

**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  
September 30, 2003

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

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**CRAY INC.**

(Exact name of registrant as specified in its charter)

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**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)

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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 November 11, 2003, 72,399,563 shares of the Company's Common Stock, par value \$0.01 per share, were outstanding.

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**Available Information**

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports 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](http://www.cray.com) as soon as reasonably practicable after we file electronically such reports with the SEC.

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CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

(unaudited)

	December 31, 2002	September 30, 2003
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 23,916	\$ 42,915
Short-term investments, available for sale.....		26,019
Accounts receivable, net of allowance of \$1,098 in 2002 and 2003 .....	31,017	47,507
Inventory, net.....	24,033	50,031
Prepaid expenses and other assets .....	5,805	13,355
Total current assets .....	84,771	179,827
Property and equipment, net.....	24,799	25,173
Service spares, net .....	9,279	5,663
Goodwill.....	22,680	22,680
Deferred tax asset .....	263	263
Other assets.....	3,453	3,323
<b>TOTAL.....</b>	<b>\$ 145,245</b>	<b>\$ 236,929</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable.....	\$ 13,173	\$ 18,210
Accrued payroll and related expenses .....	15,573	13,269
Other accrued liabilities.....	4,396	2,219
Deferred revenue .....	18,406	34,838
Notes payable .....	215	29
Current portion of warranty reserves.....	3,273	1,984
Current portion of obligations under capital leases .....	241	212
Current portion of term loan.....	2,143	
Total current liabilities.....	57,420	70,761
Warranty reserves.....	2,326	
Obligations under capital leases .....	152	
Term loan payable .....	1,786	
Shareholders' equity:		
Preferred Stock, par \$.01 - Authorized, 5,000,000 shares; issued and outstanding, 3,125,000 Series A Convertible and zero shares, respectively .....	24,946	
Common Stock, par \$.01 - Authorized, 120,000,000 shares; issued and outstanding, 56,039,016 and 71,353,811 shares, respectively .....	211,255	301,073
Accumulated other comprehensive loss .....	(291)	(74)
Accumulated deficit.....	(152,349)	(134,831)
<b>TOTAL.....</b>	<b>\$ 145,245</b>	<b>\$ 236,929</b>

*See accompanying notes*

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Revenue:				
Product .....	\$ 21,322	\$ 49,014	\$ 55,491	\$ 122,250
Service .....	20,729	14,831	60,397	47,484
Total revenue .....	<u>42,051</u>	<u>63,845</u>	<u>115,888</u>	<u>169,734</u>
Operating expenses:				
Cost of product revenue .....	12,367	25,707	29,242	67,707
Cost of service revenue .....	12,063	9,632	32,755	30,775
Research and development .....	7,301	10,533	26,440	28,371
Marketing and sales .....	5,158	6,727	14,935	18,433
General and administrative .....	2,108	3,164	6,041	7,702
Restructuring charge .....			1,878	
Total operating expenses .....	<u>38,997</u>	<u>55,763</u>	<u>111,291</u>	<u>152,988</u>
Income from operations .....	3,054	8,082	4,597	16,746
Other income, net .....	62	307	2,464	1,031
Interest income (expense), net .....	(503)	160	(1,537)	269
Income before income taxes .....	2,613	8,549	5,524	18,046
Provision for income taxes .....	474	86	1,449	528
Net income .....	<u>\$ 2,139</u>	<u>\$ 8,463</u>	<u>\$ 4,075</u>	<u>\$ 17,518</u>
Net income per common share:				
Basic .....	<u>\$ 0.04</u>	<u>\$ 0.12</u>	<u>\$ 0.09</u>	<u>\$ 0.27</u>
Diluted .....	<u>\$ 0.04</u>	<u>\$ 0.10</u>	<u>\$ 0.08</u>	<u>\$ 0.23</u>
Weighted average shares outstanding:				
Basic .....	<u>49,221</u>	<u>70,307</u>	<u>46,221</u>	<u>65,404</u>
Diluted .....	<u>59,923</u>	<u>82,963</u>	<u>51,291</u>	<u>75,973</u>

*See accompanying notes*

CRAY INC. AND SUBSIDIARIES

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

	Series A Preferred Stock		Common Stock		Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
	Number of Shares	Amount	Number of Shares	Amount			
BALANCE, January 1, 2003.....	3,125	\$ 24,946	56,039	\$ 211,255	\$ (152,349)	\$ (291)	\$ 83,561
Public sale of common stock, less issuance costs of \$3,517,000.....			8,480	49,059			49,059
Issuance of shares under Employee Stock Purchase Plan .....			70	437			437
Exercise of stock options.....			352	1,362			1,362
Exercise of warrants .....			228	979			979
Other comprehensive income:							
Unrealized gain on available for sale investments.....						8	8
Cumulative currency translation adjustment.....						(43)	(43)
Net income .....					1,197		1,197
BALANCE, March 31, 2003.....	<u>3,125</u>	<u>\$ 24,946</u>	<u>65,169</u>	<u>\$ 263,092</u>	<u>\$ (151,152)</u>	<u>\$ (326)</u>	<u>\$ 136,560</u>
Common stock issued in conversion of preferred stock .....	(3,125)	(24,946)	3,269	24,946			
Issuance of shares under Employee Stock Purchase Plan .....			67	402			402
Issuance of shares under 401k Plan .....			76	550			550
Exercise of stock options.....			452	1,706			1,706
Exercise of warrants .....			277	1,093			1,093
Other comprehensive income:							
Unrealized gain on available for sale investments.....						24	24
Cumulative currency translation adjustment.....						238	238
Net income .....					7,858		7,858
BALANCE, June 30, 2003.....		<u>\$ —</u>	<u>69,310</u>	<u>\$ 291,789</u>	<u>\$ (143,294)</u>	<u>\$ (64)</u>	<u>\$ 148,431</u>
Issuance of shares under Employee Stock Purchase Plan .....			56	381			381
Exercise of stock options.....			1,454	6,929			6,929
Exercise of warrants .....			534	1,974			1,974
Other comprehensive income:							
Unrealized loss on available for sale investments.....						(12)	(12)
Cumulative currency translation adjustment.....						2	2
Net income .....					8,463		8,463
BALANCE, September 30, 2003.....		<u>\$ —</u>	<u>71,354</u>	<u>\$ 301,073</u>	<u>\$ (134,831)</u>	<u>\$ (74)</u>	<u>\$ 166,168</u>

*See accompanying notes*

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	<b>For the Nine Months Ended September 30,</b>	
	<b>2002</b>	<b>2003</b>
Operating activities		
Net income .....	\$ 4,075	\$ 17,518
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization .....	11,271	12,091
Gain on sale of assets .....	(38)	
Beneficial conversion feature of notes payable .....	298	
Non-cash warrant and option expense .....	230	
Cash provided (used) by changes in operating assets and liabilities:		
Accounts receivable .....	(521)	(16,490)
Inventory .....	(603)	(30,209)
Other assets .....	(3,706)	(7,420)
Spares .....		(673)
Accounts payable .....	(4,695)	5,037
Other accrued liabilities .....	(3,871)	(2,177)
Accrued payroll and related expenses .....	3,525	(2,304)
Warranty reserve .....	(7,529)	(3,615)
Deferred revenue .....	<u>(2,955)</u>	<u>16,432</u>
Net cash used by operating activities .....	<u>(4,519)</u>	<u>(11,810)</u>
Investing activities .....		
Purchases of short-term investments .....		(25,999)
Purchases of spares .....	(1,469)	
Proceeds from sale of assets .....	46	
Purchases of property and equipment .....	<u>(3,932)</u>	<u>(3,965)</u>
Net cash used by investing activities .....	<u>(5,355)</u>	<u>(29,964)</u>
Financing activities .....		
Restricted cash .....	315	
Principal payments on term loan .....	(1,607)	(3,929)
Sale of common stock .....	15,593	50,829
Proceeds from exercise of options and warrants .....	10,763	14,043
Principal payments on bank note .....	(412)	(186)
Principal payments on capital leases .....	<u>(220)</u>	<u>(181)</u>
Net cash provided by financing activities .....	<u>24,432</u>	<u>60,576</u>
Net cash provided by operating, investing, and financing activities	14,558	18,802
Effect of foreign exchange rate changes on cash and cash equivalents .....	<u>415</u>	<u>197</u>
Net increase in cash and cash equivalents .....	14,973	18,999
Cash and cash equivalents .....		
Beginning of period .....	12,377	23,916
End of period .....	<u>\$ 27,350</u>	<u>\$ 42,915</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest .....	\$ 737	\$ 523
Non-cash investing and financing activities .....		
Inventory reclassified to fixed assets .....	1,293	4,211
Preferred stock converted into common stock .....		24,946

*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 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 accounting principles generally accepted in the United States of America for complete financial statements. All adjustments considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

#### Principles of Consolidation

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

#### Short-term investments

The Company considers all liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. 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; unrealized gains and losses are reflected in other comprehensive income.

#### Inventory, net

Inventory consisted of the following (in thousands):

	<u>December 31, 2002</u>	<u>September 30, 2003</u>
Components and subassemblies.....	\$ 15,653	\$ 19,336
Work in process .....	8,324	20,685
Finished goods .....	<u>2,414</u>	<u>10,747</u>
	26,391	50,768
Allowance for excess and obsolete .....	<u>(2,358)</u>	<u>(737)</u>
Inventory, net.....	<u>\$ 24,033</u>	<u>\$ 50,031</u>

Revenue in the first quarter of 2002 included \$5.9 million from the sale of obsolete inventory recorded at a zero cost basis.

#### Goodwill

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 142 ("SFAS 142") "Goodwill and Other Intangible Assets." As of January 1, 2002, the Company adopted SFAS 142 and no longer amortizes goodwill. Upon adoption of SFAS 142, the Company determined that

there was no impairment of goodwill as of January 1, 2002. Additionally, SFAS 142 requires an annual impairment test or more frequently if impairment indicators arise. In the first quarter of fiscal 2003, the Company completed its annual impairment test in accordance with SFAS 142. Results of the impairment tests did not indicate any impairment loss.

## Comprehensive Income

The components of comprehensive income are as follows (in thousands):

	<u>Three months ended September 30,</u>		<u>Nine months ended September 30,</u>	
	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>
Net income .....	\$ 2,139	\$ 8,463	\$ 4,075	\$ 17,518
Unrealized gain (loss) on short-term investments .....		(12)		20
Foreign currency translation adjustment .....	<u>123</u>	<u>2</u>	<u>415</u>	<u>197</u>
Comprehensive income .....	<u>\$ 2,262</u>	<u>\$ 8,453</u>	<u>\$ 4,490</u>	<u>\$ 17,735</u>

## Segment Information

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately \$51.3 million and \$147.1 million for the three and nine months ended September 30, 2003, compared to \$20.1 million and \$52.2 million for the three and nine months ended September 30, 2002.

The Company's significant operations outside North America include sales and service offices in Europe, the Middle East and Africa (EMEA) and Asia Pacific (Japan, Australia, Korea, China and Taiwan). 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):

	<u>North America</u>	<u>EMEA</u>	<u>Asia Pacific</u>	<u>Total</u>
Three months ended September 30, 2003:				
Product revenue .....	\$ 47,274	\$ 272	\$ 1,468	\$ 49,014
Service revenue .....	\$ 10,222	\$ 3,132	\$ 1,477	\$ 14,831
Net income (loss) .....	\$ 11,889	\$ (2,895)	\$ (531)	\$ 8,463
Nine months ended September 30, 2003:				
Product revenue .....	\$ 119,023	\$ 1,332	\$ 1,895	\$ 122,250
Service revenue .....	\$ 31,538	\$ 11,296	\$ 4,650	\$ 47,484
Net income (loss) .....	\$ 23,473	\$ (3,813)	\$ (2,142)	\$ 17,518
As of September 30, 2003:				
Long-lived assets .....	\$ 54,604	\$ 1,345	\$ 1,153	\$ 57,102
Three months ended September 30, 2002:				
Product revenue .....	\$ 16,455	\$ 4,867	\$	\$ 21,322
Service revenue .....	\$ 13,926	\$ 5,032	\$ 1,771	\$ 20,729
Net income (loss) .....	\$ 2,100	\$ 1,555	\$ (1,516)	\$ 2,139
Nine months ended September 30, 2002:				
Product revenue .....	\$ 41,447	\$ 10,460	\$ 3,584	\$ 55,491
Service revenue .....	\$ 39,110	\$ 16,071	\$ 5,216	\$ 60,397
Net income (loss) .....	\$ 423	\$ 4,275	\$ (623)	\$ 4,075
As of September 30, 2002:				
Long-lived assets .....	\$ 58,398	\$ 2,049	\$ 2,467	\$ 62,914



## Earnings Per Share

Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share 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 as computed under the treasury stock method and the conversion of preferred stock under the if-converted method.

The following data show the amounts used in computing the weighted average number of shares of dilutive potential common stock (in thousands):

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2002</b>	<b>2003</b>	<b>2002</b>	<b>2003</b>
Weighted average number of shares used in basic EPS .....	<u>49,221</u>	<u>70,307</u>	<u>46,221</u>	<u>65,404</u>
Effect of dilutive securities:				
Stock options and warrants .....	3,620	12,565	1,945	10,569
Convertible subordinated debentures .....	3,957			
Convertible preferred stock .....	<u>3,125</u>	<u>      </u>	<u>3,125</u>	<u>      </u>
Weighted average number of common shares and dilutive potential common stock used in diluted EPS .....	<u>59,923</u>	<u>82,963</u>	<u>51,291</u>	<u>75,973</u>

For the three and nine months ended September 30, 2002, common stock equivalents of 18.9 million and 23.8 million shares, respectively, were antidilutive and not included in computing diluted EPS. For the three and nine months ended September 30, 2003, common stock equivalents of 7.4 million and 9.4 million shares, respectively, were antidilutive and not included in computing diluted EPS.

## Restructuring Charges

As of September 30, 2003, an accrued liability of \$433,000 remained from a March 2002 restructuring charge of \$1.9 million. Substantially all of the restructuring charge represents severance expenses for terminated employees. The restructuring liability is included within accrued payroll and related expenses on the balance sheets. The reserve activity for the three and nine months ended September 30, 2002, and 2003 is as follows (in thousands):

	<b>2002</b>	<b>2003</b>
Liability balance, January 1 .....	\$ 1,700	\$ 866
Additional restructuring charge .....	1,878	
Payments .....	<u>(861)</u>	<u>(157)</u>
Liability balance, March 31 .....	2,717	709
Payments .....	<u>(939)</u>	<u>(146)</u>
Liability balance, June 30 .....	1,778	563
Payments .....	<u>(634)</u>	<u>(130)</u>
Liability balance, September 30 .....	<u>\$ 1,144</u>	<u>\$ 433</u>

## Warranty Reserve

Certain components in the Cray T90 vector computers have an unusually high failure rate. The cost of servicing the Cray T90 computers exceeds the related service revenue. The Company recorded a warranty reserve to reflect its estimate of the amount by which the cost of servicing the T90 vector computers would exceed the revenue generated from servicing them. The Company continually monitors the reasonableness of the estimate of the warranty reserve. In determining the appropriate reserve, the Company reduced the T90 reserve and recorded a corresponding reduction to the cost of maintenance revenue of \$691,000 and \$2.0 million for the three and nine months ended

September 30, 2003, resulting in a remaining T90 warranty reserve of \$1.9 million at September 30, 2003. In determining the appropriate reserve at September 30, 2002, the Company reduced the T90 reserve and recorded a corresponding reduction to the cost of maintenance revenue of \$1.5 million for the three months ended September 30, 2002. These adjustments offset related costs incurred in the respective periods that are not directly charged to the T90 warranty reserve.

## Public Offering

In the first quarter of 2003, the Company completed a public offering of 8,480,000 shares of newly issued common stock, and an additional 145,000 shares of common stock from certain selling shareholders, at a public offering price of \$6.20 per share. The Company received from the offering, after underwriting discount and selling expenses, net proceeds of approximately \$49,059,000. The Company is using the net proceeds for general corporate purposes.

## NEC Preferred Stock Conversion

On June 17, 2003, NEC Corporation converted all 3,125,000 shares of the Company's Series A Convertible Preferred Stock that it held and sold the underlying 3,269,154 shares of common stock. The Company has no shares of preferred stock outstanding as of September 30, 2003. The Company has a total of 5,000,000 authorized but unissued shares of preferred stock subject to designation by the Board of Directors.

## Taxes

The Company recorded a provision of \$86,000 and \$528,000 for income taxes in foreign countries, certain states and the alternative minimum tax for the three and nine months ended September 30, 2003, compared to \$474,000 and \$1.5 million for the respective 2002 periods. Due to utilization of tax losses from operations in prior years, there has been no provision for U.S. federal income (other than for alternative minimum taxes) taxes for any period.

## 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 Statement of Financial Accounting Standards (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 September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Risk-free interest rate.....	3.61%	3.94%	3.61%	3.94%
Expected dividend yield .....	0%	0%	0%	0%
Volatility.....	97%	95%	97%	95%
Expected life.....	7.25 years	7.34 years	7.25 years	7.34 years

Had compensation cost for the Company's stock option plans and its stock purchase plan been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, the Company's net income and net income per common share for the three and nine months ended September 30, 2002, and 2003 would have been the pro forma amounts indicated below (amounts in thousands, except per share data):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2002</b>	<b>2003</b>	<b>2002</b>	<b>2003</b>
Net income, as reported.....	\$ 2,139	\$ 8,463	\$ 4,075	\$ 17,518
Total stock based compensation expense determined under fair value based method for all awards .....	<u>(3,095)</u>	<u>(2,281)</u>	<u>(9,283)</u>	<u>(6,845)</u>
Pro forma net income (loss) .....	<u>\$ (956)</u>	<u>\$ 6,182</u>	<u>\$ (5,208)</u>	<u>\$ 10,673</u>
Basic and diluted net income (loss) per common share:				
Basic:				
As reported .....	\$ 0.04	\$ 0.12	\$ 0.09	\$ 0.27
Pro forma.....	\$ (0.02)	\$ 0.09	\$ (0.11)	\$ 0.16
Diluted:				
As reported .....	\$ 0.04	\$ 0.10	\$ 0.08	\$ 0.23
Pro forma.....	\$ (0.02)	\$ 0.07	\$ (0.11)	\$ 0.14

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. 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 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.

## Reclassifications

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

## Recent Accounting Pronouncements

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for certain contracts entered into or modified by the Company after June 30, 2003. The adoption of SFAS No. 149 is not expected to have a material impact on the Company's financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments With Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how the Company would classify and measure financial instruments with characteristics of both liabilities and equity and requires the Company to classify a financial instrument that is within the scope of SFAS No. 150 as a liability (or an asset in some circumstances). SFAS No. 150 also revises the definition of a liability to encompass obligations that the

Company can or must settle by issuing equity shares, depending on the nature of the relationship established between the Company and a holder of its stock. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. The adoption of SFAS No. 150 did not have an impact on the Company's financial position or results of operations.

In November 2002, the FASB Emerging Issues Task Force ("EITF") issued EITF 00-21 *Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. In applying EITF 00-21, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary. EITF 00-21 also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. The guidance in this issue is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, companies may elect to report the change in accounting as a cumulative-effect adjustment. Early application of this consensus is permitted. The Company has adopted the provisions of EITF 00-21 beginning July 1, 2003.

## **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 18. 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 mainframe computer systems and address the world's most challenging computing problems for government, industry and academia. Our revenue, net income or loss and cash flow are likely to fluctuate significantly from quarter to quarter due to the high average sales price of our principal products and our general policy of not recognizing product revenue until customer acceptance. We expect that most of our 2003 product revenue will come from sales of our Cray X1 system, the production version of which first shipped in December 2002. In mid-2002, we began a development project with Sandia National Laboratories to design and deliver a new, high bandwidth, massively parallel processing supercomputer system called Red Storm in 2004. In mid-2003, we began work under a contract with the Defense Advanced Research Projects Agency that supports our program to develop a commercially available system capable of sustained performance in excess of one petaflops, which we call our Cascade program. We provide maintenance services to the worldwide installed base of Cray computers. We also offer professional services that leverage our industry technical knowledge.

We experienced net losses in each full year of our operations prior to 2002. We incurred net losses of approximately \$35.2 million in 2001, \$25.4 million in 2000, and \$34.5 million in 1999. For the year ended December 31, 2002, we had net income of \$5.4 million and for the three and nine months ended September 30, 2003, we had net income of \$8.5 million and \$17.5 million, respectively.

We recognize product revenue from sales of our computer systems upon acceptance by the customer, although in limited circumstances, depending on sales contract terms, revenue may be recognized when title passes upon shipment or may be delayed until funding is certain or other contractual requirements are satisfied. We recognize product revenue from the Red Storm and Cascade contracts using the percentage-of-completion method. We

recognize service revenue for the maintenance of our computer systems ratably over the term of each maintenance agreement. Funds from maintenance and product sales contracts that are paid in advance are recorded as deferred revenue. We recognize service revenue from our professional services activities as services are rendered.

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 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. 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 warranty liabilities, valuation of inventory at the lower of cost or market, the percentage completed 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 consolidated financial statements.

#### ***Red Storm and Cascade Contracts***

Product revenue from the Red Storm and Cascade contracts is accounted for using the percentage-of-completion method. Revenue is recognized as costs are incurred, and margin is based on the total estimated cost to complete. The estimates to complete are based on several factors, including estimated labor hours to complete certain tasks and estimated cost of purchased components at future dates. Our estimates may need to be adjusted from quarter to quarter, which would impact our revenue and our margins on a cumulative basis.

#### ***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. Because the products we sell have high average sales prices and because a high number of our prospective customers receive funding from U.S. or foreign governments, it is difficult to estimate future sales of our products and the timing of such sales. It also is difficult to determine whether the cost of our inventories will ultimately be recovered through future sales. While we believe our inventory is stated at the lower of cost or market and that our estimates and assumptions to determine any adjustments to the cost of our inventories are reasonable, our estimates may prove to be inaccurate. We have sold inventory previously reduced in part or in whole to zero, including in the first quarter of 2002, and we may have future sales of previously written down inventory. We may also 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.

#### ***Goodwill***

Approximately 10% of our assets as of September 30, 2003, consisted of goodwill resulting from our acquisition of the Cray Research business unit from Silicon Graphics, Inc. (“SGI”) in 2000. We adopted SFAS No. 142 on January 1, 2002, and we no longer amortize goodwill associated with the acquisition, but we are required to conduct

ongoing analyses of the recorded amount of goodwill in comparison to its estimated fair value. We performed an annual impairment test effective January 1, 2003, and determined that our recorded goodwill was not impaired. This analysis and ongoing analyses of whether the fair value of recorded goodwill is impaired involve a substantial amount of judgment. Future charges related to goodwill could be material depending on future developments and changes in technology and our business.

### ***T90 Reserve***

We acquired service contracts in the acquisition of the Cray Research business unit in April 2000 for Cray T90 vector computers. Some of the components in the Cray T90 vector computers have an unusually high failure rate. As of April 1, 2000, the date of our acquisition of the Cray Research business unit from SGI, we recorded a warranty reserve of \$47.5 million, of which \$46.3 million reflected our estimate of the amount by which the cost of servicing the T90 vector computers would exceed the revenue generated from servicing them until they were no longer in use by our customers. As we incur costs to service these computers in excess of the related service revenue, we reduce the amount of the T90 warranty reserve. As of September 30, 2003, our total warranty reserve balance was \$2.0 million, of which \$1.9 million related to the T90 vector computers. We continually monitor the reasonableness of our estimate of the warranty reserve. This involves analysis of our assumptions with regard to the length of time the T90 vector computers will be in use by our customers, the failure rate of modules in the computers considering actual historical failure rates, and personnel and resources, including service spares, that will be required to correct failures that occur in the future. In determining the appropriate reserve, we reduced the T90 reserve and recorded a corresponding reduction to the cost of maintenance revenue of \$691,000 and \$2.0 million for the three and nine months ended September 30, 2003. These adjustments offset costs incurred in the respective period that are not directly charged to the reserve. We believe that the T90 warranty reserve balance at September 30, 2003, is a reasonable estimate of the extent to which our costs to service these computers will exceed the revenue generated from existing service contracts. The most significant cost of maintenance is the amortization of T90 spare parts. The quarterly amortization is \$1.1 million, and the spares will be fully amortized as of March 31, 2004. The T90 reserve will be almost fully utilized on March 31, 2004, with revenue on the few remaining T90's then in service expected to cover the cost to maintain.

## **Results of Operations**

### ***Product Revenue***

We had product revenue of \$49.0 million and \$122.3 million for the three and nine months ended September 30, 2003, compared to \$21.3 million and \$55.5 million for the respective 2002 periods. Product revenue represented 77% and 72% of total revenue for the three and nine months ended September 30, 2003, compared to 51% and 48% for the respective 2002 periods, and consisted in the three months ended September 30, 2003 of \$41.2 million for our Cray X1 product line, \$4.7 million for our Red Storm project and \$3.1 million for our other products and projects. Product revenue for the three months ended September 30, 2002 consisted of \$6.1 million for our Cray SV1 product line, \$5.1 million for our SX6 product line, \$5.7 million for our Cray X1 product line, and \$4.4 million for our MTA product line.

With the delivery of the Cray X1 system to customers and the performance of the Red Storm project and the general decline in service revenue, we expect our product revenue in 2003 to increase and be a larger percentage of total revenue than in 2002 and earlier years. We expect our product revenue to vary quarterly.

### ***Service Revenue***

We had service revenue, which includes revenue from maintenance services and professional services, of \$14.8 million and \$47.5 million for the three and nine months ended September 30, 2003, compared to \$20.7 million and \$60.4 million, for the respective 2002 periods. Service revenue represented 23% and 28% of total revenue for the three and nine months ended September 30, 2003, compared to 49% and 52% for the corresponding 2002 periods.

Maintenance services are provided under separate 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, which was \$13.9 million and \$44.4 million for the three and nine months ended September 30, 2003, respectively, has declined on an annual basis as older systems are withdrawn from service. We expect maintenance service revenue to continue to decline slowly over the next twelve months as our older systems continue to be withdrawn from service and then to stabilize as our new systems are placed in service. Professional services revenue was \$957,000 and \$3.3 million for the three and nine months ended September 30, 2003, and we expect this revenue to decline from the third quarter to the fourth quarter.

### ***Operating Expenses***

*Cost of Product Revenue.* We had cost of product revenue of \$25.7 million and \$67.7 million for the three and nine months ended September 30, 2003, compared to \$12.4 million and \$29.2 million for the respective 2002 periods. Our cost of product represented 52% and 55% of product revenue for the three and nine months ended September 30, 2003, compared to 58% and 53% for the corresponding 2002 periods. The lower cost of product revenue in the first nine months of 2002 was due in large part to the sale of \$5.9 million of inventory previously written down to zero cost in the first quarter of 2002.

Our cost of product revenue in the first nine months of 2003 was adversely affected by start-up costs incurred in the Cray X1 ramp-up, particularly in the first half of the year. The improvement in product margins in the third quarter of 2003 was due primarily to increased factory efficiencies and lower cost of components. While these factors will continue to affect product margins in the fourth quarter positively, product margins will be negatively impacted by lower margins on the Red Storm project and we may grant favorable pricing for large multi-system contracts and to obtain strategic accounts. We expect product margins in the fourth quarter to decline slightly from third quarter levels.

*Cost of Service Revenue.* We had cost of service revenue of \$9.6 million and \$30.8 million for the three and nine months ended September 30, 2003, compared to \$12.1 million and \$32.8 million for the corresponding 2002 periods. Our cost of service revenue represented 65% of service revenue for both the three and nine month periods ended September 30, 2003, compared to 58% and 54% for the corresponding 2002 periods.

Several items impacted service costs in the third quarter and first nine months of 2003. Margins from maintenance revenue were adversely affected due to the withdrawal of legacy Cray systems without a commensurate decrease in maintenance expenses and personnel. As we reduce maintenance service personnel, cost of service is impacted adversely by associated severance expenses. In addition, the amortization of spare parts valued at the time of acquisition is an increasingly greater negative impact to service margins as the installed base of legacy products decline. This non-cash charge has been fixed at \$1.1 million per quarter since the date of acquisition, and will continue until the spare parts are fully written-off in the first quarter of 2004. Professional services margins were very positive in the third quarter and are expected to be slightly positive in the fourth quarter. Favorably impacting maintenance costs during the third quarter and first nine months of 2003 was the respective \$691,000 and \$2.0 million reduction of the Cray T90 warranty reserves reflecting costs not directly charged to the reserve and our current estimate of future costs associated with Cray T90 maintenance.

Maintenance revenue is expected to decline into 2004 before new shipments into the installed base offset retirements. Also, the legacy spares will be fully amortized and the cost of servicing the Cray T90 computers remaining in 2004 past the first quarter is not expected to exceed the associated service revenue. Maintenance costs should then stabilize between 60% to 65% of revenue.

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

Research and development expenses for the three and nine months ended September 30, 2002, and 2003 reflect our costs associated with the development of the Cray X1 system and in 2003 its enhancements and successors, and to a lesser extent, the Cray MTA-2 in both the 2002 and 2003 periods, 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 expenses in the table below reflect 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 the Cray X1 systems, enhancements and successors to the Cray X1 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 2002 and 2003 were as follows (in thousands):

	<u>For the three months ended September 30,</u>		<u>For the nine months ended September 30,</u>	
	<u>2002</u>	<u>2003</u>	<u>2002</u>	<u>2003</u>
Gross research and development .....	\$ 12,376	\$ 17,864	\$ 40,927	\$ 49,143
Governmental funding .....	<u>(5,075)</u>	<u>(7,331)</u>	<u>(14,487)</u>	<u>(20,772)</u>
Net research and development .....	<u>\$ 7,301</u>	<u>\$ 10,533</u>	<u>\$ 26,440</u>	<u>\$ 28,371</u>

Net research and development expenditures represented 16% and 17% of revenue for the three and nine months ended September 30, 2003, and 17% and 23% for the three and nine months ended September 30, 2002.

We expect that gross research and development expenses will reach or slightly exceed \$65 million for 2003 as a whole as we ramp-up our work on the Red Storm and Cascade projects. However, we expect that net research and development expenses will remain flat or decline in the last quarter of 2003, primarily due to increased governmental funding, and will decline as a percentage of overall revenue as we increase our overall revenue.

Government funding levels has not been even throughout the year. In the first quarter of 2003 development funding for the Cray X1 system concluded. Although we have entered into agreements for additional funding for follow-on products, the transition of our engineers to these projects was not immediate, resulting in less government funding for the second and third quarters of 2003 than anticipated. We expect to receive this funding in subsequent quarters.

### ***Marketing and Sales***

Marketing and sales expenses were \$6.7 million and \$18.4 million for the three and nine months ended September 30, 2003, compared to \$5.2 million and \$14.9 million for the respective 2002 periods. The increase in these expenses from 2002 to 2003 was due to the roll out of the Cray X1 product line and increased sales commissions due to higher sales activity. We expect marketing and sales expenses to grow in line with product revenue in the fourth quarter of 2003.

### ***General and Administrative***

General and administrative expenses were \$3.2 million and \$7.7 million for the three and nine months ended September 30, 2003, compared to \$2.1 million and \$6.0 million for the respective 2002 periods. Third quarter 2003 general and administrative expenses compared to the 2002 period were adversely impacted by additional personnel and related compensation expense, severance expenses and legal costs and settlement expenses related to a patent litigation matter. We expect general and administrative expenses to decline slightly in the fourth quarter of 2003.

### ***Restructuring Charges***

Restructuring charges were zero for the three and nine months ended September 30, 2003, compared to zero and \$1.9 million for the three and nine months ended September 30, 2002, representing primarily severance expenses related to the termination of 20 employees in the first quarter of 2002.



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

Other income was \$307,000 and \$1.0 million for the three and nine months ended September 30, 2003, compared to other income of \$62,000 and \$2.5 million for the respective 2002 periods and consisted primarily in 2003 of foreign currency gains from inter company receivables. The decrease in other income from 2002 primarily resulted from a negotiated settlement of an accrued cancellation charge on a purchase commitment in the first quarter of 2002.

### ***Interest Income (Expense), net***

Interest income was \$167,000 and \$482,000 for the three and nine months ended September 30, 2003, compared to \$23,000 and \$59,000 for the respective 2002 periods. The higher amount in 2003 reflects our increased average cash position due to the completion of our public offering of common stock in the first quarter of 2003 and increased cash from operations in the third quarter of 2003.

Interest expense was \$7,000 and \$213,000 for the three and nine months ended September 30, 2003, compared to \$526,000 and \$1.6 million for the respective 2002 periods. Third quarter 2003 interest expense reflected interest on our capital leases; for the first nine months of 2003, interest expense reflected interest on our term loan for the first fourth months of the year and interest on our capital leases. The interest expense for 2002 was largely due to a non-cash charge of \$435,000 associated with the convertible debenture financing completed in November 2001, and \$1.2 million of interest on our term loan, line of credit and capital leases. In April 2003 we paid off the term loan in full and we have not borrowed under our line of credit since May of 2002.

### ***Taxes***

We recorded a provision of \$86,000 and \$528,000 for income taxes in foreign countries and certain U.S. states for the three and nine months ended September 30, 2003, compared to \$474,000 and \$1.5 million for the respective 2002 periods. The decline in 2003 largely is due to lower earnings in foreign countries. There has been no provision for U.S. federal income taxes, other than for alternative minimum taxes, for any period.

## **Liquidity and Capital Resources**

Cash, cash equivalents, short-term investments and accounts receivable totaled \$116.4 million at September 30, 2003, compared to \$54.9 million at December 31, 2002. Over that period, cash, cash equivalents, and short-term investments increased from \$23.9 million to \$68.9 million. At September 30, 2003, we had working capital of \$109.1 million compared to \$27.4 million at December 31, 2002. In the first quarter of 2003, we realized \$49.1 million of net proceeds from the public sale of our common stock. Our accounts receivable balance at September 30, 2003 of \$47.5 million included the following third quarter non-revenue generating items: \$6.2 million of product prepayments and \$5.7 million of governmental funding.

Net cash used by operating activities for the nine months ended September 30, 2003, was \$11.8 million compared to \$4.5 million for the respective 2002 period; the 2003 nine month results were favorably impacted by third quarter operations which generated net cash of \$24.3 million. For the nine months ended September 30, 2003, net operating cash was used primarily by increases in accounts receivable and inventory and decreases in warranty reserve offset in part by increases in accounts payable.

Net cash used by investing activities was \$30.0 million for the nine months ended September 30, 2003, compared to \$5.4 million for the respective 2002 period. Net cash used by investing activities for 2003 consisted primarily of purchases of \$26.0 million of short-term investments following completion of our public offering of common stock and \$4.0 million of purchases of computers and electronic test equipment, computer software and furniture and fixtures. In 2002, the net cash used in investing activities was primarily for electronic test equipment and computer hardware purchases.

Net cash provided by financing activities was \$60.6 million for the nine months ended September 30, 2003, compared to \$24.4 million for the respective 2002 period. The 2003 net cash provided by financing activities was primarily from our public offering, in which we received net proceeds of \$49.1 million, and \$14.0 million from warrant and stock option exercises. We used \$3.9 million to retire our term loan debt. In the nine months ended September 30, 2002, we raised \$15.6 million primarily through the sale of common stock and received another \$10.8 million through the exercise of warrants. We also converted \$24.9 million of preferred stock into common stock during the second quarter of 2003.

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 increase production of Cray X1 systems and move to production of the Cray X1E system and Red Storm project, third-party engineering expenses, and acquisition of property and equipment. Our remaining fiscal year 2003 capital expenditure budget for property and equipment is estimated currently at \$2.9 million. In addition, we lease certain equipment used in our operations under operating or capital leases in the normal course of business. We expect that operations over the next twelve months will generate positive cash flow. The following table is a summary of our contractual cash obligations as of September 30, 2003 (in thousands):

<u>Contractual Obligations</u>	<u>Payments Due By Periods</u>			
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>
Notes payable .....	\$ 29	\$ 29	\$	\$
Capital lease obligations .....	212	212		
Operating leases .....	<u>17,396</u>	<u>3,134</u>	<u>8,762</u>	<u>5,500</u>
Total contractual cash obligations .....	<u>\$ 17,637</u>	<u>\$ 3,375</u>	<u>\$ 8,762</u>	<u>\$ 5,500</u>

At any particular time, given the high average selling price of our products, our cash position is affected by the timing of payment for product sales, receipt of prepaid maintenance revenue and receipt of government funding of research and development activities and the need to purchase inventory. We believe our current cash resources will be adequate for the next twelve months.

We may consider additional financings to enhance our cash and working capital positions if we experience lower than anticipated product sales due to delays in the availability of Cray X1E or Red Storm systems for customer deliveries or if we fail to receive sufficient government support for our products and research activities, or if we were successful in our product developments and market conditions were favorable.

### **Factors That Could Affect Future Results**

The following factors should be considered in evaluating our business, operations and prospects and may affect our future results and financial condition.

#### ***Factors Related To Our Business***

**If application programs were not successfully ported to the Cray X1 system, we would have difficulty selling these systems to a number of customers.** To make sales of the Cray X1 system in the automotive, aerospace, chemistry and other engineering and technical markets, including certain governmental users, we must have application programs ported to the Cray X1 system and tuned so that they will achieve high performance. The Cray X1 system has a new architecture that makes porting and tuning of application programs difficult. These application programs are owned in some instances by independent software vendors and in others by potential customers. We must induce these vendors and customers to undertake this activity. The relatively low volume of supercomputer sales makes it difficult for us to attract independent software vendors to make this investment. We also modify and rewrite thirty-party and customer specific application programs to run on the Cray X1 system. There can be no assurance that we will be able to induce the third-party vendors and customers to rewrite their

applications or that we will rewrite successfully third-party and customer specific applications for use on the Cray X1 system.

**We may not be successful in completing the Red Storm project on time and on budget, which would adversely affect our earnings.** Our efforts to complete the development and delivery of the Red Storm project for Sandia National Laboratories in 2004 on time and on budget are subject to significant risks. 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. Our success depends on third-party software development, some of which is to be supplied by Sandia National Laboratories. The contract is incrementally funded and is subject to future federal government appropriations. This project is lengthy and technically challenging, and requires a significant investment of engineering and other resources. Falling behind schedule or incurring cost overruns would adversely affect our capital resources and earnings.

**We may face significant pressure on the pricing of our products, which may result in lower margins and earnings.** We anticipate that the product line based on the Red Storm system, which is targeted for markets now largely served by clustered systems, generally will have lower margins than our vector-based products due to a more competitive market. We also face margin pressure for our Cray X1 systems in 2004, particularly as we near introduction of the Cray X1E system. We may grant favorable pricing for large multi-system contracts and to obtain strategic accounts. We may not be able to sell sufficient additional systems and produce more revenue to offset lower gross margins; if not our earnings would be reduced.

**If the U.S. government purchases fewer supercomputers, our revenue would be reduced and our profitability 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. From January 1, 2001, through December 31, 2002, approximately 79% of our product revenue was derived from sales to various agencies of the U.S. government; in the first nine months of 2003, approximately 84% of our product revenue was derived from such sales. Our initial sales of Cray X1 systems have been to government agencies in the United States and other countries, and we expect that will continue throughout 2003 and largely in 2004. Sales to government agencies may be affected by factors outside our control, such as changes in procurement policies, budget considerations and international political developments. The U.S. Congress only recently adopted the budget for the Department of Defense and has not yet adopted budgets for the Department of Energy and other agencies, which may affect our sales in 2004. If 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 a loss 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 2004 and beyond.** We expect that our success in 2004 and in the following years depends on completing the Red Storm project, adapting the Red Storm concept to a highly scalable microprocessor-based high bandwidth Linux system for the governmental, industrial and academic markets and developing the Cray X1E system as a significant enhancement to the Cray X1 system; in subsequent years we must develop further enhancements to the Red Storm system and develop the Black Widow system as a successor to the Cray X1 and X1E systems. We also must integrate our product lines so that we use as many common components and systems as possible. These 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. Difficulties in delivering the initial Cray X1 systems and integrating large configurations of the Cray X1 system have introduced delays in the development schedule for the Cray X1E and Black Widow systems; we may not be successful in shortening these development schedules. Delays in completing the design of the hardware components, of software for the systems or in integrating the full systems would make it difficult for us to develop and market these systems successfully. If we were unable to market and sell the Cray X1E and Red Storm systems in the latter part of 2004, our revenue and earnings would be adversely affected. We are dependent on our vendors to manufacture components of these systems, and few companies can meet our design requirements. The failure of vendors to manufacture our components to our design specifications would delay the completion of our products. Redesign work may be costly and cause delays in the development of these systems.

**If we were unable to continue to improve our Cray X1 system software, our revenue and profits would be reduced.** We need to scale our Cray X1 system software to run satisfactorily on four and larger number of cabinet systems in order to market and sell larger configurations of Cray X1 systems. We also need to improve the reliability of system software to sell Cray X1 systems to production environment governmental and industrial customers. We continue to fix reported software problems and anticipate additional software problems to be reported in the future.

**Procurement proposals based on theoretical peak performance reduce our ability to market 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 comparable 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/actual performance ratio of our products compares unfavorably to the price/peak performance ratio of our competitors' products. Unless these criteria are changed, we are disadvantaged in these instances by being unable to submit competitive bids, which limits our revenue potential.

**The change by NEC Corporation of our distribution rights for the Cray SX-6 system may decrease our revenue and increase competition.** We market a rebranded product known as the Cray SX-6 system, which was developed and is built in Japan by NEC Corporation. This product first became available for delivery in North America in the first quarter of 2002, and we became the exclusive distributor of NEC vector supercomputer systems in North America and a non-exclusive distributor outside North America. Effective August 1, 2003, our North American distribution rights for this product became non-exclusive. Supercomputer customers in the United States have been reluctant to purchase supercomputers from non-U.S. sources, and domestic demand for the Cray SX-6 systems has been far less than we anticipated. NEC may decide to compete directly with us in North America, which could adversely affect our revenue. Outside of North America, NEC has competed aggressively based on price, and promised deliveries of its NEC SX-8 system, which it has not yet announced formally.

**Lower than anticipated sales of new supercomputers 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. Revenue from maintenance service contracts has declined from approximately \$125 million in 1999 to approximately \$68 million in 2002 and is expected to decline to approximately \$58 million in 2003 as our older systems are withdrawn from service. This revenue is expected to decline further until a sufficient number of our new computer systems are placed in service to balance the withdrawal of our older systems.

**Development of a new operating system for our Black Widow and other future products is a difficult process, and may delay the availability of our Black Widow System.** We plan to develop our own UNIX-based operating system for successor systems to the Cray X1 product family, starting with the Black Widow system, based on Linux. Developing a new operating system is lengthy and difficult process, and might delay the availability of the Black Widow system.

**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 (processor and memory), printed circuit boards, flex circuits and power supplies, on a sole or limited source basis to third-party suppliers. We use a contract manufacturer to assemble our components for the Cray X1 and other 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 meet 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 by 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;

- 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.

From time to time we have experienced delays in obtaining manufactured components and completed assemblies on a timely basis and in sufficient quantities from our suppliers, which have resulted in delays in the development and production of our products.

**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, including the current Cray X1 system and our planned Cray X1E, Black Widow, Cascade and Red Storm development projects. U.S. government agencies may delay or decrease funding of these development efforts due to change of priorities, international political developments or for any other reason. Any such decrease or delay may cause an increased need for capital and may adversely affect our research and development expenditures and our ability to implement our product roadmap.

**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.

**If we cannot attract, retain and motivate key personnel, we may be unable to implement effectively 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. 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.

**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.

**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.

### ***Factors Related To An Investment In Our Company***

**Our quarterly operating results may fluctuate significantly.** Our operating results are subject to significant fluctuations due to many factors. One or a few system sales may account for a substantial percentage of our quarterly and annual revenue, and thus revenue, net income or loss and cash flow are likely to fluctuate significantly from quarter to quarter. This is due to the high average sales price of our products, the timing of purchase orders and product delivery, and our general policy of not recognizing product revenue until our customers accept our products. These factors make forecasting revenue and earnings in any short-term period very difficult. The acceptances of two large installations of Cray X1 systems are scheduled for the fourth quarter and largely depend on the availability of single-image system software operating satisfactorily on 256 processor systems. If these systems were not accepted in the fourth quarter, revenue would move to subsequent quarters and adversely affect fourth quarter and 2003 operating results. We were able to book most of the 2003 sales for the Cray X1 systems through a few very large contracts entered into during the first quarter of 2003. Sales of Cray X1 systems in 2004 will be pursuant more numerous and smaller contracts, often in very competitive situations. If we do not obtain a sufficient number of such contracts, our operating results in any particular period will be adversely affected. Red Storm revenue and margin may fluctuate from quarter to quarter due to the level of contract activity, including purchases of materials and changes in the estimates of the cost to complete. Because a number of our prospective customers receive funding from the U.S. or foreign governments, the timing of orders from our customers may be subject to the appropriation and funding schedules of the relevant government agencies. The U.S. Congress only recently adopted the budget for the Department of Defense and has not yet adopted budgets for the Department of Energy and other agencies, which may affect our sales in 2004. The timing of orders and shipments also could be affected by other 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;
- timing of the receipt of necessary export licenses; or
- currency fluctuations and international conflicts or economic crises.

**We have experienced annual losses from operations prior to 2002, and we may not achieve net income on a consistent basis.** We experienced net losses in each full year of our operations prior to 2002. We incurred net losses of approximately \$35.2 million in 2001, \$25.4 million in 2000, and \$34.5 million in 1999. For the year ended December 31, 2002, we had net income of \$5.4 million and for the first nine months of 2003 we had net income of \$17.5 million. Whether we will achieve net income on a consistent basis will depend on a number of factors, including:

- our ability to market and sell the Cray X1 system, the Cray X1E system, Red Storm and other products;
- our ability to maintain the Red Storm project and development of the Cray X1E system and subsequent development projects on schedule;
- the level of revenue in any given period;
- our expense levels, particularly for research and development and manufacturing and service costs; and
- the terms and conditions of sale or lease for our products.

Because of the numerous factors affecting our results of operations, there can be no assurance that we will have consistent net income on a quarterly basis in the future.

**Our stock price may be 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, changes in analysts' estimates, our future capital raising activities, announcements of technological innovations by us or our competitors and general conditions in our industry.

**Additional financings may be dilutive to our shareholders.** We may need to raise additional equity or debt capital if we experience lower than anticipated product sales due to delays in availability of Cray X1E or Red Storm systems for delivery to customers or general economic conditions, or if we fail to receive sufficient governmental support for our products and research activities. If we are successful in our product developments and market conditions were favorable, we may consider financings to enhance our cash and working capital positions. Financings may not be available to us when needed or, if available, may not be available on satisfactory terms and may be dilutive to our shareholders.

**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 September 30, 2003, we had outstanding:

- 71,565,199 shares of common stock;
- warrants to purchase 7,816,523 shares of common stock; and
- stock options to purchase an aggregate of 12,179,204 shares of common stock, of which 7,016,139 options were then exercisable.

Almost all of our outstanding shares of common stock may be sold without substantial restrictions. All of the shares purchased under the warrants and exercisable options are available for sale in the public market, subject in some cases to volume and other limitations. At September 30, 2003, warrants to purchase 2,376,673 shares of common stock, with exercise prices ranging from \$3.00 to \$6.00 per share, expire between January 20, 2004, and November 2, 2004; warrants to purchase 300,442 shares of common stock, with exercise prices ranging from \$4.50 to \$6.00 per share, expire between November 7, 2005, and September 3, 2006; and the remaining warrants to purchase 5,139,408 shares of common stock, with an exercise price of \$2.53 per share, expire on June 21, 2009. Sales in the public market of substantial amounts of our common stock, including sales of common stock issuable upon the exercise of the warrants and options, 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 and options may prove to be a hindrance to our future equity financings. Further, the holders of the warrants and options may exercise 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:

- a staggered Board of Directors, so that only two or three of our eight directors are elected each year;
- 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 must be followed to bring matters before our shareholders at our annual shareholders' meeting; and
- special procedures must be followed 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 facilities prohibit us from paying cash dividends without the consent of our lenders.

### ***Factors Related To Our Industry***

**If we are unable to compete successfully against larger, more established companies 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 and Sun Microsystems. Each of these competitors has broader product lines and substantially greater research, engineering, manufacturing, marketing and financial resources than we do. 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. Most 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 may be required to provide discounts to make sales or to provide lease financing for our products, which would result in a deferral of our receipt of cash for these systems. These developments would limit our revenue and resources and would reduce our ability to be profitable.

**We may not compete successfully against innovative competitors or new entrants.** Our market is characterized by rapidly changing technology, accelerated product obsolescence and continuously evolving industry standards. Our success will depend upon our ability to sell our current products, and to develop successor systems. We will need to introduce new products and features 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. New companies have capitalized on developments in parallel processing and increased computer performance through networking and cluster systems. Currently, these products are limited in applicability and scalability and can be difficult to program. A breakthrough in architecture or software technology could make cluster systems more attractive to our potential customers. Such a breakthrough would impair our ability to sell our products and reduce our revenue.



**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 or delays in purchases would decrease our revenue, increase our need for working capital and adversely affect our profitability.

### **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 impacted 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 September 30, 2003, our short-term investment balance was \$26.0 million.

*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. We may use forward currency contracts to minimize these 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, 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 date of the evaluation, our disclosure controls and procedures were effective in providing reasonable assurance that material information relating to Cray and our consolidated subsidiaries is made known to management, including during the period when we prepare our periodic SEC reports. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

## **Part II. Other Information**

### **Item 6. Exhibits and Reports on Form 8-K**

#### **(a) Exhibits**

- |      |   |
|------|---|
| 31.1 | Rule 13a-14(a) / 15d-14(a) Certification of Mr. Rottsolk, President and Chief Executive Officer   |
| 31.2 | Rule 13a-14(a) / 15d-14(a) Certification of Mr. Poteracki, Chief Financial and Accounting Officer |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350 by the President and Chief Executive Officer     |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350 by the Chief Financial and Accounting Officer    |

(b) Reports on Form 8-K

A report on Form 8-K for an event of September 2, 2003, was filed on September 5, 2003, reporting Company officers who have entered into 10b5-1 plans under Item 5, “Other Events.”

A report on Form 8-K for an event of August 25, 2003, was filed on August 28, 2003, reporting Company officers who have entered into 10b5-1 plans under Item 5, “Other Events.”

A report on Form 8-K for an event of August 20, 2003, was filed on August 21, 2003, reporting Company officers who have entered into 10b5-1 plans under Item 5, “Other Events.”

A report on Form 8-K for an event of August 14, 2003, was filed on August 18, 2003, reporting Company officers who have entered into 10b5-1 plans under Item 5, “Other Events.”

A report on Form 8-K for an event of August 7, 2003, was filed on August 7, 2003, reporting the hire of Peter J. Ungaro as Vice President, Worldwide Sales and Marketing under Item 5, “Other Events.”

A report on Form 8-K for an event of July 31, 2003, was filed on August 1, 2003, reporting the issuance of a press release of the Company’s second quarter financial results under Item 5, “Other Events.”

**Items 1, 2, 3, 4 and 5 of Part II are not applicable and have been omitted.**

## **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.**

November 14, 2003

By: /s/ JAMES E. ROTTSOLK  
James E. Rottsolk  
President and Chief Executive Officer

/s/ SCOTT J. POTERACKI  
Scott J. Poteracki  
Chief Financial and Accounting Officer