

**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
March 31, 2004

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 May 3, 2004, 85,688,668 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

	<u>Page No.</u>
PART I FINANCIAL INFORMATION	
Item 1. Unaudited Condensed Consolidated Financial Statements:	
Balance Sheets as of December 31, 2003 and March 31, 2004	3
Statements of Operations for the Three Months Ended March 31, 2003 and 2004	4
Statement of Shareholders' Equity for the Three Month period Ended March 31, 2004	5
Statements of Cash Flows for the Three Months Ended March 31, 2003 and 2004	6
Notes to Financial Statements	7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures About Market Risk	23
Item 4. Controls and Procedures	24
PART II OTHER INFORMATION	
Item 6. Exhibits and Reports on Form 8-K	24

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 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 SV1ex, Cray X1, Cray X1e, Cray SX-6, Cray T90, Cray MTA-2, Cray SV1 and Cray T3E are trademarks of Cray Inc.

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	December 31, 2003	March 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 39,773	\$ 33,319
Short-term investments, available for sale	34,570	38,690
Accounts receivable, net of allowance of \$1,125 in 2003 and 2004	48,474	43,506
Inventory, net	43,022	46,836
Prepaid expenses and other assets	18,932	17,036
Total current assets	184,771	179,387
Property and equipment, net	26,157	29,536
Service spares, net	4,925	3,636
Goodwill	13,344	13,344
Deferred tax asset	58,595	61,933
Other assets	3,797	3,734
TOTAL	\$ 291,589	\$ 291,570
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 12,553	\$ 14,074
Accrued payroll and related expenses	19,035	16,127
Other accrued liabilities	3,480	1,540
Deferred revenue	33,233	36,473
Warranty reserves	655	
Total current liabilities	68,956	68,214
Shareholders' equity:		
Common Stock, par \$.01 - Authorized, 120,000,000 shares; issued and outstanding, 72,601,016 and 73,279,570 shares, respectively	312,646	316,918
Deferred compensation	(105)	(60)
Accumulated other comprehensive loss	(807)	(558)
Accumulated deficit	(89,101)	(92,944)
TOTAL	\$ 291,589	\$ 291,570

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended March 31,	
	2003	2004
Revenue:		
Product	\$ 27,284	\$ 28,368
Service	16,845	13,767
Total revenue	<u>44,129</u>	<u>42,135</u>
Operating expenses:		
Cost of product revenue	17,675	19,755
Cost of service revenue	10,281	8,581
Research and development	7,475	9,042
Marketing and sales	5,521	7,646
General and administrative	1,874	2,873
Total operating expenses	<u>42,826</u>	<u>47,897</u>
Income (loss) from operations	1,303	(5,762)
Other expense, net	(53)	(386)
Interest income, net	6	143
Income (loss) before income taxes	1,256	(6,005)
Provision (benefit) for income taxes	59	(2,162)
Net income (loss)	<u>\$ 1,197</u>	<u>\$ (3,843)</u>
Net income per common share:		
Basic	\$ 0.02	\$ (0.05)
Diluted	<u>\$ 0.02</u>	<u>\$ (0.05)</u>
Weighted average shares outstanding:		
Basic	<u>59,780</u>	<u>72,977</u>
Diluted	<u>72,764</u>	<u>72,977</u>

See accompanying notes

CRAY INC. AND SUBSIDIARIES

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

	<u>Common Stock</u>		<u>Deferred Compensation</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total</u>
	<u>Number of Shares</u>	<u>Amount</u>				
BALANCE, January 1, 2004	72,601	\$312,646	\$ (105)	\$(89,101)	\$ (807)	\$222,633
Issuance of shares under Company 401k Plan	91	627				627
Issuance of shares under Employee Stock Purchase Plan	69	447				447
Exercise of stock options	477	1,891				1,891
Exercise of warrants	42	203				203
Compensation expense on restricted stock			45			45
Tax benefit on options		1,104				1,104
Other comprehensive income:						
Unrealized gain on available for sale investments					9	9
Cumulative currency translation adjustment					240	240
Net income (loss)				(3,843)		(3,843)
BALANCE, March 31, 2004	<u>73,280</u>	<u>\$316,918</u>	<u>\$ (60)</u>	<u>\$(92,944)</u>	<u>\$ (558)</u>	<u>\$223,356</u>

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	For the Three Months Ended March 31,	
	2003	2004
Operating activities		
Net income (loss)	\$ 1,197	\$ (3,843)
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization	4,042	3,769
Deferred tax asset		(2,234)
Deferred compensation on restricted stock		45
Cash provided (used) by changes in operating assets and liabilities:		
Accounts receivable	(5,136)	5,106
Inventory	(14,498)	(7,103)
Other assets	(2,495)	2,013
Spares	(33)	(38)
Accounts payable	6,502	1,563
Other accrued liabilities	(1,155)	(1,853)
Accrued payroll and related expenses	(3,373)	(2,988)
Warranty reserve	(2,018)	(655)
Deferred revenue	4,763	3,330
Net cash used by operating activities	(12,204)	(2,888)
Investing activities		
Purchases of short-term investments	(22,940)	(25,984)
Sales / maturities of short-term investments		21,864
Purchases of property and equipment	(1,550)	(2,532)
Net cash used by investing activities	(24,490)	(6,652)
Financing activities		
Principal payments on term loan	(536)	
Sale of common stock	49,059	
Proceeds from exercise of option and warrants	2,341	2,094
Proceeds from issuance of common stock through employee stock purchase plan and 401k plan	437	1,074
Principal payments on bank note	(62)	
Principal payments on capital leases	(49)	(137)
Net cash provided by financing activities	51,190	3,031
Effect of foreign exchange rate changes on cash and cash equivalents	(43)	55
Net increase (decrease) in cash and cash equivalents	14,453	(6,454)
Cash and cash equivalents		
Beginning of period	23,916	39,773
End of period	<u>\$ 38,369</u>	<u>\$ 33,319</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 119	\$ 16
Non-cash investing and financing activities		
Inventory reclassified to spares	507	313
Tax benefit on stock options		1,104
Inventory reclassified to fixed assets	68	2,976
Unrealized gain on short term investments	8	9

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, 2003.

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):

	December 31, 2003	March 31, 2004
Components and subassemblies	\$ 16,916	\$ 14,816
Red Storm inventory	1,698	2,258
Work in process	14,178	17,220
Finished goods	10,230	12,542
Inventory, net	<u>\$ 43,022</u>	<u>\$ 46,836</u>

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 2004, 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 (loss)

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

	Three months ended March 31,	
	2003	2004
Net income (loss)	\$ 1,197	\$ (3,843)
Unrealized gain on short-term investments	8	9
Foreign currency translation adjustment	(43)	240
Comprehensive income (loss)	<u>\$ 1,162</u>	<u>\$ (3,594)</u>

Segment Information

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately \$20.1 million for the three months ended March 31, 2004, compared to \$38.9 million for the three months ended March 31, 2003.

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):

	North America	EMEA	Asia Pacific	Total
Three months ended March 31, 2004:				
Product revenue	\$ 20,940	\$ 3,018	\$ 4,410	\$ 28,368
Service revenue	\$ 9,546	\$ 3,030	\$ 1,191	\$ 13,767
Net income (loss)	\$ (4,426)	\$ (923)	\$ 1,506	\$ (3,843)
As of March 31, 2004:				
Long-lived assets	\$ 108,703	\$ 2,105	\$ 1,375	\$ 112,183
Three months ended March 31, 2003:				
Product revenue	\$ 25,964	\$ 1,060	\$ 260	\$ 27,284
Service revenue	\$ 10,947	\$ 4,253	\$ 1,645	\$ 16,845
Net income (loss)	\$ 2,147	\$ (152)	\$ (798)	\$ 1,197
As of March 31, 2003:				
Long-lived assets	\$ 54,808	\$ 1,697	\$ 1,523	\$ 58,028

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. Because outstanding stock options and warrants are antidilutive, their effect has not been included in the calculation of the net loss per share for the three months ended March 31, 2004.

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

	Three months ended March 31,	
	2003	2004
Weighted average number of shares used in basic EPS	<u>59,780</u>	<u>72,977</u>
Effect of dilutive securities:		
Stock options and warrants	9,847	
Convertible preferred stock	<u>3,137</u>	<u> </u>
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	<u>72,764</u>	<u>72,977</u>

For the three months ended March 31, 2003, common stock equivalents of 12.0 million shares were antidilutive and not included in computing diluted EPS. For the three months ended March 31, 2004, common stock equivalents of 19.9 million shares were antidilutive and not included in computing diluted EPS.

Restructuring Charges

As of March 31, 2003, an accrued liability of \$709,000 was due to a March 2002 restructuring charge of \$1.9 million. Substantially all of the restructuring charge represents severance expenses for terminated employees.

As of March 31, 2004, an accrued liability of \$1.8 million remained related to a December 2003 restructuring charge of \$3.3 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 liability activity for the three months ended March 31, 2003, and 2004 is as follows (in thousands):

	2003	2004
Liability balance, January 1	\$ 866	\$ 3,101
Payments	<u>(157)</u>	<u>(1,338)</u>
Liability balance, March 31	<u>\$ 709</u>	<u>\$ 1,763</u>

Taxes

The Company recorded a benefit of \$2.2 million for U.S. income taxes for the three months ended March 31, 2004, compared to a provision of \$59,000 for the respective 2003 period. The Company's annual effective tax rate is estimated at 36% for 2004.

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 March 31,	
	2003	2004
Risk — free interest rate	3.8%	4.3%
Expected dividend yield	0%	0%
Volatility	95%	84%
Expected life	8.2 years	7.1 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 months ended March 31, 2003 and 2004 would have been the pro forma amounts indicated below (amounts in thousands, except per share data):

	Three Months Ended March 31,	
	2003	2004
Net income (loss), as reported	\$ 1,197	\$ (3,843)
Total stock based compensation expense determined under fair value based method for all awards	(2,013)	(2,823)
Pro forma net income (loss)	<u>\$ (816)</u>	<u>\$ (6,666)</u>
Basic and diluted net income (loss) per Common share:		
Basic:		
As reported	\$ 0.02	\$ (0.05)
Pro forma	\$ (0.01)	\$ (0.09)
Diluted:		
As reported	\$ 0.02	\$ (0.05)
Pro forma	\$ (0.01)	\$ (0.09)

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.

Subsequent Event

On April 1, 2004, the Company completed the previously announced acquisition of OctigaBay Systems Corporation (OctigaBay), a development-stage privately-held company located in Vancouver, British Columbia. OctigaBay is developing an innovative high performance computing system designed to make supercomputing performance accessible to the growing community of scientific and technical computing users. The acquisition was accomplished pursuant to the Arrangement Agreement, dated February 25, 2004, among Cray, 3084317 Nova Scotia Limited, a Nova Scotia company and wholly-owned subsidiary of Cray, and OctigaBay. Shareholders and option holders of OctigaBay and the British Columbia Supreme Court approved the transaction on March 31, 2004. In the acquisition, the Company paid \$14,925,000 in cash, issued 7,560,885 shares of Cray common stock, and 4,840,421 of exchangeable shares. Of the total shares issued and reserved, 1,838,953 were not included in the purchase price calculation as they represent repurchaseable shares that will be earned over the repurchase period. The Company also assumed outstanding OctigaBay stock options exercisable for 740,722 shares of Cray common stock. After the acquisition, we changed the name of OctigaBay Systems Corporation to Cray Canada Inc.

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 17. 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. In 2002 we completed hardware development of and began selling our Cray X1 system, an "extreme performance" supercomputer designed for the high end of the supercomputer market. We are developing enhancements to this system that will increase significantly processor speed and capability, which we call the Cray X1E system, with first shipments scheduled for the second half of 2004. In mid-2002 we began a development project with Sandia National Laboratories to design and deliver in 2004 a new, high bandwidth, massively parallel processing supercomputer system called Red Storm. In October 2003 we announced that we would develop a product line based on the Red Storm system, targeting the need for highly scalable microprocessor-based Linux supercomputers with high bandwidth. This product is scheduled for shipment in the second half of 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. On April 1, 2004, we acquired OctigaBay Systems Corporation, a privately-held development-stage company located in Vancouver, B.C. OctigaBay is developing a balanced high bandwidth system designed to be highly reliable and easy-to-use that is targeted for the midrange market. We have renamed OctigaBay Systems Corporation as Cray Canada Inc. and have renamed the OctigaBay product as the Cray XD1 system. Commercial shipments of the Cray XD1 system are not expected until late 2004. We expect that most of our 2004 product revenue will come from sales of our Cray X1 and Cray X1E systems, with additional contributions from the completion of the Red Storm project, continued work on the Cascade project and sales of the commercial version of the Red Storm system. We provide maintenance services to the worldwide installed base of Cray computers. We also offer high performance computing services that leverage our industry technical knowledge.

We experienced net losses in each full year of our operations prior to 2002. We incurred a net loss of \$35.2 million in 2001. For 2002, we had net income of \$5.4 million and for 2003 we had net income of \$63.2 million (including non-recurring items of \$38.5 million). For the three months ended March 31, 2004, we had a net loss of \$3.8 million.

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 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, deferred tax realizability, 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 consolidated financial statements.

Revenue Recognition

We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectability is reasonably assured. In addition to the aforementioned general policy, the following are the specific revenue recognition policies for each major category of revenue and for multiple-element arrangements.

Product. 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.

Revenue from contracts that require us to design, develop, manufacture or modify complex information technology systems to a buyer’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.

Revenue from contracts that are operating leases is recorded as earned over the lease term.

Services. Service 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 enter into transactions that include multiple-element arrangements, which may include any combination of services, hardware, and/or software. 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. Otherwise, revenue is deferred until delivery of the last element.

- Vendor-specific objective evidence (VSOE) of fair value of the undelivered element.
- The functionality of the delivered elements are not dependent on the undelivered elements.
- Delivery of the delivered element represents the culmination of the earnings process.

VSOE is the price we charge to an external customer for the same element when such element is sold separately and/or the Company's established price list.

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, 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 5% of our assets as of March 31, 2004, consisted of goodwill resulting from our acquisition of the Cray Research business unit from Silicon Graphics Inc. ("SGI") in 2000. 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, 2004, and determined that our recorded goodwill was not impaired. This analysis and ongoing analyses of whether the fair value of recorded goodwill is impaired will 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.

Results of Operations

Product Revenue

We had product revenue of \$28.4 million for the three months ended March 31, 2004, compared to \$27.3 million for the respective 2003 period. Product revenue represented 67% of total revenue for the three months ended March 31, 2004, compared to 62% for the respective 2003 period, and consisted in the three months ended March 31, 2004, of \$22.0 million for our Cray X1 product line, and other products, the bulk of which was for Cray X1 systems, and \$6.4 million for our Red Storm and Cascade development projects. Product revenue decreased from levels in immediately preceding quarters due to fewer sales of Cray X1 systems to governmental customers; in the 2004 quarter, less than half of our product revenue came from governmental sales compared to over 80% in 2003. Product revenue for the three months ended March 31, 2003, consisted of \$23.4 million for our Cray X1 product line and our Red Storm project, and \$3.9 million for our other products.

We expect product revenue to grow in 2004 in both absolute amounts and as a percentage contribution to total revenue. This revenue growth depends on continued sales of the Cray X1 system, completion of the Red Storm project and the availability of the Cray X1E enhancements, the commercial version of the Red Storm system and the Cray XD1 system in the second half of 2004. We expect our product revenue to vary quarterly, perhaps significantly, with the second quarter at or below first quarter levels and the second half of 2004 being substantially stronger than the first half.

Service Revenue

We had service revenue, which includes revenue from maintenance services and professional services, of \$13.8 million for the three months ended March 31, 2004, compared to \$16.8 million for the respective 2003 period. Service revenue represented 33% of total revenue for the three months ended March 31, 2004, compared to 38% for the corresponding 2003 period.

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 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. The decline in percentage contribution to total revenue is due to the increase in product revenue as new products and projects have become available as well as the decline in maintenance revenue.

Operating Expenses

Cost of Product Revenue. We had cost of product revenue of \$19.8 million for the three months ended March 31, 2004, compared to \$17.7 million for the respective 2003 period. Our cost of product represented 70% of product revenue for the three months ended March 31, 2004, compared to 65% for the corresponding 2003 period. Cost of product revenue in the first quarter of 2004 was adversely affected by the product mix, with proportionately fewer sales of Cray X1 products and more revenue from the low margin Red Storm and Cascade development projects and sales of low margin cluster systems.

We anticipate lower overall product margins in 2004 than in 2003 due to the completion of the Red Storm project, which has minimal margins, increasing margin pressure on the Cray X1 systems, particularly in advance of the availability of the Cray X1E system, low margin contribution from the Cascade project and the introduction of the commercial version of the Red Storm system, which will be marketed in the more competitive massively parallel processor market. We also may grant favorable pricing for large multi-system contracts and to obtain strategic accounts.

Cost of Service Revenue. We had cost of service revenue of \$8.6 million for the three months ended March 31, 2004, compared to \$10.3 million for the corresponding 2003 period. Our cost of service revenue represented 62% of service revenue for the three months ended March 31, 2004, compared to 61% for the corresponding 2003 period. First quarter 2004 cost of service was favorably impacted by high margin professional service contracts as well as service cost reductions implemented in the fourth quarter of 2003.

As we continue to experience declines in maintenance revenue before new shipments into the installed base offset retirements, we may continue to reduce maintenance service personnel and experience associated severance expenses. One factor will favorably affect costs of service revenue for the remaining quarters of 2004, the cost of servicing the Cray T90 computers remaining in 2004 past the first quarter is not expected to exceed the associated service revenue. We expect maintenance costs to stabilize at about 65% of revenue.

Research and Development

Research and development expenses for the three months ended March 31, 2004, reflect our costs associated with the development of the Cray X1E system and Black Widow project, 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 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 the three months ended March 31, 2004 were as follows (in thousands):

	For the three months ended March 31,	
	2003	2004
Gross research and development	\$ 15,451	\$ 20,025
Governmental funding	(7,750)	(10,983)
Net research and development	<u>\$ 7,475</u>	<u>\$ 9,042</u>

Net research and development expenditures represented 21% of revenue for the three months ended March 31, 2004, and 17% for the three months ended March 31, 2003.

We expect that gross and net research and development expenses will increase in 2004 as we continue the development of the Cray X1E system, continue our efforts on the Cascade project, complete our work on the Red Storm project and develop the Cray XD1 system. We expect net research and development expenses to decrease as a percentage of overall anticipated revenue as we expect to increase our overall revenue and continue to receive increased government funding.

Marketing and Sales

Marketing and sales expenses were \$7.6 million for the three months ended March 31, 2004, compared to \$5.5 million for the respective 2003 period. The increase in these expenses was due primarily to additional sales, benchmarking and application personnel and the amortization of a prepaid expense associated with the usage of computer time with a customer. We also experienced an unfavorable currency exchange rate in our overseas personnel expenses in 2004 compared to 2003. We expect marketing and sales expenses to grow in line with anticipated product revenue in 2004 with the introduction of the Cray X1E, Red Storm and XD1 products, increased sales commissions due to higher sales activities, the impact of the Cray Canada acquisition and continued emphasis on benchmarking and applications developments.

General and Administrative

General and administrative expenses were \$2.9 million for the three months ended March 31, 2004, compared to \$1.9 million for the respective 2003 period. The increase in general and administrative costs in 2004 was due to increased premiums for directors and officers insurance, including our international finance group in general and administrative expenses rather than as service costs and various smaller increases in finance and human resources costs. We also experienced an unfavorable currency exchange rate in our overseas personnel expenses in 2004 compared to 2003. We expect general and administrative expenses to increase in 2004 as we add personnel through the Cray Canada acquisition and incur increased compliance costs associated with the Sarbanes-Oxley Act of 2002, but to decline as a percentage of total anticipated revenue.

Other Income (Expense), net

Other expense was \$386,000 for the three months ended March 31, 2004, compared to other expense of \$53,000 for the respective 2003 period, and consisted primarily in 2004 of foreign currency losses.

Interest Income (Expense), net

Interest income was \$159,000 for the three months ended March 31, 2004, compared to \$125,000 for the respective 2003 period. The higher amount in 2004 reflects our increased average cash position due to the completion of our public offering of common stock in the first quarter of 2003.

Interest expense was \$16,000 for the three months ended March 31, 2004, compared to \$119,000 for the respective 2003 period. In April 2003 we paid off the term loan in full and we have not borrowed under our line of credit since then.

Taxes

We recorded a benefit of \$2.2 million for income taxes in foreign countries and certain U.S. states for the three months ended March 31, 2004, compared to a provision of \$59,000 for the respective 2003 period. The Company's annual effective tax rate is estimated at 36% for 2004.

Liquidity and Capital Resources

Cash, cash equivalents, short-term investments and accounts receivable totaled \$115.5 million at March 31, 2004, compared to \$122.8 million at December 31, 2003. Over that period, cash, cash equivalents, and short-term investments decreased from \$74.3 million to \$72.0 million. At March 31, 2004, we had working capital of \$111.2 million compared to \$115.8 million at December 31, 2003.

Net cash used by operating activities for the three months ended March 31, 2004, was \$2.9 million compared to \$12.2 million for the respective 2003 period. For the three months ended March 31, 2004, net operating cash was used primarily by our net loss, increases in inventory and our deferred tax asset and decreases in accrued payroll offset in part by increases in deferred revenue and decreases in accounts receivable.

Net cash used by investing activities was \$6.7 million for the three months ended March 31, 2004, compared to \$24.5 million for the respective 2003 period. Net cash used by investing activities for 2004 consisted primarily of purchases of \$4.1 million of short-term investments and \$2.6 million of purchases of computers and electronic test equipment, computer software and furniture and fixtures. In 2003, the net cash used in investing activities was primarily for purchases of short-term investments.

Net cash provided by financing activities was \$3.1 million for the three months ended March 31, 2004, compared to \$51.2 million for the respective 2003 period. The 2004 net cash provided by financing activities was primarily from warrant and stock option exercises. The 2003 net cash provided by financing activities was primarily from our public offering, in which we received net proceeds of \$49.1 million.

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 ramp-up production of Cray X1E, Red Storm and XD1 products, third-party engineering expenses, and acquisition of property and equipment. Our remaining fiscal year 2004 capital expenditure budget for property and equipment is estimated currently at \$12.4 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 March 31, 2004 (in thousands):

<u>Contractual Obligations</u>	<u>Total</u>	<u>Payments Due By Periods</u>		
		<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>
Development agreements	\$ 5,584	\$ 4,219	\$ 1,279	\$ 86
Capital lease obligations	102	102		
Operating leases	17,396	3,943	14,428	2,750
Total contractual cash obligations	<u>\$ 21,121</u>	<u>\$ 8,264</u>	<u>\$ 15,707</u>	<u>\$ 2,836</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.

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.

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 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 prices of our products and limited number of sales per quarter, the timing of purchase orders and product delivery, and our general policy of not recognizing product revenue until customers accept our products. These factors make forecasting revenue and earnings in any short-term period very difficult. While we were profitable in every quarter in 2003, profitability often depended upon customers accepting systems at the end of the quarter. Any delay in an acceptance of a system at the end of a quarter, which would have moved the associated revenue into a subsequent quarter, could have resulted in a loss for the quarter. We were able to book most of our 2003 sales of the Cray X1 systems through a few very large contracts entered into during the first quarter of 2003. We expect that sales of Cray X1 systems in 2004 will be pursuant to more numerous and smaller contracts, often in very competitive situations. We have not yet signed sales contracts covering most of our anticipated 2004 revenue from sales of Cray X1 and X1E systems. If we do not obtain such contracts, our operating results in any particular period will be adversely affected and may produce a loss; we incurred a loss in the first quarter of 2004 and will incur a loss in the second quarter due to a lower level of Cray X1 system sales. Red Storm revenue and margin may fluctuate from quarter to quarter due to our level of contract activity, including purchases of materials and potential 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 government customers may be subject to the funding schedules for the relevant government agencies as well as delays that may be experienced in competitive procurements. 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;
- the receipt and timing of necessary export licenses; and
- currency fluctuations and international conflicts or economic crises.

We have experienced annual losses from operations prior to 2002, a quarterly loss in 2004, and 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. We incurred net losses of approximately \$35.2 million in 2001, \$25.4 million in 2000, and \$34.5 million in 1999. For 2002, we had net income of \$5.4 million and for 2003 we had net income of \$24.7 million (before non-recurring items added another \$38.5 million to net income). For the three months ended March 31, 2004 we had a net loss of \$3.8 million and will incur a loss in the second quarter of 2004 due to a lower level of Cray X1 system sales. 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 X1 system, the Cray X1E system, Red Storm, Cray XD1 and other products, and the timing and funding of government purchases, especially in the United States;
- completing the development of the Red Storm project, the Cray X1E system, the commercial version of the Red Storm system and the Cray XD1 system in time for deliveries and customer acceptances in 2004 and subsequently 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;
- 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 and annual basis in the future.

We face significant pressure on the pricing of our products, which may result in lower margins and earnings. In 2004, our product margins will be negatively impacted by the low margins recognized on the Red Storm and Cascade development contracts. 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 highly competitive market. We expect that the Cray XD1 system will sell at similarly lower margins. 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 2003, approximately 83% of our product revenue was derived from such sales. For the three months ended March 31, 2004, approximately 46% of our product revenue was derived from such sales. Our sales of Cray X1 systems to date have been largely to government agencies in the United States and other countries, and we expect that will continue throughout 2004. To date, however, we have entered into a limited number of significant new contracts for sales of the Cray X1 and Cray X1E systems. 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 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.

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.

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, including the planned Cray X1E upgrade 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 third-party and customer specific application programs to run on the Cray X1 and X1E systems. 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 those systems.

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; developing the Cray X1E system as a significant enhancement to the Cray X1 system and completing the development of the Cray XD1 system and successfully selling it in the midrange market. In subsequent years we must develop further enhancements to the Red Storm system for the high end market, and to the product adapted from it, along with the Cray XD1 system, for the midrange market, and develop the Black Widow system as a successor to the Cray X1 and X1E systems. We also must increasingly 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, Red Storm and Cray XD1 systems in the second half of 2004, our revenue and earnings would be adversely affected. We are dependent on our outsourced 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 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.

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

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 system, 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, increase significantly our research and development expenditures and adversely impact our ability to implement our product roadmap.

The failure to integrate Cray Canada Inc. could adversely affect our business. With the acquisition of OctigaBay Systems Corporation, now named Cray Canada Inc., we added an additional product line, 66 employees and a fourth major office location, our first major office outside of the United States. We need to increase our sales force and develop new sales channels to handle the Cray XD1 product, develop a different approach for providing customer servicing of the Cray XD1 product, integrate our financial and information systems and over time integrate our development programs. These changes may place a significant strain on our management resources. The failure to retain the current Cray Canada engineers and employees would adversely affect the development schedule and delay introduction of the Cray XD1 system. Difficulties in integrating our operations will divert our management's time and resources. Failure to complete this integration successfully could cause us to increase expenditures and adversely affect our revenue and results of operations.

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 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. Unless these criteria are changed to favor actual performance, we will continue to be 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 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. Our revenue from maintenance service contracts has declined from approximately \$125 million in 1999 to approximately \$57 million in 2003; we estimate that 2004 maintenance revenue will approximate \$48 million. This revenue may decline further, as our older systems are withdrawn from service, until a sufficient number of our new computer systems are placed in service to balance or exceed 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 based on Linux for successor systems to the Cray X1 product family, starting with the Black Widow system. Developing a new operating system is a 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 or service 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.

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 are 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.

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, Dell 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 existing and 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.

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.

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 March 31, 2004, we had outstanding:

- 73,279,570 shares of common stock;
- warrants to purchase 7,071,333 shares of common stock; and
- stock options to purchase an aggregate of 12,866,163 shares of common stock, of which 7,801,765 options were then exercisable.

We have also committed to issue a total of 12,401,306 additional shares of Common Stock and assume an additional 740,722 stock options in connection with the acquisition of Cray Canada Inc.

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 March 31, 2004, warrants to purchase 1,631,483 shares of common stock, with exercise prices ranging from \$3.00 to \$4.42 per share, expire between May 17, 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 classified Board of Directors, so that only two or three of our eight directors are elected each year (we are proposing to the shareholders at the 2004 Annual Meeting that they approve eliminating our classified Board);
- 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 facility prohibits us from paying cash dividends without the consent of our lenders.

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 March 31, 2004, our short-term investment balance was \$38.7 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.

There were no changes in our internal controls 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.

Part II. Other Information

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 2.1 Arrangement Agreement, dated on February 25, 2004, by and among Cray Inc., 3084317 Nova Scotia Limited and OctigaBay Systems Corporation (1)
- 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 and the Chief Financial and Accounting Officer

(1) Incorporated by reference to the Company's report on Form 8-K filed with the Commission on April 2, 2004.

(b) Reports on Form 8-K

A report on Form 8-K for an event of January 29, 2004, was filed on January 30, 2004, reporting the issuance of a press release of the Company's fourth quarter and 2003 year end financial results under Item 5, "Other Events."

A report on Form 8-K for an event of February 25, 2004, was filed on February 26, 2004, reporting Company's acquisition of OctigaBay Systems Corporation 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.

May 10, 2004

By: /s/ JAMES E. ROTTBOLK

James E. Rottbolk
President and Chief Executive Officer

/s/ SCOTT J. POTERACKI

Scott J. Poteracki
Chief Financial and Accounting Officer

EXHIBIT 31.1

Certification of Chief Executive Officer Pursuant to Rule 13a-14 of the
Securities Exchange Act of 1934,
as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, James E. Rottsolk, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cray Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures, and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the report based on such evaluation; and
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 7, 2004

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

EXHIBIT 31.2

Certification of Chief Financial Officer Pursuant to Rule 13a-14 of the
Securities Exchange Act of 1934,
as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Scott J. Poteracki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cray Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
 - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures, and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the report based on such evaluation; and
 - (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 7, 2004

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

EXHIBIT 32.1

Certificate Pursuant to 18 U.S.C. Section 1350,
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to 18 U.S.C. Section 1350, as adopted to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officers of Cray Inc. (the "Company") hereby certify, to such officers' knowledge, that:

(i) the accompanying Annual Report on Form 10-Q of the Company for the period ended March 31, 2004 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 7, 2004

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

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

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. ss. 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.