |
| Interest income, net | 37 | 23 | 36 | 40 |
| Income (loss) before income taxes | 151,748 | (2,702) | 160,370 | (4,095) |
| Income tax expense | (4,326) | (256) | (7,984) | (348) |
| Net income (loss) | $ 147,422 | $ (2,958) | $ 152,386 | $ (4,443) |
| Basic net income (loss) per common share | $ 4.05 | $ (0.08) | $ 4.24 | $ (0.13) |
| Diluted net income (loss) per common share | $ 3.91 | $ (0.08) | $ 4.12 | $ (0.13) |
| Basic weighted average shares outstanding | 36,367 | 35,040 | 35,947 | 34,911 |
| Diluted weighted average shares outstanding | 37,682 | 35,040 | 36,956 | 34,911 |

*See accompanying notes*

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CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited and in thousands)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net income (loss) | $ 147,422 | $ (2,958) | $ 152,386 | $ (4,443) |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustments | 210 | (231) | 325 | (96) |
| Unrealized gain (loss) on cash flow hedges | 562 | (1,203) | (195) | (3,634) |
| Reclassification adjustments on cash flow hedges included in net income | (53) | | (442) | 1,016 |
| Other comprehensive income (loss) | 719 | (1,434) | (312) | (2,714) |
| Comprehensive income (loss) | $ 148,141 | $ (4,392) | $ 152,074 | $ (7,157) |

*See accompanying notes*

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CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2012 | 2011 |
| Operating activities: | | |
| Net income (loss) | $ 152,386 | $ (4,443) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,047 | 4,279 |
| Loss on disposal of fixed assets | 10 | 141 |
| Net gain on sale of interconnect hardware development program | (139,068) | 0 |
| Share-based compensation expense | 2,435 | 2,106 |
| Inventory write-down | 2,329 | |
| Deferred income taxes | 2,870 | 63 |
| Cash provided (used) due to changes in operating assets and liabilities: | | |
| Accounts and other receivables | (29,234) | 85,577 |
| Inventory | (37,869) | 488 |
| Prepaid expenses and other assets | (425) | 1,483 |
| Accounts payable | (1,172) | 2,466 |
| Accrued payroll and related expenses and other accrued liabilities | 15,079 | (13,437) |
| Other non-current liabilities | 41 | 710 |
| Deferred revenue | 54,276 | (3,906) |
| Net cash provided by operating activities | 25,705 | 75,527 |
| Investing activities: | | |
| Decrease in restricted cash | 276 | 135 |
| Proceeds from the sale of interconnect hardware development program, net | 139,225 | 0 |
| Purchases of property and equipment | (2,315) | (2,276) |
| Net cash provided by (used in) investing activities | 137,186 | (2,141) |
| Financing activities: | | |
| Proceeds from issuance of common stock through employee stock purchase plan | 196 | 186 |
| Proceeds from exercises of stock options | 5,893 | 552 |
| Net cash provided by financing activities | 6,089 | 738 |
| Effect of foreign exchange rate changes on cash and cash equivalents | 68 | 322 |
| Net increase in cash and cash equivalents | 169,048 | 74,446 |
| Cash and cash equivalents: | | |
| Beginning of period | 50,411 | 57,381 |
| End of period | $ 219,459 | $ 131,827 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | $ 48 | $ 47 |
| Cash paid for income taxes | $ 799 | $ 1,443 |
| Non-cash investing and financing activities: | | |
| Inventory transfers to fixed assets and service inventory | $ 1,884 | $ 751 |

*See accompanying notes*

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CRAY INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**Note 1 Basis of Presentation**

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, Statements of Operations, Statements of Comprehensive Income (Loss), 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, 2011.

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.

**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 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.

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 the Company s prices or competitor prices for similar deliverables when sold separately. However, the Company is often unable to determine TPE, as the Company s offerings contain a significant level of customization and differentiation from those of competitors and the Company is often unable to reliably determine what similar competitor products selling prices are on a standalone basis.

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 upon customer acceptance of the system, when the price is fixed or determinable, collection is reasonably assured and no significant unfulfilled obligations exist.

*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

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.

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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.

*Nonmonetary Transactions*. We value and record nonmonetary transactions at the fair value of the asset surrendered unless the fair value of the asset received is more clearly evident, in which case the fair value of the asset received is used.

**Note 2 New Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board issued ASU No. 2011-05, *Comprehensive Income,* or ASU 2011-05. The guidance in ASU 2011-05 revises the manner in which entities present comprehensive income in their financial statements. An entity is required to report the components of comprehensive income in either one or two consecutive financial statements:

A single, continuous statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income.

In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income.

ASU 2011-05 does not change the items that must be reported in other comprehensive income. The amendments in ASU 2011-05 are effective for fiscal years beginning after December 15, 2011 and the Company adopted this guidance during the three months ended March 31, 2012. The Company has elected to present a separate Condensed Consolidated Statements of Comprehensive Income.

**Note 3 Sale of Interconnect Hardware Development Program**

On May 2, 2012, the Company sold its interconnect hardware development program to Intel Corporation ( Intel ) for cash consideration of $140 million. As part of the transaction, 73 of the Company s employees joined Intel, and certain intellectual property and fixed assets were transferred to Intel. The Company retained certain rights to use the transferred assets and intellectual property. As a result of the sale, the Company recorded a gain of $139.1 million in Net Gain on Sale of Interconnect Hardware Development Program on the Condensed Consolidated Statements of Operations in the three and six month periods ended June 30, 2012.

**Note 4 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 June 30, 2012, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands):

| Description | Fair Value at June 30, 2012 | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Assets: | | | |
| Cash, cash equivalents and restricted cash | $ 222,959 | $ 222,959 | $ 0 |
| Foreign exchange forward contracts (1) | 1,395 | 0 | 1,395 |
| Assets measured at fair value at June 30, 2012 | $ 224,354 | $ 222,959 | $ 1,395 |
| Liabilities: | | | |
| Foreign exchange forward contracts (2) | $ 36 | $ 0 | $ 36 |
| Liabilities measured at fair value at June 30, 2012 | $ 36 | $ 0 | $ 36 |

(1) Included in Prepaid expenses and other current assets and Other non-current assets on the Company s Condensed Consolidated Balance Sheets.

(2) Included in Other accrued liabilities and Other non-current liabilities on the Company s Condensed Consolidated Balance Sheets.

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*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 June 30, 2012, 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 approximately 18.7 million Euro and 745.4 million of Japanese yen and hedged foreign currency exposure of approximately $34.5 million. Cash receipts associated with the hedged contracts are expected to be received from 2012 through 2014, during which time the revenue on the associated sales contracts is expected to be recognized.

As of December 31, 2011, the outstanding notional amounts were approximately 3.5 million British pound sterling, 33.7 million Euro and 20.6 million Norwegian krona and hedged foreign currency exposure of approximately $55.8 million.

Fair Values of Derivative Instruments (in thousands):

| Hedge Classification | Balance Sheet Location | Fair Value as of June 30, 2012 | Fair Value as of December 31, 2011 |
|---|---|---|---|
| Foreign currency contracts | Prepaid expenses and other current assets | $ 1,315 | $ 2,117 |
| Foreign currency contracts | Other non-current assets | 80 | $ 1,134 |
| Foreign currency contracts | Other accrued liabilities | (7) | $ (3) |
| Foreign currency contracts | Other non-current liabilities | (29) | |
| Total derivatives classified as hedging instruments | | $ 1,359 | $ 3,248 |

As of June 30, 2012 and December 31, 2011, foreign currency gains of $1.4 million and $2.1 million, respectively, were included in Accumulated other comprehensive income on the Company s Condensed Consolidated Balance Sheets. For the three and six months ended June 30, 2012, the Company recorded $53,000 and $0.4 million in net reclassification adjustments, which increased product revenue, as revenue on the associated sales contracts was recognized. For the three and six months ended June 30, 2011, the Company recorded $0 and $1.0 million, respectively, in net reclassification adjustments, which reduced product revenue, as revenue on the associated sales contracts was recognized.

**Note 5 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 and six month periods ended June 30, 2011, 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 and six-month periods ended June 30, 2012, the added shares from these items included in the calculation of diluted shares and EPS totaled approximately 1.3 million and 1.0 million, respectively. For the three and six-month periods ended June 30, 2011, potential gross common shares of 4.3 million were antidilutive and not included in computing diluted EPS. For the three and six-month periods ended June 30, 2012, potential gross common shares of 0.2 million and 0.8 million, respectively, were antidilutive and not included in computing diluted EPS.

**Note 6 Accounts and Other Receivables, Net**

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

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| Trade accounts receivable | $ 70,363 | $ 34,927 |
| Unbilled receivables | 685 | 7,307 |
| Advance billings | 30,189 | 24,490 |
| Other receivables | 494 | 5,767 |
| | 101,731 | 72,491 |
| Allowance for doubtful accounts | (36) | (110) |
| Accounts and other receivables, net | $ 101,695 | $ 72,381 |

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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 June 30, 2012 and December 31, 2011, accounts receivable included $36.2 million and $32.2 million, respectively, due from U.S. government agencies and customers primarily serving the U.S. government. Of this amount, $0.3 million and $0.7 million were unbilled as of June 30, 2012 and December 31, 2011, respectively, based upon contractual billing arrangements with these customers. As of June 30, 2012, one non-U.S. government customer accounted for 57% of total accounts receivable. As of December 31, 2011, one non-U.S. government customers accounted for 30% of total accounts receivable.

**Note 7 Inventory**

Inventory consisted of the following (in thousands):

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| Components and subassemblies | $ 18,486 | $ 29,402 |
| Work in process | 8,623 | 19,956 |
| Finished goods | 104,428 | 48,523 |
| Total | $ 131,537 | $ 97,881 |

Finished goods inventory of $103.8 million and $47.9 million was located at customer sites pending acceptance as of June 30, 2012 and December 31, 2011, respectively. At June 30, 2012, one customer accounted for $88.5 million, and at December 31, 2011, two customers accounted for $46.4 million of finished goods inventory.

During the three and six months ended June 30, 2012, the Company wrote off $0.8 million and $2.3 million of inventory, related to the Cray XE and Cray XK product lines. There were no write offs during the three and six months ended June 30, 2011.

**Note 8 Deferred Revenue**

Deferred revenue consisted of the following (in thousands):

| | June 30, 2012 | December 31, 2011 |
|---|---|---|
| Deferred product revenue | $ 68,715 | $ 22,068 |
| Deferred service revenue | 44,232 | 36,752 |
| Total deferred revenue | 112,947 | 58,820 |
| Less long-term deferred revenue | (29,631) | (14,184) |
| Deferred revenue in current liabilities | $ 83,316 | $ 44,636 |

As of June 30, 2012, three customers accounted for 67% of total deferred revenue. At December 31, 2011, three customers accounted for 50% of total deferred revenue.

**Note 9 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.

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In determining fair value of stock options, the Company uses the Black-Scholes option pricing model. As no options were granted in the three or six month periods ended June 30, 2011, no calculation was performed. The following key weighted average assumptions were employed in the calculation for the three and six month periods ended June 30, 2012:

| | Three Months Ended June 30, 2012 | Six Months Ended June 30, 2012 |
|---|---|---|
| Risk-free interest rate | 0.5% | 0.6% |
| Expected dividend yield | 0% | 0% |
| Volatility | 74.9% | 75.3% |
| Expected life | 4.0 years | 4.0 years |
| Weighted average Black-Scholes value of options granted | $ 6.20 | $ 5.42 |

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 and six month periods ended June 30, 2012 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 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 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.

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.

The following table sets forth the gross share-based compensation cost resulting from stock options and unvested restricted stock grants and restricted stock units that was recorded in the Company s Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2012 and 2011 (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Cost of product revenue | $ 7 | $ 46 | $ 17 | $ 98 |
| Cost of service revenue | 69 | 99 | 134 | 207 |
| Research and development, net | 261 | 302 | 543 | 638 |
| Sales and marketing | 354 | 99 | 617 | 240 |
| General and administrative | 551 | 439 | 1,124 | 923 |
| Total | $ 1,242 | $ 985 | $ 2,435 | $ 2,106 |

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

| | Options | Weighted Average Exercise | Weighted Average Remaining |
|---|---|---|---|

| | | Price | Contractual Term |
|---|---|---|---|
| Outstanding at December 31, 2011 | 3,417,920 | $ 6.28 | |
| Grants | 25,500 | 9.81 | |
| Exercises | (1,057,768) | $ 5.57 | |
| Cancellations | (104,329) | $ 9.95 | |
| Outstanding at June 30, 2012 | 2,281,323 | $ 6.49 | 7.0 years |
| Exercisable at June 30, 2012 | 1,260,763 | $ 7.19 | 6.0 years |
| Available for grant at June 30, 2012 | 2,413,306 | | |

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As of June 30, 2012, there was $14.0 million of aggregate intrinsic value of outstanding stock options, including $7.4 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 second quarter of 2012 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 June 30, 2012. During the three and six months ended June 30, 2012, stock options covering 915,630 and 1,057,768 shares of common stock, respectively, with a total intrinsic value of $4.9 million and $5.4 million, respectively, were exercised. During the three and six months ended June 30, 2011, stock options covering 20,616 and 111,887 shares of common stock, respectively, with a total intrinsic value of $41,227 and $266,146, respectively, were exercised.

A summary of the Company s unvested restricted stock grants and restricted stock units and changes during the six month period ended June 30, 2012 is as follows:

| | Shares | Weighted Average Grant Date Fair Value |
|---|---|---|
| Outstanding at December 31, 2011 | 1,302,414 | $ 5.47 |
| Granted | 253,447 | 9.36 |
| Forfeited | (104) | 6.55 |
| Vested | (371,019) | 5.93 |
| Outstanding at June 30, 2012 | 1,184,738 | $ 6.16 |

The aggregate fair value of restricted stock vested during the six months ended June 30, 2012 was $4.0 million.

As of June 30, 2012, the Company had $7.9 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 2.1 years.

**Note 10 Taxes**

The Company recorded income tax expense of $4.3 million and $8.0 million, respectively, for the three and six months ended June 30, 2012. The primary reason for the difference between the expected statutory rate of 35% and the actual tax rates of 3% and 5% for the three and six months ended June 30, 2012 is that the gain from the sale of the Company s interconnect hardware development program did not result in significant income tax expense. The Company had existing deferred tax assets that were subject to valuation allowances and deductible temporary differences that were previously unrecognized. The sale of the interconnect hardware development program was never anticipated in previous evaluations of the realizability of the Company s deferred tax assets and consequently the sale, together with a tax benefit that was recognized as a result of a restructuring of the Company s Canadian operations, resulted in the Company s ability to experience a relatively small tax consequence from the sale.

The Company recorded income tax expense of $0.3 million and $0.3 million, respectively, for the three and six months ended June 30, 2011. The tax expense for the three and six months ended June 30, 2011 was primarily attributable to foreign income taxes payable.

During the three months ended June 30, 2012 the Company reduced the valuation allowance established at December 31, 2011 held against its U.S. deferred tax assets by $0.5 million based upon an evaluation of all available positive and negative evidence relating to future years. The Company considers its actual historical results over several years to have stronger weight than other more subjective indicators when considering whether to establish or reduce a valuation allowance on deferred tax assets. The assessment of the Company s ability to utilize its deferred tax assets included an assessment of all known business risks and industry trends as well as forecasted domestic and international earnings over a number of years. The Company s ability to forecast results significantly into the future is severely limited due to the rapid rate of technological change in the industry in which it operates. As a result of an improved business forecast over the next few quarters and the impact that the sale of the Company s interconnect hardware development program will have on its business, the Company concluded that it was more likely than not that additional deferred tax assets would be realized in future years.

The Company continues to provide a full valuation allowance against its net operating losses and other net deferred taxes in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not.

If management s conclusion about the realizability of the Company s deferred tax assets changes in a future period, the Company could record a substantial tax provision or benefit in its Consolidated Statement of Operations when that occurs.

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**Note 11 Segment Information**

The Company has undergone an organizational change and, beginning in 2012, has the following two reportable business segments: HPC Systems and Maintenance and Support. Those operating activities that do not meet the definition of a reportable segment are reported in Other below. 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.

*HPC Systems*

HPC Systems includes a suite of highly advanced systems, including the Cray XE6, Cray XE6m, Cray XK6, and Cray XK6m, which are used by single users all the way up through large research centers.

*Maintenance and Support*

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

*Other*

Included within Other is the Company s YarcData division, Storage and Data Management and the former Special Purpose Systems practice of Custom Engineering which is now referred to as Custom Engineering.

The following table presents revenues and gross margin for the Company s operating segments for the three and six months ended June 30 (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Revenue: | | | | |
| HPC Systems | $ 58,065 | $ 46,064 | $ 152,563 | $ 62,017 |
| Maintenance and Support | 14,963 | 15,955 | 30,013 | 31,315 |
| Other | 11,155 | 5,901 | 13,914 | 14,455 |
| Total revenue | $ 84,183 | $ 67,920 | $ 196,490 | $ 107,787 |
| Cost of Revenue: | | | | |
| HPC Systems | $ 33,420 | $ 30,549 | $ 89,829 | $ 41,271 |
| Maintenance and Support | 9,809 | 8,093 | 18,872 | 15,977 |
| Other | 6,459 | 3,524 | 8,138 | 7,585 |
| Total cost of revenue | $ 49,688 | $ 42,166 | $ 116,839 | $ 64,833 |
| Gross Profit: | | | | |
| HPC Systems | $ 24,645 | $ 15,515 | $ 62,734 | $ 20,746 |
| Maintenance and Support | 5,154 | 7,862 | 11,141 | 15,338 |
| Other | 4,696 | 2,377 | 5,776 | 6,870 |
| Total gross profit | $ 34,495 | $ 25,754 | $ 79,651 | $ 42,954 |

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.

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

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The Company s geographic operations outside the United States include sales and service offices in Canada, Brazil, Europe, Japan, Australia, India, South Korea, China 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):

| | United States | | Other Countries | | Total | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Three months ended June 30, | | | | | | |
| Product revenue | $ 45,244 | $ 39,739 | $ 23,272 | $ 7,915 | $ 68,516 | $ 47,654 |
| Service revenue | 9,738 | 13,687 | 5,929 | 6,579 | 15,667 | 20,266 |
| Total revenue | $ 54,982 | $ 53,426 | $ 29,201 | $ 14,494 | $ 84,183 | $ 67,920 |

| | United States | | Other Countries | | Total | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 | 2012 | 2011 |
| Six months ended June 30, | | | | | | |
| Product revenue | $ 122,476 | $ 47,219 | $ 42,017 | $ 17,131 | $ 164,493 | $ 64,350 |
| Service revenue | 19,698 | 31,038 | 12,299 | 12,399 | 31,997 | 43,437 |
| Total revenue | $ 142,174 | $ 78,257 | $ 54,316 | $ 29,530 | $ 196,490 | $ 107,787 |

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately $9.2 million and $94.4 million, respectively, for the three and six months ended June 30, 2012, compared to approximately $51.7 million and $73.9 million, respectively, for the three and six months ended June 30, 2011. For the six months ended June 30, 2012, one commercial customer in the U.S. accounted for 24% of total revenue and one customer in Canada accounted for 11% of total revenue. For the six months ended June 30, 2011, no customer other than the U.S. government accounted for more than 10% of total revenue.

**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 tha 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 our management; 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, 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. 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**

We design, develop, manufacture, market and service high-performance computing, or HPC, systems, commonly known as supercomputers, and provide storage solutions and engineering services related to HPC systems and solutions to our customers, which include government agencies, academic institutions and commercial entities. Our supercomputer systems provide capability and sustained performance far beyond typical

server-based computer systems and address challenging scientific, engineering, commercial and national security computing problems. 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 in areas where we can leverage our experience and technology, such as storage and data management, big data graph analytics, technical enterprise/midrange supercomputing systems and custom engineered solutions.

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***Summary of First Six Months of 2012 Results***

Total revenue increased $88.7 million for the first six months of 2012 compared to the first six months of 2011, from $107.8 million to $196.5 million, largely due to increased product revenue of $100.1 million. The increase in product revenue was primarily due to the revenue for the first phase of the upgrade at Oak Ridge National Laboratory that was recognized in the first three months of 2012. The increase in product revenue was partially offset by an $11.4 million decrease in service revenue, principally due to lower service revenue from our former Special Purpose Systems practice.

Net income for the first six months of 2012 was $152.4 million compared to a net loss of $4.4 million for the same period in 2011. The increase in net income was primarily attributable to the $139.1 million gain on the sale of our interconnect hardware development program to Intel and an increase in gross profit of $36.7 million. These were partially offset by an increase in income tax expense of $7.6 million and higher incentive compensation of $11.0 million.

Net cash provided by operating activities was $25.7 million for the first six months of 2012 compared to net cash provided by operating activities of $75.5 million for the first six months of 2011. Cash provided from operating activities in the first six months of 2012 was driven by large cash collections from multiple customers that accepted large systems in the fourth quarter of 2011 and first quarter of 2012, particularly the first phase of the upgrade at Oak Ridge National Laboratory. Cash provided by operating activities was partially offset by significant inventory purchases. Cash and cash equivalents, including restricted cash balances, were $223.0 million as of June 30, 2012 compared to $54.2 million as of December 31, 2011. The increase in cash and cash equivalents was principally from the $140 million in proceeds from the sale of our interconnect hardware development program and large cash collections, partially offset by a large increase in inventory.

***Market Overview and Challenges***

Significant trends in the HPC industry include:

- The commoditization of HPC hardware, particularly processors and system interconnects;
- 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;
- Electrical power requirements becoming a design constraint and driver in total cost of ownership determinations;
- Increased micro-architectural diversity, including increased usage of many-core processors and growing use of accelerators, as the rate of per-core performance increase slows; and
- Data needs growing faster than computational needs, which is driving the need for Big Data .

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, such as Infiniband and Ethernet, 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.

In the markets for the largest systems, those costing significantly in excess of $3 million, the use of commodity 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 and accelerators, 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 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 technologies that enable our supercomputers to perform at scale that is, to continue to increase actual performance as systems grow ever larger in size and in areas where we can leverage our core expertise in other markets. We also have demonstrated expertise in several processor technologies. 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, our 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 strategic initiatives, such as storage and data management, big data graph analytics through our YarcData subsidiary, technical enterprise/midrange supercomputing systems and custom engineered solutions.

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**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 from a small number of transactions 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. We believe product revenue growth over several sequential periods 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 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 product gross profit margin increased from 33% for the six months ended June 30, 2011 to 41% during the same period in 2012 principally due to a small number of high margin transactions and lower component costs. Service gross profit margin decreased from 50% for the six months ended June 30, 2011 to 38% for the six months ended June 30, 2012. The decrease in service gross profit margin was due to higher incentive compensation in 2012 and an additional $3.5 million in revenue recorded on a Custom Engineering contract in the first six months of 2011 where revenue was recorded on the cash basis as our ability to collect payment was not reasonably assured.

*Operating expenses.* Our operating expenses are driven largely by headcount, the level of recognized co-funding for research and development, contracted third-party research and development services and the level of incentive compensation accrued. The level of government co-funding can vary significantly from quarter to quarter and year to year as 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 largely due to varying milestone schedules, milestone completion risk and because funding from the U.S. government is subject to certain budget restrictions. Incentive compensation, excluding sales commissions, is recorded based on year-to-date operating income relative to the expected full year operating income. Operating expenses for the six months ended June 30, 2012 were $12.1 million higher than for the same period in 2011, increasing from $46.7 million to $58.9 million. The increase in operating expenses was caused by higher incentive compensation of $8.8 million, higher commissions as well as investments in new initiatives. These were partially offset by a $1.9 million increase in recognized co-funding R&D credits in 2012 and a non-recurring restructuring expense of $1.2 million in 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.

**Results of Operations**

Our 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 our 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, the timing of payments for product sales, maintenance services, government research and development funding, the impact of the timing of new products on customer orders, and purchases of inventory during periods of inventory build-up. As a result of these factors, revenue, gross margin, expenses, cash and inventory are expected to vary significantly from quarter-to-quarter and year-to-year.

***Revenue and Gross Profit Margins***

Our revenue, cost of revenue and gross profit margin for the three and six months ended June 30, 2012 and 2011, respectively, were (in thousands, except for percentages):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |

| | | | | |
|---|---|---|---|---|
| Product revenue | $ 68,516 | $ 47,654 | $ 164,493 | $ 64,350 |
| Less: Cost of product revenue | 39,521 | 31,638 | 97,071 | 42,955 |
| Product gross profit | $ 28,995 | $ 16,016 | $ 67,422 | $ 21,395 |
| Product gross profit margin | 42% | 34% | 41% | 33% |
| Service revenue | $ 15,667 | $ 20,266 | $ 31,997 | $ 43,437 |
| Less: Cost of service revenue | 10,167 | 10,528 | 19,768 | 21,878 |
| Service gross profit | $ 5,500 | $ 9,738 | $ 12,229 | $ 21,559 |
| Service gross profit margin | 35% | 48% | 38% | 50% |
| Total revenue | $ 84,183 | $ 67,920 | $ 196,490 | $ 107,787 |
| Less: Total cost of revenue | 49,688 | 42,166 | 116,839 | 64,833 |
| Total gross profit | $ 34,495 | $ 25,754 | $ 79,651 | $ 42,954 |
| Total gross profit margin | 41% | 38% | 41% | 40% |

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*Product Revenue*

Product revenue for the three and six months ended June 30, 2012 was $68.5 million and $164.5 million, respectively, primarily from sales of Cray XE6, Cray XK6 and Sonexion storage systems. Product revenue for the three and six months ended June 30, 2011 was $47.7 million and $64.4 million, respectively, primarily from sales of Cray XE systems and XE system upgrades. Product revenue for the six months ended June 30, 2012 was significantly higher than the prior year period primarily due to the recognition of revenue for several large systems in the six months ended June 30, 2012, including revenue of approximately $65 million for the first phase of the upgrade at Oak Ridge National Laboratory and a significant product sale to a commercial customer.

*Service Revenue*

Service revenue for the three months ended June 30, 2012 was $15.7 million compared to $20.3 million for the same period in 2011. Service revenue for the six months ended June 30, 2012 was $32.0 million compared to $43.4 million for the same period in 2011, a decrease of $11.4 million. The decrease in service revenue was primarily due to lower service revenue from our former Custom Engineering practices, particularly Special Purpose Systems.

*Cost of Product Revenue and Product Gross Profit*

For the three and six months ended June 30, 2012, cost of product revenue increased $7.9 million and $54.1 million, respectively, as a result of higher product revenues from the same period in 2011. For the three months ended June 30, 2012, product gross profit margin increased eight percentage points to 42% from the same period in 2011. The increase in product gross profit margin for the three months ended June 30, 2012 was attributable to a small number of large, higher margin transactions and lower costs on certain commodity components, partially offset by $0.8 million in inventory write-downs. Historical product gross profit margins may not be indicative of future results as product gross profit margins can vary significantly between contracts for many reasons.

*Cost of Service Revenue and Service Gross Profit*

Cost of service revenue decreased $0.4 million and service gross profit margin decreased by 13 percentage points to 35% during the three months ended June 30, 2012 compared to the same period in 2011. For the six months ended June 30, 2012, cost of service revenue decreased $2.1 million and service gross profit margin decreased by 12 percentage points to 38% compared to the same period in 2011. The decrease in service gross profit margin percentage was due to higher incentive compensation expense in 2012 and an additional $3.5 million in revenue recorded on a Custom Engineering contract in the first six months of 2011where revenue was recorded on a cash basis as our ability to collect payment was not reasonably assured and the related costs were incurred in a prior period.

***Research and Development Expenses***

Research and development expenses for the three and six months ended June 30, 2012 and 2011, respectively, were (in thousands, except for percentages):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2012** | **2011** | **2012** | **2011** |
| Gross research and development expenses | $ 22,015 | $ 19,187 | $ 46,037 | $ 38,405 |
| Less: Amounts included in cost of revenue | (122) | (108) | (232) | (216) |
| Less: Reimbursed research and development (excludes amounts in cost of revenue) | (15,000) | (615) | (15,162) | (13,269) |
| Net research and development expenses | $ 6,893 | $ 18,464 | $ 30,643 | $ 24,920 |
| Percentage of total revenue | 8% | 27% | 16% | 23% |

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 and six months ended June 30, 2012, gross research and development expenses increased $2.8 million and $7.6 million, respectively, from the same period in 2011, due to higher research and development on our uRiKA product and higher incentive compensation. The total of reimbursed research and development expense and amounts included in cost of revenue increased $14.4 million and $1.9 million for the three and six months ended June 30, 2012, respectively, compared to the same periods in 2011, primarily due to higher reimbursement from our ongoing Defense Advanced Research Projects Agency, or DARPA, High Productivity Computing Systems program. As a result of the sale of our interconnect hardware intellectual property and the transfer of 73 personnel to Intel, we currently expect that gross research and development expenses should be somewhat lower for the remainder of 2012.

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In October 2011, we amended the Phase III agreement with DARPA. As with the previous Phase III agreement, we expect to receive reimbursement after the achievement of a series of predefined milestones culminating in the delivery of a prototype system. Consistent with the changes, certain deliverables have been eliminated from the contract, reducing the overall scope and cost of the project. Pursuant to the amended contract, the full co-funding amount was revised down to $180.0 million. As of June 30, 2012, we had earned and received $173.0 million of reimbursement under the DARPA Phase III agreement, leaving $7.0 million to be earned and received. Assuming our development plans remain on schedule, we expect to earn the remaining $7.0 million in the fourth quarter of 2012.

***Sales and Marketing and General and Administrative Expenses***

Our sales and marketing and general and administrative expenses for the three and six months ended June 30, 2012 and 2011, respectively, were (in thousands, except for percentages):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Sales and marketing | $ 10,233 | $ 6,373 | $ 18,106 | $ 12,729 |
| Percentage of total revenue | 12% | 9% | 9% | 12% |
| General and administrative | $ 4,971 | $ 3,777 | $ 10,101 | $ 7,914 |
| Percentage of total revenue | 6% | 6% | 5% | 7% |

***Sales and Marketing***. Sales and marketing expense for the three and six months ended June 30, 2012 increased $3.9 million and $5.4 million, respectively, from the same periods in 2011, primarily due to higher headcount, commissions, and accrued incentive compensation.

***General and Administrative***. General and administrative expense for the three and six months ended June 30, 2012 increased $1.2 million and $2.2 million, respectively, from the same periods in 2011, primarily due to higher accrued incentive compensation.

***Restructuring***

We eliminated approximately 50 positions in the first quarter of 2011 and recorded a restructuring charge of $1.2 million for the six months ended June 30, 2011. The restructuring was designed to rebalance our headcount to areas of more need in the future such as software development, Big Data , storage, and customer service, and in select international geographies.

***Sale of Interconnect Hardware Development Program***

On May 2, 2012, we sold our interconnect hardware development program to Intel for cash consideration of $140 million. As part of the transaction, 73 of our employees joined Intel, and certain intellectual property and fixed assets were transferred to Intel. We retained certain rights to use the transferred assets and intellectual property. As a result of the sale, we recorded a gain of $139.1 million for the three and six month periods ended June 30, 2012.

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

For the three months ended June 30, 2011 and 2012, we recognized net other income of $0.2 million. For the six months ended June 30, 2012, we recognized net other income of $0.5 million compared to net other expense of $0.4 million for the same period in 2011. Net other income and expense for the three and six months ended June 30, 2012 and 2011 was principally the result of foreign currency transaction gains and losses.

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***Interest Income, net***

Our interest income and interest expense for the three and six months ended June 30, 2012 and 2011, respectively, were (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Interest income | $ 79 | $ 76 | $ 110 | $ 156 |
| Interest expense | (42) | (53) | (74) | (116) |
| Interest income, net | $ 37 | $ 23 | $ 36 | $ 40 |

***Taxes***

Cray s effective tax rates were approximately 3% and 5% for the three and six months ended June 30, 2012 compared to (9%) and (8%) for the three and six months ended June 30, 2011.

The primary reason for the difference between the expected statutory rate of 35% and our actual tax rates of 3% and 5% for the three and six months ended June 30, 2012 was that our gain from the sale of our interconnect hardware development program did not result in significant income tax expense. We had existing deferred tax assets that were subject to valuation allowances and deductible temporary differences that were previously unrecognized. The sale of the interconnect hardware development program was never anticipated in previous evaluations of the realizability of our deferred tax assets and consequently the sale, together with a tax benefit that was recognized as a result of a restructuring of the Company s Canadian operations, resulted in our ability to experience a relatively small tax consequence from the sale.

Our effective tax rate for the three and six months ended June 30, 2011 was primarily attributable to foreign income taxes payable.

**Liquidity and Capital Resources**

We generate cash from operations predominantly from the sale of high performance computing systems and related services. We typically have a small number of significant contracts that make up the majority of total revenue. In the second quarter of 2012, we received proceeds of $140 million from the sale of our interconnect hardware development program. The material changes in certain of our 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.

Cash and cash equivalents and restricted cash increased by $168.8 million from December 31, 2011 to June 30, 2012. The increase is attributable to the $140 million received from the sale of our interconnect hardware development program to Intel and large collections from systems that accepted in the fourth quarter of 2011 and the first quarter of 2012, including the first phase of the upgrade at Oak Ridge National Laboratory. Partially offsetting these items was an increase in inventory from $97.9 million at December 31, 2011 to $131.5 million at June 30, 2012. Accounts and other receivables also increased from $72.4 million at December 31, 2011 to $101.7 million at June 30, 2012.

Accrued payroll and related expenses increased from $11.3 million at December 31, 2011 to $19.6 million at June 30, 2012 primarily due to higher accruals for incentive compensation of $11.0 million. The current portion of deferred revenues increased to $83.3 million as of June 30, 2012 from $44.6 million at December 31, 2011, resulting principally from advance payments billed to customers prior to acceptance of the associated system.

Cash and cash equivalents and restricted cash totaled $223.0 million at June 30, 2012 compared to $54.2 million at December 31, 2011. As of June 30, 2012, we had working capital of $315.4 million compared to $137.7 million as of December 31, 2011.

Cash flow information included the following (in thousands):

| | Six Months Ended June 30, | |
|---|---|---|
| | 2012 | 2011 |
| Cash provided by (used in): | | |
| Operating Activities | $ 25,705 | $ 75,527 |
| Investing Activities | $ 137,186 | $ (2,141) |
| Financing Activities | $ 6,089 | $ 738 |

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*Operating Activities.* Net cash provided by operating activities for the six months ended June 30, 2012 was $25.7 million compared to net cash provided by operating activities of $75.5 million for the same period in 2011. For the six months ended June 30, 2012, net cash provided by operating activities was principally the result of high cash collections from customers partially offset by a large increase in inventory. For the six months ended June 30, 2011, net cash provided by operating activities was principally the result of decreases in accounts receivable as payments were received for certain large-scale systems previously accepted.

*Investing Activities.* Net cash provided by investing activities was $137.2 million for the six months ended June 30, 2012, compared to net cash used in investing activities of $2.1 million for the same 2011 period. Net cash provided by investing activities for the six months ended June 30, 2012 was due principally to the sale of our interconnect hardware development program to Intel for $139.2 million, net of direct transaction costs. Net cash used by investing activities for the six months ended June 30, 2011 was principally due to purchases of property and equipment.

*Financing Activities.* Net cash provided by financing activities for the six months ended June 30, 2012 was $6.1 million, compared to net cash provided by financing activities of $0.7 million for the same period in 2011. Net cash provided by financing activities for the six months ended June 30, 2012 resulted primarily from cash received from the issuance of common stock from the exercise of options. Net cash provided by financing activities for the six months ended June 30, 2011 resulted primarily from cash received from the issuance of common stock from the exercise of options and through our employee stock purchase plan.

In addition, we lease certain equipment and facilities used in our operations under operating leases in the normal course of business and have contractual commitments under certain development arrangements. The following table summarizes our contractual obligations as of June 30, 2012 (in thousands):

| | | Amounts Committed by Year | | | |
|---|---|---|---|---|---|
| **Contractual Obligations** | **Total** | **2012 (Less than 1 Year)** | **2013-2014** | **2015-2016** | **Thereafter** |
| Development agreements | $ 2,619 | $ 2,296 | $ 323 | $ 0 | $ 0 |
| Operating leases | 24,268 | 2,134 | 8,049 | 7,434 | 6,651 |
| Total contractual cash obligations | $ 26,887 | $ 4,430 | $ 8,372 | $ 7,434 | $ 6,651 |

We have a line of credit with Wells Fargo Bank of $3.5 million, which has a maturity date of June 1, 2013. 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 met. 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 June 30, 2012.

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 and six months ended June 30, 2012, we incurred $0.9 million and $2.6 million for such arrangements, respectively.

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 and cash from operations. We expect our cash resources to be adequate for at least the next twelve months.

**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 2011 Annual Report on Form

10-K and should be reviewed in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto as of June 30, 2012 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-

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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**

We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when we have 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, where applicable, 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. We record 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 our statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

*Multiple-Element Arrangements.* We commonly enter into revenue arrangements that include multiple deliverables of our product and service offerings due to the needs of our 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. We consider the maintenance period to commence upon acceptance of the product or installation in situations where a formal acceptance is not required, which may include a warranty period and accordingly allocate 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 our control.

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.

We follow 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 we are sometimes able to determine vendor specific objective evidence, or VSOE. We determine VSOE based on normal pricing and discounting practices for the product or service when sold separately.

When we are not able to establish VSOE for all deliverables in an arrangement with multiple elements, we attempt to establish the selling price of each remaining element based on third-party evidence, or TPE. Our 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. However, we are often unable to determine TPE, as our offerings contain a significant level of customization and differentiation from those of competitors and we are often unable to reliably determine what similar competitor products selling prices are on a standalone basis.

When we are unable to establish selling price using VSOE or TPE, we use estimated selling price, or ESP, in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a

standalone basis. In determining ESP, we use 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, we use 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, we consider the total cost of the product or service, including

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customer-specific and geographic factors. We also consider 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*. We most often recognize revenue from sales of products upon customer acceptance of the system. Where formal acceptance is not required, we recognize revenue upon delivery or installation. When the product is part of a multiple element arrangement, we allocate a portion of the arrangement consideration to product revenue based on estimates of selling price.

*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. We consider the maintenance period to commence upon acceptance of the product or installation in situations where a formal acceptance is not required, which may include a warranty period. When service is part of a multiple element arrangement, we allocate a portion of the arrangement consideration to maintenance service revenue based on estimates of selling price. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue. Maintenance revenue is recognized ratably over the term of the maintenance contract.

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. We perform ongoing profitability analyses of our 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.

We record 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:
  - Our 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 our 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 non-substantive 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.

*Nonmonetary Transactions*. We value and record nonmonetary transactions at the fair value of the asset surrendered unless the fair value of the asset received is more clearly evident, in which case the fair value of the asset received is used.

***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

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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.

As of June 30, 2012, we had approximately $105.1 million of net deferred tax assets, against which we provided a $90.4 million valuation allowance, resulting in a net deferred tax asset of $14.7 million. We continue to provide a partial valuation allowance against our U.S. deferred tax assets and a full valuation allowance against our deferred tax assets in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not. Our conclusion about the realizability of our deferred tax assets, and therefore the appropriateness of a valuation allowance, is reviewed quarterly. If our conclusion about the realizability of our deferred tax assets changes in a future period we could record a substantial tax provision or benefit in our Consolidated Statement of Operations when that occurs.

Estimated interest and penalties are recorded as a component of interest expense and other expense, respectively.

***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 or other customers 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.

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 a result, 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. Accordingly, there can be substantial variability in the amount of net research and development expenses from quarter to quarter and year to year.

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.

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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.

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

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

*Interest Rate Risk*: We invest our available cash principally in highly liquid 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 in our investment portfolio. We protect and preserve invested funds by limiting default, liquidity, market and reinvestment risk.

*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 in U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we commonly 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 June 30, 2012, we were a party to forward exchange contracts that hedged approximately $34.5 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 contract was signed and when the cash receipts are expected to be received. Our foreign maintenance contracts are typically paid in local currencies and provide a 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 June 30, 2012, a 10% change in foreign exchange rates could impact our annual earnings and cash flows by approximately $0.4 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 June 30, 2012 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.

*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 June 30, 2012 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 2011 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 because a material portion of product revenue recognized in any given quarter or year typically depends on a

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very limited number of system sales expected for that quarter or year and the product revenue generally depends on the timing of product acceptances by customers and contractual provisions affecting revenue recognition. For example, a system sale to the University of Illinois National Center for Supercomputing Applications planned for acceptance in the last three months of 2012 accounts for approximately $150 million of our anticipated revenue in fiscal 2012. Delays in achieving customer acceptances of installed systems and 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, inability of a system to meet performance requirements or targets, 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 to another, or even 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, High Productivity Computing Systems, or 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, 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 and 2011, we have historically experienced net losses 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, which included a non-cash goodwill impairment charge of approximately $54.5 million and a net loss of $0.6 million in 2009. Net income in 2011 benefited from the partial reduction of the valuation allowance held against our U.S. deferred tax assets of $13.9 million and a complete reduction of the valuation allowance held against the deferred tax assets of our German subsidiary of $0.8 million.

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:

- successfully delivering and obtaining customer acceptances of our Cray XE6 and Cray XK6 systems, including the systems delivered or to be delivered to the University of Illinois National Center for Supercomputing Applications and the Department of Energy s Oak Ridge National Laboratory;

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

- 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;

- our ability to successfully and timely design, integrate and secure competitive processors for our Cray XE6 and Cray XK6 systems and upgrades and successors systems, including for the planned upgrade to our current Cray XK6 system that will be based on the NVIDIA Kepler GPUs;

- our ability to secure orders for our Cray XE6/Cray XE6m, Cray XK6/Cray XK6m and Cascade systems as well as upgrades and successor systems;

- our ability to successfully generate revenue and profitability from opportunities developed from our YarcData subsidiary and storage and data management business;

- 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 remaining milestone under our DARPA HPCS program;

our ability to secure additional government funding for future development projects such as funding targeted for exascale computing initiatives as the DARPA HPCS program is expected to be completed shortly;

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, acceptance penalties and component costs;

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 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, including, but not limited to, processors, in sufficient quantities to meet customer delivery schedules;

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

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

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

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

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

currency fluctuations, international conflicts or economic crises, including the ongoing macroeconomic challenges in the United States and the debt crisis in certain countries in the European Union; 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 2012 and in future years.

**If our current and future strategic initiatives targeting markets outside of our traditional markets, primarily our YarcData subsidiary, technical enterprise/midrange HPC systems and storage and data management business, 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 are currently focusing on big data analytics and storage and data management opportunities originally developed from our former Custom Engineering business and selling our Cray XE6m and Cray XK6m systems into the technical enterprise/midrange supercomputing segment. To grow our revenue from new opportunities outside our primary market, we must continue to win awards for new contracts, timely perform on existing contracts, develop our capability for broader market sales and business development and successfully develop and introduce new solution-oriented offerings, notwithstanding that these are relatively new businesses for Cray and we do not have significant experience targeting these markets. The Cray XE6m, Cray XK6m and successor systems require successful sales in a lower priced segment of the supercomputer market as well as in relatively new commercial market segments. These data analytics and storage and data management opportunities and our Cray XE6m/Cray XK6m (and successor systems) efforts require monetary investments ahead of revenue, including adding experienced personnel and initiating new marketing and sales efforts.

**If the U.S. government and other governments purchase, or fund the purchase of, fewer supercomputers or delay 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 2009, 2010, 2011 and the first six months of 2012, approximately 72%, 62%, 54% and 48%, respectively, of our revenue was derived from such sales. Our plans for the foreseeable future contemplate significant sales to U.S. government agencies and customers primarily serving the U.S. government. Sales to government agencies and customers primarily serving the U.S. government, including further sales pursuant to existing contracts, may be adversely affected by factors outside our control, such as the current economic uncertainty, the downgrading of U.S. government debt, the political climate in a U.S. presidential election year focusing on cutting or limiting budgets and their effect on government budgets, the effects of Congressional failures or successes in addressing budgetary concerns, limits on federal borrowing capacity, changes in procurement policies, budgetary considerations including Congressional delays in completing appropriation bills as occurred in 2011, domestic crises, and international political developments, such as the downgrading of European debt. 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.

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**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. Because specific components 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 key elements of 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:

If a supplier does not provide components that meet our specifications in sufficient quantities on time or deliver when required, then production, delivery, acceptance and revenue from our systems could be delayed and we could be subject to costly penalties even once delivered and accepted, which happened during the last three months of 2011 and adversely affected our efforts to complete the acceptance process on the Cray XK6 upgrade at Oak Ridge National Laboratory, which in turn significantly lowered our total revenue for fiscal year 2011;

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 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 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 provides us with hardware or software that contains bugs or other errors or is different from what we expected, as is occurring with a key component, 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. Certain delays in the availability of acceptable 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, including in 2011, and could adversely affect future results. In particular, planned upgrades to and variants of our Cray XK6 and Cray XK6m systems are dependent upon the NVIDIA Kepler graphics processors. If we are unable to obtain adequate quantities of this processor when needed or meet the anticipated specifications, our revenue in 2012 and in subsequent periods would be adversely affected.

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**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, and Bull S.A. 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 companies that benefit from the low research and development costs needed to assemble systems from commercially available commodity products, such as Appro. Such companies, because they can offer high peak performance per dollar, 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, such as those from AMD, our Cray XE6, Cray XE6m and Cray XK6 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 collaboration with Intel is 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 in our Cascade systems.

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 successfully deliver our Cray XE6 and the Cray XK6 systems and develop, sell and deliver our Cascade system and successor systems, our operating results will be adversely affected.** We expect that a substantial portion of our revenue in the foreseeable future will come from deliveries of Cray XE6 and Cray XK6 systems and sales and deliveries of our Cascade and successor systems, including systems integrating 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 Cray XK6 systems and our Cascade 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 our Cray XE6 and Cray XK6 systems and our Cascade 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 Cray XK6 systems and our Cascade 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 companies 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 have adversely affected 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 Cray XE6 and Cray XK6 systems and is occurring for subsequent systems.

- Our ability to source competitive, key components in appropriate quantities, in a timely fashion and on acceptable terms and conditions. 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, as has happened in the past.

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

Failure to successfully sell our Cray XE6 and Cray XK6 systems and develop and sell upgrades and our Cascade and successor systems, into the high-end of the HPC market will adversely affect our operating results.

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**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, as well as the potential for integration of differentiated technology into already-commoditized components, has resulted in, and may result 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. 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.

**We may not realize the anticipated benefits, or minimize the possible risks, of the sale of certain interconnect hardware assets to Intel Corporation, which could alter the revenue, costs and nature of our business.** In connection with our sale of certain interconnect hardware assets to Intel, we conducted business, legal and financial due diligence with the goal of identifying and evaluating material risks involved in the transaction. Despite our efforts, we ultimately may be unsuccessful in ascertaining or evaluating all such risks and, as a result, might not realize the intended advantages of the transaction. Additionally, the process of transitioning our employees and technologies to Intel may result in unforeseen operating difficulties and expenditures and could involve a number of potential adverse risks to our business, including the following:

- harm to our ability to compete in relevant markets or in customer perception of our products;
- delays in delivering our products as a result of supply difficulties or other factors;
- loss of too many key employees;
- unanticipated costs, adverse tax consequences and unforeseen accounting charges or fluctuations;
- exposure to potential liabilities to third parties or Intel, or claims for indemnification by Intel, including with respect to third-party litigation matters;
- failure to successfully further develop our current products or disruption to our current or future product roadmaps and ongoing business;
- delays and difficulties in receiving key components for our products from suppliers, including Intel;
- loss of customers, vendors or alliances; and
- failure to create shareholder value with the additional cash resources.

If we fail to realize the expected benefits from the transaction, or to minimize the expected risks of the transaction, whether as a result of unidentified risks or other unforeseen events, our business, results of operations and financial condition could be adversely affected.

**If we are unable to complete and obtain acceptance on the final DARPA milestone when or as expected or at all, our net research and development expenditures would increase significantly and our operating results would be adversely affected.** The DARPA HPCS program calls for the delivery of a prototype system in late 2012, and currently provides for a contribution by DARPA to us of up to $180

million assuming we meet certain milestones, $173 million of which we had already earned as of June 30, 2012, leaving $7 million to be earned. In February of 2010, the total possible contribution from DARPA over the term of the HPCS program was reduced from $250 million to $190 million and, in October 2011, it was further reduced to $180 million. If the completion of the remaining 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 milestone, or the milestone payment is delayed, reduced and/or eliminated, our cash flows and expenses would be adversely impacted. 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. 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. 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, a delay in the timing of the last milestone or a decision to terminate the program before completion.

**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

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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.

**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 and Cray XK6 systems and our Cascade system, and expect to incorporate Intel technologies into our products as part of our DARPA HPCS program and our Cascade systems. We have also begun to incorporate GPU accelerators into our supercomputer systems, such as with the Cray XK6 systems. The incorporation of GPUs and future many-core processors 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 that 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 that 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 investment 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 2009, 2010, 2011 and the first six months of 2012, 72%, 62%, 54% and 48% respectively, of our revenue was derived from the U.S. government or customers primarily serving the U.S. government. 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, particularly in this U.S. Presidential election year, 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 or non-compliance with the terms of a specific contract, 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.

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*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 certain foreign customers, eliminating an important source of potential revenue. Our ability to have certain components manufactured in certain 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 enough. 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 as well as other 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 supercomputer 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 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.

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**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 adequately protect 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 Amended and Restated 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 Amended and Restated 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 Amended and Restated 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

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.

**Item 6. Exhibits**

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|---|---|
| 2.1 | Asset Purchase Agreement among Cray Inc., Intel Corporation and Cray Canada Corporation, dated April 24, 2012 (incorporated by reference to Exhibit 2.1 to Form 8-K filed on April 25, 2012)* |
| 10.1 | Intellectual Property Agreement by and between Intel Corporation and Cray Inc., dated as of May 2, 2012 (incorporated by reference to Exhibit 10.1 to Form 8-K filed on May 5, 2012) |
| 10.2 | Eighth Amendment to Credit Agreement between Wells Fargo Bank, National Association and Cray Inc., dated June 1, 2012. |

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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

101.INS XBRL Instance Document**

101.SCH XBRL Taxonomy Extension Schema Document**

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document**

101.LAB XBRL Taxonomy Extension Label Linkbase Document**

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document**

* Exhibits and schedules omitted pursuant to Item 601(b)(2) of Regulation S-K. Cray agrees to furnish a supplemental copy of an omitted exhibit or schedule to the SEC upon request.

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**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.

**CRAY INC.**

Date: July 31, 2012

/s/ Peter J. Ungaro
Peter J. Ungaro
President and Chief Executive Officer

Date: July 31, 2012

/s/ Brian C. Henry
Brian C. Henry
Executive Vice President and Chief Financial Officer

Date: July 31, 2012

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