Form 10-Q

Cray Inc - CRAY

August, 9 2005

Quarterly report [Sections 13 or 15(d)]

10-Q 1 v11356e10vq.htm FORM 10-Q QUARTER ENDED JUNE 30, 2005

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2005

OR

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

For the transition period from to

Commission file number 0-26820

CRAY INC.
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	**93-0962605** (I.R.S. Employer Identification No.)

411 First Avenue South, Suite 600
Seattle, WA 98104-2860
(206) 701- 2000

(Address of principal executive offices)
(Registrant's telephone number, including area code)

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

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

As of August 5, 2005, 88,114,507 shares of the Company's Common Stock, par value $0.01 per share, were outstanding.

TABLE OF CONTENTS

CRAY INC. AND SUBSIDIARIES

TABLE OF CONTENTS

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 web site at www.cray.com as soon as reasonably practicable after we file electronically such reports with the SEC.

Cray is a federally registered trademark of Cray Inc., and Cray X1, Cray X1E, Cray XT3 and Cray XD1 are trademarks of Cray Inc.

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	December 31, 2004	June 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,732	$ 8,528
Restricted cash	11,437	
Short-term investments, available for sale	34,253	
Accounts receivable, net of allowance of $1,439 and $1,344, respectively	33,185	51,160
Inventory	71,521	106,576
Prepaid expenses and other current assets	5,225	7,987
Total current assets	197,353	174,251
Property and equipment, net	36,875	37,769
Service spares, net	3,590	3,951
Goodwill	55,644	54,579
Intangible assets, net	6,197	5,362
Other non-current assets	9,130	10,103
TOTAL	$ 308,789	$ 286,015
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 23,875	$ 38,507
Accrued payroll and related expenses	14,970	13,176
Other accrued liabilities	8,214	13,639
Deferred revenue	54,246	53,510
Total current liabilities	101,305	118,832
Deferred tax liability, net	1,662	1,309
Other non-current liabilities	522	1,874
Convertible notes payable	80,000	80,000
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid in capital, par $.01 — Authorized, 150,000,000 shares; issued and outstanding, 87,348,641 and 88,076,380 shares, respectively	413,911	416,231
Exchangeable shares, no par value — Unlimited shares authorized; issued and outstanding, 570,963 and 500,116 shares, respectively	4,173	3,655
Deferred compensation	(4,220)	(1,034)
Accumulated other comprehensive income	4,560	3,103
Accumulated deficit	(293,124)	(337,955)
	125,300	84,000
TOTAL	$ 308,789	$ 286,015

See accompanying notes

Table of Contents

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2005	Six Months Ended June 30, 2004	Six Months Ended June 30, 2005
Revenue:				
Product	$ 9,539	$ 40,201	$ 37,907	$ 66,511
Service	12,171	13,218	25,938	24,542
Total revenue	21,710	53,419	63,845	91,053
Operating expenses:				
Cost of product revenue	9,282	41,210	29,037	67,562
Cost of service revenue	7,784	7,531	16,365	15,106
Research and development	12,393	13,427	21,426	26,459
Sales and marketing	8,584	7,574	16,230	14,173
General and administrative	4,507	4,607	7,389	8,874
Restructuring and severance charges		1,947		1,732
In-process research and development charge	43,400		43,400	
Total operating expenses	85,950	76,296	133,847	133,906
Loss from operations	(64,240)	(22,877)	(70,002)	(42,853)
Other income (expense), net	184	153	(202)	(349)
Interest income (expense), net	25	(767)	168	(1,204)
Loss before income taxes	(64,031)	(23,491)	(70,036)	(44,406)
Provision (benefit) for income taxes	(9,527)	305	(11,689)	425
Net loss	$(54,504)	$(23,796)	$ (58,347)	$ (44,831)
Basic and diluted net loss per share:	$ (0.64)	$ (0.27)	$ (0.74)	$ (0.51)
Shares used in computation of basic and diluted net loss per share:	85,824	88,392	79,359	88,253

See accompanying notes

Table of Contents

CRAY INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(in thousands)
(unaudited)

	Common Stock		Exchangeable Shares					
	Number of Shares	Amount	Number of Shares	Amount	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, January 1, 2005	87,349	$413,911	571	$4,173	$(4,220)	$(293,124)	$ 4,560	$125,300
Issuance of shares under 401(k) plan	207	770						770
Issuance of shares under employee stock purchase plan	140	440						440
Exercise of stock options	88	138						138
Exchangeable shares converted into common shares	65	475	(65)	(475)				
Amortization of deferred compensation					1,199			1,199
Other comprehensive income:								
Unrealized loss on available for sale investments							(63)	(63)
Currency translation adjustment					47		(1,032)	(985)
Net loss						(21,035)		(21,035)
BALANCE, March 31, 2005	87,849	415,734	506	3,698	(2,974)	(314,159)	3,465	105,764
Issuance of shares under employee stock purchase plan	221	351						351
Exchangeable shares converted into common shares	6	43	(6)	(43)				
Warrants issued in connection with financing		219						219
Reversal of deferred compensation due to employee terminations		(116)			116			
Amortization of deferred compensation					1,794			1,794
Other comprehensive income:								
Adjustment for realized gain on investments							87	87
Currency translation adjustment					30		(449)	(419)
Net loss						(23,796)		(23,796)
BALANCE, June 30, 2005	88,076	$416,231	500	$3,655	$(1,034)	$(337,955)	$ 3,103	$ 84,000

See accompanying notes

Table of Contents

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited and in thousands)

	For the Six Months Ended June 30, 2004	2005
Operating activities		
Net loss	$(58,347)	$(44,831)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	8,019	9,844
Stock-based compensation expense	2,129	2,993
In-process research and development charge	43,400	
Inventory write-down		1,582
Tax benefit on stock options	1,294	
Deferred taxes	(13,581)	(102)
Bad debt expense		34
Cash provided (used) by changes in operating assets and liabilities, net of effects of the OctigaBay Systems Corporation acquisition in 2004:		
Accounts receivable	14,206	(15,095)
Inventory	(25,835)	(44,209)
Prepaid expenses and other current assets	4,990	(2,315)
Service spares	(38)	(376)
Other assets	(748)	(816)
Accounts payable	(712)	12,265
Accrued payroll and related expenses	(7,493)	(1,504)
Other accrued liabilities	(1,986)	4,773
Warranty reserve	(655)	
Deferred revenue	8,737	(617)
Other non-current liabilities		1,133
Net cash used by operating activities	(26,620)	(77,241)
Investing activities		
Acquisition of OctigaBay, net of cash acquired	(6,270)	
Purchases of short-term investments	(30,160)	(10,161)
Sales / maturities of short-term investments	36,760	44,414
Purchases of property and equipment	(6,742)	(2,843)
Net cash provided (used) by investing activities	(6,412)	31,410
Financing activities		
Proceeds from exercise of stock options and warrants	6,047	138
Proceeds from issuance of common stock through employee stock purchase plan and 401(k) plan	1,913	1,561
Decrease in restricted cash		11,437
Principal payments on capital leases	(162)	(269)
Net cash provided by financing activities	7,798	12,867
Effect of foreign exchange rate changes on cash and cash equivalents	(235)	(240)
Net decrease in cash and cash equivalents	(25,469)	(33,204)
Cash and cash equivalents:		
Beginning of period	39,773	41,732
End of period	$ 14,304	$ 8,528
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 38	$ 1,300
Non-cash investing and financing activities:		
Inventory transferred to spares	1,382	998
Inventory transferred to fixed assets	5,268	6,574
Shares issued for acquisition of OctigaBay	83,542	
Issuance of warrants in connection with financing arrangement		219

See accompanying notes

CRAY INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Basis of Presentation

In the opinion of management, the accompanying condensed consolidated balance sheets and related condensed consolidated statements of operations, shareholders' equity and 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. All adjustments (consisting of normal recurring accruals) 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, 2004.

The Company's revenue, net income or loss and cash balances are likely to fluctuate significantly from quarter to quarter and within a quarter due to the high average sales prices and limited number of sales of its larger products, the timing of purchase orders and product deliveries, its general policy of not recognizing product revenue for its larger systems 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 inventory. Given the nature of the Company's business, its revenue, receivables and other related accounts are likely to be concentrated among a few customers.

During the six months ended June 30, 2005, Cray Inc. and its wholly-owned subsidiaries ("the Company") incurred a net loss of $44.8 million and used $77.2 million of cash in operating activities. The Company used significant working capital in the first half of 2005 primarily to fund its operating loss, increased inventory purchases, increased accounts receivable and additional equipment purchases associated with the introduction of three new products. Management's plans project that the Company's current cash resources, including its credit facility, and cash to be generated from operating activities should be adequate for the remainder of the year. These plans assume customer acceptances and subsequent collections from several large customers. Should acceptances be delayed significantly, the Company could face a significant liquidity challenge and require it to pursue additional initiatives to reduce costs further, including reductions in inventory purchases and commitments, and/or seek additional financing. There can be no assurance the Company will be successful in its efforts to achieve future profitable operations or generate sufficient cash from operations, or obtain additional funding in the event its financial resources became insufficient.

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 conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These judgments are difficult as matters that are inherently uncertain directly impact their valuation and accounting. Actual results may vary from management's estimates and assumptions.

Short-Term Investments

Short-term investments generally mature between three months and two years from the purchase date. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. All short-term investments are classified as available for sale and are recorded at fair value, based on quoted market prices, and unrealized gains and losses are reflected in other comprehensive income.

Balance Sheet Details

Net accounts receivable consisted of the following (in thousands):

	December 31, 2004	June 30, 2005
Trade accounts receivable	$20,905	$36,915
Unbilled receivables	6,770	9,672
Government funding co-development	4,015	3,514
Other	2,934	2,403
	34,624	52,504
Allowance for doubtful accounts	(1,439)	(1,344)
Accounts receivable, net	$33,185	$51,160

Receivables from one customer, Sandia National Laboratories, associated with the Red Storm project, represented a total of $16.3 million and $15.3 million in gross receivables at December 31, 2004, and June 30, 2005, respectively. Of these totals, $6.7 million and $8.9 million, at December 31, 2004, and June 30, 2005, respectively, represented unbilled receivables as a consequence of percentage of completion project accounting.

Inventory consisted of the following (in thousands):

	December 31, 2004	June 30, 2005
Components and subassemblies	$20,579	$ 36,914
Work in process	31,688	16,713
Finished goods	27,365	58,786
	79,632	112,413
Reserve	(8,111)	(5,837)
Total	$71,521	$106,576

Finished goods inventory of $58.8 million represents inventory located at customer sites pending acceptance. Of this amount, $22.1 million was related to a single customer. Revenue for the three months and six months ended June 30, 2005 includes $2 million from the sale of refurbished inventory recorded at a zero cost basis.

Deferred revenue consisted of the following (in thousands):

	December 31, 2004	June 30, 2005
Deferred product revenue	$37,519	$41,624
Deferred service revenue	16,685	11,857
Other deferred revenue	42	29
Total	$54,246	$53,510

As of December 31, 2004, and June 30, 2005, deferred revenue included $23.6 million of deferred product revenue from one customer not expected to be realized for at least 12 months. The Company considers this balance to be a current liability as the customer has contractual cancellation rights.

Goodwill

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets,* the Company does not amortize goodwill but instead tests it for impairment at least annually, and between annual tests if indicators of potential impairment exist, using a fair-value based approach. The Company performs its annual impairment test in January of each calendar year. Results of the January 2004 and January 2005 impairment tests did not indicate an impairment loss.

The following table provides information about activity in goodwill for the period from January 1, 2005, to June 30, 2005 (in thousands):

Goodwill, at January 1, 2005	$55,644
Deferred tax adjustment	(251)
Foreign currency translation adjustment	(814)
Goodwill, at June 30, 2005	$54,579

In connection with the acquisition of OctigaBay Systems Corporation in April 2004, the Company recognized certain deferred tax liabilities in the amount of $2.0 million. As realization of those deferred tax liabilities occurs, goodwill established due to the acquisition is reduced.

Red Storm Loss Reserves

In accordance with the Company's revenue recognition policy, revenue from the Red Storm development project is recognized using the percentage of completion method. Percentage of completion is measured based on the ratio of costs incurred to date compared to total estimated costs. On an on-going basis, the Company revises its estimate of total costs expected to be incurred on the contract. In the third quarter of 2004, the Company concluded this would be a loss contract. As of June 30, 2005, the estimated cumulative loss was $15.5 million. As of December 31, 2004, the estimated cumulative loss was $7.6 million. The remaining loss reserves are included in accrued liabilities in the accompanying condensed consolidated balance sheets.

Line of Credit

On May 31, 2005, the Company entered into a Senior Secured Credit Agreement with Wells Fargo Foothill, Inc. (“the Credit Agreement”), providing for a two-year revolving line of credit for up to $30.0 million. The Credit Agreement currently restricts the Company from using $5.0 million of the credit line. The new credit line replaces the Company’s previous line of credit with Wells Fargo Bank, N.A. The Credit Agreement provides support for the Company’s existing letters of credit while permitting the Company to use the previously restricted $11.4 million of cash and permitting additional cash advances, subject to a borrowing base composed of (a) up to $20,000,000 based on 100% of the Company’s maintenance service revenue for the trailing six-month period and (b) up to $10,000,000 based on 85% of eligible accounts receivable, as defined in the Credit Agreement, subject to other limitations provided in the Credit Agreement. At June 30, 2005, the Company had outstanding $11.5 million of letters of credit supported by the Credit Agreement and its calculated borrowing base as of that date was approximately $13.5 million The Credit Agreement bears interest on a performance-based formula, contains covenants to maintain or achieve certain financial performance standards and is collateralized by all of the Company’s assets and pledges of the stock of its subsidiaries. As of June 30, 2005, the Company was in compliance with the covenants. The Company is obligated to pay a closing fee of 2.5% of the maximum amount of the credit line, or $750,000, half of which was paid at closing and half of which is payable one year from closing, and other fees and costs customary for such transactions. These costs have been capitalized and are being amortized over the two-year life of the Credit Agreement. The indebtedness under the Credit Agreement constitutes senior indebtedness under the indenture governing the Company’s outstanding convertible senior subordinated notes issued in December 2004. As of June 30, 2005, the Company had not drawn upon the credit facility.

In connection with the Credit Agreement, the Company also issued the lender a four-year warrant to purchase 200,000 shares of its common stock, with an exercise price equal to $1.65, the closing price of its common stock on the date the warrant was issued. The value of the warrant was estimated as $219,000 and is being amortized over the two-year life of the Credit Agreement.

Comprehensive Loss

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Net loss	$(54,504)	$(23,796)	$(58,347)	$(44,831)
Gain (loss) on available for sale investments	52	87	61	24
Foreign currency translation adjustment	(2,155)	(449)	(1,915)	(1,481)
Comprehensive loss	$(56,607)	$(24,158)	$(60,201)	$(46,288)

Segment Information

SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments and for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions on allocating resources and assessing performance. Cray’s chief decision-maker, as defined under SFAS No. 131, is the Chief Executive Officer. As of June 30, 2005, Cray operated in one business segment: global sales and service of high performance computers.

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately $17.6 million and $38.3 million for the three and six months ended June 30, 2005, compared to $13.5 million and $33.6 million for the three and six months ended June 30, 2004.

The Company’s significant operations outside the Americas include sales and service offices in Europe, the Middle East and Africa (“EMEA”) and Japan, Australia, Korea, China and Taiwan (“Asia Pacific”). Intercompany transfers between operating segments and geographic areas are primarily accounted for at prices that approximate arm’s length transactions. Geographic revenue and long-lived assets related to operations were as follows (in thousands):

	The Americas	EMEA	Asia Pacific	Total
Three months ended June 30, 2004:				
Product revenue	$ 8,905	$ 405	$ 229	$ 9,539
Service revenue	$ 9,194	$ 1,819	$ 1,158	$ 12,171
Net loss	$ (50,357)	$ (2,369)	$ (1,778)	$ (54,504)
Six months ended June 30, 2004:				
Product revenue	$ 29,845	$ 3,423	$ 4,639	$ 37,907
Service revenue	$ 18,740	$ 4,849	$ 2,349	$ 25,938
Net loss	$ (54,783)	$ (3,292)	$ (272)	$ (58,347)
As of June 30, 2004:				
Long-lived assets	$166,836	$ 3,142	$ 1,270	$171,248
Three months ended June 30, 2005:				
Product revenue	$ 15,541	$15,381	$ 9,279	$ 40,201
Service revenue	$ 9,086	$ 2,934	$ 1,198	$ 13,218
Net income (loss)	$ (27,396)	$ 4,091	$ (491)	$ (23,796)
Six months ended June 30, 2005:				
Product revenue	$ 34,315	$17,757	$14,439	$ 66,511
Service revenue	$ 17,473	$ 4,655	$ 2,414	$ 24,542
Net income (loss)	$ (45,316)	$ 2,390	$ (1,905)	$ (44,831)
As of June 30, 2005:				
Long-lived assets	$105,574	$ 4,132	$ 2,058	$111,764

Earnings Per Share ("EPS")

Basic EPS is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS is computed by dividing net income available to common shareholders by the weighted average number of common and common equivalent shares outstanding during the period, which includes the additional dilution related to conversion of stock options and common stock purchase warrants as computed under the treasury stock method and the common shares issuable upon conversion of the outstanding convertible notes (see "Convertible Notes Payable"). Because outstanding stock options and warrants and shares issuable upon conversion of the convertible notes are antidilutive, their effect has not been included in the calculation of the net loss per share for the three months and six months ended June 30, 2004, and 2005.

For the three and six months ended June 30, 2005, common stock equivalents of 39.2 million shares were antidilutive and not included in computing diluted EPS. For the three and six months ended June 30, 2004, common stock equivalents of 19.3 million shares were antidilutive and not included in computing diluted EPS.

Restructuring and Severance Charges

During the three and six months ended June 30, 2005, the Company recognized restructuring and severance charges of $1.9 million and $1.7 million, respectively. Substantially all of the charges represent severance expenses for terminated employees.

The restructuring liability is included within accrued payroll and related expenses on the accompanying condensed consolidated balance sheets as of June 30, 2005 and December 31, 2004. The liability activity related to restructuring during the six months ended June 30, 2004, and 2005, was as follows (in thousands):

	2004	2005
Liability balance, January 1	$ 3,101	$ 4,690
Payments	(1,338)	(2,212)
Adjustments to previously accrued amounts		(236)
Current period charges		21
Foreign currency translation adjustment		(162)
Liability balance, March 31	1,763	2,101
Payments	(1,404)	(846)
Adjustments to previously accrued amounts		—

	2004	2005
Current period charges		1,947
Foreign currency translation adjustment		(49)
Liability balance, June 30	$359	$3,153

Taxes

The Company recorded a tax provision of $305,000 and $425,000 for the three and six month periods ended June 30, 2005, compared to a tax benefit of $9.5 million and $11.7 million for the respective 2004 periods. The expense recorded for the three and six months ended June 30, 2005, was primarily related to foreign income taxes payable. The tax benefit recorded in 2004 represented the recognition of deductible temporary differences that occurred in those periods. In the third quarter of 2004, it was determined that is was not more likely than not that future economic benefits resulting from these temporary differences would be recognized, and a valuation allowance was recorded.

Convertible Notes Payable

In December 2004 the Company issued $80 million aggregate principal amount of 3.0% Convertible Senior Subordinated Notes due 2024 (“Notes”) in a private placement pursuant to Rule 144A under the Securities Act of 1933, as amended. These unsecured Notes bear interest at an annual rate of 3.00%, payable semiannually on June 1 and December 1 of each year through the maturity date of December 1, 2024. The Notes may be called by the Company beginning in December 2007 or required to be redeemed by the Note holders beginning in December 2009.

The Notes are convertible, under certain circumstances, into the Company’s common stock at an initial conversion rate of 207.2002 shares of common stock per $1,000 principal amount of Notes, which is equivalent to an initial conversion price of approximately $4.83 per share of common stock, or 16,576,016 shares (subject to adjustment in certain events). Upon conversion of the Notes, in lieu of delivering common stock, the Company may, at its discretion, deliver cash or a combination of cash and common stock.

The Notes are general unsecured senior subordinated obligations, ranking junior in right of payment to the Company’s existing and future senior indebtedness, equally in right of payment with the Company’s existing and future indebtedness or other obligations that are not, by their terms, either senior or subordinated to the Notes and senior in right of payment to the Company’s future indebtedness that, by its terms, is subordinated to the Notes. In addition, the Notes are effectively subordinated to any of the Company’s existing and future secured indebtedness to the extent of the assets securing such indebtedness and structurally subordinated to the claims of all creditors of the Company’s subsidiaries.

Holders may convert the Notes during a conversion period beginning with the mid-point date in a fiscal quarter to, but not including, the mid-point date (or, if that day is not a trading day, then the next trading day) in the immediately following fiscal quarter, if on each of at least 20 trading days in the period of 30 consecutive trading days ending on the first trading day of the conversion period, the closing sale price of the Company’s common stock exceeds 120% of the conversion price in effect on that 30th trading day of such period. The “mid-point dates” for the fiscal quarters are February 15, May 15, August 15 and November 15. Holders may also convert the Notes if the Company has called the Notes for redemption or, during prescribed periods, upon the occurrence of specified corporate transactions or a fundamental change, in each case as described in the indenture governing the Notes. As of June 30, 2005, none of the conditions for conversion of the Notes were satisfied.

The Company may, at its option, redeem all or a portion of the Notes for cash at any time on or after December 1, 2007, and prior to December 1, 2009, at a redemption price of 100% of the principal amount of the Notes plus accrued and unpaid interest plus a make whole premium of $150.00 per $1,000 principal amount of Notes, less the amount of any interest actually paid or accrued and unpaid on the Notes prior to the redemption date, if the closing sale price of the Company’s common stock exceeds 150% of the conversion price for at least 20 trading days in the 30-trading day period ending on the trading day prior to the date of mailing of the redemption notice. On or after December 1, 2009, the Company may redeem for cash all or a portion of the Notes at a redemption price of 100% of the principal amount of the Notes plus accrued and unpaid interest. Holders may require the Company to purchase all or a part of their Notes for cash at a purchase price of 100% of the principal amount of the Notes plus accrued and unpaid interest on December 1, 2009, 2014, and 2019, or upon the occurrence of certain events provided in the indenture governing the Notes.

In connection with the issuance of the Notes, the Company incurred $3.4 million of issuance costs, which primarily consisted of investment banking fees, legal and other professional fees. These costs are being amortized to interest expense over a five-year period from December 2004 through November 2009, coinciding with the start of the period in which the Note holders may require the Company to redeem the Notes. The unamortized balance of these costs is included in other non-current assets in the accompanying consolidated balance sheets.

Stock-Based Compensation

The Company accounts for its stock-based compensation plans under the intrinsic value method, which follows the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. In accordance with APB Opinion No. 25, the Company does not record any expense when stock options are granted that are priced at the fair market value of the Company's stock at the date of grant.

To estimate compensation expense which would be recognized under SFAS No. 123, *Accounting for Stock-based Compensation*, the Company uses the modified Black-Scholes option-pricing model with the following weighted-average assumptions for options granted:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Risk-free interest rate	4.6%	3.9%	4.3%	3.9%
Expected dividend yield	0%	0%	0%	0%
Volatility	82%	88%	82%	89%
Expected life	7.3 years	5.8 years	7.3 years	5.9 years

If compensation cost for the Company's stock option plans and its stock purchase plan had been determined based on the fair value at the grant dates for awards under those plans in accordance with SFAS No. 123, the Company's net loss and net loss per common share for the three and six months ended June 30, 2004, and 2005 would have been the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Net loss, as reported	$(54,504)	$(23,796)	$(58,347)	$(44,831)
Add:				
Stock-based compensation included in reported net loss	2,084	1,794	2,129	2,993
Total stock-based compensation expense determined under fair value-based method for all awards	(2,574)	(1,806)	(5,148)	(20,889)
Pro forma net loss	$(54,994)	$(23,808)	$(61,366)	$(62,727)
Basic and diluted net loss per share:				
As reported	$ (0.64)	$ (0.27)	$ (0.74)	$ (0.51)
Pro forma	$ (0.64)	$ (0.27)	$ (0.77)	$ (0.71)

For purposes of this pro forma disclosure, the value of the options is amortized ratably to expense over the options' vesting periods. Because the estimated value is determined as of the date of grant, the actual value ultimately realized by the employee may be significantly different.

SFAS No. 123 requires the use of option-pricing models that were not developed for use in valuing employee stock options or stock purchase plan rights. The Black-Scholes option pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. Because the Company's employee stock options and stock purchase plan rights have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of employee stock options and stock purchase plan rights.

In accordance with Financial Accounting Standards Board Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, deferred compensation includes the unamortized intrinsic value of vested and unvested options assumed in the April 2004 acquisition of OctigaBay Systems Corporation. For this acquisition, the Company measured the intrinsic value based on the number of options granted and the difference between the converted exercise price of the options and the fair value of the underlying common stock based on the quoted price of the Company's common stock at the date the options were assumed. The deferred compensation is being amortized over the requisite service periods. Allocation of this acquisition related deferred compensation expense to the operating categories for the three and six months ended June 30 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Research and development	$1,072	$1,541	$1,072	$2,569
Sales and marketing	421	242	421	411
General and administrative	546	11	546	13
Total acquisition-related compensation expense	$2,039	$1,794	$2,039	$2,993

On May 11, 2005, the Board of Directors approved the acceleration of the vesting of all unvested outstanding stock options previously granted to employees and executive officers under the Company's stock option plans with a per share exercise price of $1.47 or greater (the last sale price on the Nasdaq National Market for the Company's common stock on May 10, 2005). As a result of the acceleration, options to acquire approximately 360,000 shares, with per share exercise prices ranging from $1.47 to $2.35, which otherwise would have vested from time to time over the next four years, became immediately exercisable, including options for 67,720 shares held by executive officers. Options granted to consultants and to non-employee directors were not accelerated. All other terms and conditions applicable to outstanding stock option grants, including the exercise prices and numbers of shares subject to the accelerated options, were unchanged. The acceleration resulted in a charge to income of approximately $1.1 million related to the deferred compensation of previously unvested options granted as part of the OctigaBay Systems Corporation acquisition in April 2004.

Earlier, in March 2005, the Board similarly had accelerated the vesting of all unvested outstanding stock options previously granted to employees and executive officers with a per share exercise price of $2.36 or higher, resulting in options to acquire approximately 4.2 million shares of the Company's common stock to become immediately exercisable.

The acceleration eliminates future compensation expense that the Company would have recognized in its statement of operations with respect to these options upon the adoption of SFAS No. 123(R), *Shared-Based Payment,* on January 1, 2006. The acceleration of existing stock options resulted in the substantial increase in the stock-based compensation expense for the six months ended June 30, 2005, set forth in the above table, as compared to earlier periods.

Reclassifications

Certain prior-period amounts have been reclassified to conform with the current-period presentation.

Recent Accounting Pronouncement

In December 2004 the FASB issued SFAS No. 123(R), *Share-Based Payment.* SFAS No. 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost should be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123(R) covers a wide range of share-based compensation arrangements including employee share options, performance-based awards and employee stock purchase plans. SFAS No. 123(R) will be effective for the Company as of January 1, 2006. The impact of the adoption of SFAS No. 123(R) cannot be accurately computed at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net loss and net loss per share in the Stock-Based Compensation section above.

Litigation

The Company was served on May 25, 2005, with a complaint filed by Marie Limantour, on behalf of herself and all others similarly situated, in the U.S. District Court for the Western District of Washington. The Company subsequently was served with five additional similar complaints filed against it in that court on June 3, 2005, and later dates. Each of the complaints names the Company and certain of its current and former officers as defendants. The plaintiffs in these complaints seek to represent a class of purchasers of its securities during periods that begin as early as October 23, 2002, and end as recently as May 12, 2005. The complaints allege federal securities law violations in connection with the issuance of various reports, press releases and in some cases, statements in investor telephone conference calls. Each complaint requests certification of the class described therein and seeks unspecified damages, interest, attorneys' fees, costs and other relief. The Company expects that these cases will be consolidated into a single action. The Company disputes the allegations contained in these complaints, and intends to contest them aggressively. The ultimate outcome of these matters cannot be now determined, but management believes that the final disposition of these proceedings will not have a material adverse effect on the financial position, results of operations or liquidity of the Company.

On June 3 and June 17, 2005, two shareholder derivative complaints were filed in the U.S. District Court for the Western District of Washington against members of the Company's Board of Directors and certain current and former officers. The derivative plaintiffs purport to act on behalf of the Company and make allegations substantially similar to those in the putative class action complaints, as well as allegations of breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. The complaints seek to recover on behalf of the Company unspecified damages and seek attorney's fees, costs and other relief. The Company expects that these cases will be consolidated into a single action.

Other Matters

Change in Auditors. On April 11, 2005, Deloitte & Touche LLP ("D&T") informed the chairman of the Company's Audit Committee that D&T would not stand for re-election as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2005. The Company was informed by D&T that its decision not to stand for re-election was not the result of any disagreements between the Company and D&T on matters of accounting principles or practices, financial statement disclosure or audit scope or procedures.

The audit reports of D&T on the Company's financial statements for fiscal years ended December 31, 2003, and 2004 contained no adverse opinion or disclaimer of opinion, and were not qualified or modified as to uncertainty, audit scope or accounting principles. In the past two years, there have been no disagreements between the Company and D&T on any matter of accounting principles or practices, financial statement disclosure or audit scope or procedure which, if not resolved to D&T's satisfaction, would have caused it to make a reference to the subject matter of the disagreement in connection with its reports.

On June 30, 2005, the Company's Audit Committee engaged the firm of Peterson Sullivan PLLC ("Peterson Sullivan") of Seattle, Washington to act as its independent registered public accounting firm. Prior to that date, the Company did not consult with Peterson Sullivan regarding either: (i) the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company's financial statements; or (ii) any matter that was either the subject of a disagreement (as defined in Item 304(a)(1)(iv) of Regulation S-K and the related instructions of that Item) or a reportable event (as described in Item 304(a)(i)(v) of Regulation S-K).

Nasdaq Potential Delisting Notice. On May 6, 2005, the Company received a notice from the Listing Qualifications Department of The Nasdaq Stock Market ("Nasdaq") stating that, due to the auditor's disclaimer of opinion on management's assessment of internal control over financial reporting required pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 in its Form 10-K/A filed on May 3, 2005, the Company was not in compliance with the requirements of Marketplace Rule 4310(c)(14). As a result, the trading symbol for the Company's common stock was changed from "CRAY" to "CRAYE" at the opening of business on May 10, 2005, and a hearing to determine whether the Company's common stock should be delisted from the Nasdaq National Market system was scheduled. On June 1, 2005, the Company received another letter from Nasdaq stating that, upon further review, Nasdaq determined that the Company complied with all requirements necessary for continued listing on the Nasdaq National Market, and the delisting hearing was cancelled as moot. Effective with the open of business on June 3, 2005, the Company's common stock traded under its original trading symbol "CRAY".

Subsequent Events

On July 13, 2005, the U.S. Securities and Exchange Commission declared effective the Company's Registration Statement on Form S-3 relating to the resale of its issued and outstanding 3.0% convertible senior subordinated notes due 2024 (see "Convertible Notes Payable" above) and the shares of common stock issuable upon conversion of the notes. The Company will not receive any proceeds from the sale by any selling security holder of these notes or the common stock issuable upon conversion of the notes.

On August 8, 2005, the Company's Board of Directors announced that Peter J. Ungaro had been appointed Chief Executive Officer of the Company, that Stephen C. Kiely had been appointed non-executive Chairman of the Board of Directors and that James E. Rottsolk was retiring as both Chief Executive Officer and as Chairman of the Board of Directors. Mr. Ungaro was also elected to the Board of Directors; Mr. Rottsolk continues as a Board member.

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

Preliminary Note Regarding Forward-Looking Statements

The information set forth in this Item 2 includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and is subject to the safe harbor created by those sections. Factors that realistically could cause results to differ materially from those projected in the forward- looking statements are set forth in the following discussion and under "Factors That Could Affect Future Results" beginning on page 23. The following discussion should also be read in conjunction with the Financial Statements and Notes thereto.

Overview

We design, develop, market and service high performance computer systems, commonly known as supercomputers. These systems provide capability and capacity far beyond typical server-based computer systems and address challenging scientific and engineering computing problems for government, industry and academia.

We are dedicated solely to the high performance computing market. We have concentrated our product roadmap on building purpose-built, balanced systems combining highly capable processors (whether developed by ourselves or by others) with rapid interconnect and communications capabilities throughout the entire computing system, not solely processor-to-processor. We believe we are very well positioned to meet the high performance computer market’s demanding needs by providing superior supercomputer systems with performance and cost advantages over low-bandwidth and cluster systems when sustained performance on challenging applications and workloads and total cost of ownership are taken into account.

We also derive revenue from providing maintenance and support services to the worldwide installed base of Cray computers and professional services that leverage our industry technical knowledge.

Our revenue, net income or loss and cash balances are likely to fluctuate significantly from quarter to quarter and within a quarter due to the high average sales prices and limited number of sales of our larger products, the timing of purchase orders and product deliveries, our general policy of not recognizing product revenue for our larger systems 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 inventory. Given the nature of our business, our revenue, receivables and other related accounts are likely to be concentrated among a few customers.

In 2002 we completed hardware development of and began selling our Cray X1 system. We were then also selling other hardware products we obtained with the acquisition of the Cray Research assets from SGI in 2000. In mid-2002 we began development of the Red Storm project for Sandia National Laboratories and began work on the Cascade project under a grant from the Defense Advanced Research Projects Agency (“DARPA”). In 2003 we were principally selling Cray X1 systems and continuing work on the Red Storm and Cascade projects. In 2004 we were in transition from a single product, the Cray X1 system, to three new products: the Cray X1E system, an enhancement to the Cray X1 system that significantly increases processor speed and capability; the Cray XT3 system, developed through the Red Storm project; and the Cray XD1 system, a product in development we acquired with the April 2004 acquisition of OctigaBay Systems Corporation. Initial customer shipments for each of these products occurred in late 2004, with full production ramp in the first half of 2005.

We experienced net losses in each full year of our development stage operations prior to 2002. For 2002, we had net income of $5.4 million and for 2003 we had net income of $63.2 million (including an income tax benefit of $42.5 million from the reversal of a valuation allowance against deferred tax assets). For 2004 we had a net loss of $204.0 million (including an expense for acquired in-process research and development of $43.4 million and an income tax expense of $59.1 million related to the establishment of a valuation allowance against deferred tax assets). For the six months ended June 30, 2005, we had a net loss of $44.8 million. In order to become profitable, we need to complete system software development for our Cray XT3 and Cray XD1 systems and obtain related product acceptances, obtain sufficient revenue and margins in a highly competitive market and control expense levels while not adversely impacting future growth.

Factors that should be considered in evaluating our business, operations and prospects and that could affect our future results and financial condition are set forth below under “Factors That Could Affect Future Results.”

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 accounting principles generally accepted in the United States of America for interim financial information. 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. On an ongoing basis, we evaluate the estimates used, including those related to estimates of deferred tax realization, valuation of inventory at the lower of cost or market, the percentage complete and estimated gross profit on the Red Storm and Cascade contracts, and impairment of goodwill.

We base our estimates on historical experience, current conditions and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources as well as identifying and assessing our accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies involve the more significant judgments and estimates used in the preparation of the condensed consolidated financial statements.

Revenue Recognition

Products: We recognize revenue from our product lines, as follows:

- *Cray X1/X1E and XT3 Product Lines:* We generally recognize revenue from product sales upon customer acceptance and when there are no unfulfilled company obligations that affect the customer's final acceptance. A customer-signed notice of acceptance or similar document is required from the customer prior to revenue recognition.
- Cray *XD1 Product Line:* We generally recognize revenue from product sales of Cray XD1 systems upon shipment to or delivery to the customer, depending upon contract terms. If there is a contractual requirement for customer acceptance, revenue is recognized upon receipt of the notice of acceptance and when we have no unfulfilled obligations.

Revenue from contracts that require us to design, develop, manufacture or modify complex information technology systems to a customer's specifications, and to provide services related to the performance of such contracts, is recognized using the percentage of completion method for long-term development projects. Percentage of completion is measured based on the ratio of costs incurred to date compared to the total estimated costs. Total estimated costs are based on several factors, including estimated labor hours to complete certain tasks and the estimated cost of purchased components at future dates. Estimates may need to be adjusted from quarter to quarter, which would impact revenue and margins on a cumulative basis. To the extent the estimate of total costs to complete the contract indicates a negative margin, the loss is recognized in full at the time.

Revenue from contracts structured as operating leases is recorded as earned over the lease terms.

Services: Revenue for the maintenance of computers is recognized ratably over the term of the maintenance contract. Funds from maintenance contracts that are paid in advance are recorded as deferred revenue. High performance computing service revenue is recognized as the services are rendered.

Multiple-Element Arrangements. We commonly enter into transactions that include multiple-element arrangements, which may include any combination of hardware, maintenance and other services and/or software. In accordance with Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, when some elements are delivered prior to others in an arrangement and all of the following criteria are met, revenue for the delivered element is recognized upon delivery and acceptance of such item:

- The fair value of the elements, or for residual method calculations, the undelivered element, is established;
- The functionality of the delivered elements are not dependent on the undelivered elements; and
- Delivery of the delivered elements represent the culmination of the earnings process.

If all of the criteria are not met, revenue is deferred until delivery of the last element.

Inventories

We record our inventories at the lower of cost or market. We regularly evaluate the technological usefulness of various inventory components. When it is determined that previously inventoried components do not function as intended in a fully operational system, the costs associated with these components are expensed. Due to rapid changes in technology and the increasing demands of our customers, we are continually developing new products. As a result, it is possible that older products we have developed may become obsolete or we may sell these products below cost. When we determine that we will likely not recover the cost of inventory items through future sales, we write down the related inventory to our estimate of its market value. In the quarters ended March 31, 2005, and June 30, 2005, we wrote down product inventory by $0.2 million and $1.4 million, respectively. Because our larger systems have high average sales prices and because a high number of our prospective customers receive funding from U.S. or foreign governments, it is difficult to estimate future sales of our products and the timing of such sales. It also is difficult to determine whether the cost of our inventories will ultimately be recovered through future sales. While we believe our inventory is stated at the lower of cost or market and that our estimates and assumptions to determine any adjustments to the cost of our inventories are reasonable, our estimates may prove to be inaccurate. We have sold inventory previously reduced in part or in whole to zero, including the first half of 2005 (see Notes to the Condensed Consolidated Financial Statements above), 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.

Business Combinations

Business combinations accounted for under the purchase method of accounting include the results of operations of the acquired business from the date of acquisition. Net assets of the company acquired are recorded at their fair value at the date of acquisition. Amounts allocated to in-process research and development are expensed in the period of acquisition. The valuation of the shares issued is based on a seven-day stock price average using the measurement date and three days prior to and after this date. If the Company issued a public announcement of the acquisition, the measurement date is the date of such announcement. If the purchase consideration is based on a formula, the measurement date is based on the requirements in Emerging Issues Task Force Issue No. 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*. If no public announcement was made and a formula is not used in determining the purchase consideration, then the measurement date is the date of purchase.

Goodwill

Approximately 19% of our assets as of June 30, 2005, consisted of goodwill resulting from our acquisitions of the Cray Research business unit from SGI in 2000 and our acquisition of OctigaBay Systems Corporation in April 2004. We no longer amortize goodwill associated with the acquisitions, but we conduct ongoing analyses of the recorded amount of goodwill in comparison to its estimated fair value. We performed our annual impairment test effective January 1, 2005, and determined that our recorded goodwill was not impaired. This analysis and ongoing analyses of whether the fair value of recorded goodwill is impaired involves a substantial amount of judgment. Future charges related to goodwill could be material depending on future developments and changes in technology and our business.

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 are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. In accordance with SFAS No. 109, *Accounting for Income Taxes,* a valuation allowance for deferred tax assets is provided when it is estimated that it is more likely than not that all or a portion of the deferred tax assets may not be realized through future operations. The provision for or benefit from income taxes represents taxes payable or receivable for the current period plus the net change in deferred tax and valuation allowance amounts during the period. As of June 30, 2005, we had approximately $122.2 million of deferred tax assets, all of which were fully reserved. In addition, we had $1.3 million of deferred tax liabilities. For the three and six months ended June 30, 2005, we recognized income tax expense of $305,000 and $425,000, respectively.

Allowance for Doubtful Accounts

Our management must make estimates of allowances for potential future uncollectible amounts related to current period revenues of our products and services. Our allowance for doubtful accounts is a management estimate that considers actual facts and circumstances of individual customers and other debtors, such as financial condition and historical payment trends. We evaluate the adequacy of the allowance utilizing a combination of specific identification of potentially problematic accounts and identification of accounts that have exceeded payment terms. As of June 30, 2005 and December 31, 2004, our allowance for doubtful accounts was $1.3 million and $1.4 million, respectively.

Red Storm Loss Reserves

In accordance with our revenue recognition policy, revenue from our Red Storm development project is recognized using the percentage of completion method. Percentage of completion is measured based on the ratio of costs incurred to date compared to total estimated costs. On an on-going basis, we revise our estimate of total costs expected to be incurred on the contract. In the third quarter of 2004, we concluded this would be a loss contract for us. As of December 31, 2004, our estimated cumulative loss was $7.6 million and as of June 30, 2005, our estimated cumulative loss was $15.5 million. The remaining loss reserves are included in accrued liabilities in the accompanying condensed consolidated balance sheets.

Results of Operations

Product Revenue

Product revenue was $40.2 million and $66.5 million for the three and six months ended June 30, 2005, compared to $9.5 million and $37.9 million for the respective 2004 periods. Product revenue represented 75% and 73% of total revenue for the three and six months ended June 30, 2005, compared to 44% and 59% for the respective 2004 periods, and consisted of $35.4 million primarily for our Cray X1E systems but also for our Cray XT3 and Cray XD1 systems and other products, and $4.8 million for our Red Storm and Cascade development projects in the three months ended June 30, 2005. Product revenue for the three months ended June 30, 2004, consisted of $3.6 million for our Cray X1 and other products, and $5.9 million for our Red Storm and Cascade development projects.

Product revenue for the first half of 2005 does not include revenue for several systems that were shipped and installed in the quarter due to pending customer acceptances; we expect to recognize revenue for many of those systems in the second half of 2005 and therefore, we expect our product revenue to increase over the first half. Quarterly product revenue is likely to vary significantly, and is likely to be weighted more significantly to the fourth quarter of 2005.

Service Revenue

We recorded service revenue, which includes revenue from maintenance services and professional services, of $13.2 million and $24.5 million for the three and six months ended June 30, 2005, compared to $12.2 million and $25.9 million for the respective 2004 periods. In the second quarter of 2005, service revenue benefited from a product acceptance which allowed us to recognize revenue on previously performed services. Service revenue represented 25% and 27% of total revenue for the three and six months ended June 30, 2005, compared to 56% and 41% for the corresponding 2004 periods. The decrease in percentage contribution to total revenue in 2005 is due to increased product revenue.

Maintenance services are provided under maintenance contracts with our customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods. Maintenance service revenue has declined on an annual basis as older systems are withdrawn from service. We expect the absolute amount of maintenance service revenue to continue to decline slowly over the next year as our older systems continue to be withdrawn from service and then to stabilize as our new systems are placed in service. We also expect that our newer products will require less hardware maintenance than our historic vector systems, which will adversely affect future service revenue.

Operating Expenses

Cost of Product Revenue. We recorded cost of product revenue of $41.2 million and $67.6 million for the three and six months ended June 30, 2005, compared to $9.3 million and $29.0 million for the respective 2004 periods. Our cost of product represented 103% and 102% of product revenue for the three and six months ended June 30, 2005, compared to 97% and 77% for the corresponding 2004 periods. Second quarter 2005 cost of product revenue was adversely affected by the recognition of an additional $7.8 million loss on the Red Storm project, a $2.3 million charge for write-downs of excess and scrap inventory and a $0.4 million charge for amortization of core technology acquired as part of the OctigaBay Systems Corporation acquisition in April 2004. In addition to the foregoing, year-to-date cost of product revenue also was adversely affected by manufacturing variances aggregating $5.0 million, including a $2.2 million charge related to the absorption of manufacturing overhead, a $1.1 million charge related to the termination of IBM as our foundry supplier and $0.4 million of amortization of core technology acquired as part of the OctigaBay acquisition.

We presently estimate that we will recognize a cumulative loss of approximately $15.5 million on the Red Storm contract. In the first half of 2005, we recorded a loss of $7.9 million on the Red Storm contract, and we expect to record zero margin on future Red Storm revenue.

Cost of Service Revenue. We recorded cost of service revenue of $7.5 million and $15.1 million for the three and six months ended June 30, 2005, compared to $7.8 million and $16.4 million for the corresponding 2004 periods. Our cost of service revenue represented 57% and 62% for the three and six months ended June 30, 2005, compared to 64% and 63% for the corresponding 2004 periods. The decrease in cost of service revenue in 2005 is primarily due to the 2004 restructuring efforts, which reduced headcount by approximately 12%.

As we continue to experience declines in maintenance revenue as new shipments have not offset retirements, we may continue to reduce maintenance service personnel and experience associated severance expenses. We expect cost of service revenue for the next several quarters to be in the range of approximately 60%-65% of revenue.

Research and Development

Research and development expenses for the three and six months ended June 30, 2005, reflect our costs associated with the development of the Cray X1E, Cray XD1 and Cray XT3 systems and successor projects, including related software development. Research and development expenses also include personnel expenses, allocated overhead and operating expenses, software, materials and engineering expenses, including payments to third parties. Gross research and development in the table below reflects all research and development expenditures, including expenses related to our research and development activities on the Red Storm and Cascade projects. The government funding reflects reimbursement by the government for development and services, including development of enhancements and successors to the Cray X1E system and other products, and our research and development personnel dedicated to the Red Storm and Cascade projects. The Red Storm and Cascade research and development costs are reflected as cost of product revenue and the related reimbursements are recorded as product revenue. Research and development expenses for the three and six months ended June 30 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Gross research and development	$ 24,878	$ 24,205	$ 44,894	$ 46,494
Governmental funding	(12,485)	(10,778)	(23,468)	(20,035)
Net research and development expense	$ 12,393	$ 13,427	$ 21,426	$ 26,459

Net research and development expenditures represented 25% and 29% of total revenue for the three and six months ended June 30, 2005, as compared to 57% and 34% for the corresponding 2004 periods. The lower 2005 percentage is due to the higher revenue recognized in that period. Net research and development expenditures increased in the three and six months ended June 30, 2005, primarily due to increased amortization of deferred stock compensation, deprecation from additional capitalized computer equipment and increased costs for the use of third-party design tools. We expect that net research and development expenses will decline throughout the rest of 2005, given the 2004 and June 2005 restructuring actions coupled with an increase in government funding.

Sales and Marketing

Sales and marketing expenses were $7.6 million and $14.2 million for the three and six months ended June 30, 2005, compared to $8.6 and $16.2 million for the corresponding 2004 periods. The decrease in the expenses in 2005 is primarily due to a decrease in external benchmark machine usage and a decrease in headcount as a result of the third quarter 2004 restructuring. Sales and marketing expenses in the second half of 2005 are expected to be in the same range as the first half as we expect costs associated with a major trade-show and higher sales commissions will be offset by lower personnel costs.

General and Administrative

General and administrative expenses were $4.6 million and $8.9 million for the three and six months ended June 30, 2005, compared to $4.5 million and $7.4 million for the corresponding 2004 periods. The increase in general and administrative costs in 2005 is due primarily to consulting costs related to Sarbanes-Oxley Act of 2002 compliance and increased audit fees. We expect general and administrative expenses in the third quarter and beyond to increase as we continue to expend significant efforts on achieving Sarbanes-Oxley compliance and we begin to incur legal fees associated with the litigation filed against us and certain officers and directors.

Restructuring and Severance Charges

Restructuring and severance charges primarily represent out efforts to reduce our overall cost structure primarily by reducing headcount. During the three months ended June 30, 2005, we implemented a worldwide reduction in our work force of approximately 90 employees, or 10%, primarily in operations, sales and marketing. While this resulted in charges of $1.9 million, we anticipate future benefits to be in the range of $5.5 million annually.

Other Income (Expense), net

For the three and six months ended June 30, 2005, we recognized other income, net, of $153,000 and other expense, net, of $349,000, respectively. For the three and six months ended June 30, 2004, we recognized other income, net, of $184,000 and other expense, net, of $202,000, respectively. These balances consisted primarily of foreign currency gains and losses.

Interest Income (Expense)

Interest income was $77,000 and $415,000 for the three and six months ended June 30, 2005, compared to $47,000 and $206,000 for the corresponding 2004 periods. Interest income benefited in the first quarter of 2005 from comparatively high invested cash balances generated from the net proceeds of our December 2004 convertible note offering.

Interest expense was $825,000 and $1.6 million for the three and six months ended June 30, 2005, compared to $22,000 and $38,000 for the corresponding 2004 periods. During 2005, we recognized $1.2 million of interest expense on our 3.0% convertible senior subordinated notes which were issued in December 2004 and approximately $340,000 of amortization of the prepaid issuance costs incurred in connection with that financing.

Taxes

We recorded a tax provision of $305,000 and $425,000 for the three and six months ended June 30, 2005, compared to a tax benefit of $9.5 million and $11.7 million for the respective 2004 periods. The tax expense recognized in 2005 reflects estimated current foreign and state income tax expense for the first half of the year. The tax benefit recorded in 2004 represented the recognition of deductible temporary differences that occurred in those periods. In the third quarter of 2004, we determined that it was not more likely than not that future economic benefits resulting from these temporary differences would be recognized, and a valuation allowance was recorded.

Liquidity and Capital Resources

Cash, cash equivalents, restricted cash, short-term investments and accounts receivable totaled $59.7 million at June 30, 2005, compared to $120.6 million at December 31, 2004. Over that period, cash, cash equivalents, restricted cash and short-term investments decreased from $87.4 million to $8.5 million. At June 30, 2005, we had working capital of $55.4 million compared to $96.0 million at December 31, 2004. Reducing working capital was $54.2 million and $53.5 million of deferred revenue as of December 31, 2004, and June 30, 2005, respectively.

Net cash used by operating activities for the six months ended June 30, 2005, was $77.2 million compared to $26.6 million for the respective 2004 period. For the six months ended June 30, 2005, net operating cash was used primarily by our net operating loss, increases in inventory and accounts receivable offset in part by increases in accounts payable.

Net cash provided by investing activities was $31.4 million for the six months ended June 30, 2005, compared to net cash used by investing activities of $6.4 million for the respective 2004 period. Net cash provided by investing activities for 2005 consisted primarily of net sales of short-term investments of $34.2 million, which was partially offset by purchases of approximately $2.8 million of property, plant and equipment.

Net cash provided by financing activities was $12.9 million for the six months ended June 30, 2005, compared to $7.8 million for the respective 2004 period. The 2005 net cash provided by financing activities was primarily the decrease in restricted cash and from the issuance of common stock through our 401(k) plan and our employee stock purchase plan. The 2004 net cash provided by financing activities was primarily from the issuance of common stock pursuant to warrant and stock option exercises and our 401(k) plan.

Over the next twelve months, our significant cash requirements will relate to operational expenses, consisting primarily of personnel costs, costs of inventory and spare parts as we continue production of Cray X1E, Cray XD1 and Cray XT3 products, third-party engineering expenses, and acquisition of property and equipment. Our remaining fiscal year 2005 capital expenditure budget for property and equipment is estimated currently between $4 and $5 million. In addition, we lease certain equipment used in our operations under operating or capital leases in the normal course of business. The following table is a summary of our contractual cash obligations as of June 30, 2005 (in thousands):

Contractual Obligations	Total	Payments Due By Periods Less than 1 year	1-3 years	4-5 years
Development agreements	$21,420	$17,975	$3,423	$ 22
Operating leases	10,479	3,180	5,663	1,636
Total contractual cash obligations	$31,899	$21,155	$9,086	$1,658

At any particular time, our cash position is affected by the timing of payment for product sales, receipt of payments on maintenance contracts, receipt of government funding of research and development activities and payment for inventory, resulting in significant quarter-to-quarter and within a quarter fluctuations in our cash balances. Our principal sources of liquidity are our cash, cash equivalents, operations and credit facility. We experienced lower than anticipated product sales and delays in the availability of our new products in 2004, which adversely affected cash flows in the first half of 2005. We have used significant working capital in the first half of 2005 due to our operating loss, increased inventory purchases, increased accounts receivable and additional equipment purchases associated with the introduction of three new products. Assuming acceptances of and payment for large installed systems and benefit from our 2004 and 2005 restructurings and other recent expense control efforts, we expect our cash flow to turn positive in the second half of this year.

If we were to experience a material shortfall in our 2005 plans, we would take all appropriate actions to ensure the continuing operation of our business and to mitigate any negative impact on our profitability and cash reserves. The range of actions we could take includes, in the short-term, reductions in inventory purchases and commitments, obtaining higher reimbursements for research and development activities and seeking financing from strategic partners and other financial sources and, on a longer-term basis, further reducing headcount-related expenses, reevaluating our global sales model, restricting or eliminating unfunded product development programs and licensing intellectual property.

We are focused on obtaining acceptances of certain installed large systems, expense controls and working capital management in order to maintain adequate levels of cash. While we believe these steps will generate sufficient cash funds to fund our operations for the rest of the year, we may enhance and strengthen our cash and working capital position by raising additional equity or debt capital. There can be no assurance that we would succeed in these efforts or that additional funding would be available. Beyond 2005, the adequacy of our resources largely will depend on our success in reestablishing profitable operations and positive operating cash flows on a sustained basis. See “Factors That Could Affect Future Results” below.

Factors That Could Affect Future Results

The following factors should be considered in evaluating our business, operations and prospects, they may affect our future results and financial condition and they may affect an investment in our securities. Factors specific to our 3.0% Convertible Senior Subordinated Notes due 2024 (the “Notes”) and our common stock are set forth under the subheading “Factors Pertaining to Our Notes and Underlying Common Stock” below.

We face increased liquidity risk if cash flow from operating activities does not improve in the second half of 2005. During the six months ended June 30, 2005, we incurred a net loss of $44.8 million and used $77.2 million of cash in operating activities. We used significant working capital in the first half of 2005 to fund our operating loss, increased inventory purchases, increased accounts receivable and additional equipment purchases associated with the introduction of three new products. Our plans project that our current cash resources, including our credit facility, and cash to be generated from operating activities should be adequate for the remainder of the year. These plans assume customer acceptances and subsequent collections from several large customers. Should acceptances be delayed significantly, we could face a significant liquidity challenge and require us to pursue additional initiatives to reduce costs further, including reductions in inventory purchases and commitments and/or seek additional financing. There can be no assurance we will be successful in its efforts to achieve future profitable operations or generate sufficient cash from operations, or obtain additional funding in the event our financial resources became insufficient.

We may be unable to obtain the funding necessary to reduce our liquidity risk. We currently are focused on obtaining acceptances of certain installed large systems, expense controls and working capital management in order to maintain adequate levels of cash. While we believe these steps, along with existing cash resources and our credit facility should be sufficient cash to fund our operations through the remainder of 2005, we may enhance and strengthen our cash and working capital position by raising additional equity or debt capital. A financing may not be available to us when needed or, if available, may not be available on satisfactory terms, may contain restrictions on our operations, and if involving equity or debt securities could reduce the percentage ownership of our shareholders, may cause additional dilution to our shareholders and the securities may have rights, preferences and privileges senior to the Notes and/or our common stock.

Our quarterly operating results may fluctuate significantly. Our operating results are subject to significant fluctuations due to many factors, which make forecasting revenue and earnings for any period very difficult.

First, one or a few system sales may account for a substantial percentage of our quarterly revenue, and thus revenue, net income or loss and cash flow are likely to fluctuate significantly from quarter to quarter and within a quarter. This is due to the high average sales prices and limited number of sales of our larger systems per quarter, the timing of purchase orders and product delivery, and our general policy of not recognizing product revenue until customers accept our products and other contractual provisions have been fulfilled and the uncertain timing of payments for product sales, maintenance services, government research and development funding and inventory. A delay in an acceptance of a system at the end of a quarter or year or other factors affecting revenue recognition could move the associated revenue into a subsequent quarter or year and have a significant impact on revenue, earnings and cash receipts. At June 30, 2005, we had $58.8 million of inventory located at customer sites pending acceptance. Delays in developing systems and enhancements could also result in cancellation or loss of orders. These factors have applied and will continue to apply to sales of our Cray X1E, Cray XT3 and Cray XD1 systems. We anticipate continued deferrals in recognition of revenue and associated costs for certain sales of products due to contractual provisions despite earlier installation and, in most cases, significant prepayment.

Second, our 2005 quarterly revenue and product margins depends on the success in the marketplace of each of our current products — the Cray X1E, Cray XT3 and Cray XD1 systems. Both the timing of revenue recognition and the gross margin achieved on large transactions can vary significantly.

Third, a number of our prospective customers receive funding from the U.S. or foreign governments. The timing of orders from these government customers is subject to the funding schedules for the relevant government agencies and delays that may be experienced in competitive procurements. Delays in the government appropriations process, including competitive procurements, could defer purchases and revenue recognition for transactions with government agencies.

The timing of orders and shipments and quarterly results also could be affected by additional events outside our control, such as:

- the timely availability of acceptable components in sufficient quantities to meet customer delivery schedules;
- changes in levels of customer capital spending;
- the introduction or announcement of competitive products;
- the receipt and timing of necessary export licenses; and
- currency fluctuations and international conflicts or economic crises.

If we were unable to develop and install stable systems and scaling system software for the Red Storm project and our large Cray XT3 system installations, our second half 2005 results would be materially and adversely impacted. The completion of the Red Storm system at Sandia National Laboratories and the acceptance of several large system installations of our Cray XT3 system are dependent on our ability to complete the development and installation of stable systems and of system software that enables the scaling of application programs over a large number of processors. We are engaged in a significant effort to complete this development project. A substantial delay in completing this work, or a failure to do so, could result in a delays in receiving significant payments for our Red Storm project, default under our Red Storm contract, increased costs to complete the project, further delay in revenue recognition on several large Cray XT3 installations, and adversely affect the possibility of additional orders for the Cray XT3 systems and other products

We were not successful in completing the Red Storm project on time and on budget, which adversely affected our 2004 and first half 2005 earnings and could adversely affect our future 2005 earnings and financial condition. Our 2005 revenue goals are dependent on the successful completion of the Red Storm project with Sandia National Laboratories. Our work is pursuant to a fixed-price contract with payment against significant monthly milestones setting out a tight development schedule and technically challenging performance requirements. We experienced delays in receiving timely deliveries of acceptable components from third parties and development delays, which caused us to miss the contractual third quarter 2004 delivery date. Hardware shipments of the Red Storm system to Sandia commenced in the third quarter of 2004 and completion is subject to the installation of certain component upgrades when they become available. We are developing and installing system software designed to run application programs successfully over the entire system. Falling behind schedule and incurring cost overruns on the Red Storm project has adversely affected our cash flow and earnings, and we recognized an estimated loss in 2004 and recognized additional losses of $85,000 and $7.8 million in the first and second quarters of 2005, respectively. It is possible that we may have additional losses on the Red Storm contract in the second half of 2005.

Failure to complete the Red Storm system or to receive full payment for the Red Storm system would result in the recognition of additional losses , and if severe enough, could result in a contract default or termination. In the event of a contract default, we could be required to deliver all our knowledge and data that materially concerns the Red Storm systems, subject to the trade secret and intellectual property rights of third parties, and assign to Sandia all of our rights to our contractor developed technology, as such term is defined in the contract, subject to a paid-up, non-exclusive and non-transferable license to practice such technology. In the event of a contract termination, we may be liable to pay Sandia for excess costs required to complete the contract. Such delays, default declaration and/or termination could materially adversely affect other transactions with other U.S. government agencies, our 2005 results and financial condition.

Second half 2005 performance depends on increased product revenue and margins. In the first half of 2005, we have lower product revenue and margins than anticipated for all of our products. Product revenue has been adversely affected by delays in product shipments due to development delays, including system software development for large systems, and at times by the availability of key components from third party vendors. Product margins have been adversely impacted by competitive pressures, higher than anticipated manufacturing variances and the provision of additional equipment and services to satisfy delivery delays and performance shortfalls. To improve second half performance, we need to obtain acceptances of several installed large systems, receive new higher margin orders, deliver new shipments on time, receive additional government co-funding of research and development expenses, and limit manufacturing variances and other charges that adversely affect product margin.

We may not meet the covenants imposed by its current credit agreement. We are subject to various financial and other covenants related to its line of credit with Wells Fargo Foothill, Inc. If we were to fail any of the covenants, we could be subject to fees and/or the possible termination of the credit facility. Termination of our credit facility would have a material adverse impact on our liquidity.

If the U.S. government purchases fewer supercomputers, our revenue would be reduced and our earnings would be adversely affected. Historically, sales to the U.S. government and customers primarily serving the U.S. government have represented a significant market for supercomputers, including our products. From January 1, 2001, through December 31, 2002, approximately $101 million of our product revenue was derived from sales to various agencies of the U.S. government; in 2003 and 2004, approximately $145 million and $81 million of our product revenue was derived from such sales, respectively. In the six months ended June 30, 2005, $25.8 million of our product revenue was derived from U.S. government sales. Our sales of and contracts for Cray X1E systems have been largely to government agencies in the United States and other countries, and we expect that will continue throughout 2005. To date in 2005, however, we have entered into a limited number of significant new contracts for sales of Cray X1E systems to U.S. government customers, especially in the defense segment, and we do not expect sales of the Cray X1E systems in 2005 to match the level of Cray X1 system sales in 2003 to such customers. Sales to government agencies may be affected by factors outside our control, such as changes in procurement policies, budget considerations and international political developments. If agencies and departments of the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue would be reduced, which could lead to reduced profitability or losses in future periods.

Our inability to overcome the technical challenges of completing the development of our high performance computer systems would adversely affect our revenue and earnings in 2005 and beyond. Our success in 2005 and in the following years depends on completing the Red Storm project; completing initial development (particularly of system software) and successfully selling the Cray XT3 system, which involves adapting the Red Storm concept for the broader governmental, industrial and academic markets; successfully selling the Cray X1E system as a significant enhancement to the Cray X1 system; and completing enhancements to the Cray XD1 system, completing stable system software to scale application programs across multiple units and successfully selling the Cray XD1 system in the midrange market. In subsequent years we must develop further hardware and software enhancements to the Cray XT3 and the Cray XD1 systems, as well as successfully complete several key projects on our product road map, including a special purpose product that is expected to contribute significantly in 2006. These hardware and software development efforts are lengthy and technically challenging processes, and require a significant investment of capital, engineering and other resources. Our engineering and technical personnel resources are limited, and our 2004 and 2005 restructurings have strained our engineering resources further. Given the breadth of our engineering challenges, we periodically review the anticipated contributions and expense of our product programs to determine their long-term viability. We may not be successful in meeting our development schedules for technical reasons and/or because of insufficient engineering resources. Delays in completing the design of the hardware components, developing requisite system software or in integrating the full systems, all of which may be hampered by our financial liquidity situation, would make it difficult for us to develop and market these systems successfully and could cause a lack of confidence in our capabilities among our key customers. At the beginning of 2004, we had planned on generating sizeable revenue shipments of the Cray X1E and XT3 systems in the second half of 2004. Due to development delays, however, we did not record any Cray X1E or Cray XT3 system revenue in 2004. We may incur similar delays in the future, which would adversely affect our revenue and earnings.

The decline in the vector processor market may make sales of the Cray X1 and Cray X1E systems more difficult, which would adversely affect our revenue and earnings. The market for vector-based systems has declined over the past several years, and is now served only by NEC and us. We expect that in 2005, sales of Cray X1E systems primarily will be to domestic and foreign government agencies, including upgrades to existing Cray X1 customers. The Cray X1E system offers processor speed improvements and enhanced price-performance characteristics. Lack of parts availability may impact new Cray X1E revenues after 2005. If we are unable to market and sell the Cray X1E system successfully, our revenue and earnings will be adversely affected.

If we cannot attract, retain and motivate key personnel, we may be unable to effectively implement our business plan. Our success also depends in large part upon our ability to attract, retain and motivate highly skilled management, technical and marketing and sales personnel. The loss of and failure to replace key engineering management and personnel could adversely affect our multiple development efforts. Recruitment for highly skilled management, technical, marketing and sales personnel is very competitive, and we may not be successful in attracting and retaining such personnel. As part of our strategy to attract and retain personnel, we offer stock option grants. However, given the fluctuations of the market price of our common stock, potential employees may not perceive our equity incentives such as stock options as attractive, and current employees whose options are no longer priced below market value may choose not to remain employed by us. We may not have sufficient options in reserve to offer attractive retention packages to key employees and to offer sufficient options to attract new potential hires. 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. In the second quarter of 2005 we obtained the services of Margaret Williams as Senior Vice President responsible for engineering and Brian C. Henry as Executive Vice President and Chief Financial Officer, and Peter J. Ungaro was recently elevated to Chief Executive Officer. Additional changes to our senior management team, if they were to occur, and the integration of new senior executives could result in some disruption to our business while these new executives become familiar with our business model and establish their management systems. If our new management team, including any additional senior executives who join us in the future, is unable to work together effectively to implement our strategies and manage our operations and accomplish our business objectives, our ability to grow our business and successfully meet operational challenges could be severely impaired.

Our reliance on third-party suppliers poses significant risks to our business and prospects. We subcontract the manufacture of substantially all of our hardware components for all of our products, including integrated circuits, printed circuit boards, connectors, cables, power supplies, software components and certain memory parts, on a sole or limited source basis to third-party suppliers. We use contract manufacturers to assemble our components for all of our systems. We are subject to substantial risks because of our reliance on these and other limited or sole source suppliers. For example:

- if a supplier did not provide components that met our specifications in sufficient quantities, then production and sale of our systems would be delayed;
- if a reduction or an interruption of supply of our components occurred, either because of a significant problem with a supplier or a single-source supplier deciding to no longer provide those components to us, it could take us a considerable period of time to identify and qualify alternative suppliers to redesign our products as necessary and to begin manufacture of the redesigned components or we may not be able to so redesign such components;
- if we were ever unable to locate a supplier for a key component, we would be unable to deliver our products;
- one or more suppliers could make strategic changes in their product offerings, which might delay, suspend manufacture or increase the cost of our components or systems; and
- some of our key 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.

Our products must meet demanding specifications, such as integrated circuits that perform reliably at high frequencies in order to meet acceptance criteria. From time to time in 2004 and 2005 we have incurred delays in the receipt of key components for the Cray X1E, Red Storm, Cray XT3 and the Cray XD1 systems. The delays in product shipments and acceptances adversely affected 2004 and first half 2005 revenue and margins, and may continue to so in the second half of 2005.

We have used IBM as a key foundry supplier of our integrated circuits for many years. In 2004 IBM informed us that it would no longer act as our foundry supplier on a long-term basis, although it will continue production of our current products for a limited time. We have negotiated a termination of the relationship with IBM and completed contracts with Texas Instruments Incorporated to act as our foundry for certain key integrated circuits for new products planned for 2006 and later. Moving to a new foundry involves a costly redesign of components and processes that will adversely affect operating results in 2005, limit availability of parts for existing products, and may cause delays in the development of these future products.

Our Cray XT3 and Cray XD1 systems utilize AMD OpteronTM processors. If AMD suffers delays or cancels the development of enhancements to its processors, such as delays in the delivery of its planned dual-core processors, our Cray XT3 and Cray XD1 system sales would be adversely affected. Changing our product designs to utilize another supplier's microprocessors would be a costly and time-consuming process.

We face last-time-buy deadlines for certain key components, particularly for our Cray X1 and Cray X1E systems, for which there is no practical alternative supplier. We may have to place such last-time-buy orders before we know all possible sales prospects. We may either estimate low, in which case we limit the number of possible sales of products, or we may estimate too high, and incur inventory write-downs. Either way, our earnings would be adversely affected.

We may not achieve quarterly or annual net income on a consistent basis. We experienced net losses in each full year of our development-stage operations prior to 2002. For 2002, we had net income of $5.4 million and for 2003 we had net income of $63.2 million (including an income tax benefit of $42.5 million from the reversal of a valuation allowance against deferred tax assets). For 2004, we had a net loss of $204.0 million (including an expense for in-process research and development of $43.4 million and an income tax expense of $58.5 million related to the establishment of a valuation allowance against deferred tax assets). For the six months ended June 30, 2005, we had a net loss of $44.8 million. Whether we will achieve net income on a consistent quarterly and annual basis will depend on a number of factors, including:

- successfully selling the Cray X1E, Cray XT3 and Cray XD1 systems and other products, and the timing and funding of government purchases, especially in the United States;
- maintaining our other development projects on schedule and within budgetary limitations;
- the level of revenue in any given period, including the timing of product acceptances by customers and contractual provisions affecting revenue recognition;
- the level of product margin contribution in any given period;
- our expense levels, particularly for research and development and manufacturing and service costs;
- the terms and conditions of sale or lease for our products; and
- the impact of expensing our stock-based compensation under SFAS 123(R), once effective.

Because of the numerous factors affecting our results of operations, we cannot assure our investors that we will have consistent net income on a quarterly or annual basis in the future.

If we are unable to compete successfully in the high performance computer market, our revenue will decline. The performance of our products may not be competitive with the computer systems offered by our competitors. Many of our competitors are established companies that are well known in the high performance computer market, including IBM, NEC, Hewlett-Packard, SGI, Dell and Sun Microsystems. 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 microprocessors manufactured by Intel, AMD, IBM and others. These competitors include the previously named companies as well as smaller firms that benefit from the low research and development costs needed to assemble systems from commercially available technology. These companies have capitalized on developments in parallel processing and increased computer performance through networking and cluster systems.

Periodic announcements by our competitors of new high performance computer 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 very high performance computer systems. Some of our competitors offer trade-in allowances or substantial discounts to potential customers, and engage in other aggressive pricing tactics, and we have not always been able to match these sales incentives. We have in the past and may again be required to provide substantial discounts to make strategic sales, which may reduce or eliminate any positive margin on such transactions, or to provide lease financing for our products, which would result in a deferral of our receipt of cash for these systems. These developments limit our revenue and resources and reduce our ability to be profitable.

Our market is characterized by rapidly changing technology, accelerated product obsolescence and continuously evolving industry standards. Our success depends upon our ability to sell our current products, and to develop successor systems and enhancements in a timely manner to meet evolving customer requirements. We may not succeed in these efforts. Even if we succeed, products or technologies developed by others may render our products or technologies noncompetitive or obsolete. A breakthrough in architecture or software technology could make low-bandwidth and cluster systems even more attractive to our existing and potential customers. Such a breakthrough would impair our ability to sell our products and reduce our revenue and earnings.

If we cannot establish the value of our high-bandwidth sustained performance systems, we may not have long-term success. We are dedicated solely to the high performance computing market. We have concentrated our product roadmap on building purpose-built, balanced systems combining highly capable processors with rapid interconnect and communications capabilities throughout the entire computing system. The high performance computing market currently is replete with low-bandwidth systems and off-the-shelf commodity-based cluster systems offered by larger competitors with significant resources and smaller companies with minimal research and development expenditures. Many customers are able to meet their computer needs through the use of such systems, and are willing to accept lower capability (lower bandwidth and higher latency) and less accurate modeling in return for lower acquisition costs, even in the face of higher post-sale operating expense. If we are not successful in establishing the value of our balanced high-bandwidth systems beyond a core of customers, largely certain agencies of the U.S. government, that require systems with the performance and features we offer, we may not be successful on a long-term basis.

Failure to manufacture and sell Cray XD1 systems in planned quantities and margins would adversely affect revenue and earnings in the second half of 2005. To be successful, the Cray XD1 system must be manufactured and sold in quantities much higher than our high-end products. We have redesigned our supply and manufacturing processes to accommodate significant daily production and shipment of Cray XD1 systems, although procurement and manufacturing costs continue to be higher than anticipated. We have experienced delays in receiving acceptable components from third parties, which delayed shipments of Cray XD1 systems in the fall of 2004 and at times in 2005. We have changed our sales procedures to accommodate higher volume sales through the retraining of our current sales personnel and, with varying success, adding independent sales channels in various markets. To date these problems have proved more intractable than anticipated. We need to sell Cray XD1 systems at increased margins in a highly competitive market to improve our 2005 second half performance.

If we lose government support for supercomputer systems, our capital requirements would increase and our ability to conduct research and development would decrease. A few government agencies and research laboratories fund a significant portion of our development efforts. Agencies of the U.S. government historically have facilitated the development of, and have constituted a market for, new and enhanced very high performance computer systems. U.S. government agencies may delay or decrease funding of our future product development efforts due to a change of priorities, international political developments, overall budgetary considerations or for any other reason. Any such decrease or delay would cause an increased need for capital, increase significantly our research and development expenditures and adversely impact our profitability and our ability to implement our product roadmap.

If we were unable to port application programs to our new products successfully, we would have difficulty in selling these systems to a number of customers. To sell our products in the automotive, aerospace, chemistry and other engineering and technical markets, including certain governmental users, we must have application programs ported to these systems and tuned so that they will achieve high performance. These application programs are owned in some instances by independent software vendors and in others by potential customers. We must induce these vendors and potential customers to undertake this activity. We must also modify and rewrite third-party and customer specific application programs. We have had limited success in porting such applications to the Cray X1/X1E systems with sufficient performance to make sales of this product compelling in industrial markets. There can be no assurance that we will be able to induce third-party vendors and customers to successfully rewrite third-party and customer specific applications for use on our new products. In addition, our Cray XD1 and Cray XT3 systems use a modified version of standard Linux kernels that may result in delays in having independent software vendor certified applications available on our systems and/or a reduced number of certified applications, which would limit our ability to address some part of our target markets.

Requests for proposals based on theoretical peak performance could reduce our ability to sell our systems. Our high performance computer systems are designed to provide high actual sustained performance on difficult computational problems. Some of our competitors offer systems with higher theoretical peak performance at lower prices, although their actual sustained performance on real applications frequently is a small fraction of their theoretical peak performance. Nevertheless, a number of requests for proposals, primarily from governmental agencies in the United States and elsewhere, continue to have criteria based wholly or significantly on theoretical peak performance. Under such criteria, the price/peak performance ratio of our products compares unfavorably to the price/peak performance ratio of our competitors' products. To the extent that these criteria are not changed to favor actual performance, we will continue to be disadvantaged in these instances by being unable to submit competitive bids, which would limit our revenue potential.

Lower than anticipated sales of new supercomputers and the termination of maintenance contracts on older and/or decommissioned systems would further reduce our service revenue from maintenance service contracts. High performance computer systems are typically sold with maintenance service contracts. These contracts generally are for annual periods, although some are for multi-year periods, and provide a predictable revenue base. Our revenue from maintenance service contracts has declined from a run-rate of approximately $95 million in 2000 to approximately $46 million in 2004. We expect maintenance service revenue to decline slowly over the next year as our older systems continue to be withdrawn from service and then to stabilize as our new systems are placed in service. In addition, we expect that our newer products will require less hardware maintenance than our historic vector systems, which will adversely affect the rate of service revenue growth.

Class action and derivative lawsuits have been filed against us and additional lawsuits may be filed. We and certain of our former and current officers and directors have been named in six lawsuits based upon alleged violations of the federal securities laws and in two derivative actions. These cases are still in their early stages. Additional lawsuits may be filed against us. See Part II, Item 1 "Legal Proceedings" for a description of the pending litigation.

An adverse result in any of these cases could have a material negative financial impact on us. Regardless of the outcome, it is likely that such actions will cause a diversion of our management's time, resources and attention and the expense of defending the litigation may be costly.

If we continue to have material weaknesses in our internal controls over financial reporting we may have to restate our results for one or more future fiscal periods. In our amended 2004 Annual Report on Form 10K/A, we identified and described a number of material weaknesses in our internal control over financial reporting. A material weakness in internal control over financial reporting is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected by the internal control system. We have taken and are taking a number of steps to eliminate these material weaknesses and to prevent future material weaknesses but there can be no assurance that these actions will be effective. Depending on their nature and severity, any continuing or 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, and litigation based on the events themselves or their consequences.

Testing performed as a part of our management's evaluation of our internal control over financial reporting was insufficient to support an opinion of our auditors as to management's evaluation. The auditors for our 2004 financial statements disclaimed an opinion with respect to management's assessment of our internal control over financial reporting as of December 31, 2004, because testing that we performed in connection with management's evaluation failed to provide all of the support required to provide such an opinion. We are actively engaged in a program to ensure that adequate testing will occur in support of the 2005 audit but there can be no assurance that such testing will fully support all such requirements. Because the requirement for an attestation report applied for the first time with respect to 2004, we are unable to predict the effect of any future disclaimed opinion on management's assessment. Future disclaimers could result in an erosion in market confidence in our internal control over financial reporting. Because we did not complete the full complement of tests that would have been required to support our auditors' attestation report on management's assessment of our internal control over financial reporting for the year ended December 31, 2004, it is possible that we have not identified control issues that such testing would have revealed.

The adoption of SFAS 123(R) will lower our earnings and may adversely affect the market price of our common stock. We have used stock-based compensation, primarily stock options and an employee stock purchase plan, as a key component in our employee compensation. We currently grant stock options to each new employee and to all employees on an annual basis. We believe we have structured these programs to align the incentives for employees with those of our long-term shareholders. We are reviewing our stock-based compensation programs and their structure in light of the imposition of SFAS 123(R) which, without Congressional action, will become effective for us on January 1, 2006. In previous years, as we have reported in the footnotes to our financial statements, our stock option program as currently structured would add approximately $7 million to $13 million of additional non-cash expense annually and consequently would reduce our operating results by that amount. These estimates are based on use of the Black-Scholes valuation method, which was developed for estimating the fair value of fully transferable short-lived exchange traded options, in which a key component is the price volatility of the underlying common stock; this methodology was not designed to value longer-term employee stock options with vesting requirements and transferability restrictions. In the first half of 2005 we accelerated the vesting of our outstanding employee stock options with a per share exercise price of $1.47 or higher, resulting in the complete vesting of almost all of our then outstanding options, and granted new stock options with a December 31, 2005, vesting date, in order in part to minimize this expense, at least in the short term. We do not know how analysts and investors will react to the additional expense recorded in our statement of operations rather than in the footnotes, which may adversely affect the market price of our common stock.

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 high performance computer systems such as our products. Occasionally we have experienced delays in receiving appropriate approvals necessary for certain sales, which have delayed the shipment of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to foreign customers, eliminating an important source of potential revenue.

We incorporate software licensed from third parties into the operating systems for our 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. The operating system software we develop for our high performance computer 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 either to redesign our operating system software to function with alternate third-party software, or develop these components ourselves, which would result in increased costs and could result in delays in product shipments. Furthermore, we might be forced to limit the features available in our current or future operating system software offerings. Our Cray XD1 and Cray XT3 systems utilize operating system variants that incorporate Linux technology. The SCO Group, Inc. has filed and threatened to file lawsuits against companies that operate Linux for commercial purposes, alleging that such use of Linux infringes The SCO Group's rights. It is possible that The SCO Group could assert a claim of infringement against us with respect to our use of 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 SCO Group's lawsuit and open source generally, we may be forced to protect our customers from potential claims of infringement by The SCO Group or other parties. In any such event, our financial condition and results of operations may be adversely affected.

General economic and market conditions could decrease our revenue, increase our need for cash and adversely affect our profitability. While much of our business is related to the government sector, which is less affected by short-term economic cycles, a slow-down in the overall U.S. and global economy and resultant decreases in capital expenditures have affected sales to our industrial customers and may continue to do so. Cancellations, delays or reductions in purchases would decrease our revenue, increase our need for working capital and adversely affect our profitability.

We may infringe or be subject to claims that we infringe the intellectual property rights of others. Third parties may assert intellectual property infringement claims against us, and such claims, if proved, could require us to pay substantial damages or to redesign our existing products. Regardless of the merits, any claim of infringement requires management attention and causes us to incur significant expense to defend.

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

Factors Pertaining to our Notes and Underlying Common Stock

Our indebtedness may adversely affect our financial strength. With the sale of the Notes, we incurred $80.0 million of indebtedness. As of June 30, 2005, we had no other outstanding indebtedness for money borrowed and no material equipment lease obligations. We have a $30.0 million secured credit facility ($25.0 million is the maximum currently available) in place to support the issuance of letters of credit of which $11.5 million were outstanding as of June 30, 2005. We may incur additional indebtedness for money borrowed, which may include borrowing under new credit facilities or the issuance of new debt securities. The level of our indebtedness could, among other things:

- make it difficult or impossible for us to make payments on the Notes;
- increase our vulnerability to general economic and industry conditions, including recessions;
- require us to use cash flow from operations to service our indebtedness, thereby reducing our ability to fund working capital, capital expenditures, research and development efforts and other expenses;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- place us at a competitive disadvantage compared to competitors that have less indebtedness; and
- limit our ability to borrow additional funds that may be needed to operate and expand our business.

Our credit facility may affect our ability to make payments under the Notes. Our failure to comply with the financial covenants in our current credit facility could result in an event of default, which, if not cured or waived, could result in the acceleration of our indebtedness. Such covenants include agreements that if the credit facility is in default, we will not make payments to other creditors, including payments under the Notes. Because our credit facilities will constitute senior indebtedness, any enforcement by the Note holders of their rights under the indenture to such payments could lead to our insolvency and a proceeding in which our senior and secured indebtedness would have priority over claims under the Notes.

We will require a significant amount of cash to service our indebtedness and to fund planned capital expenditures, research and development efforts and other corporate expenses. Our ability to make payments on our indebtedness, including the Notes, and to fund planned capital expenditures, research and development efforts and other corporate expenses will depend on our future operating performance and on economic, financial, competitive, legislative, regulatory and other factors. Many of these factors are beyond our control. Our business may not generate sufficient cash flow from operations and future borrowings may not be available to us in an amount sufficient to enable us to pay our indebtedness, including the Notes, or to fund our other needs.

If we are unable to generate sufficient cash flow to enable us to pay our indebtedness, we may need to pursue one or more alternatives, such as:

- reducing our operating expenses;
- reducing or delaying capital expenditures or research and development;
- selling assets;
- raising additional equity capital and/or debt; and
- seek legal protection from our creditors.

Any reduction in operating expenses, reduction or delay in capital expenditures, or sale of assets may materially and adversely affect our future revenue prospects. In addition, we may not be able to raise additional equity capital on commercially reasonable terms or at all. Finally, any of the above actions may not provide sufficient cash to repay our indebtedness, including the Notes.

There are no covenants in the indenture for the Notes restricting our ability or the ability of our subsidiaries to incur future indebtedness or restricting the terms of any such indebtedness. The indenture governing the Notes does not contain any financial or operating covenants or restrictions on the amount or terms of indebtedness that we or any of our subsidiaries may incur. We may therefore incur additional debt without limitation by the Indenture, including senior indebtedness, to which the Notes are contractually subordinated, and secured indebtedness, to which the Notes are effectively subordinated. In addition, our subsidiaries may incur additional debt to which the Notes are structurally subordinated, without limitation. We or our subsidiaries may also agree to terms of any such indebtedness that may restrict our flexibility in complying with our obligations under the Notes. If we or any of our subsidiaries incur additional indebtedness, the related risks that we and they now face may intensify. Our credit facility, however, currently restricts our ability, directly or through our subsidiaries, to incur additional indebtedness.

The Notes are subordinated in right of payment to our existing and future senior indebtedness. The Notes are our general unsecured senior subordinated obligations. The Notes rank junior in right of payment to our existing and future senior indebtedness and equal in right of payment with any future indebtedness or other obligation that is not, by its terms, either senior or subordinated to the Notes. The indenture for the Notes does not limit our ability to incur additional indebtedness of any kind. In the event of our bankruptcy, liquidation or reorganization, the note holders will share in any assets available to our general creditors, only after all obligations to the holders of senior indebtedness have been paid. The note holders do not have the right to limit the amount of senior indebtedness or the competing claims of our general creditors.

The Notes are effectively subordinated to our secured indebtedness and are structurally subordinated to all indebtedness and other liabilities of our current and future subsidiaries. The Notes are general unsecured obligations and are effectively subordinated to our current and future secured indebtedness to the extent of the assets securing the indebtedness. The indenture for the Notes does not limit our ability to incur secured indebtedness. In the event of bankruptcy, liquidation or reorganization or upon acceleration of our secured indebtedness and in certain other events, our assets pledged in support of secured indebtedness will not be available to pay our obligations under the Notes. As a result, we may not have sufficient assets to pay amounts due on any or all of the Notes.

In addition, the Notes are structurally subordinated to all indebtedness and other liabilities of our current and future subsidiaries. Note holders do not have any claim as a creditor against our subsidiaries, and indebtedness and other liabilities, including trade payables, of our subsidiaries effectively are senior to Note holders' claims against our subsidiaries. The indenture for the Notes does not limit the ability of our subsidiaries to incur indebtedness or other liabilities. In the event of a bankruptcy, liquidation or reorganization of any of our subsidiaries, holders of their indebtedness and their trade creditors will generally be entitled to payment on their claims from assets of that subsidiary before any assets are made available for distribution to our direct creditors.

In certain circumstances, holders of senior debt can require us to suspend or defer cash payments due in respect of the Notes. If we are in default as to any payment obligation under any Senior Debt, as defined in the indenture governing the Notes, including a payment default that results from the acceleration of such Senior Debt as a result of a non-payment default, we will be prohibited, under the terms of the indenture from making any further cash payments in respect of the Notes until such default has been cured or waived or shall have ceased to exist. In addition, if we incur a non-payment default under any Designated Senior Debt, as defined in the indenture, the holder or holders may provide, or cause to be provided, a notice to the indenture trustee that will have the effect of prohibiting any further cash payments in respect of the Notes for a period not exceeding 179 days from the date on which the trustee receives the notice or until such default is earlier cured or waived. A holder of Designated Senior Debt may have the right to accelerate such debt as a result of the non-payment default during the 179 day blockage period or otherwise, in which event future payments in respect of the Notes will be prohibited as described above.

Unless a condition to conversion is met prior to the maturity of the Notes, the Notes will not be convertible at any time. The Notes are convertible only upon the occurrence of stated conditions. If none of these conditions occurs during the term of the Notes, the Notes will never be convertible and the holders may never have an opportunity to realize any appreciation in value based on the value of our common stock.

Upon conversion of the Notes, we may pay cash or a combination of cash and shares of our common stock in lieu of issuing shares of our common stock. Therefore, Note holders may receive no shares of our common stock or fewer shares than the number into which their Notes are convertible. We have the right to satisfy our conversion obligation to Note holders by issuing shares of our common stock into which the Notes are convertible, paying the cash value of the shares of our common stock into which the Notes are convertible, or a combination thereof. In addition, we have the right to irrevocably elect to satisfy our conversion obligation in cash with respect to the principal amount of the Notes to be converted after the date of such election. Accordingly, upon a conversion of a Note, a holder may not receive any shares of our common stock, or it might receive fewer shares of our common stock relative to the conversion value of the Note. Our liquidity may be reduced to the extent that we choose to deliver cash rather than shares of our common stock upon conversion of Notes.

If a principal conversion settlement election is made, we may not have sufficient funds to pay the cash settlement upon conversion. If we make a principal conversion settlement election, upon conversion of the Notes, we will be required to satisfy our conversion obligation relating to the principal amount of such Notes in cash. If a significant number of holders were to tender their Notes for conversion at any given time, we may not have the financial resources available to pay the principal amount in cash on all such Notes tendered for conversion.

The conversion rate of the Notes may not be adjusted for all dilutive events, including third-party tender or exchange offers, that may adversely affect the trading price of the Notes or our common stock issuable upon conversion of the Notes. The conversion rate of the Notes is subject to adjustment upon specified events, including specified issuances of stock dividends on our common stock, issuances of rights or warrants, subdivisions, combinations, distributions of capital stock or assets, cash dividends and issuer tender or exchange offers. The conversion rate will not be adjusted upon other events, such as third-party tender or exchange offers, that may adversely affect the trading price of the Notes or our common stock.

If we pay cash dividends on our common stock, Note holders may be deemed to have received a taxable dividend without the receipt of cash. If we pay cash dividends on our common stock and there is a resulting adjustment to the conversion rate, a Note holder could be deemed to have received a taxable dividend subject to U.S. federal income tax without the receipt of any cash.

If we elect to settle upon conversion in cash or a combination of cash and shares of common stock, there will be a delay in settlement. Upon conversion, if we elect to settle in cash or a combination of cash and shares of our common stock, there will be a significant delay in settlement. In addition, because the amount of cash or common stock that a Note holder will receive in these circumstances will be based on the sale price of our common stock for an extended period between the conversion date and such settlement date, holders will bear the market risk with respect to the value of the common stock for such extended period.

Some significant corporate transactions may not constitute a fundamental change, in which case we would not be obligated to offer to repurchase the Notes. Upon the occurrence of a fundamental change, as defined in the indenture governing the Notes, which includes specified change of control events, we will be required to offer to repurchase all outstanding Notes. The fundamental change provisions, however, will not require us to offer to repurchase the Notes in the event of some significant corporate transactions. For example, various transactions, such as leveraged recapitalizations, refinancings, restructurings or acquisitions initiated by us, would not constitute a change of control and, therefore, would not constitute a fundamental change requiring us to repurchase the Notes. Other transactions may not constitute a fundamental change because they do not involve a change in voting power or beneficial ownership of the type described in the definition of fundamental change. Accordingly, Note holders may not have the right to require us to repurchase their Notes in the event of a significant transaction that could increase the amount of our indebtedness, adversely affect our capital structure or any credit ratings or otherwise adversely affect the holders of Notes.

In addition, a fundamental change includes a sale of all or substantially all of our properties and assets. Although there is limited law interpreting the phrase "substantially all," there is no precise established definition of the phrase under the laws of New York, which govern the indenture and the Notes, or under the laws of Washington, our state of incorporation. Accordingly, a Note holder's ability to require us to repurchase Notes as a result of a sale of less than all of our properties and assets may be uncertain.

Our Notes may not be rated or may receive a lower rating than investors anticipate, which could cause a decline in the trading volume and market price of the Notes and our common stock. We do not intend to seek a rating on the Notes, and we believe it is unlikely the Notes will be rated. If, however, one or more rating agencies rates the Notes and assigns a rating lower than the rating expected by investors, or reduces any rating in the future, the trading volume and market price of the Notes and our common stock may be adversely affected.

We may not have the funds necessary to purchase the Notes upon a fundamental change or other purchase date and our ability to purchase the Notes in such events may be limited. On December 1, 2009, December 1, 2014 and December 1, 2019, holders of the Notes may require us to purchase their Notes for cash. In addition, holders may also require us to purchase their Notes upon a fundamental change, as defined in the indenture governing the Notes. Our ability to repurchase the Notes in such events may be limited by law, and by the terms of other indebtedness, including the terms of senior indebtedness, we may have outstanding at the time of such events. Our credit facility does not permit us to use it to fund a repurchase of the Notes, and does not permit repurchase of the Notes prior to maturity unless there is no outstanding amount and no default under that credit facility. Any subsequent credit facility may include similar provisions. If we do not have sufficient funds, we will not be able to repurchase the Notes tendered to us for purchase. If a repurchase event occurs, we expect that we would require third-party financing to repurchase the Notes, but we may not be able to obtain that financing on favorable terms or at all. Our failure to repurchase tendered Notes at a time when the repurchase is required by the indenture would constitute a default under the indenture. In addition, a default under the indenture or a fundamental change, in and of itself, could lead to a default under our credit facility and other existing and future agreements governing our indebtedness. In these circumstances, the subordination provisions in the indenture governing the Notes may limit or prohibit payments to Note holders. If, due to a default, the repayment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness or repurchase the Notes.

The make whole premium payable on Notes that are converted in connection with certain fundamental changes may not adequately compensate Note holders for the lost option time value of the Notes as a result of that fundamental change. If any of certain fundamental changes occurs on or prior to December 1, 2009, we will under certain circumstances pay a make whole premium on the Notes that are converted in connection with such fundamental change. The amount of the make whole premium and additional shares delivered depends on the date on which the fundamental change becomes effective and the price paid per share of our common stock in the transaction constituting the fundamental change, as defined in the indenture governing the Notes. Although the make whole premium is designed to compensate Note holders for the lost option value of the Notes as a result of the fundamental change, the amount of the make whole premium is only an approximation of the lost value and may not adequately compensate Note holders for the loss. In addition, if a fundamental change occurs after December 1, 2009, or if the applicable price is less than or equal to $3.51 per share or greater than $10.50 per share (in each case, subject to adjustment), then we will not pay any make whole premium. Also, a holder may not receive the make whole premium payable upon conversion until the fundamental change repurchase date relating to the applicable fundamental change, or even later, which could be a significant period of time after the date the holder has tendered its Notes for conversion.

There are restrictions on the Note holders' ability to transfer or resell the Notes without registration under applicable securities laws, and if we fail to fulfill our obligations to keep effective the registration statement the Notes for resale, we will be required to pay additional interest on the Notes affected by that failure and to issue additional shares of common stock on

Notes converted during such failure and satisfied by us in common stock. We sold the Notes under an exemption from registration under applicable U.S. federal and state securities laws. The registration statement covering the resale of the Notes and underlying common stock became effective in July 2005. Under the registration rights agreement, we are permitted to suspend the use of the effective registration statement for specific periods of time for certain specified reasons. If we fail to fulfill our obligations specified in the registration rights agreement governing the Notes, we will be required to pay additional interest on Notes adversely affected by such failure. Such additional interest will accrue from the date of such failure at a rate per year equal to 0.25% for the first 90 days, and 0.50% thereafter, on the principal amount of such Notes until such failure is cured or until the registration statement is no longer required to be kept effective and is payable on the scheduled interest payment dates. If a holder converts Notes during a registration default, no accrued and unpaid additional interest will be paid with respect to the Notes converted, but the holder would receive on any conversion that we elect to satisfy in common stock 103% of the number of shares of our common stock that such holder would have received in the absence of such default. We would have no other liability for monetary damages for a failure to fulfill our registration obligations.

There is no active market for the Notes and if an active trading market does not develop for these Notes, the holders of the Notes may be unable to resell them. The Notes are a new issue of securities for which the only current trading market is the Nasdaq's screen-based automated trading system known as PORTAL, which facilitates the trading of unregistered securities eligible to be resold by qualified institutional buyers pursuant to SEC Rule 144A. The resale of the Notes is registered under the Securities Act. Any Notes resold using an effective prospectus will no longer be eligible for trading in the PORTAL market. Moreover, if enough Notes are converted, redeemed or sold pursuant to an effective prospectus, trading of Notes in the PORTAL market may become inactive or may cease altogether. In that event, and in the absence of an alternative trading market, there would exist no organized market for the Notes from which their market value could be determined or realized. We do not intend to list the Notes on any national securities exchange or to seek the admission of the Notes for trading in the Nasdaq National Market or SmallCap Market. We have been advised by Bear, Stearns & Co. Inc. that it intends to make a market in the Notes. However, it is not obligated to do so and any market-making activities with respect to the Notes may be discontinued at any time without notice. In addition, market-making activity is subject to the limits imposed by law.

Further, even if a market in the Notes develops, the Notes could trade at prices lower than the initial offering price. In addition, the liquidity of, and the trading market for, the Notes may be adversely affected by many factors, including prevailing interest rates, the markets for similar securities, general economic conditions, our financial condition, performance and prospects and general declines or disruptions in the market for non-investment grade debt.

Our stock price is volatile. The stock market has been and is subject to price and volume fluctuations that particularly affect the market prices for small capitalization, high technology companies like us. The trading price of our common stock is subject to significant fluctuations in response to many factors, including our quarterly operating results (particularly if they are less than our or analysts' previous estimates), changes in analysts' estimates, our capital raising activities, announcements of technological innovations by us or our competitors and general conditions in our industry.

A substantial number of our shares are eligible for future sale and may depress the market price of our common stock and may hinder our ability to obtain additional financing. As of June 30, 2005, we had outstanding:

- 88,576,496 shares of common stock, including 500,116 shares of common stock issuable upon exchange of certain exchangeable securities issued in connection with the acquisition of OctigaBay Systems Corporation in April 2004;
- warrants to purchase 5,639,850 shares of common stock;
- stock options to purchase an aggregate of 16,968,008 shares of common stock, of which 13,683,752 options were then exercisable; and
- Notes convertible into 16,576,016 shares of common stock.

Almost all of our outstanding shares of common stock may be sold without substantial restrictions. All of the shares of common stock that may be issued on exercise of the warrants and options will be available for sale in the public market when issued, subject in some cases to volume and other limitations. The warrants outstanding at June 30, 2005, consisted of warrants to purchase 300,442 shares of common stock, with exercise prices ranging from $4.50 to $6.00 per share, expiring between November 8, 2005, and September 3, 2006, warrants to purchase 200,000 shares of common stock, with an exercise price of $1.65, expiring on May 30, 2009, and warrants to purchase 5,139,408 shares of common stock, with an exercise price of $2.53 per share, expiring on June 21, 2009. The

Notes are not now convertible, and only become convertible upon the occurrence of certain events. We have registered the resale of the Notes and of the underlying common stock under the Securities Act of 1933, as amended, which facilitates transferability of those securities. Sales in the public market of substantial amounts of our common stock, including sales of common stock issuable upon the exercise of warrants, options and Notes, may depress prevailing market prices for the common stock. Even the perception that sales could occur may impact market prices adversely. The existence of outstanding warrants, options and Notes may prove to be a hindrance to our future financings. Further, the holders of warrants, options and Notes may exercise or convert them for shares of common stock at a time when we would otherwise be able to obtain additional equity capital on terms more favorable to us. Such factors could impair our ability to meet our capital needs.

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

- removal of a director only in limited circumstances and only upon the affirmative vote of not less than two-thirds of the shares entitled to vote to elect directors;
- the ability of our board of directors to issue preferred stock, without shareholder approval, with rights senior to those of the common stock;
- no cumulative voting of shares;
- calling 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;
- amendments to our Restated Articles of Incorporation require the affirmative vote of not less than two-thirds of the outstanding shares entitled to vote on the 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.

We do not anticipate declaring any cash dividends on our common stock. We have never paid any dividends on our common stock, and we do not anticipate paying any cash dividends on our common stock in the foreseeable future. In addition, our credit facility prohibits us, and any future credit facility is likely to prohibit us from paying cash dividends without the consent of our lender.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk: We invest our available cash in 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, market and reinvestment risk. Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. Fixed-rate securities may have their fair market value adversely affected due to a rise in interest rates, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities, which have declined in market value due to changes in interest rates. At June 30, 2005, we did not have any short-term investments.

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 occasionally call for payment in foreign currencies and to the extent we do so, we are subject to foreign currency exchange risks. Our foreign maintenance contracts are paid in local currencies and provide a natural hedge against local expenses. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks.

Item 4. Controls and Procedures

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of the end of the period covered by this report. Our principal executive and financial officers supervised and participated in the evaluation. Based on the evaluation, our principal executive and financial officers each concluded that, as of the end of the period covered by this report, due to the material weaknesses in our internal control over financial reporting identified in our 2004 Form 10-K/A, our disclosure controls and procedures were not effective in providing reasonable assurance that information that we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

There were no material changes in our internal control over financial reporting during the most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting except that: in the second quarter of 2005 we hired as our chief financial officer Brian C. Henry, who has twenty years of experience as a technology company chief financial officer; we strengthened our Sarbanes-Oxley Act compliance team through the addition of a full time director; and we are involved in ongoing efforts addressing each of the material weaknesses and significant deficiencies identified in our 2004 review as well as reviewing all of our procedures and key controls relating to financial reporting in scope for 2005. Although we have implemented changes in a number of our procedures and key controls, we had not commenced testing of these key controls as of June 30, 2005. We are not planning on reporting whether there had been full remediation of the material weaknesses described in our Annual Report on Form 10-K/A for 2004 until our 2005 report on internal controls is complete.

Part II. Other Information

Item 1. Legal Proceedings

We were served on May 25, 2005, with a complaint filed by Marie Limantour, on behalf of herself and all others similarly situated, in the U.S. District Court for the Western District of Washington. We subsequently were served with five additional similar complaints filed against us in that court on June 3, 2005, and later dates. Each of these complaints names us and certain of our current and former officers as defendants. The plaintiffs in these complaints seek to represent a class of purchasers of our securities during periods that begin as early as October 23, 2002, and end as recently as May 12, 2005. The complaints allege federal securities law violations in connection with the issuance of various reports, press releases and, in some cases, statements in investor telephone conference calls. Each complaint requests certification of the class described therein and seeks unspecified damages, interest, attorneys' fees, costs and other relief. We expect that these cases will be consolidated into a single action. We dispute the allegations contained in these complaints, and intend to contest them aggressively. The ultimate outcome of these matters cannot be now determined, but our management believes that the final disposition of these proceedings will not have a material adverse effect on our financial position, results of operations or liquidity.

On June 3 and June 17, 2005, two shareholder derivative complaints were filed in the U.S. District Court for the Western District of Washington against members of our Board of Directors and certain current and former officers. The derivative plaintiffs purport to act on behalf of Cray and make allegations substantially similar to those in the putative class action complaints, as well as allegations of breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. The complaints seek to recover on behalf of Cray unspecified damages and seek attorney's fees, costs and other relief. We expect that these cases will be consolidated into a single action.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In connection with the acquisition of OctigaBay Systems Corporation on April 1, 2004, we reserved 4,840,421 shares of our Common Stock for issuance upon exchange of exchangeable securities issued to certain OctigaBay shareholders by our Nova Scotia subsidiary. In the quarter ended June 30, 2005, we issued an aggregate of 5,901 shares of our common stock upon exchange of the exchangeable shares.

The issuances of the shares described above were exempt from the registration provisions of the Securities Act of 1933 under Sections 4(2) and 4(6) and the rules and regulations there under and Regulation S under the Securities Act because of the nature of the investors and the manner in which the offering was conducted.

Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of shareholders was held on May 11, 2005. At the annual meeting, the following actions occurred.

1. The following individuals were re-elected as directors for terms expiring in 2006:

Name	Votes For	% For	Withheld	% Withheld
John B. Jones, Jr.	71,327,040	94.42	4,213,024	5.58
Kenneth W. Kennedy, Jr.	71,109,395	94.13	4,430,669	5.87
Stephen C. Kiely	71,336,671	94.44	4,203,393	5.56
Frank L. Lederman	71,315,231	94.41	4,224,833	5.59
Sally G. Narodick	74,897,722	99.15	642,342	0.85
Daniel C. Regis	74,385,792	98.47	1,154,272	1.53
Stephen C. Richards	74,917,335	99.18	622,729	0.82
James E. Rottsolk	74,623,786	98.79	916,278	1.21
Burton J. Smith	74,870,671	99.11	669,393	0.89

2. A proposal to approve amendments to our 2001 Employee Stock Purchase Plan in order to comply with the requirements of Statement of Accounting Financial Standards No. 123(R), *Accounting for Stock-Based Compensation,* and to provide administrative improvements was approved by the shareholders, with 35,659,696 shares voting in favor (98.85%) and 1,545,486 shares voting against (4.15%) with 1,521,324 shares abstaining and 36,813,558 broker non-votes.

Item 6. Exhibits

3.1	Bylaws, as amended through May 11, 2005 (2)
4.1	Form of Warrant issued to Wells Fargo Foothill, Inc. (2)
10.1	Offer Letter, dated April 14, 2005, between Cray Inc. and Margaret A. Williams (1)
10.2	Executive Severance Policy, as amended on May 11, 2005 (2)
10.3	Senior Secured Credit Agreement by and among Cray Inc., Cray Federal Inc. and Wells Fargo Foothill, Inc., dated May 31, 2005 (2)
16.3	Letter, dated April 15, 2005, from Deloitte & Touche LLP to the Securities and Exchange Commission as to the statements regarding Deloitte & Touche LLP (3)
31.1	Rule 13a-14(a) / 15d-14(a) Certification of Mr. Ungaro, Chief Executive Officer and President
31.2	Rule 13a-14(a) / 15d-14(a) Certification of Mr. Henry, Executive Vice President and Chief Financial and Accounting Officer
32.1	Certification pursuant to 18 U.S.C. Section 1350 by the Chief Executive Officer and Chairman of the Board of Directors and the Principal Financial Officer and Principal Accounting Officer

(1) Incorporated by reference to the Company's Current Report on Form 8-K, as filed with the Commission on May 10, 2005.

(2) Incorporated by reference to the Company's Current Report on Form 8-K, as filed with the Commission on June 2, 2005.

(3) Incorporated by reference to the Company's Current Report on Form 8-K, as filed with the Commission on April 16, 2005.

Items 3 and 5 of Part II are not applicable and have been omitted.

Table of Contents

SIGNATURES

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

CRAY INC.

August 9, 2005

By: /s/ PETER J. UNGARO
Peter J. Ungaro
Chief Executive Officer and President

/s/ BRIAN C. HENRY
Brian C. Henry
Chief Financial and Accounting Officer