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

FORM 10-Q

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

For the quarterly period ended: June 30, 2009

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.)

901 Fifth Avenue, Suite 1000
Seattle, Washington
(Address of Principal Executive Office)

98164
(Zip Code)

Registrant's Telephone Number, Including Area Code:
(206) 701-2000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

As of July 31, 2009, there were 35,062,989 shares of Common Stock issued and outstanding.

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

Cray is a federally registered trademark of Cray Inc., and Cray XT4, Cray XT5, Cray XT5m, Cray XT, Cray XMT and Cray CX are trademarks of Cray Inc. The registered trademark Linux® is used pursuant to a sublicense from LMI, the exclusive licensee of Linus Torvalds, owner of the mark on a worldwide basis. Other trademarks used in this report are the property of their respective owners.

PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands, except share data)

	<u>June 30, 2009</u>	<u>December 31, 2008 (As Adjusted)</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 61,487	\$ 72,373
Restricted cash	1,906	2,691
Short-term investments, available-for-sale	5,488	5,350
Accounts receivable, net	47,727	95,667
Inventory	50,432	80,437
Prepaid expenses and other current assets	<u>22,494</u>	<u>29,993</u>
Total current assets	189,534	286,511
Property and equipment, net	17,735	18,396
Service inventory, net	1,702	1,917
Deferred tax asset	1,322	1,200
Other non-current assets	<u>7,124</u>	<u>5,837</u>
TOTAL ASSETS	<u>\$ 217,417</u>	<u>\$ 313,861</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 18,815	\$ 16,730
Accrued payroll and related expenses	13,232	23,672
Advance research and development payments	1,467	13,887
Convertible notes, net of discount	158	25,681
Other accrued liabilities	8,369	24,670
Deferred revenue	<u>34,711</u>	<u>67,692</u>
Total current liabilities	76,752	172,332
Long-term deferred revenue	16,690	18,154
Other non-current liabilities	<u>3,266</u>	<u>3,170</u>
TOTAL LIABILITIES	96,708	193,656
Commitments and contingencies		
Shareholders' equity:		
Preferred stock - Authorized and undesignated, 5,000,000 shares; no shares issued or outstanding	—	—
Common stock and additional paid-in capital, par value \$.01 per share - Authorized, 75,000,000 shares; issued and outstanding 35,021,880 and 33,506,573 shares, respectively	547,852	543,442
Accumulated other comprehensive income	6,926	9,364
Accumulated deficit	<u>(434,069)</u>	<u>(432,601)</u>
TOTAL SHAREHOLDERS' EQUITY	<u>120,709</u>	<u>120,205</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 217,417</u>	<u>\$ 313,861</u>

See accompanying notes

CRAY INC. AND SUBSIDIARIES

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 (As Adjusted)	2009	2008 (As Adjusted)
Revenue:				
Product	\$ 42,101	\$ 32,851	\$ 101,563	\$ 43,541
Service	20,643	13,882	35,662	29,320
Total revenue	<u>62,744</u>	<u>46,733</u>	<u>137,225</u>	<u>72,861</u>
Cost of revenue:				
Cost of product revenue	22,263	22,003	68,597	28,415
Cost of service revenue	11,952	9,241	22,228	17,600
Total cost of revenue	<u>34,215</u>	<u>31,244</u>	<u>90,825</u>	<u>46,015</u>
Gross profit	<u>28,529</u>	<u>15,489</u>	<u>46,400</u>	<u>26,846</u>
Operating expenses:				
Research and development, net	13,710	11,890	24,925	25,609
Sales and marketing	6,341	5,848	12,404	11,230
General and administrative	3,901	3,465	8,047	7,161
Total operating expenses	<u>23,952</u>	<u>21,203</u>	<u>45,376</u>	<u>44,000</u>
Income (loss) from operations	4,577	(5,714)	1,024	(17,154)
Other income (expense), net	(737)	540	(1,491)	793
Interest expense, net	(351)	(1,123)	(884)	(1,619)
Income (loss) before income taxes	3,489	(6,297)	(1,351)	(17,980)
Income tax expense	(69)	(107)	(117)	(389)
Net income (loss)	<u>\$ 3,420</u>	<u>\$ (6,404)</u>	<u>\$ (1,468)</u>	<u>\$ (18,369)</u>
Basic and diluted net income (loss) per common share	<u>\$ 0.10</u>	<u>\$ (0.20)</u>	<u>\$ (0.04)</u>	<u>\$ (0.57)</u>
Basic weighted average shares outstanding	<u>33,580</u>	<u>32,521</u>	<u>33,390</u>	<u>32,446</u>
Diluted weighted average shares outstanding	<u>33,965</u>	<u>32,521</u>	<u>33,390</u>	<u>32,446</u>

See accompanying notes

CRAY INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and in thousands)

	Six Months Ended June 30,	
	2009	2008 (As Adjusted)
Operating activities:		
Net loss	\$ (1,468)	\$ (18,369)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,490	5,421
Share-based compensation expense	3,403	1,378
Inventory write-down	956	420
Amortization of debt issuance costs	79	254
Loss on repurchase of Notes	910	—
Amortization of convertible notes debt discount	828	2,802
Deferred income taxes	94	(89)
Cash provided by (used in) due to changes in operating assets and liabilities:		
Accounts receivable	47,580	(8,893)
Inventory	27,776	(61,531)
Prepaid expenses and other assets	5,871	(10,723)
Accounts payable	2,070	50,642
Accrued payroll and related expenses, other accrued liabilities and advance research and development payments	(39,433)	(16,033)
Other non-current liabilities	95	234
Deferred revenue	(34,699)	(8,395)
Net cash provided by (used in) operating activities	18,552	(62,882)
Investing activities:		
Sales/maturities of short-term investments	5,350	35,549
Purchases of short-term investments	(5,481)	(1,673)
Decrease in restricted cash	785	—
Purchases of property and equipment	(2,225)	(1,871)
Net cash provided by (used in) investing activities	(1,571)	32,005
Financing activities:		
Repurchase of Notes	(27,150)	—
Proceeds from issuance of common stock through employee stock purchase plan	255	234
Proceeds from exercises of stock options	28	48
2009 stock option repurchase tender offer, purchase of options	(669)	—
Net cash provided by (used in) financing activities	(27,536)	282
Effect of foreign exchange rate changes on cash and cash equivalents	(331)	166
Net decrease in cash and cash equivalents	(10,886)	(30,429)
Cash and cash equivalents:		
Beginning of period	72,373	120,539
End of period	\$ 61,487	\$ 90,110
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 393	\$ 1,202
Non-cash investing and financing activities:		
Inventory transfers to fixed assets and service inventory	\$ 1,273	\$ 1,727
Shares issued for 401(k) match	\$ 1,311	\$ 1,223

See accompanying notes

CRAY INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1 - Basis of Presentation

In these notes, Cray Inc. and its wholly-owned subsidiaries are collectively referred to as “the Company.” In the opinion of management, the accompanying Condensed Consolidated Balance Sheets and related Condensed Consolidated Statements of Operations and Statements of Cash Flows have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Management believes that all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2008 (the “2008 Form 10-K”).

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

During the six months ended June 30, 2009, the Company incurred a net loss of \$1.5 million but generated \$18.6 million of cash from operating activities. The Company had \$112.8 million of working capital as of June 30, 2009. Management’s plans project that the Company’s current cash resources and cash to be generated from operations will be adequate to meet the Company’s liquidity needs for at least the next twelve months. These plans assume sales, shipment, acceptance and subsequent collections from several large customers, as well as cash receipts on future sales opportunities not yet contracted.

Principles of Consolidation

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

Adjustments and Reclassifications

Effective January 1, 2009, the Company adopted Financial Accounting Standards Board (“FASB”) Staff Position (“FSP”) No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (“FSP APB 14-1”), which states that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) should have the liability and equity components of the instruments accounted for separately in a manner that will reflect the entity’s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. As a result, the liability component would be recorded at a discount reflecting its below market coupon interest rate, and the liability component would be accreted to its par value over its expected life, with the rate of interest that reflects the market rate at issuance being reflected in the results of operations. This change in methodology affects the calculations of net income and earnings per share, but will not increase the Company’s cash interest payments.

Upon adoption of FSP APB 14-1, on January 1, 2009, the Company retrospectively applied the change in accounting principle to prior accounting periods as if the principle has always been in effect. See *Note 12 - Convertible Notes* for impact of the adoption of FSP APB 14-1.

Certain other prior period amounts have been reclassified to conform with the current-period presentation. There has been no impact on previously reported net income (loss) or shareholders' equity due to these reclassifications.

Use of Estimates

Preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates are based on management's best knowledge of current events and actions the Company may undertake in the future. Estimates are used in accounting for, among other items, fair value determination used in revenue recognition, percentage of completion accounting, estimates of proportional performance on co-funded engineering contracts and prepaid engineering services, determination of inventory at the lower of cost or market, useful lives for depreciation and amortization, determination of future cash flows associated with impairment testing for long-lived assets, determination of the fair value of stock options and assessments of fair value, calculation of deferred income tax assets, potential income tax assessments and other contingencies. The Company bases its estimates on historical experience, current conditions and on other assumptions that it believes to be reasonable under the circumstances. Actual results could differ materially from those estimates.

Note 2 - New Accounting Pronouncements

In March 2008, the FASB issued Statement of Financial Accounting Standards ("FAS") No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ("FAS 161"). FAS 161 amends and expands the disclosure requirements in FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. FAS 161 was effective for the quarter ended March 31, 2009 and the Company has included the required disclosures in *Note 3 - Fair Value Measurement*.

In April 2009, the FASB issued FSP FAS 107-1 and Accounting Principles Board ("APB") 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ("FSP 107-1"). FSP 107-1 amends FAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require an entity to provide disclosures about fair value of financial instruments in interim financial statements. This FSP is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. The Company adopted FSP 107-1 for its quarter ended June 30, 2009. As of June 30, 2009, the 3.0% Convertible Senior Subordinated Notes due 2024 ("Notes"), with a contractual face amount of \$164,000, had a fair value of \$162,000.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ("FSP 115-2"). The guidance applies to investments in debt securities for which other-than-temporary impairments may be recorded. If an entity's management asserts that it does not have the intent to sell a debt security and it is more likely than not that it will not have to sell the security before recovery of its cost basis, then an entity may separate other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings), and 2) all other amounts (recorded in other comprehensive income). FSP 115-2 is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. The Company adopted FSP 115-2 for its quarter ended June 30, 2009. There was no impact on the Company's financial position or results of operations from adoption.

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ("FSP FAS 157-4"). Based on the guidance, if an entity determines that the level of activity for an asset or liability has significantly decreased and that a transaction is not orderly, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value in accordance with FAS 157. FSP FAS 157-4 is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. The Company adopted FSP FAS 157-4 for its quarter ended June 30, 2009. There was no impact on the Company's financial position or results of operations from adoption.

In May 2009, the FASB issued FAS No. 165, *Subsequent Events* ("FAS 165"). FAS 165 is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. The Company adopted FAS 165 during the second quarter of 2009. The Company has evaluated subsequent events and any related required disclosures through August 5, 2009, which is the date this Quarterly Report on Form 10-Q was submitted for filing with the Securities and Exchange Commission.

In June 2009, the FASB issued FAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (“FAS 168”). FAS 168 represents the last numbered standard to be issued by FASB under the old (pre-Codification) numbering system, and amends the GAAP hierarchy. On July 1, 2009, FASB launched a new Accounting Standards Codification which will supersede existing GAAP for nongovernmental entities. This pronouncement is expected to have no effect on the Company’s financial position or results of operations.

Note 3 - Fair Value Measurement

Effective January 1, 2008, the Company implemented FAS 157 for its financial assets and liabilities that are remeasured and reported at fair value at each reporting period and non-financial assets and liabilities that are remeasured and reported at fair value at least annually. In accordance with the provisions of FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, the Company elected to defer implementation of FAS 157 as it relates to its non-financial assets and non-financial liabilities that are recognized and disclosed at fair value in the financial statements on a nonrecurring basis until January 1, 2009. The adoption of FAS 157 did not have a material impact on the Company’s financial position or results of operations.

In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The following table presents information about the Company’s financial assets that have been measured at fair value as of June 30, 2009, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands):

<u>Description</u>	<u>Fair Value at June 30, 2009</u>	<u>Quoted Prices in Active Markets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>
Assets:			
Cash, cash equivalents and restricted cash	\$ 63,393	\$ 63,393	\$ —
Short-term investments, available-for-sale	5,488	5,488	—
Assets measured at fair value at June 30, 2009	<u>\$ 68,881</u>	<u>\$ 68,881</u>	<u>\$ —</u>
Foreign exchange forward contracts (1)	(2,693)	—	(2,693)
Liabilities measured at fair value at June 30, 2009	<u>\$ (2,693)</u>	<u>\$ —</u>	<u>\$ (2,693)</u>

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

As of June 30, 2009, the Company’s short-term investments consisted of corporate notes and bonds and treasury bills which are categorized as Level 1 in accordance with FAS 157. The fair values of Level 1 assets, cash, cash equivalents, restricted cash and short-term investments are determined through market, observable and corroborated sources. The fair values of Level 2 assets do not have observable prices, but have inputs that are based on observable inputs, either directly or indirectly.

Short-term Investments

The Company’s short-term investments have been classified as available-for-sale and consisted of the following (in thousands):

	<u>Amortized Cost Basis</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
June 30, 2009				
Corporate notes and bonds	\$ 2,499	\$—	\$ —	\$ 2,499
Treasury bills	2,990	—	(1)	2,989
Total short-term investments	<u>\$ 5,489</u>	<u>\$—</u>	<u>\$ (1)</u>	<u>\$ 5,488</u>
December 31, 2008				
Corporate notes and bonds	\$ 5,351	\$ 2	\$ (3)	\$ 5,350
Total short-term investments	<u>\$ 5,351</u>	<u>\$ 2</u>	<u>\$ (3)</u>	<u>\$ 5,350</u>

No material gains or losses were realized on sales of short-term investments for the three and six month periods ended June 30, 2009 and 2008. The Company uses the specific identification method to determine the cost basis for calculating realized gains or losses. As of June 30, 2009, the Company had no auction rate securities in its short-term investments.

Short-term investments held at June 30, 2009 have contractual maturities in 2009 and 2010.

Foreign Currency Derivatives

The Company may enter into foreign currency derivatives to hedge future cash receipts on certain sales transactions that are payable in foreign currencies. The Company does not enter into any derivatives other than those that can be classified as hedging instruments.

As of June 30, 2009, the Company had outstanding forward contracts which were designated as cash flow hedges of anticipated future cash receipts on sales contracts payable in foreign currencies. The outstanding notional amount was approximately 11.8 million British pound sterling and 10.3 million Swiss Franc and hedged foreign currency exposure of approximately \$26.2 million. Cash receipts associated with the hedged contracts are expected to be received in 2009 and 2010, during which time the revenue on the associated sales contracts are expected to be recognized.

As of December 31, 2008, the Company had outstanding forward contracts designated as cash flow hedges with notional amounts of 11.8 million British pound sterling and 5.5 million euro. These contracts hedged foreign currency exposure of \$30.3 million.

Fair Values of Derivative Instruments (in thousands):

<u>Hedge Classification</u>	<u>Balance Sheet Location</u>	<u>Fair Value as of June 30, 2009</u>	<u>Fair Value as of December 31, 2008</u>
Cash flow hedges	Other accrued liabilities/Prepaid expenses and other current assets	\$ (2,693)	\$ 5,478
Total derivatives classified as hedging instruments		<u>\$ (2,693)</u>	<u>\$ 5,478</u>

As of June 30, 2009 and December 31, 2008, foreign currency gains of \$3.4 million and \$5.3 million, respectively, were included in "Accumulated other comprehensive income" on the Company's Condensed Consolidated Balance Sheets. For the three and six months ended June 30, 2009, the Company recorded approximately \$512,000 and \$488,000, respectively, in net reclassification adjustments, which increased product revenue, as revenue on the associated sales contracts was recognized. For the three and six months ended June 30, 2008, the Company reclassified approximately \$0.5 million of foreign exchange losses against product revenue as revenue was recognized on the hedged transaction.

Note 4 - Earnings (Loss) Per Share ("EPS")

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

For the three months ended June 30, 2009, outstanding stock options and unvested restricted stock of 385,000 shares were included in the diluted weighted average shares outstanding. For the six months ended June 30, 2009 and 2008, and for the three months ended June 30, 2008, outstanding stock options, unvested restricted stock grants and restricted stock units, warrants and shares issuable upon conversion of the Notes were antidilutive because of net losses and, as such, their effect has not been included in the calculation of basic or diluted net loss per share. For the three and six month periods ended June 30, 2009, potential gross common shares of 4.8 million and 5.2 million, respectively, were antidilutive and not included in computing diluted EPS. For the three and six month periods ended June 30, 2008, potential gross common shares of 11.8 million were antidilutive and not included in computing diluted EPS.

Note 5 - Comprehensive Loss

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 (1)	2009	2008 (1)
Net income (loss)	\$ 3,420	\$ (6,404)	\$ (1,468)	\$ (18,369)
Unrealized net gain (loss) on available-for-sale investments	4	(83)	—	(7)
Cash flow hedges:				
Net loss on cash flow hedges	(1,515)	(320)	(979)	(123)
Reclassification adjustment to revenue	(512)	500	(488)	500
	(2,027)	180	(1,467)	377
Foreign currency translation adjustment	(1,409)	485	(971)	(2,840)
Comprehensive loss	<u>\$ (12)</u>	<u>\$ (5,822)</u>	<u>\$ (3,906)</u>	<u>\$ (20,839)</u>

(1) Net loss adjusted for retrospective application of FSP APB 14-1 (see *Note 12 - Convertible Notes*)

Note 6 - Accounts Receivable

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

	June 30, 2009	December 31, 2008
Trade accounts receivable	\$ 45,165	\$ 75,624
Unbilled receivables	1,023	6,703
Advance billings	<u>1,770</u>	<u>13,439</u>
	47,958	95,766
Allowance for doubtful accounts	<u>(231)</u>	<u>(99)</u>
Accounts receivable, net	<u>\$ 47,727</u>	<u>\$ 95,667</u>

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

As of June 30, 2009 and December 31, 2008, accounts receivable included \$31.1 million and \$79.1 million, respectively, due from U.S. government agencies and customers primarily serving the U.S. government. Of this amount, \$0.8 million and \$6.6 million were unbilled as of June 30, 2009 and December 31, 2008, respectively, based upon contractual billing arrangements with these customers. As of June 30, 2009, one non-government customer accounted for 21% of total accounts receivable. As of December 31, 2008, no non-government accounts receivable were greater than 10% of total accounts receivable.

Note 7 - Inventory

Inventory consisted of the following (in thousands):

	June 30, 2009	December 31, 2008
Components and subassemblies	\$ 23,967	\$ 16,805
Work in process	12,097	6,284
Finished goods	<u>14,368</u>	<u>57,348</u>
Total	<u>\$ 50,432</u>	<u>\$ 80,437</u>

As of June 30, 2009, finished goods inventory included \$13.7 million located at customer sites pending acceptance. As of December 31, 2008, finished goods inventory of \$57.3 million was located at customer sites pending acceptance. At June 30, 2009, two customers accounted for \$11.8 million, and at December 31, 2008, three customers accounted for \$47.6 million of finished goods inventory.

During the three and six months ended June 30, 2009, the Company wrote off \$800,000 and \$956,000, respectively, of inventory, primarily related to scrap, excess or obsolete inventory of the Cray XT product line. During the three and six months ended June 30, 2008, the Company wrote off \$363,000 and \$420,000 of inventory, respectively, primarily related to scrap, excess or obsolete inventory of the Cray XT3 product.

Note 8 - Deferred Revenue

Deferred revenue consisted of the following (in thousands):

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
Deferred product revenue	\$ 24,937	\$ 49,326
Deferred service revenue	26,464	36,520
Total deferred revenue	51,401	85,846
Less long-term deferred revenue	(16,690)	(18,154)
Deferred revenue in current liabilities	<u>\$ 34,711</u>	<u>\$ 67,692</u>

As of June 30, 2009 and December 31, 2008, three customers accounted for 45% and 46%, respectively, of total deferred revenue.

Note 9 - Share-Based Compensation

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

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

In determining fair value of stock options, the Company uses the Black-Scholes option pricing model and employed the following key weighted average assumptions:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
Risk-free interest rate	1.6%	2.9%	1.6%	2.8%
Expected dividend yield	0%	0%	0%	0%
Volatility	79%	69%	79%	69%
Expected life	4.0 years	4.0 years	4.0 years	4.0 years
Weighted average Black-Scholes value of options granted	\$ 2.20	\$ 3.57	\$ 2.19	\$ 3.52

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Volatility is based on historical data. The expected life of an option was based on the assumption that options will be exercised, on average, about two years after vesting occurs. The Company recognizes compensation expense for only the portion of options or stock units that are expected to vest. Therefore, management applies an estimated forfeiture rate that is derived from historical employee termination data and adjusted for expected future employee turnover rates. The estimated forfeiture rate for stock option grants during the three and six month periods ended June 30, 2009 was 8% for each period. The estimated forfeiture rate for stock option grants during the three and six month periods ended June 30, 2008 was 9% for each period. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods. The Company's stock price volatility, option lives and expected forfeiture rates involve management's best estimates at the time of such determination, which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. The Company typically issues stock options with a four-year vesting period (the requisite service period). The Company amortizes stock compensation cost ratably over the requisite service period.

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

The following table sets forth the gross share-based compensation cost resulting from stock options and unvested restricted stock grants and restricted stock units (before consideration of any offsets for research and development co-funding) that was recorded in the Company's Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2009 and 2008 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Cost of product revenue	\$ 33	\$ 23	\$ 124	\$ 37
Cost of service revenue	81	43	298	69
Research and development, net	347	296	1,239	517
Sales and marketing	148	128	512	209
General and administrative	424	315	1,230	546
Total	<u>\$ 1,033</u>	<u>\$ 805</u>	<u>\$ 3,403</u>	<u>\$ 1,378</u>

A summary of the Company's stock option activity for the six months ended June 30, 2009 and related information follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2008	3,755,894	\$ 12.30		
Grants	1,210,200	\$ 3.74		
Exercises	(4,775)	\$ 5.96		
Cancellations	(1,896,657)	\$ 16.35		
Outstanding at June 30, 2009	<u>3,064,662</u>	\$ 6.42	7.9 years	\$7.5 million
Exercisable at June 30, 2009	<u>1,170,103</u>	\$ 9.00	5.4 years	\$1.7 million
Available for grant at June 30, 2009	<u>4,290,485</u>			

Intrinsic value represents the total pretax intrinsic value for all "in-the-money" options (i.e., the difference between the Company's closing stock price on the last trading day of its second quarter of 2009 and the exercise price, multiplied by the number of shares) that would have been received by the option holders had all option holders exercised their options on June 30, 2009. During the three and six months ended June 30, 2009, stock options covering 4,775 shares, with a total intrinsic value of \$7,000, were exercised. For the three and six months ended June 30, 2008, stock options covering 8,072 shares, with a total intrinsic value of \$2,000, were exercised.

A summary of the Company's unvested restricted stock grants and restricted stock units and changes during the period ended June 30, 2009 is as follows:

	Shares	Weighted Average Grant date Fair Value
Outstanding at December 31, 2008	623,874	\$ 7.36
Granted	852,170	3.77
Vested	(56,659)	7.07
Forfeited	—	—
Outstanding at June 30, 2009	<u>1,419,385</u>	<u>\$ 5.21</u>

The aggregate fair value of restricted stock vested during the second quarter of 2009 was \$0.2 million.

As of June 30, 2009, the Company had \$10.6 million of total unrecognized compensation cost related to unvested stock options and unvested restricted stock and restricted stock units, which is expected to be recognized over a weighted average period of 2.9 years.

In February 2009, the Company commenced a tender offer to purchase up to 2.1 million of eligible vested and unvested employee and director stock options outstanding. The tender offer was for options with a grant price of \$8.00 or more, which were granted prior to May 2007. The tender offer was completed on March 20, 2009, and the Company purchased 1.8 million options for \$669,000. The amount charged to shareholders' equity for stock options purchased at or below the estimated fair value of the options on the date of

repurchase was \$587,000, with the balance of \$82,000 charged to compensation expense as amounts paid were in excess of estimated fair value. During the six months ended June 30, 2009, the Company recorded \$1.4 million of stock-based compensation expense related to previously unrecognized compensation cost of unvested stock options that were purchased.

Note 10 - Taxes

The Company recorded income tax expense of \$69,000 and \$117,000, respectively, for the three and six months ended June 30, 2009. The Company recorded income tax expense of \$107,000 and \$389,000, respectively, for the three and six months ended June 30, 2008. The expense recorded was primarily related to foreign income taxes payable.

The Company continues to provide a full valuation allowance against net operating losses and other net deferred tax assets arising in certain jurisdictions, primarily in the United States and Canada, as the realization of such assets is not considered to be more likely than not.

In March 2008, Cray U.K. Limited, a wholly-owned subsidiary of the Company, received notice from HM Revenue & Customs, which is the United Kingdom equivalent of the Internal Revenue Service, of its intent to open an inquiry into Cray U.K. Limited's 2005 and 2006 corporate income tax returns. At this time, it is not possible to determine the extent or the outcome of such inquiry.

Note 11 - Geographic Segment Information

Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions regarding allocation of resources and assessing performance. Cray's chief decision-maker is the Chief Executive Officer. The Company continues to operate in a single operating segment.

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

	<u>United States</u>		<u>Other Countries</u>		<u>Total</u>	
	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>	<u>2009</u>	<u>2008</u>
Three months ended June 30,						
Product revenue	\$ 29,057	\$ 21,760	\$ 13,044	\$ 11,091	\$ 42,101	\$ 32,851
Service revenue	<u>15,023</u>	<u>7,994</u>	<u>5,620</u>	<u>5,888</u>	<u>20,643</u>	<u>13,882</u>
Total revenue	<u>\$ 44,080</u>	<u>\$ 29,754</u>	<u>\$ 18,664</u>	<u>\$ 16,979</u>	<u>\$ 62,744</u>	<u>\$ 46,733</u>
Six months ended June 30,						
Product revenue	\$ 79,766	\$ 31,544	\$ 21,797	\$ 11,997	\$ 101,563	\$ 43,541
Service revenue	<u>24,650</u>	<u>17,524</u>	<u>11,012</u>	<u>11,796</u>	<u>35,662</u>	<u>29,320</u>
Total revenue	<u>\$ 104,416</u>	<u>\$ 49,068</u>	<u>\$ 32,809</u>	<u>\$ 23,793</u>	<u>\$ 137,225</u>	<u>\$ 72,861</u>

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately \$42.6 million and \$99.1 million, respectively, for the three and six months ended June 30, 2009, compared to approximately \$28.2 million and \$41.3 million, respectively, for the three and six months ended June 30, 2008.

There have been no material changes in the balances of long-lived assets during the three and six months ended June 30, 2009.

Note 12 - Convertible Notes

Upon adoption of FSP APB 14-1, the Company retrospectively, as of the Notes' December 2004 issue date, recorded a debt discount of \$25.8 million. As of June 30, 2009, the remaining debt discount was \$6,000, and the Notes, with a contractual principal balance of \$164,000, have a net carrying value of \$158,000. The Company is amortizing the debt discount over a five-year period which will conclude in December 2009. As of June 30, 2009, the carrying amount of the equity component was \$24.7 million.

The Notes bear contractual interest at an annual rate of 3.0%, payable semiannually on June 1 and December 1 of each year. The nonconvertible borrowing rate applied to the principal balance of the Notes was 11.7%. For the three and six month periods ended June 30, 2009, the Company recorded \$0.4 million and \$1.1 million, respectively, of interest expense related to the Notes, of which \$0.3 million and \$0.8 million, respectively, related to amortization of the debt discount. For the three and six month periods ended June 30, 2008, the Company recorded \$2.0 million and \$3.9 million, respectively, of interest expense related to the Notes, of which \$1.4 million and \$2.8 million, respectively, related to the amortization of the debt discount.

The following table reflects the retrospective application of the adoption of FSP ABP 14-1 for the periods presented. No other accounts were impacted by the adoption of FSP APB 14-1.

	<u>As Originally Reported</u>	<u>Effect of Change</u>	<u>As Adjusted</u>
<i>Income Statement for the three-month period ended June 30, 2008:</i>			
Interest income (expense), net	\$ 254	\$ (1,377)	\$ (1,123)
Loss before income taxes	(4,920)	(1,377)	(6,297)
Net loss	(5,027)	(1,377)	(6,404)
Basic and diluted net loss per common share	<u>\$ (0.15)</u>	<u>\$ (0.04)</u>	<u>\$ (0.20)</u>
<i>Income Statement for the six-month period ended June 30, 2008:</i>			
Interest income (expense), net	\$ 1,091	\$ (2,710)	\$ (1,619)
Loss before income taxes	(15,270)	(2,710)	(17,980)
Net loss	(15,659)	(2,710)	(18,369)
Basic and diluted net loss per common share	<u>\$ (0.48)</u>	<u>\$ (0.08)</u>	<u>\$ (0.57)</u>
<i>Cash Flow Statement for the six-month period ended June 30, 2008:</i>			
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Net loss	\$ (15,659)	\$ (2,710)	\$ (18,369)
Amortization of debt issuance costs	346	(92)	254
Amortization of convertible notes debt discount	<u>\$ —</u>	<u>\$ 2,802</u>	<u>\$ 2,802</u>
<i>Balance Sheet as of December 31, 2008:</i>			
Prepaid expenses and other current assets	\$ 30,023	\$ (30)	\$ 29,993
Total Assets	<u>\$ 313,891</u>	<u>\$ (30)</u>	<u>\$ 313,861</u>
Convertible notes, net of discount	\$ 27,727	(2,046)	25,681
Total Liabilities	195,702	(2,046)	193,656
Common stock and additional paid-in capital	518,727	24,715	543,442
Accumulated deficit	(409,902)	(22,699)	(432,601)
Total Shareholders' Equity	118,189	2,016	120,205
Total Liabilities and Shareholders' Equity	<u>\$ 313,891</u>	<u>\$ (30)</u>	<u>\$ 313,861</u>

Note 13 - Subsequent Events

In July 2009, the Company entered into a lease with NEA Galtier, LLC for office space in St. Paul, Minnesota. Upon the completion of the leasehold improvements, expected to be by November 2009, the Company plans to move approximately 225 employees currently based in Mendota Heights, Minnesota. The new premises consist of approximately 51,100 square feet with options for up to an additional 15,000 square feet. One option for 4,996 square feet has been exercised. The lease has a term of approximately 126 months from the commencement date, with the Company having two five-year renewal options. The initial annual rent will be approximately \$1.1 million, subject to full abatement of rent for the first six months of the lease term.

In July 2009, the Company amended its Credit Agreement with Wells Fargo Bank, National Association, effective as of June 1, 2009, to change the principal amount of the credit facility to \$3.5 million and to extend the maturity date to June 1, 2010. This facility may be used to provide foreign exchange contracts (with a potential exposure of no more than \$2.5 million) and to support letters of credit (up to no more than \$1.0 million in aggregate). Under this amendment the Company is required to maintain at least \$3.5 million of cash, cash equivalents and similar investments to secure the facility and to maintain \$3.5 million of additional liquid assets.

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 "Management's Discussion and Analysis of Financial Condition and Results of Operations" below contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, including any projections of earnings, revenue or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements concerning proposed new products, services or developments; any statements regarding future economic conditions or performance; any statements of belief and any statement of assumptions underlying any of the foregoing. We assume no obligation to update these forward-looking statements. These forward-looking statements are subject to the safe harbor created by Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Factors that could cause our actual results to differ materially from those expressed or implied in the forward-looking statements are set forth in the discussion under "Item 1A. Risk Factors" in Part II of this Report. The following discussion should also be read in conjunction with the Consolidated Financial Statements and accompanying Notes thereto in our 2008 Form 10-K and the Condensed Consolidated Financial Statements and accompanying Notes thereto in this Report.

Overview and Executive Summary

We design, develop, manufacture, market and service high performance computing ("HPC") systems, commonly known as supercomputers. Our supercomputer systems provide capability, capacity and sustained performance far beyond typical server-based computer systems and address challenging scientific and engineering computing problems.

We believe we are well-positioned to meet the demanding needs of the high-end of the HPC market by providing superior supercomputer systems with performance and cost advantages when sustained performance on challenging applications and total cost of ownership are taken into account. We differentiate ourselves from our competitors primarily by concentrating our research and development efforts on the processing, interconnect and system capabilities that enable our supercomputers to scale - that is, to continue to increase performance as they grow in size. In addition, we have demonstrated expertise in several processor technologies. Purpose-built for the supercomputer market, our systems balance highly capable processors, highly scalable system software and very high speed interconnect and communications capabilities.

Summary of First Six Months of 2009 Results

Total revenue increased \$64.4 million for the first six months of 2009, from \$72.9 million to \$137.2 million, compared to the first six months of 2008, primarily due to increased product revenue of \$58.0 million, largely from Cray XT systems, and \$6.3 million of increased service revenue.

Income from operations for the first six months of 2009 was \$1.0 million compared to a loss from operations of \$17.2 million for the same period in 2008, due to increased gross profit of \$19.6 million partially offset by a \$1.4 million increase in operating expenses. Operating expenses increased primarily due to higher stock-based compensation, in large part due to the stock option repurchase tender offer completed in the first quarter of 2009, and higher variable pay expenses, including higher sales commissions on higher product sales offset in part by lower net research and development expenses.

Net cash provided by operations was \$18.6 million for the first six months of 2009 compared to net cash used in operations of \$62.9 million for the first six months of 2008. Cash and short-term investment balances, including restricted cash balances, were \$68.9 million as of June 30, 2009 compared to \$80.4 million as of December 31, 2008.

Market Overview and Challenges

In recent years the most significant trends in the HPC industry have been:

- The commoditization of HPC hardware, particularly processors and also interconnect systems,

- The growing commoditization of software, including plentiful building blocks and more capable open source software,
- Supercomputing with multi-core commodity processors causing increasing scalability requirements,
- Electrical power requirements becoming a design constraint and driver in total cost of ownership determinations,
- Increased micro-architectural diversity, including many-core processors with vector extensions and growing experimentation with accelerators, as the rate of per-core performance has decreased, and
- Data needs growing faster than computational needs.

These trends have resulted in the expansion and acceptance of lower-bandwidth cluster systems using processors manufactured by Intel, AMD and others combined with commercially available commodity networking and other components throughout the HPC market, especially in capacity, or throughput, computing situations. These systems may offer higher theoretical peak performance for equivalent cost, and “price/peak performance” is often the dominant factor in HPC procurements outside of the high-end supercomputer market segment. Vendors of such systems often put pricing pressure on us in competitive procurements, even at times in larger procurements where “time to solution” is of significant importance.

In the markets for larger systems costing significantly in excess of \$1 million, the use of commodity processors and networking components results in increasing data transfer bottlenecks as these components do not balance processor power with network communication capability. With the arrival of increasing processor core counts due to quad-core and soon many-core processors, these unbalanced systems will typically have even lower productivity, especially in larger systems running more complex applications. Vendors have also begun to augment standard microprocessors with other processor types in order to increase computational power, further complicating programming models. In addition, with increasing scale, bandwidth and processor core counts, large computer systems use progressively higher amounts of power to operate and require special cooling capabilities.

We believe we are well-positioned to meet the market’s demanding needs, as we concentrate our research and development efforts on the interconnect, system software and packaging capabilities that enable our supercomputers to perform at scale - that is, to continue to increase actual performance as systems grow ever larger in size. We have demonstrated expertise in several processor technologies - massively parallel processing, multithreading, vector processing and co-processing with field programmable gate arrays and graphics processing units. Further, we offer unique capabilities in high-speed, high bandwidth interconnect design, compiler technology, system software and packaging capabilities. Our experience and capabilities across each of these fronts are becoming ever more important, especially in larger procurements. We expect to be in a comparatively advantageous position as larger many-core processors become available and as multiple processing technologies become integrated into single systems. In addition, we intend to expand our addressable market by leveraging our technologies and customer base, the Cray brand and industry trends by introducing complementary products and services to new and existing customers, as demonstrated by our emphasis on Custom Engineering projects and the introduction of our new Cray CX and Cray XT5m systems.

Our Goals and Strategy

Our goals are to become the leading provider of supercomputers in the HPC market segments that we target and to have sustained annual profitability. Key elements of our strategy to achieve these goals include:

Gain Share in Our Core Supercomputing Market. We intend to leverage our strong product portfolio, product roadmap and brand recognition in the high end of the HPC market to gain market share. We believe that most of our competitors are focused primarily on the mid-range and lower end of the HPC market where lower bandwidth cluster systems dominate. We continue to be focused primarily on the nearly \$3 billion high-end supercomputing segment of the HPC market.

Extend Technology Leadership. We are an innovation driven company in a technology driven market. We plan to maintain a technology leadership position by investing in research and development and partnering with key suppliers and customers with interests strongly aligned with ours. We will rely in part on government funding for our research and development efforts. We intend to execute on our product roadmap, supporting multiple processing technologies within single, highly scalable systems.

Expand Our Total Addressable Market. Over time, we intend to expand our addressable market by leveraging our technologies and customer base, the Cray brand and industry trends by introducing complementary products and services to new and existing customers. We believe we have the opportunity to compete in a broader portion of the HPC market as well as selective adjacent markets outside of traditional HPC. Our expansion of our engineering services offerings, including our Custom Engineering program, our Cray CX systems, our first system based on Intel processors, and our new Cray XT5m system are three initiatives to further this strategy.

Maintain Our Focus on Execution and Profitability. We are committed to achieving sustained profitability on an annual basis. We intend to continue to refine our product roadmap, converge our technologies and development processes, improve our ability to deliver high quality products on time and on budget and continue our commitment to financial discipline.

In the future we will be able to provide the HPC market with access to the best processors, whether from Intel or AMD, that are available at any point in time.

Key Performance Indicators

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

Revenue. Product revenue generally constitutes the major portion of our revenue in any reporting period and, for the reasons discussed elsewhere in this Quarterly Report on Form 10-Q, is subject to significant variability from period to period. In the short term, we closely review the status of product shipments, installations and acceptances in order to forecast revenue and cash receipts; longer-term, we monitor the status of the pipeline of product sales opportunities and product development cycles. Revenue growth is the best indicator of whether we are achieving our objective of increased market share in the markets we address. The introduction of the Cray XT family and our longer-term product roadmap, including our Intel initiative, are efforts to increase product revenue. We also plan to increase our engineering services offerings, which include our Custom Engineering team, and market new products, such as the Cray CX and Cray XT5m systems, to increase revenue. Maintenance service revenue is more constant in the short term and assists, in part, to offset the impact that the variability in product revenue has on total revenue. While there is a wide range of potential outcomes, we currently expect our total revenue to increase slightly for the full year 2009 compared to 2008.

Gross profit margin. Our total gross profit margin and our product gross profit margin for the first six months of 2009 were 34% and 32%, respectively, which reflect decreases from the respective 2008 levels of 37% and 35% due to a large, low gross profit contract (on which \$36 million was recognized in the first quarter of 2009) and a delay in signing of a contract and revenue recognition issues relating to a Custom Engineering project, which was signed in July 2009. We need to focus on maintaining and improving our product gross profit margin over the long term, which we believe is best achieved through product differentiation, although we expect product gross profit margin to decline in 2009 from 2008, principally due to the low gross profit system sale, most of which was recognized in the first quarter of 2009.

Operating expenses. Our operating expenses are driven largely by headcount, the level of recognized co-funding for research and development and contracted third-party research and development services. As part of our ongoing efforts to control operating expenses, we monitor headcount levels in specific geographic and operational areas. Our November 2006 award under the DARPA High Performance Computer System Phase III project (the "DARPA HPCS project") is in line with our long-term development path. This award, however, is expected to result in overall increases in gross and net research and development expenditures due to the size of the overall program and the cost-sharing requirement on our part. Operating expenses for the first six months of 2009 were approximately \$1.4 million more than the first six months of 2008 due to increased stock-based compensation and increased sales commissions on higher product revenues, partially offset by lower net research and development expense.

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

Critical Accounting Policies and Estimates

This discussion, as well as disclosures included elsewhere in this Quarterly Report on Form 10-Q, are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingencies. In preparing our financial statements in accordance with GAAP, there are certain accounting policies that are particularly important. These include revenue recognition, inventory valuation, accounting for income taxes, research and development expenses and share-based compensation. Our significant accounting policies are set forth in Note 2 to the Consolidated Financial Statements included in our 2008 Form 10-K and should be reviewed in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto as of June 30, 2009, as they are integral to understanding our results of operations and financial condition in this interim period. In some cases, these policies represent required accounting. In other cases, they may represent a choice between acceptable accounting methods or may require substantial judgment or estimation.

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

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

Revenue Recognition

We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when we have persuasive evidence of an arrangement, the product has been shipped or the services have been provided to our customer, the sales price is fixed or determinable, no significant unfulfilled obligations exist and collectibility is reasonably assured. We record revenue in our consolidated statements of operations net of any sales, use, value added or certain excise taxes imposed by governmental authorities on specific sales transactions. In addition to the aforementioned general policy, the following are our statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

Multiple-Element Arrangements. We commonly enter into transactions that include multiple-element arrangements, which may include any combination of hardware, maintenance and other services. When some elements are delivered prior to others in an arrangement and all of the following criteria are met, revenue for the delivered element is recognized upon delivery and acceptance of such item:

- The element could be sold separately;
- The fair value of the undelivered element is established; and
- In cases with any general right of return, our performance with respect to any undelivered element is within our control and probable.

If all of the criteria are not met, revenue is deferred until delivery of the last element as the elements would not be considered a separate unit of accounting and revenue would be recognized as described below under our product or service revenue recognition policies. We consider the maintenance period to commence upon acceptance of the product, which may include a warranty period and accordingly allocate a portion of the sales price as a separate deliverable which is recognized as service revenue over the entire service period.

Products. We recognize revenue from sales of our products other than the Cray CX system, upon customer acceptance of the system, when we have no significant unfulfilled obligations stipulated by the contract that affect the customer's final acceptance, the price is fixed or determinable and collection is reasonably assured. A customer-signed notice of acceptance or similar document is typically

required from the customer prior to revenue recognition. Revenue from sales of our Cray CX products are generally recognized upon shipment when title and risk of loss transfers to the customer.

Project Revenue. Revenue from contracts that require us to design, develop, manufacture or modify complex HPC systems to a customer's specifications 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 or services. Estimates may need to be adjusted from quarter to quarter, which would impact revenue and gross profit on a cumulative basis. To the extent the estimate of total costs to complete the contract indicates a loss, such amount is recognized in full in the period that the determination is made.

Services. 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, often with prepayments for the term of the contract. We consider the maintenance period to commence upon acceptance of the product, which may include a warranty period. We allocate a portion of the sales price to maintenance service revenue based on estimates of fair value. Maintenance revenue is recognized ratably over the term of the maintenance contract. Maintenance contracts that are paid in advance are recorded as deferred revenue. We consider fiscal funding clauses as contingencies for the recognition of revenue until the funding is virtually assured. Revenue from engineering services is recognized as services are performed.

Inventory Valuation

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

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

Accounting for Income Taxes

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

As of June 30, 2009, we had approximately \$134.5 million of net deferred tax assets, against which we provided a \$133.2 million valuation allowance, resulting in a net deferred tax asset of \$1.3 million. Our net deferred tax assets relate primarily to certain foreign jurisdictions where we believe it is more likely than not that such assets will be realized.

Research and Development Expenses

Research and development costs include costs incurred in the development and production of our hardware and software, costs incurred to enhance and support existing product features and expenses related to future product development. Research and development costs are expensed as incurred, and may be offset by co-funding from third parties. We may also enter into arrangements whereby we make advance, non-refundable payments to a vendor to perform certain research and development services. These payments are deferred and recognized over the vendor's estimated performance period. As of June 30, 2009, we had \$16.1 million of engineering advance payments, which may be refundable at June 30, 2009 if services are not rendered. We are currently evaluating the extent to which these services will be rendered. If a determination is made that these services will not be rendered, any amounts not previously recognized and not otherwise recoverable will be charged to expense in that period.

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

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

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

Share-based Compensation

We account for share-based compensation by estimating the fair value of share-based compensation using the Black-Scholes option pricing model. We utilize assumptions related to stock price volatility, stock option term and forfeiture rates that are based upon both historical factors as well as management's judgment.

New Accounting Pronouncements

In March 2008, the FASB issued FAS 161. FAS 161 amends and expands the disclosure requirements in FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. FAS 161 was effective for the quarter ended March 31, 2009 and we have included the required disclosures in *Note 3 - Fair Value Measurement*.

In April 2009, the FASB issued FSP 107-1. FSP 107-1 amends FAS No. 107, *Disclosures about Fair Value of Financial Instruments*, to require an entity to provide disclosures about fair value of financial instruments in interim financial statements. FSP 107-1 is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. We adopted FSP 107-1 for the quarter ended June 30, 2009. As of June 30, 2009, our Notes with a contractual face amount of \$164,000 had a fair value of \$162,000.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2. The guidance applies to investments in debt securities for which other-than-temporary impairments may be recorded. If an entity's management asserts that it does not have the intent to sell a debt security and it is more likely than not that it will not have to sell the security before recovery of its cost basis, then an entity may separate other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings), and 2) all other amounts (recorded in other comprehensive income). FSP 115-2 is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. We adopted FSP 115-2 for the quarter ended June 30, 2009. The adoption of FSP 115-2 did not have a material impact on our financial position or results of operations.

In April 2009, the FASB issued FSP FAS 157-4. Based on the guidance, if an entity determines that the level of activity for an asset or liability has significantly decreased and that a transaction is not orderly, further analysis of transactions or quoted prices is needed, and a

significant adjustment to the transaction or quoted prices may be necessary to estimate fair value in accordance with FAS No. 157, *Fair Value Measurements*. FSP 157-4 is to be applied prospectively and is effective for interim and annual periods ending after June 15, 2009. We adopted FSP 157-4 for the quarter ended June 30, 2009. The adoption of FSP 157-4 did not have a material impact on our financial position or results of operations.

In May 2009, the FASB issued FAS No. 165. FAS 165 is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. We adopted FAS 165 during our 2009 second quarter. We have evaluated subsequent events and any related required disclosures through August 5, 2009, which is the date this Quarterly Report on Form 10-Q was submitted for filing with the Securities and Exchange Commission.

In June 2009, the FASB issued FAS No. 168. FAS 168 represents the last numbered standard to be issued by FASB under the old (pre-Codification) numbering system, and amends the GAAP hierarchy. On July 1, 2009, the FASB launched a new Accounting Standards Codification which will supersede existing GAAP for nongovernmental entities. This pronouncement is not expected to have a significant effect on our financial position or results of operations.

Results of Operations

Revenue and Gross Profit Margins

Our revenue, cost of revenue and gross profit margin for the three and six months ended June 30, 2009 and 2008, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Product revenue	\$ 42,101	\$ 32,851	\$ 101,563	\$ 43,541
Less: Cost of product revenue	<u>22,263</u>	<u>22,003</u>	<u>68,597</u>	<u>28,415</u>
Product gross profit	<u>\$ 19,838</u>	<u>\$ 10,848</u>	<u>\$ 32,966</u>	<u>\$ 15,126</u>
Product gross profit margin	47%	33%	32%	35%
Service revenue	\$ 20,643	\$ 13,882	\$ 35,662	\$ 29,320
Less: Cost of service revenue	<u>11,952</u>	<u>9,241</u>	<u>22,228</u>	<u>17,600</u>
Service gross profit	<u>\$ 8,691</u>	<u>\$ 4,641</u>	<u>\$ 13,434</u>	<u>\$ 11,720</u>
Service gross profit margin	42%	33%	38%	40%
Total revenue	\$ 62,744	\$ 46,733	\$ 137,225	\$ 72,861
Less: Total cost of revenue	<u>34,215</u>	<u>31,244</u>	<u>90,825</u>	<u>46,015</u>
Total gross profit	<u>\$ 28,529</u>	<u>\$ 15,489</u>	<u>\$ 46,400</u>	<u>\$ 26,846</u>
Total gross profit margin	45%	33%	34%	37%

Product Revenue

Product revenue for the three months ended June 30, 2009 was \$42.1 million, primarily from sales of and upgrades to Cray XT systems, compared to \$32.9 million for the three months ended June 30, 2008. Product revenue for the six months ended June 30, 2009, was \$101.6 million, principally from sales of and upgrades to Cray XT systems, compared to \$43.5 million for the six months ended June 30, 2008.

While a wide range of potential results is possible, we expect full year product revenue will decrease about \$15 million to \$30 million from 2008 levels, primarily due to lower revenue from Cray XT systems.

Service Revenue

Service revenue for the three months ended June 30, 2009 was \$20.6 million compared to \$13.9 million for the same period in 2008, due to a \$4.4 million increase in engineering services revenue and a \$2.3 million increase in maintenance revenue. Service revenue for

the six months ended June 30, 2009 was \$35.7 million compared to \$29.3 million for the same period in 2008 due to a \$3.8 million increase in engineering services revenue and a \$2.6 million increase in maintenance revenue.

For the full year 2009, we expect service revenue to increase to over \$90 million principally due to strong forecasted growth from our Custom Engineering activities.

Cost of Product Revenue and Product Gross Profit

For the three months ended June 30, 2009, cost of product revenue increased only \$0.3 million while product gross profit increased \$9.0 million, with product gross profit margin increasing 14 percentage points to 47 percent compared to the same period in 2008. The very small increase in cost of product revenue and the substantial increase in product gross profit was the result of product mix and favorable costs on large Cray XT system upgrades and contract closeouts. For the six months ended June 30, 2009, product gross profit increased \$17.8 million, although product gross profit margin declined 3 percentage points to 32 percent compared to the same period in 2008. Product gross profit margin for the six months ended June 30, 2009 was negatively impacted by a large system sale in the first quarter of 2009, for which we recognized \$36 million of product revenue with a gross profit margin in the mid-teens.

We expect product gross profit margin to decrease about 5 to 8 percentage points for the full year 2009 compared to 2008 levels primarily due to the impact of the low gross profit contract, most of which was recognized in the first quarter of 2009.

Cost of Service Revenue and Service Gross Profit

Cost of service revenue increased \$2.7 million during the three months ended June 30, 2009 compared to the same 2008 period, principally due to costs for our increased engineering services activities, which included increased personnel and outside services costs for our Custom Engineering activities. Service gross profit margin increased by 9 percentage points for the three-month period ended June 30, 2009 as compared to the same period in 2008, however, due to the increased revenue from engineering services, including our Custom Engineering activities, which more than offset the increase in costs. Cost of service revenue increased \$4.6 million during the six months ended June 30, 2009 compared to the same 2008 period, principally due to the personnel and outside service costs incurred in connection with increasing our Custom Engineering activities. Service gross profit margin declined by 2 percent for the six months ended June 30, 2009 compared to the same 2008 period, principally due to lower revenue from our Custom Engineering activities due to a contract delay which did not offset the increased costs.

We expect full year 2009 service gross profit margin to approximate 2008 levels, with increased service revenue being offset by increased costs, primarily additional personnel and outside services related to additional Custom Engineering activity.

Research and Development Expenses

Research and development expenses for the three and six months ended June 30, 2009 and 2008, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Gross research and development expenses	\$ 24,874	\$ 22,215	\$ 50,892	\$ 44,307
Less: Amounts included in cost of revenue	(713)	—	(1,295)	—
Less: Reimbursed research and development (excludes amounts in revenue)	<u>(10,451)</u>	<u>(10,325)</u>	<u>(24,672)</u>	<u>(18,698)</u>
Net research and development expenses	<u>\$ 13,710</u>	<u>\$ 11,890</u>	<u>\$ 24,925</u>	<u>\$ 25,609</u>
Percentage of total revenue	22%	25%	18%	35%

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

For the three months ended June 30, 2009, gross research and development expenses increased \$2.7 million from the same period in 2008, due principally to costs for a process improvement consulting contract, which was substantially completed as of June 30, 2009.

Reimbursed research and development and amounts included in cost of revenue increased \$0.8 million for the three months ended June 30, 2009 compared to the same period in 2008, principally due to amounts classified as cost of revenue on an engineering services contract. For the six months ended June 30, 2009, gross research and development expenses increased \$6.6 million from the same period in 2008, due principally to process improvement consulting costs. Reimbursed research and development and amounts included in cost of revenue increased \$7.3 million for the first six months of 2009 compared to the same period in 2008, principally due to higher amounts recognized on the DARPA HPCS project.

During the fourth quarter of 2008, we amended the DARPA HPCS agreement to incorporate Intel technologies into our development project and establish later delivery dates, new milestones and new payment dates and amounts. We are still required to spend a total of \$375 million on the DARPA HPCS project in order to receive \$250 million of co-funding. As of June 30, 2009, we had billed \$97.5 million of the anticipated \$250 million of DARPA co-funding. During the first quarter of 2009, we began discussions with DARPA on additional potential modifications to the DARPA HPCS contract. These negotiations are reasonably likely to delay our next milestone beyond the third quarter of 2009 and if this occurs, we will incur costs during the third quarter of 2009 which will not be offset by any reimbursement during the period. This could negatively impact the third quarter of 2009 Net research and development expenses by about \$6 million to \$7 million from second quarter 2009 levels. Unless these negotiations are prolonged or the contract is significantly modified or cancelled, net research and development spending reported for the quarter in which the milestone is accepted would likely be offset by a similar amount.

For full year 2009, we expect net research and development expense to approximate or be somewhat lower than 2008 levels due to lower variable compensation expense and increased levels of recognized government co-funding offset by process improvement consulting costs.

Sales and Marketing and General and Administrative Expenses

Our sales and marketing and general and administrative expenses for the three and six months ended June 30, 2009 and 2008, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Sales and marketing	\$ 6,341	\$ 5,848	\$ 12,404	\$ 11,230
Percentage of total revenue	10%	13%	9%	15%
General and administrative	\$ 3,901	\$ 3,465	\$ 8,047	\$ 7,161
Percentage of total revenue	6%	7%	6%	10%

Sales and Marketing. Sales and marketing expenses for the three months ended June 30, 2009 increased from the same period in 2008, primarily due to \$0.3 million of increased sales commissions on higher product sales and \$0.2 million of higher personnel costs, principally from additional headcount in Europe. Sales and marketing expense for the six months ended June 30, 2009 increased from the same period in 2008, primarily due to \$0.7 million of increased sales commissions on higher product sales and \$0.5 million of higher personnel costs, principally from additional headcount in Europe. For full year 2009, we anticipate modestly higher sales and marketing expenses from 2008 levels due to headcount increases and additional marketing expenses associated with our new product introductions, partially offset by decreases in variable compensation and sales commissions.

General and Administrative. General and administrative expenses for the three and six months ended June 30, 2009 were \$0.4 million and \$0.9 million higher than the same periods in 2008, primarily due to higher stock-based compensation expense. For full year 2009, we expect general and administrative expenses to increase modestly from 2008 levels due to increases in stock-based compensation expense compensation levels.

Other Income (Expense), net

For the three months ended June 30, 2009, we recognized net other expense of \$0.7 million compared to net other income of \$0.5 million for the same period of 2008. Net other expense for the three months ended June 30, 2009 was principally the result of a \$0.9 million loss on the repurchase of \$27.6 million of Notes offset somewhat by foreign currency transaction gains. For the six months ended June 30, 2009, we recognized net other expense of \$1.5 million compared to net other income of \$0.8 million for the same period of 2008. Net other expense for the six months ended June 30, 2009 was due to the \$0.9 million loss on the Notes repurchase and foreign currency

transaction losses. Net other income for the three and six months ended June 30, 2008 was principally the result of foreign currency transaction gains.

Interest Income (Expense)

Our interest income and interest expense for the three and six months ended June 30, 2009 and 2008, respectively, were (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2009	2008	2009	2008
		(As Adjusted)		(As Adjusted)
Interest income	\$ 110	\$ 1,031	\$ 380	\$ 2,666
Interest expense	<u>(461)</u>	<u>(2,154)</u>	<u>(1,264)</u>	<u>(4,285)</u>
Net interest expense	<u>\$ (351)</u>	<u>\$ (1,123)</u>	<u>\$ (884)</u>	<u>\$ (1,619)</u>

Interest income decreased during the three and six months ended June 30, 2009 compared to the same periods in 2008 as a result of significantly lower short-term interest rates and average invested balances.

Interest expense for the three months ended June 30, 2009 and 2008 included \$0.1 million and \$0.6 million of contractual interest on our Notes, respectively, non-cash amortization of our Notes' debt discount of \$0.3 million and \$1.4 million, respectively, and non-cash amortization of capitalized issuance costs of \$27,000 and \$0.1 million, respectively. Interest expense for the six months ended June 30, 2009 and 2008 included \$0.3 million and \$1.2 million of contractual interest on our Notes, respectively, non-cash amortization of our Notes' debt discount of \$0.8 million and \$2.8 million, respectively, and non-cash amortization of capitalized issuance costs of \$0.1 million and \$0.3 million, respectively. Interest expense in the second half of 2009 is expected to be minimal.

Taxes

We recorded an income tax expense of \$69,000 and \$107,000 for the three months ended June 30, 2009 and 2008, respectively. We recorded an income tax expense of \$117,000 and \$389,000 for the six months ended June 30, 2009 and 2008, respectively. The decrease in income tax expense in the 2009 periods compared to the same periods in 2008 was primarily the result of tax legislation included in the American Recovery and Reinvestment Act of 2009 which enables a corporation to recover certain previously generated U.S. research and development income tax credits.

Liquidity and Capital Resources

Cash and cash equivalents, restricted cash, short-term investments and accounts receivable totaled \$116.6 million at June 30, 2009 compared to \$176.1 million at December 31, 2008; cash and cash equivalents and restricted cash decreased by \$11.7 million and accounts receivable decreased by \$47.9 million. At June 30, 2009, we had working capital of \$112.8 million compared to \$114.2 million at December 31, 2008.

Net cash provided by operating activities for the six months ended June 30, 2009 was \$18.6 million compared to net cash used in operating activities of \$62.9 million for the same period in 2008. For the six months ended June 30, 2009, net cash provided by operating activities was principally the result of decreases in accounts receivable and inventory, partially offset by decreases in accrued payroll and related expenses, other accrued liabilities and advance research and development payments and deferred revenue. For the six months ended June 30, 2008, net cash used by operating activities was principally the result of our net loss for the period and an increase in inventory and other assets and decreases in advance research and development payments and deferred revenue, partially offset by an increase in accounts payable.

Net cash used in investing activities was \$1.6 million for the six months ended June 30, 2009, compared to net cash provided by investing activities of \$32.0 million for the same 2008 period. Net cash used in investing activities for the six months ended June 30, 2009 was due principally to purchases of property and equipment and net purchases of short-term investments net of sales or maturities partially offset by a reduction in restricted cash. Net cash provided by investing activities for the six months ended June 30, 2008 was due principally to the sales or maturities of short-term investments partially offset by purchases of property and equipment.

Net cash used in financing activities for the six months ended June 30, 2009 was \$27.5 million, compared to net cash provided by financing activities of \$0.3 million for the same period in 2008. Net cash used in financing activities for the six months ended June 30, 2009 resulted primarily from the repurchase of our Notes and our stock options from our 2009 stock option repurchase tender offer, partially offset by the issuance of common stock through our employee stock purchase plan and exercises of stock options. Net cash provided by financing activities for the six months ended June 30, 2008 resulted primarily from cash received from the issuance of common stock through our employee stock purchase plan.

Over the next twelve months, we expect our significant cash requirements will relate to operational expenses, consisting primarily of personnel costs, costs of inventory associated with certain large-scale product deliveries and spare parts, outside engineering expenses, particularly as we continue development of our Cray XT5 and successor systems and internally fund a portion of the expenses pursuant to the DARPA HPCS award and acquisition of property and equipment. Our remaining 2009 capital budget for property and equipment is approximately \$8.0 million. In addition, we lease certain equipment and facilities used in our operations under operating or capital leases in the normal course of business. The following table summarizes our contractual obligations at June 30, 2009 (in thousands):

<u>Contractual Obligations</u>	<u>Amounts Committed by Year</u>				
	<u>Total</u>	<u>2009 (Less than 1 Year)</u>	<u>2010-2011</u>	<u>2012-2013</u>	<u>Thereafter</u>
Development agreements	\$ 14,511	\$ 6,240	\$ 8,271	\$ —	\$ —
Operating leases	17,502	980	4,425	4,216	7,881
Unrecognized income tax benefits	646	292	354	—	—
Total contractual cash obligations	<u>\$ 32,659</u>	<u>\$ 7,512</u>	<u>\$ 13,050</u>	<u>\$ 4,216</u>	<u>\$ 7,881</u>

As of June 30, 2009, we had \$164,000 contractual face amount of outstanding Notes. The Notes bear interest at an annual rate of 3.0%, and holders of the Notes may require us to purchase the Notes on December 1, 2009, December 1, 2014 and December 1, 2019 or upon the occurrence of certain events provided in the indenture governing the Notes. We expect that the holders of the Notes will likely require us to purchase the remaining Notes on December 1, 2009. In August 2008, we amended our line of credit reducing the maximum line of credit to \$1.4 million from \$10.0 million. In July 2009, we amended this agreement to increase the maximum line of credit to \$3.5 million and extend the maturity date to June 1, 2010.

In our normal course of operations, we have development arrangements under which we engage outside engineering resources to work on our research and development projects. For the three and six month periods ended June 30, 2009, we incurred \$5.8 million and \$13.6 million, respectively, for such arrangements.

At any particular time, our cash position is affected by the timing of cash receipts for product sales, maintenance contracts, government co-funding for research and development activities and our payments for inventory, resulting in significant fluctuations in our cash balance from quarter-to-quarter and within a quarter. Our principal sources of liquidity are our cash and cash equivalents, short-term investments and cash from operations. During 2009, our net cash (cash and cash equivalents, including restricted cash and short-term investments less the contractual face amount of the outstanding Notes) is anticipated to be generally above the year-end 2008 balance of \$52.7 million. We expect our cash resources to be adequate for at least the next twelve months.

The adequacy of our cash resources is dependent on the amount and timing of government funding as well as our ability to sell our products, particularly the Cray XT5 and successor systems and to engage in Custom Engineering projects with adequate gross profit. Beyond the next twelve months, the adequacy of our cash resources will largely depend on our success in reestablishing profitable operations and positive operating cash flows on a sustained basis. See Item 1A. "Risk Factors" in Part II below.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk: We invest our available cash principally in highly liquid investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. government and its agencies. We do not have any derivative instruments in our investment portfolio. We protect and preserve invested funds by limiting default, market and reinvestment risk. Our investments are currently in fixed interest rate instruments, which carry a modest degree of market risk. Fixed-rate investments may have their fair value adversely affected due to a rise in interest rates. 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 fair value due to changes in interest rates. A 0.5 percent change in interest rates would not be significant.

The table below presents fair value and related weighted average interest rate by investment class at June 30, 2009 (in thousands, except for percentages). The average maturity of these investments is less than six months with a credit quality range of A-1+.

	<u>Fair Value</u>	<u>Maturities</u>	<u>Weighted Averaged Interest Rate</u>
Corporate notes and bonds	\$ 2,499	2009	0.6%
Treasury bills	<u>\$ 2,989</u>	2010	0.5%
Total short-term investments	<u>\$ 5,488</u>		

Foreign Currency Risk: We sell our products primarily in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our products are generally priced in U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we commonly sell products with payments in U.S. dollars, our product sales contracts may call for payment in foreign currencies and to the extent we do so, or engage with our foreign subsidiaries in transactions deemed to be short-term in nature, we are subject to foreign currency exchange risks. As of June 30, 2009, we were a party to forward exchange contracts that hedged approximately \$26.2 million of anticipated cash receipts on specific foreign currency denominated sales contracts. These forward contracts hedge the risk of foreign exchange rate changes between the time that the related contracts were signed and when the cash receipts are expected to be received. Our foreign maintenance contracts are typically paid in local currencies and provide a natural hedge against foreign exchange exposure. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks. As of June 30, 2009, a 10% change in foreign exchange rates could impact our annual earnings and cash flows by approximately \$0.8 million.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this quarterly report. Based on this evaluation, our chief executive officer and chief financial officer concluded as of June 30, 2009, that our disclosure controls and procedures were effective such that the information required to be disclosed in our Securities and Exchange Commission (“SEC”) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting. There have been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2009 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Item 4T. Controls and Procedures

Not applicable.

Part II. OTHER INFORMATION

Item 1A. Risk Factors

The following factors should be considered in evaluating our business, operations, prospects and common stock as they may affect our future results and financial condition and they may affect an investment in our securities.

Our operating results may fluctuate significantly and we may not achieve profitability in any given period. Our operating results are subject to significant fluctuations due to the factors listed below, which make estimating revenue and operating results for any specific period very difficult, particularly as the product revenue recognized in any given quarter may depend on a very limited number

of system sales expected for that quarter, the timing of product acceptances by customers and contractual provisions affecting revenue recognition. Delays in recognizing revenue from a product transaction due to development delays, not receiving needed components timely or with anticipated quality and performance, not achieving customer acceptances of installed systems, contractual provisions or for other reasons, could have a material adverse effect on our operating results in any specific quarter, and could shift associated revenue, gross profit and cash receipts from one fiscal period into another.

We have experienced net losses in recent periods and last recorded positive annual net income in 2003. For example, we recorded a net loss of \$12.1 million in 2006, a net loss of \$5.7 million in 2007, a net loss of \$31.3 million in 2008, including a non-cash goodwill impairment charge of approximately \$54.5 million, and, although we recorded a profit for the second quarter of 2009, we recorded a net loss of \$1.5 million in the first half of 2009.

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

- successfully completing development and selling of our Cray XT5 and Cray XT5m systems, including upgrades and successor systems;
- the level of revenue recognized in any given period, which is affected by the very high average sales prices and limited number of system sales in any quarter, the timing of product acceptances by customers and contractual provisions affecting the timing and amount of revenue recognition;
- the successful expansion of our Custom Engineering program, including winning new contracts in time for performance in 2009 and subsequent years;
- our expense levels, including research and development net of government funding, which are affected by the amount and timing of such funding and the meeting of contractual development milestones, including the milestones under our DARPA HPCS program;
- maintaining our product development projects on schedule and within budgetary limitations;
- the level of product gross profit contribution in any given period due to product mix, strategic transactions, product life cycle and component costs;
- the competitiveness of our products, which may be affected by the competitiveness of key components from suppliers;
- the level and timing of maintenance contract renewals with existing customers;
- revenue delays or losses due to customers postponing purchases to wait for future upgraded or new systems, delays in delivery of upgraded or new systems and longer than expected customer acceptance cycles;
- the building of a reseller network for our Cray CX products and achieving significant sales of Cray CX systems; and
- the terms and conditions of sale or lease for our products.

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

- the timely availability of acceptable components in sufficient quantities to meet customer delivery schedules;
- the timing and level of government funding for research and development contracts and product acquisitions, which may be adversely affected by the current economic and fiscal situation;
- price fluctuations in the commodity electronics and memory markets;

- the availability of adequate customer facilities to install and operate new Cray systems;
- general economic trends, including changes in levels of customer capital spending;
- the introduction or announcement of competitive products;
- currency fluctuations, international conflicts or economic crises; and
- the receipt and timing of necessary export licenses.

Because of the numerous factors affecting our revenue and results of operations, we cannot assure our investors that we will have net income on a quarterly or annual basis in the future. We anticipate that our quarterly results will fluctuate significantly, and include losses. Delays in component availability, product development, receipt of orders and product acceptances had a substantial adverse effect on our past results and could continue to have such an effect on our results in 2009 and in future years.

Our reliance on third-party suppliers poses significant risks to our operating results, business and prospects. We subcontract the manufacture of a majority of the hardware components for our high-end products, including integrated circuits, printed circuit boards, connectors, cables, power supplies and memory parts, on a sole or limited source basis to third-party suppliers. We use service providers to co-develop key technologies, including integrated circuit design and verification. We use contract manufacturers to assemble certain important components for all of our systems. We also rely on third parties to supply key capabilities, such as file systems and storage subsystems. We use an original equipment manufacturer to deliver complete Cray CX systems. We are subject to substantial risks because of our reliance on limited or sole source suppliers. For example:

- if a supplier does not provide components that meet our specifications in sufficient quantities on time, then production and sales of our systems could be delayed, which would result in decreased revenue and gross profit and adversely affect cash flow - these risks are accentuated during steep production ramp periods as we introduce new or successor products;
- if an interruption of supply of our components occurs because a supplier changes its technology roadmap, decides to no longer provide those components, increases the price of those components significantly or imposes allocations on its customers, it could take us a considerable period of time to identify and qualify alternative suppliers, to redesign our products as necessary and to begin to manufacture the redesigned components. In some cases, such as with key integrated circuits and memory parts, we may not be able to redesign such components or find alternate sources that we could use in any realistic time frame. Defective components may need to be replaced, which may result in increased costs and obsolete inventory;
- if a supplier providing us with key research and development and design services or core technology components with respect to integrated circuit design, network communication capabilities or software is late, fails to provide us with effective functionality or loses key internal talent, our development programs may be delayed or prove to be not possible to complete;
- if a supplier cannot provide a competitive key component or eliminates key features from components, such as processors, our systems may be less competitive than systems using components with greater capabilities;
- if a supplier provides us with hardware, software or other intellectual property that contains bugs or other errors or is different from what we expected, our development projects and production systems may be adversely affected through additional design testing and verification efforts, respins of integrated circuits and/or development of replacement components, the production and sales of our systems could be delayed and systems installed at customer sites could require significant field component replacements, resulting in decreased revenue and gross profit and adversely affecting cash flow;
- some of our key component and service suppliers are small companies with limited financial and other resources, and consequently may be more likely to experience financial and operational difficulties than larger, well-established companies; and
- if a key supplier is acquired or has a significant business change, production and sales of our systems may be delayed or our development programs may be delayed or may not be possible to complete.

Our DARPA HPCS project is expected to incorporate certain Intel technologies, but recent changes by Intel in its high performance technology roadmap could adversely affect our ability to complete that program successfully. See “If DARPA terminated our DARPA HPCS program, our desired strategy would be adversely affected, our net research and development expenditures and capital requirements would increase significantly and our ability to conduct research and development would decrease” below. In addition, we have prepaid Intel for certain engineering expenses and if we do not obtain the value of those prepayments from Intel due to its changed technology plans, we may have to write-down or write-off those prepayments on our balance sheet and record an adverse charge to our earnings. Our Cray XT5 and successor systems are based on certain AMD Opteron™ processors. Delays in the availability of certain acceptable reliable components, including processors and memory parts, adversely affected our revenue and operating results in prior periods and could continue to adversely affect results for 2009 and in subsequent periods. If any of our integrated circuit suppliers suffers delays or cancels the development of enhancements to its processors or develops less competitive products, our product revenue, gross profits and operating results would be adversely affected in 2009 and subsequent periods.

The achievement of our business plan in 2009 and future periods is highly dependent on increased product revenue and gross profit from our Cray XT5 and successor systems. We expect that a substantial majority of our product revenue in 2009 and subsequent years will come from sales of Cray XT5 systems, including upgrades and successor systems. With procurements for large systems that require that we link together multiple cabinets containing powerful processors and other components into an integrated system, our Cray XT5 systems must scale to unprecedented levels of performance. During our internal testing and the customer acceptance processes, we may discover that we cannot achieve acceptable system stability across these large systems without incurring significant additional delays and expense. Any additional delays in receiving acceptable components or in product development, assembly, final testing and obtaining large system stability would delay delivery, installation and acceptance of Cray XT5 and successor systems.

Several factors affect our ability to obtain higher gross profits for our products, such as:

- the level of product differentiation in our Cray XT5 and successor systems. We need to compete successfully against HPC systems from large established companies and lower bandwidth cluster systems. Our long-term success may be adversely affected if we are not successful in demonstrating the value of our balanced high bandwidth systems with the capability of solving challenging problems quickly to a market beyond our current core of customers, largely certain agencies of the U.S. and other governments, that require systems with the performance and features we offer;
- we sometimes do not meet all of the contract requirements for customer acceptance and ongoing reliability of our systems, which has resulted in contract penalties. Most often these penalties adversely affect the gross profit through the provision of additional equipment and services and/or service credits to satisfy delivery delays and performance shortfalls. Such penalties adversely impacted gross profits in 2008 and 2007, and we will incur additional penalties in 2009. The risk of contract penalties is increased when we bid for new business prior to completing development of new products when we must estimate future system performance;
- in March 2008, we placed a last-time buy for a key component for our Cray XT4, Cray XT5 and Cray XMT systems, which had to be placed before we could know all the possible sales prospects for these products. If we estimated our needs too low, we could limit the number of possible sales of these products and reduce potential revenue, or if we estimated too high, we could incur inventory obsolescence charges and reduce our gross profit. Either way, our operating results could be adversely affected; and
- from time to time, including in the 2009 second quarter, product gross profit has been adversely impacted by lower volumes than planned and higher than anticipated manufacturing variances, including scrap, rework and excess and obsolete inventory.

To improve our financial performance, we need greater product differentiation and to limit contract penalties, negative manufacturing variances and other charges that adversely affect product gross profit, and failure to do so will adversely affect our operating results.

If DARPA terminated our DARPA HPCS program, our desired strategy would be adversely affected, our net research and development expenditures and capital requirements would increase significantly and our ability to conduct research and development would decrease. The DARPA HPCS program calls for the delivery of prototype systems in 2012, and provides for a contribution by DARPA to us of up to \$250 million payable over approximately five years, assuming we meet twelve milestones. We have met five of these milestones through June 30, 2009. Our DARPA program is expected to incorporate certain Intel technologies. We

are currently discussing with DARPA changes to the scope and schedule of this program due to changes by Intel in its technology roadmap that could adversely affect our ability to perform on the program successfully. If we are unable to renegotiate the terms of the program or, even if we succeed in our negotiations but are unable to meet the remaining milestones, either of which may lead to a termination of the program, our cash flows and expenses would be adversely impacted and our product development programs would be at risk. DARPA's future financial commitments are subject to subsequent Congressional and federal inter-agency action, and our development efforts and the level of reported research and development expenses would be adversely impacted if DARPA did not receive expected funding, delayed payment for completed milestones, delayed the timing of milestones or decided to terminate the program before completion. We incurred some delays in payments and program milestones by DARPA in 2007 and 2008, with additional delays possible in 2009 related to our discussions with DARPA on the changes in scope and program schedule. If we do not achieve a milestone in the period we had estimated, we may incur research and development expense, without offsetting co-funding, which will increase our net research and development expense during the period; it is reasonably likely that the completion of a development milestone could be delayed from the 2009 third quarter to the 2009 fourth quarter, which would adversely affect our reported net research and development expenses in the third quarter. The amount of DARPA funds we can recognize as an offset to our periodic research and development expenses depends on our estimates of the total costs and the time to complete the program; changes in our estimates may decrease the amount of funding recognized in any period, which may increase the amount of net research and development expense recognized in that quarter. By the project's completion, we must spend at least \$375 million on the project for us to receive all of the DARPA \$250 million reimbursements; failure to do so would result in a lower level of DARPA contribution and could result in a termination of the funding contract. The DARPA program will result in increased net research and development expenditures by us for the cost-sharing portion of the program and will adversely affect our cash flow, particularly in the later years of the program.

If we do not meet our revenue goals for our new strategic initiatives, our revenue and operating results will be adversely affected. Our 2009 plans assume material revenue from our three new strategic initiatives: providing Custom Engineering services and selling our new Cray CX and Cray XT5m systems. In order to meet our Custom Engineering goals, we must win awards for new contracts in time for significant performance in 2009. Sales of the Cray CX system will depend upon building a new global network of independent resellers in Europe, North America and Asia-Pacific and having those resellers successfully sell these new Cray CX systems in the competitive workgroup server market. We use an original equipment manufacturer to deliver complete Cray CX systems, and sales of those systems were adversely affected in the second quarter of 2009 and will likely be affected in the third quarter of 2009 due to the failure by the manufacturer to obtain necessary safety certifications; future sales will be impacted until such certifications are obtained. The Cray XT5m system requires successful sales in the lower end of the supercomputer market segment. These efforts require monetary investments ahead of revenue, including adding experienced personnel and initiating new marketing efforts. These additional costs, if not offset by new contributions from these initiatives, will adversely affect our 2009 operating results, as they have in the first half of 2009. In addition, many of the new Custom Engineering projects will be for the U.S. government and likely will require us to enter into agreements that are subject to new or additional Federal Acquisition Regulations, including costing and pricing requirements that we have not previously experienced. These regulations are complex and subject to audit to ensure compliance. We may need to enhance existing financial and costing systems to accommodate these new requirements. Errors made in interpreting and complying with these regulations could result in significant penalties. If we are not successful in these three initiatives, our 2009 revenue and operating results will be adversely affected.

Failure to overcome the technical challenges of completing the development of our supercomputer systems on our product roadmap would adversely affect our revenue and operating results in subsequent years. In addition to completing the development of the scalable system software and hardware for Cray XT5 and upgrade systems for revenue generation in 2009, we continue to work on our product roadmap, including successor systems to the Cray XT5 and Cray XMT systems and incorporating Intel technologies into and completing our DARPA HPCS program. These development efforts are lengthy and technically challenging processes, and require a significant investment of capital, engineering and other resources. Unanticipated performance and/or development issues may require more engineers, time or testing resources than are currently available. In the past several years, directing engineering resources to solving current issues has adversely affected the timely development of successor products. Given the breadth of our engineering challenges and our limited engineering and technical personnel resources, we periodically review the anticipated contributions and expense of our product programs to determine their long-term viability, and we may substantially modify or terminate one or more development programs. We may not be successful in meeting our development schedules for technical reasons and/or because of insufficient engineering resources, which could cause a lack of confidence in our capabilities among our key customers. To the extent we incur delays in completing the design, development and production of hardware components, delays in development of requisite system software, cancellation of programs due to technical infeasibility or uncover stability issues, our revenue, results of operations and cash flows, and the reputation of such systems in the market, could be adversely affected. Future sales of our products may be adversely affected by any of these factors.

If the U.S. government purchases fewer supercomputers, our revenue would be reduced and our operating results would be adversely affected. Historically, sales to the U.S. government and customers primarily serving the U.S. government have represented a significant market for supercomputers, including our products. In 2007, 2008 and the first half of 2009, approximately 64%, 88%, and 76% respectively, of our product revenue was derived from such sales. Our plans for the rest of 2009 and the future contemplate significant sales to U.S. government agencies. Sales to government agencies, including cancellations of existing contracts, may be adversely affected by factors outside our control, such as changes in procurement policies, budgetary considerations including Congressional delays in completing appropriation bills, the current economic uncertainty and its effect on government budgets, domestic crises, and international political developments. If agencies and departments of the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue and operating results would be adversely affected.

If we are unable to compete successfully in the HPC 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 well known in the HPC market, including IBM, NEC, Hewlett-Packard, Fujitsu, Hitachi, SGI, Dell, Bull S.A. and Sun Microsystems. Most of these competitors have substantially greater research, engineering, manufacturing, marketing and financial resources than we do. We also compete with systems builders and resellers of systems that are constructed from commodity components using processors manufactured by Intel, AMD and others. These competitors include the previously named companies, with IBM using both third-party processors and its own proprietary processors, as well as smaller firms that benefit from the low research and development costs needed to assemble systems from commercially available commodity products. Such companies, because they can offer high peak performance per dollar, can put pricing pressure on us in certain competitive procurements. In addition, to the extent that Intel, IBM and other processor suppliers develop processors with greater capabilities than the processors we use from AMD, our Cray XT5, Cray XT5m and successor systems may be at a competitive disadvantage to systems utilizing such other processors. Our April 2008 collaboration with Intel will mitigate this risk but not for several years.

Periodic announcements by our competitors of new HPC systems or plans for future systems and price adjustments may reduce customer demand for our products. Many of our potential customers already own or lease very high performance computer systems. Some of our competitors may offer substantial discounts to potential customers, and we have not always been able to match these sales incentives. We have in the past and may again be required to provide substantial discounts to make strategic sales, which may reduce or eliminate any gross profit on such transactions, or to provide lease financing for our products, which could result in a deferral of our receipt of cash and revenue for these systems. These developments limit our revenue and resources and reduce our ability to be profitable.

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

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

Our stock price is volatile. The trading price of our common stock is subject to significant fluctuations in response to many factors, including our quarterly operating results (particularly if they are less than our or analysts' previous estimates), changes in analysts'

estimates or our outlook, our capital raising activities, announcements of technological innovations by us or our competitors, general economic conditions and conditions in our industry.

U.S. export controls could hinder our ability to make sales to foreign customers and our future prospects. The U.S. government regulates the export of HPC systems such as our products. Occasionally we have experienced delays for up to several months in receiving appropriate approvals necessary for certain sales, which have delayed the shipment of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to foreign customers, eliminating an important source of potential revenue.

We may infringe or be subject to claims that we infringe the intellectual property rights of others. Third parties in the past have asserted, and may in the future assert intellectual property infringement claims against us, and such future claims, if proved, could require us to pay substantial damages or to redesign our existing products or pay fees to obtain cross-license agreements. Regardless of the merits, any claim of infringement would require management attention and could be expensive to defend.

We incorporate software licensed from third parties into the operating systems for our products and any significant interruption in the availability of these third-party software products or defects in these products could reduce the demand for our products. The operating system software we develop for our HPC systems contains components that are licensed to us under open source software licenses. Our business could be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case we would be required to redesign our operating system software to function with alternative third-party software, or develop these components ourselves, which would result in increased costs and could result in delays in product shipments. Our Cray CX, Cray XT and successor systems utilize software system variants that incorporate Linux technology. The open source licenses under which we have obtained certain components of our operating system software may not be enforceable. Any ruling by a court that these licenses are not enforceable, or that Linux-based operating systems, or significant portions of them, may not be copied, modified or distributed as provided in those licenses, would adversely affect our ability to sell our systems. In addition, as a result of concerns about the risks of litigation and open source software generally, we may be forced to protect our customers from potential claims of infringement. In any such event, our financial condition and results of operations may be adversely affected.

We also incorporate proprietary incidental software from third parties, such as for file systems, job scheduling and storage subsystems. We have experienced some functional issues in the past with implementing such software with our supercomputer systems. These issues, if repeated, may result in additional expense by us and/or loss of customer confidence.

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

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

A substantial number of our shares are eligible for future sale and may depress the market price of our common stock and may hinder our ability to obtain additional financing. As of June 30, 2009, we had outstanding:

- 35,021,880 shares of common stock;
- 3,064,662 shares of common stock issuable upon exercise of options, of which options to purchase 1,170,103 shares of common stock were then exercisable; and
- Notes convertible into an aggregate of 8,495 shares of common stock at a current conversion price of approximately \$19.31 per share, subject to adjustment, or, under certain circumstances specified in the indenture governing the Notes, a maximum of 11,680 shares of common stock.

Almost all of our outstanding shares of common stock may be sold without substantial restrictions, with certain exceptions including, as of June 30, 2009, an aggregate of 1,419,385 shares and restricted stock units held by Board members, executive officers and key managers that may be forfeited and are restricted against transfer until vested.

Almost all of the shares of common stock that may be issued on exercise of the options will be available for sale in the public market when issued, subject in some cases to volume and other limitations. The Notes are not now convertible, and only become convertible upon the occurrence of certain events specified in the indenture governing the Notes. Sales in the public market of substantial amounts of our common stock, including sales of common stock issuable upon the exercise of 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 options may prove to be a hindrance to our future financings. Further, the holders of 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. We also have authorized 5,000,000 shares of undesignated preferred stock, although no shares of preferred stock currently are outstanding.

Provisions of our Restated 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 Restated Articles of Incorporation and Bylaws provide for:

- removal of a director only in limited circumstances and only upon the affirmative vote of not less than two-thirds of the shares entitled to vote to elect directors;
- the ability of our board of directors to issue up to 5,000,000 shares of preferred stock, without shareholder approval, with rights senior to those of the common stock;
- no cumulative voting of shares;
- the right of shareholders to call a special meeting of the shareholders only upon demand by the holders of not less than 30% of the shares entitled to vote at such a meeting;
- the affirmative vote of not less than two-thirds of the outstanding shares entitled to vote on an amendment, unless the amendment was approved by a majority of our continuing directors, who are defined as directors who have either served as a director since August 31, 1995, or were nominated to be a director by the continuing directors;
- special voting requirements for mergers and other business combinations, unless the proposed transaction was approved by a majority of continuing directors;
- special procedures to bring matters before our shareholders at our annual shareholders' meeting; and
- special procedures to nominate members for election to our board of directors.

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

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

Our annual meeting of shareholders was held on May 13, 2009. At the annual meeting, the following actions occurred:

1. The following individuals were re-elected as directors for terms expiring in 2010:

<u>Name</u>	<u>Votes For</u>	<u>% For</u>	<u>Withheld</u>	<u>% Withheld</u>
William C. Blake	20,673,671	66.3%	10,524,499	33.7%
John B. Jones, Jr.	18,454,968	59.2%	12,743,202	40.8%
Stephen C. Kiely	18,402,245	59.0%	12,795,925	41.0%
Frank L. Lederman	18,414,961	59.0%	12,783,209	41.0%
Sally G. Narodick	20,642,410	66.2%	10,555,760	33.8%
Daniel C. Regis	20,665,626	66.2%	10,532,544	33.8%
Stephen C. Richards	18,756,010	60.1%	12,442,160	39.9%
Peter J. Ungaro	20,584,529	66.0%	10,613,641	34.0%

2. A proposal to approve our 2009 Long-Term Equity Compensation Plan was approved by the shareholders, with 12,395,424 shares voting in favor (56.8%) and 9,439,069 shares voting against (43.2%), with 786,178 shares abstaining and 8,577,499 broker non-votes.

3. A proposal to ratify the appointment of Peterson Sullivan LLP as the Company's independent auditors for 2009 was approved by the shareholders, with 30,686,346 shares voting in favor (99.4%) and 179,340 shares voting against (0.6%), with 332,479 shares abstaining and 5 broker non-votes.

Item 6. Exhibits

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

Items 1, 2, 3 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.

Date: August 5, 2009

CRAY INC.

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

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

/s/ KENNETH D. ROSELLI
Kenneth D. Roselli
Chief Accounting Officer

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

I, Peter J. Ungaro, 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) 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
- (d) 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 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: August 5, 2009

/s/ PETER J. UNGARO

Peter J. Ungaro

Chief Executive Officer and President

EXHIBIT 31.2

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

I, Brian C. Henry, 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) 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
- (d) 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 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: August 5, 2009

/s/ BRIAN C. HENRY

Brian C. Henry
Chief Financial 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 pursuant 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 Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2009 (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: August 5, 2009

/s/ PETER J. UNGARO

Peter J. Ungaro

Chief Executive Officer and President

/s/ BRIAN C. HENRY

Brian C. Henry

Chief Financial Officer

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. Section 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.0