CRAY INC
Form 10-Q
July 31, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: June 30, 2013

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)

(206) 701-2000
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

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

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

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

As of July 26, 2013, there were 39,903,694 shares of Common Stock issued and outstanding.

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Available Information

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

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PART I. FINANCIAL INFORMATION
Item 1. Unaudited Condensed Consolidated Financial Statements
CRAY INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited and in thousands, except share data)

	June 30, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$149,146	$253,065
Short-term investments	91,804	52,563
Accounts and other receivables, net	25,137	13,440
Inventory	126,199	89,796
Prepaid expenses and other current assets	17,634	11,823
Total current assets	409,920	420,687
Long-term investments	12,242	17,577
Property and equipment, net	26,990	25,543
Service inventory, net	1,524	1,490
Goodwill	14,182	14,182
Intangible assets other than goodwill, net	6,829	7,981
Deferred tax assets	19,664	10,041
Other non-current assets	11,418	12,813
TOTAL ASSETS	$502,769	$510,314
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$62,297	$34,732
Accrued payroll and related expenses	9,162	25,927
Other accrued liabilities	4,662	8,616
Deferred revenue	48,563	68,060
Total current liabilities	124,684	137,335
Long-term deferred revenue	37,042	29,254
Other non-current liabilities	2,759	3,179
TOTAL LIABILITIES	164,485	169,768
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 39,698,604 and 39,435,215 shares, respectively	582,093	577,938
Accumulated other comprehensive income	6,820	5,181
Accumulated deficit	(250,629)	(242,573)
TOTAL SHAREHOLDERS' EQUITY	338,284	340,546
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$502,769	$510,314

See accompanying notes

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CRAY INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited and in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue:				
Product	$62,353	$68,516	$122,221	$164,493
Service	22,114	15,667	41,793	31,997
Total revenue	84,467	84,183	164,014	196,490
Cost of revenue:				
Cost of product revenue	47,477	39,521	93,047	97,071
Cost of service revenue	10,189	10,167	20,017	19,768
Total cost of revenue	57,666	49,688	113,064	116,839
Gross profit	26,801	34,495	50,950	79,651
Operating expenses:				
Research and development, net	19,968	6,893	40,194	30,643
Sales and marketing	11,550	10,233	22,693	18,106
General and administrative	5,085	4,971	10,570	10,101
Total operating expenses	36,603	22,097	73,457	58,850
Net gain on sale of interconnect hardware development program	—	139,068	—	139,068
Income (loss) from operations	(9,802)	151,466	(22,507)	159,869
Other income (expense), net	145	245	(190)	465
Interest income, net	204	37	580	36
Income (loss) before income taxes	(9,453)	151,748	(22,117)	160,370
Income tax (expense) benefit	9,303	(4,326)	14,357	(7,984)
Net income (loss)	$(150)	$147,422	$(7,760)	$152,386
Basic net income (loss) per common share	$—	$4.05	$(0.21)	$4.24
Diluted net income (loss) per common share	$—	$3.91	$(0.21)	$4.12
Basic weighted average shares outstanding	37,658	36,367	37,497	35,947
Diluted weighted average shares outstanding	37,658	37,682	37,497	36,956

See accompanying notes

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CRAY INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited and in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income (loss)	$(150)	$147,422	$(7,760)	$152,386
Other comprehensive income (loss), net of tax:				
Unrealized loss on available-for-sale investments	(51)	—	(2)	—
Foreign currency translation adjustments	(481)	210	(316)	325
Unrealized gain (loss) on cash flow hedges	(55)	562	1,965	(195)
Reclassification adjustments on cash flow hedges included in net income (loss)	12	(53)	(8)	(442)
Other comprehensive income (loss)	(575)	719	1,639	(312)
Comprehensive income (loss)	$(725)	$148,141	$(6,121)	$152,074

See accompanying notes

CRAY INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited and in thousands)

	Six Months Ended June 30, 2013	2012
Operating activities:		
Net income (loss)	$(7,760)	$152,386
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	6,906	4,047
Loss on disposal of fixed assets	3	10
Net gain on sale of interconnect hardware development program	—	(139,068)
Share-based compensation expense	3,286	2,435
Inventory write-down	545	2,329
Deferred income taxes	(14,272)	2,870
Cash provided (used) due to changes in operating assets and liabilities:		
Accounts and other receivables	(11,676)	(29,234)
Inventory	(39,886)	(37,869)
Prepaid expenses and other assets	(1,062)	(425)
Accounts payable	27,614	(1,172)
Accrued payroll and related expenses and other accrued liabilities	(17,352)	15,079
Other non-current liabilities	(419)	41
Deferred revenue	(11,688)	54,276
Net cash provided by (used in) operating activities	(65,761)	25,705
Investing activities:		
Purchases of available-for-sale investments	(33,983)	—
Decrease in restricted cash	—	276
Proceeds from the sale of interconnect hardware development program, net	—	139,225
Purchases of property and equipment	(4,422)	(2,315)
Net cash provided by (used in) investing activities	(38,405)	137,186
Financing activities:		
Proceeds from issuance of common stock through employee stock purchase plan	262	196
Purchase of employee restricted shares to fund related statutory tax withholding	(1,719)	—
Proceeds from exercises of stock options	2,029	5,893
Net cash provided by financing activities	572	6,089
Effect of foreign exchange rate changes on cash and cash equivalents	(325)	68
Net increase (decrease) in cash and cash equivalents	(103,919)	169,048
Cash and cash equivalents:		
Beginning of period	253,065	50,411
End of period	$149,146	$219,459
Supplemental disclosure of cash flow information:		
Cash paid for interest	$1	$48
Cash paid for income taxes	$2,561	$799
Non-cash investing and financing activities:		
Inventory transfers to fixed assets and service inventory	$2,938	$1,884

See accompanying notes

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CRAY INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 — Basis of Presentation

In these notes, Cray Inc. and its wholly-owned subsidiaries are collectively referred to as the "Company." In the opinion of management, the accompanying Condensed Consolidated Balance Sheets, Statements of Operations, Statements of Comprehensive Income (Loss), and Statements of Cash Flows have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. Management believes that all adjustments (consisting of normal recurring adjustments) considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

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

Principles of Consolidation

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

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Company's condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

Revenue Recognition

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. Delivery does not occur until the products have been shipped or services provided to the customer, risk of loss has transferred to the customer, and a customer acceptance has been obtained, where applicable. The sales price is not considered to be fixed or determinable until all material contingencies related to the sales have been resolved. The Company records revenue in the Condensed Consolidated Statements of Operations net of any sales, use, value added or certain excise taxes imposed by governmental authorities on specific sales transactions. In addition to the aforementioned general policy, the following are the Company's statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

Multiple-Element Arrangements. The Company commonly enters into revenue arrangements that include multiple deliverables of its product and service offerings due to the needs of its customers. Products may be delivered in phases over time periods which can be as long as five years. Maintenance services generally begin upon acceptance of the first equipment delivery and future deliveries of equipment generally have an associated maintenance period. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period and accordingly allocates a portion of the arrangement consideration as a separate deliverable which is recognized as service revenue over the entire service period. Other services such as training and engineering services can be delivered as a discrete delivery or over the term of the contract. A multiple-element arrangement is separated into more than one unit of accounting if the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis; and
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company.

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If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative selling price.

The Company follows a selling price hierarchy in determining the best estimate of the selling price of each deliverable. Certain products and services are sold separately in standalone arrangements for which the Company is sometimes able to determine vendor specific objective evidence, or VSOE. The Company determines VSOE based on normal pricing and discounting practices for the product or service when sold separately.

When the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements, the Company attempts to establish the selling price of each remaining element based on third-party evidence, or TPE. The Company's inability to establish VSOE is often due to a relatively small sample of customer contracts that differ in system size and contract terms which can be due to infrequently selling each element separately, not pricing products within a narrow range, or only having a limited sales history, such as in the case of certain advanced and emerging technologies. TPE is determined based on the Company's prices or competitor prices for similar deliverables when sold separately. However, the Company is often unable to determine TPE, as the Company's offerings contain a significant level of customization and differentiation from those of competitors and the Company is often unable to reliably determine what similar competitor products' selling prices are on a standalone basis.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses estimated selling price, or ESP, in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a standalone basis. In determining ESP, the Company uses the list price of the deliverable less a discount, the cost to provide the product or service plus a margin, or considers other factors. When using list price less a discount, the Company uses discounts from list price for previous transactions. This approach incorporates several factors, including the size of the transaction and any changes to list prices. The data is collected from prior sales, and although the data may not have the sample size or consistency to establish VSOE, it is sufficiently objective to estimate the selling price. When using cost plus a margin, the Company considers the total cost of the product or service, including customer-specific and geographic factors. The Company also considers the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

Products. The Company recognizes revenue from sales of products upon delivery or customer acceptance of the system, when the price is fixed or determinable, collection is reasonably assured and no significant unfulfilled obligations exist.

Services. Maintenance services are provided under separate maintenance contracts with customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods, often with prepayments for the term of the contract. The Company considers the maintenance period to commence upon acceptance of the product, which may include a warranty period. When service is part of a multiple element arrangement, the Company allocates a portion of the arrangement consideration to maintenance service revenue based on estimates of selling price. Maintenance revenue is recognized ratably over the term of the maintenance contract. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue.

Revenue from engineering services is recognized as services are performed.

Project Revenue. Revenue from design and build contracts is recognized under the percentage-of-completion, (or POC method). Under the POC method, revenue is recognized based on the costs incurred to date as a percentage of the total estimated costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are recorded in income in the period in which the circumstances that gave rise to the revision become known by management. The Company performs ongoing profitability analyses of its contracts accounted for under the POC method in order to determine whether the latest estimates of revenue, costs and extent of progress require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately.

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The Company records revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if management believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

- It is commensurate with either of the following:
  - The Company's performance to achieve the milestone; or
  - The enhancement of value of the delivered item or items as a result of a specific outcome resulting from the Company's performance to achieve the milestone.
- It relates solely to past performance.
- It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

The individual milestones are determined to be substantive or nonsubstantive in their entirety and milestone consideration is not bifurcated.

Revenue from projects is classified as Product Revenue or Service Revenue, based on the nature of the work performed.

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

Note 2 — New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued ASU No. 2013-02, Comprehensive Income, or ASU 2013-02. The guidance in ASU 2013-02 requires entities to disclose additional information about reclassification adjustments and significant items reclassified out of accumulated other comprehensive income by component and by respective line items of net income (loss). ASU 2013-02 is effective for fiscal years beginning after December 15, 2012. The Company adopted this guidance on January 1, 2013 and has included all disclosure required by ASU 2013-02.

Note 3 — Acquisition

On November 21, 2012, the Company acquired all the outstanding shares of Appro International, Inc., or Appro, for cash consideration of $24.9 million. Appro was a provider of cluster solutions in the high performance computing market. The acquisition of Appro allowed the Company to expand its product offering in the high performance computing market. Subsequent to the acquisition, Appro was renamed Cray Cluster Solutions, or CCS, and its financial results are reported in the HPC Systems segment.

The following unaudited pro forma condensed financial information presents the combined results of operations of the Company and Appro for the three and six months ended June 30, 2012 as if the acquisition had occurred on January 1, 2011 (in thousands):

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Revenue	$97,887	$247,594
Net income	$147,520	$154,262

The unaudited pro forma condensed financial information is not intended to represent or be indicative of the results of operations of the Company that would have been reported had the acquisition been completed as of January 1, 2011, and should not be taken as representative of the future consolidated results of operations of the Company.

For the three and six months ended June 30, 2013, amortization expense related to purchased intangibles was $0.6 million and $1.1 million, respectively.

NOTE 4 — Sale of Interconnect Hardware Development Program

On May 2, 2012, the Company sold its interconnect hardware development program to Intel Corporation ("Intel") for cash consideration of $140 million. As part of the transaction, 73 of the Company's employees joined Intel, and certain intellectual property and fixed assets were transferred to Intel. The Company retained certain rights to use the transferred assets and intellectual property. As a result of the sale, the Company recorded a gain of $139.1 million in "Net gain on sale of interconnect hardware

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development program" on the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2012.

Note 5 — Fair Value Measurement

Based on the observability of the inputs used in the valuation techniques used to determine the fair value of certain financial assets and liabilities, the Company is required to provide the following information according to the fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values.

In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs utilize observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The following table presents information about the Company's financial assets and liabilities that have been measured at fair value as of June 30, 2013, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands):

Description	Fair Value as of June 30, 2013	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets:			
Cash and cash equivalents	$149,146	$149,146	
Available-for-sale investments (1)	104,046	104,046	
Foreign exchange forward contracts (2)	3,155		3,155
Assets measured at fair value at June 30, 2013	$256,347	$253,192	$3,155
Liabilities:			
Foreign exchange forward contracts (3)	$(396)	$—	$(396)
Liabilities measured at fair value at June 30, 2013	$(396)	$—	$(396)

(1) Included in "Short-term investments" and "Long-term investments" on the Company's Condensed Consolidated Balance Sheets.

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

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

Foreign Currency Derivatives

The Company may enter into foreign currency derivatives to hedge future cash receipts on certain sales transactions that are payable in foreign currencies.

As of June 30, 2013, the Company had outstanding forward contracts which were designated as cash flow hedges of anticipated future cash receipts on sales contracts payable in foreign currencies. The outstanding notional amounts were approximately 19.2 million British Pounds, 53.0 million Euro, 802.4 million Japanese Yen and 29.3 million Swiss Francs resulting in hedged foreign currency exposure of approximately $140.4 million. Cash receipts associated with the hedged contracts are expected to be received from 2013 through 2016, during which time the revenue on the associated sales contracts is expected to be recognized.

As of December 31, 2012, the outstanding notional amounts were approximately 57.5 million Euro and 277.9 million Japanese Yen resulting in hedged foreign currency exposure of approximately $79.3 million.

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Fair Values of Derivative Instruments (in thousands):

Hedge Classification	Balance Sheet Location	Fair Value as of June 30, 2013	Fair Value as of December 31, 2012
Foreign currency contracts	Prepaid expenses and other current assets	$2,727	$719
Foreign currency contracts	Other non-current assets	428	382
Foreign currency contracts	Other accrued liabilities	(229)	(207)
Foreign currency contracts	Other non-current liabilities	(167)	(444)
Total fair value of derivatives classified as hedging instruments		$2,759	$450

Note 6 — Accumulated Other Comprehensive Income

The following table shows the gross and net of tax reclassification adjustments from accumulated other comprehensive income resulting from hedged foreign currency transactions recorded by the Company for the three and six months ended June 30, 2013 and 2012 (in thousands). The gross reclassification adjustments increased product revenue for the three and six months ended June 30, 2012. For the three and six months ended June 30, 2013 product revenue was decreased and increased, respectively.

	Three Months Ended June 30, 2013	2012	Six Months Ended June 30, 2013	2012
Gross of Tax Reclassifications	$(20)	$88	$13	$737
Net of Tax Reclassifications	$(12)	$53	$8	$442

The following tables show the changes in Accumulated Other Comprehensive Income by component for the three and six months ended June 30, 2013 (in thousands):

Three Months Ended June 30, 2013

	Unrealized Gain/(Loss) on Investments	Foreign Currency Translation Adjustments	Unrealized Gain on Cash Flow Hedges	Accumulated Other Comprehensive Income
Beginning balance	$3	$4,466	$2,926	$7,395
Current-period change, net of tax	$(51)	$(481)	$(43)	$(575)
Ending balance	$(48)	$3,985	$2,883	$6,820
Income tax associated with current-period change	$(34)	$(321)	$(29)	$(384)

Six Months Ended June 30, 2013

	Unrealized Gain/(Loss) on Investments	Foreign Currency Translation Adjustments	Unrealized Gain on Cash Flow Hedges	Accumulated Other Comprehensive Income
Beginning balance	$(46)	$4,301	$926	$5,181
Current-period change, net of tax	$(2)	$(316)	$1,957	$1,639
Ending balance	$(48)	$3,985	$2,883	$6,820
	$(1)	$(210)	$1,305	$1,094

Income tax associated with current-period change

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Note 7 — Earnings (Loss) Per Share ("EPS")

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

For the three and six months ended June 30, 2012, the added shares from these items included in the calculation of diluted shares and EPS totaled approximately 1.3 million and 1.0 million, respectively. For the three and six months ended June 30, 2013, outstanding stock options, unvested restricted stock grants and restricted stock units were antidilutive because of the net losses and, as such, their effect has not been included in the calculation of basic or diluted net loss per share. For the three and six month periods ended June 30, 2012, potential gross common shares of 0.2 million and 0.8 million, respectively, were antidilutive and not included in computing diluted EPS. For the three and six month periods ended June 30, 2013, potential gross common shares of 3.8 million were antidilutive and not included in computing diluted EPS.

Note 8 — Investments

The Company's investments in debt securities with original maturities greater than three months are classified as "available-for-sale." Changes in fair value are reflected in other comprehensive income (loss).

The carrying amount of the Company's investments in available-for-sale securities as of June 30, 2013 is shown in the table below (in thousands):

	Cost	Unrealized Losses	Fair Value
Short-term available-for-sale securities	$91,862	$(58)	$91,804
Long-term available-for-sale securities	12,261	(19)	12,242
Total	$104,123	$(77)	$104,046

The carrying amount of the Company's investments in available-for-sale securities as of December 31, 2012 is shown in the table below (in thousands):

	Cost	Unrealized Gains (Losses)	Fair Value
Short-term available-for-sale securities	$52,650	$(87)	$52,563
Long-term available-for-sale securities	17,567	10	17,577
Total	$70,217	$(77)	$70,140

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Note 9 — Accounts and Other Receivables, Net

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

	June 30, 2013	December 31, 2012
Trade accounts receivable	$19,188	$9,596
Unbilled receivables	1,540	415
Advance billings	2,034	278
Other receivables	2,457	3,156
	25,219	13,445
Allowance for doubtful accounts	(82)	(5)
Accounts and other receivables, net	$25,137	$13,440

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, 2013 and December 31, 2012, accounts receivable included $10.5 million and $5.1 million, respectively, due from U.S. government agencies and customers primarily serving the U.S. government. Of these amounts, $0.1 million was unbilled as of June 30, 2013 and December 31, 2012, based upon contractual billing arrangements with these customers. As of June 30, 2013, one non-U.S. government customer accounted for 18% of total accounts and other receivables. As of December 31, 2012, no non-U.S. government customer accounted for more than 10% of total accounts and other receivables.

Note 10 — Inventory

Inventory consisted of the following (in thousands):

	June 30, 2013	December 31, 2012
Components and subassemblies	$67,467	$21,865
Work in process	30,568	11,245
Finished goods	28,164	56,686
Total	$126,199	$89,796

Finished goods inventory of $27.1 million and $56.1 million was located at customer sites pending acceptance as of June 30, 2013 and December 31, 2012, respectively. At June 30, 2013, two customers accounted for $24.2 million, and at December 31, 2012, two customers accounted for $35.9 million of finished goods inventory.

During the six months ended June 30, 2013 the Company wrote off $0.5 million of inventory, related to the Cray XE, Cray XK and CCS product lines. During the six months ended June 30, 2012 the Company wrote off $2.3 million of inventory, related to the Cray XE and Cray XK product lines.

Note 11 — Deferred Revenue

Deferred revenue consisted of the following (in thousands):

	June 30, 2013	December 31, 2012
Deferred product revenue	$29,421	$36,848
Deferred service revenue	56,184	60,466
Total deferred revenue	85,605	97,314
Less long-term deferred revenue	(37,042)	(29,254)
Deferred revenue in current liabilities	$48,563	$68,060

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As of June 30, 2013, three customers accounted for 47% of total deferred revenue. At December 31, 2012, four customers accounted for 62% of total deferred revenue.

Note 12 — Share-Based Compensation

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

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

In determining fair value of stock options, the Company uses the Black-Scholes option pricing model. The following key weighted average assumptions were employed in the calculation for the three and six month periods ended June 30, 2013 and 2012:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Risk-free interest rate	0.5%	0.5%	0.5%	0.6%
Expected dividend yield	—%	—%	—%	—%
Volatility	51.8%	74.9%	51.8%	75.3%
Expected life	4.0 years	4.0 years	4.0 years	4.0 years
Weighted average Black-Scholes value of options granted	$8.49	$6.20	$8.49	$5.42

The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company does not anticipate declaring dividends in the foreseeable future. Volatility is based on historical data. The expected life of an option is based on the assumption that options will be exercised, on average, about two years after vesting occurs. The Company recognizes compensation expense for only the portion of options or stock units that are expected to vest. Therefore, management applies an estimated forfeiture rate that is derived from historical employee termination data and adjusted for expected future employee turnover rates. The estimated forfeiture rate for stock option grants during the three and six months ended June 30, 2013 was 5.00%. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods. The Company's stock price volatility, option lives and expected forfeiture rates involve management's best estimates at the time of such determination, which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the vesting period or requisite service period of the option. The Company typically issues stock options with a four year vesting period (the requisite service period) and amortizes the fair value of stock options (stock compensation cost) ratably over the requisite service period. The fair value of unvested restricted stock and restricted stock units is based on the market price of a share of the Company's common stock on the date of grant and is amortized over the vesting period.

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

The following table sets forth the gross share-based compensation cost resulting from stock options and unvested restricted stock grants that were recorded in the Company's Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2013 and 2012 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Cost of product revenue	$26	$7	$53	$17
Cost of service revenue	54	69	116	134
Research and development, net	330	261	716	543
Sales and marketing	450	354	966	617
General and administrative	700	551	1,435	1,124

Total	$1,560	$1,242	$3,286	$2,435

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

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term
Outstanding at December 31, 2012	2,293,505	$7.31	
Grants	20,000	$21.16	
Exercises	(312,725)	$6.49	
Cancellations	(39,990)	$11.71	
Outstanding at June 30, 2013	1,960,790	$7.49	6.9
Exercisable at June 30, 2013	1,187,668	$6.51	5.9
Available for grant at June 30, 2013	4,560,503		

As of June 30, 2013, there was $24.4 million of aggregate intrinsic value of outstanding stock options, including $16.2 million of aggregate intrinsic value of exercisable stock options. Intrinsic value represents the total pretax intrinsic value for all "in-the-money" options (i.e., the difference between the Company's closing stock price on the last trading day of its second quarter of 2013 and the exercise price, multiplied by the number of shares of common stock underlying the stock options) that would have been received by the option holders had all option holders exercised their options on June 30, 2013. During the three and six months ended June 30, 2013, stock options covering 110,404 and 312,725 shares of common stock, respectively with a total intrinsic value of $1.6 million and $4.2 million, respectively, were exercised. During the three and six months ended June 30, 2012, stock options covering 915,630 and 1,057,768 shares of common stock, respectively, with a total intrinsic value of $4.9 million and $5.4 million, respectively, were exercised.

A summary of the Company's unvested restricted stock grants and restricted stock units and changes during the six months ended June 30, 2013 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2012	2,202,738	$9.27
Granted	21,619	19.12
Vested	(363,517)	5.12
Outstanding at June 30, 2013	1,860,840	$10.19

The aggregate fair value of restricted stock vested during the six months ended June 30, 2013 and 2012 was $6.5 million and $4.0 million, respectively.

As of June 30, 2013, the Company had $16.9 million of total unrecognized compensation cost related to unvested stock options and unvested restricted stock and restricted stock units, which is expected to be recognized over a weighted average period of 1.7 years.

Note 13 — Taxes

The Company's effective tax rates for the three and six months ended June 30, 2013 and 2012 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Effective Tax Rates	98%	3%	65%	5%

The Company recorded an income tax benefit of $9.3 million and $14.4 million, respectively, for the three and six months ended June 30, 2013. The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rates of 98% and 65% for the three and six months ended June 30, 2013 was the result of an improved business outlook with respect to the current year which reduced the Company's forecasted tax rate and an improved business outlook with respect to future years that reduced the valuation allowance held against the Company's U.S. deferred tax assets by $8.3 million. The

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decision to reduce the valuation allowance held against the Company's U.S. deferred tax assets was based upon an evaluation of all available positive and negative evidence relating to future years. The Company considers its actual historical results over several years to have stronger weight than other more subjective indicators when considering whether to establish or reduce a valuation allowance on deferred tax assets. The assessment of the Company's ability to utilize its deferred tax assets included an assessment of all known business risks and industry trends as well as forecasted domestic and international earnings over a number of years. The Company's ability to forecast results significantly into the future is severely limited due to the rapid rate of technological change in the industry in which it operates. As a result of an improved business forecast, the Company concluded that it was more likely than not that additional deferred tax assets would be realized.

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

The Company continues to provide a partial valuation allowance against its U.S. deferred tax assets and a full valuation allowance against its deferred tax assets in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not. The Company's conclusion about the realizability of its deferred tax assets, and therefore the appropriateness of a valuation allowance, is reviewed quarterly. If the Company's conclusion about the realizability of its deferred tax assets changes in a future period, the Company could record a substantial tax provision or benefit in its Condensed Consolidated Statements of Operations when that occurs.

Note 14 — Segment Information

The Company has the following reportable segments: HPC Systems, Maintenance and Support, and Storage and Data Management. The Company's reportable segments represent components of the Company for which separate financial information is available that is utilized on a regular basis by the Chief Executive Officer, who is the Chief Operating Decision Maker, in determining how to allocate the Company's resources and evaluate performance. The segments are determined based on several factors, including the Company's internal operating structure, the manner in which the Company's operations are managed, client base, similar economic characteristics and the availability of separate financial information.

HPC Systems

HPC Systems includes a suite of highly advanced systems, including the Cray XC30, Cray XE6, Cray XE6m, Cray XK7, Cray XK6m, and Cray Cluster Solutions products, including the Cray CS300, which are used by single users all the way up through large research centers.

Maintenance and Support

Maintenance and Support provides ongoing maintenance of Cray HPC, Big Data systems and Storage, and systems analysts to help customers achieve their mission objectives.

Storage and Data Management

Storage and Data Management offers the Cray Sonexion 1600 as well as other third-party storage products.

Engineering Services and Other

Included within Engineering Services and Other is the Company's YarcData division and Custom Engineering.

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

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue:				
HPC Systems	$57,915	$57,834	$104,022	$151,669
Maintenance and Support	19,578	14,963	37,791	30,013
Storage and Data Management	3,748	9,094	17,465	11,236
Engineering Services and Other	3,226	2,292	4,736	3,572
Total revenue	$84,467	$84,183	$164,014	$196,490
Cost of Revenue:				
HPC Systems	$44,737	$33,297	$82,560	$89,597
Maintenance and Support	9,201	9,809	18,254	18,872
Storage and Data Management	2,565	5,326	10,313	6,581
Other	1,163	1,256	1,937	1,789
Total cost of revenue	$57,666	$49,688	$113,064	$116,839
Gross Profit:				
HPC Systems	$13,178	$24,537	$21,462	$62,072
Maintenance and Support	10,377	5,154	19,537	11,141
Storage and Data Management	1,183	3,768	7,152	4,655
Other	2,063	1,036	2,799	1,783
Total gross profit	$26,801	$34,495	$50,950	$79,651

Revenue and cost of revenue is the only discrete financial information the Company prepares for its segments. Other financial results or assets are not separated by segment.

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

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

	United States		Other Countries		Total	
	2013	2012	2013	2012	2013	2012
Three months ended June 30,						
Product revenue	$58,449	$45,244	$3,904	$23,272	$62,353	$68,516
Service revenue	15,779	9,738	6,335	5,929	22,114	15,667
Total revenue	$74,228	$54,982	$10,239	$29,201	$84,467	$84,183

	United States		Other Countries		Total	
	2013	2012	2013	2012	2013	2012
Six months ended June 30,						
Product revenue	$89,593	$122,476	$32,628	$42,017	$122,221	$164,493
Service revenue	29,252	19,698	12,541	12,299	41,793	31,997
Total revenue	$118,845	$142,174	$45,169	$54,316	$164,014	$196,490

Product and service revenue from U.S. government agencies and customers primarily serving the U.S. government totaled approximately $58.0 million and $97.0 million, respectively, for the three and six months ended June 30, 2013, compared to approximately $9.2 million and $94.4 million for the three and six months ended June 30, 2012, respectively. For

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the six months ended June 30, 2013, no foreign countries accounted for more than 10% of total revenue. For the six months ended June 30, 2012, revenue in Canada accounted for 11% of total revenue.

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

Preliminary Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or if they prove incorrect, could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements are based on our management’s beliefs and assumptions and on information currently available to them. In some cases you can identify forward-looking statements by terms such as “may,” “will,” “should,” “could,” “would,” “expect,” “plans,” “antici “believes,” “estimates,” “projects,” “predicts” and “potential” and similar expressions, but the absence of these words does not mean that a statement is not forward-looking. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, and examples of forward-looking statements include any projections of earnings, revenue or other results of operations or financial results; any statements of the plans, strategies, objectives and beliefs of our management; any statements concerning proposed new products, technologies or services; any statements regarding future research and development or co-funding for such efforts; any statements regarding future economic conditions; and any statements of assumptions underlying any of the foregoing. These forward-looking statements are subject to the safe harbor created by Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us and described in Item 1A. Risk Factors in Part II and other sections of this report and our other filings with the U.S. Securities and Exchange Commission, or SEC. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this report. You should read this report completely and with the understanding that our actual future results may be materially different from what we expect. We assume no obligation to update these forward-looking statements, whether as a result of new information, future events, or otherwise.

Overview

We design, develop, manufacture, market and service high-performance computing, or HPC, systems, including categories of systems commonly known as supercomputers and/or clusters, and provide storage solutions, software and engineering services related to HPC systems to our customers, which include government agencies and government-funded entities, academic institutions and commercial entities. We provide customer-focused solutions based on two models: (1) we provide highly integrated supercomputing, storage and data analytics solutions, complete with highly tuned software, that stress capability, scalability, sustained performance and reliability at scale; and (2) we provide flexible commodity-based "cluster" supercomputing and storage solutions based upon choosing best-of-breed components and working with our customers to define solutions that meet specific needs. All of our solutions also emphasize total cost of ownership, energy efficiency and data center flexibility as key features. Our current strategy is to gain market share in the high-end supercomputer market segment, extend our technology leadership, maintain our focus on execution and profitability and grow by expanding our addressable market in areas where we can leverage our experience and technology, such as in storage of and analytics on enormous volumes of data, popularly referred to as “Big Data”.

Summary of First Six Months of 2013 Results

Total revenue decreased $32.5 million for the first six months of 2013 compared to the first six months of 2012, from $196.5 million to $164.0 million, due to lower product revenue. The decrease in product revenue of $42.3 million was primarily attributable to high product revenue in the first six months of 2012 due to the acceptance of the first phase of the upgrade at Oak Ridge National Laboratory (ORNL), which accounted for approximately $65 million of revenue during that period. This decrease was partially offset by higher revenue for storage products and revenue from our new Cray Cluster Solutions (CCS) business unit in the first half of 2013.

Net loss for the first six months of 2013 was $7.8 million compared to net income of $152.4 million for the same period in 2012. The decrease in net income was primarily attributable to the $139.1 million gain on the sale of our interconnect hardware development program to Intel in the first half of 2012 and a decrease in gross profit of $28.7 million. This was partially reduced by an income tax benefit of $14.4 million in the six months ended 2013.

Net cash used in operating activities was $65.8 million for the first six months of 2013 compared to net cash provided by operating activities of $25.7 million for the first six months of 2012. Cash used in operating activities in the first six months of 2013 was driven by an increase in accounts and other receivables from $13.4 million at December 31, 2012 to $25.1 million at June 30, 2013, a $36.4 million increase in inventory, and payment of the 2012 accrued incentive compensation expense which resulted in a decrease in accrued payroll and related expenses from $25.9 million at December 31, 2012 to $9.2 million at

June 30, 2013. Cash used in operating activities was partially offset by an increase in accounts payable from $34.7 million at December 31, 2012 to $62.3 million at June 30, 2013.

Market Overview and Challenges

Significant trends in the HPC industry include:

- Supercomputing with many-core commodity processors driving increasing scalability requirements;
- Increased micro-architectural diversity, including increased usage of many-core processors and accelerators, as the rate of per-core performance increases slows;
- Data needs growing faster than computational needs;
- The commoditization of HPC hardware, particularly processors and system interconnects;
- Electrical power requirements becoming a design constraint and driver in total cost of ownership determinations;
- The growing commoditization of software, including plentiful building blocks and more capable open source software;
- The use of public clouds for cost-effective computing on loosely-coupled HPC applications; and
- The fusion of supercomputing with data analytics.

Several of these trends have resulted in the expansion and acceptance of loosely coupled cluster systems using processors manufactured by Intel, AMD and others combined with commercially available networking and other components, particularly in the middle and lower segments of the HPC market. These systems may offer higher theoretical peak performance for equivalent cost, and “price/peak performance” is often the dominant factor in HPC procurements outside of the high-end supercomputer market segment. Vendors of such systems often put pricing pressure on us in competitive procurements.

In the markets for the largest, and most scalable systems, those often costing significantly in excess of $3 million, the use of commodity components can result in increasing data transfer bottlenecks as these components do not balance processor power with network communication capability. With the arrival of increasing processor core counts due to new many-core processors, these unbalanced systems will typically have even lower productivity and efficiency, especially in larger systems running more complex applications. We and other vendors have also begun to augment standard microprocessors with other processor types, such as graphics processing units and field programmable gate-arrays, in order to increase computational power, further complicating programming models. In addition, with increasing scale, bandwidth and processor core counts, large computer systems use progressively higher amounts of power to operate and require special cooling capabilities.

To position ourselves to meet the market’s demanding needs, we concentrate our research and development efforts on technologies that enable our supercomputers to perform at scale - that is, to continue to increase actual performance as systems grow ever larger in size - and in areas where we can leverage our core expertise in other markets whose applications demand these tightly-coupled architectures. We also have demonstrated expertise in several processor technologies. We expect to be in a comparatively advantageous position as larger many-core processors become available and as multiple processing technologies become integrated into single systems in heterogeneous environments. In addition, we have begun 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 strategic initiatives, such as storage and data management and “Big Data” analytics. We have also recently significantly expanded our addressable market with the acquisition of Appro. Appro provides cluster systems and solutions to the HPC market. The Appro business was renamed Cray Cluster Solutions, or CCS, following the acquisition.

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 in this Form 10-Q or in our annual report on Form 10-K, is subject to significant variability from period to period. In the short term, we closely review the status of product shipments, installations and acceptances in order to forecast revenue and cash receipts; longer-term, we monitor the status of the pipeline of product sales opportunities and product development cycles. We believe product revenue growth over several quarters is an indicator of whether we are achieving our objective of increased market share in the supercomputing market. The introduction of the Cray XC30 and the addition of CCS products, along with longer-term product roadmap are efforts to increase product revenue. We are also increasing our business and product development efforts in storage and data management, big data analytics, technical enterprise HPC systems and custom engineered solutions. Maintenance service revenue is more constant in the short term and assists, in part, to offset the impact that the variability in product revenue has on total revenue.

Gross profit margin. Our product gross profit margin decreased from 41% for the six months ended June 30, 2012 to 24% during the same period in 2013. The decrease was due in part to higher than anticipated costs on the second phase of the upgrade at ORNL, fluctuations in foreign currency rates, particularly the Japanese yen, and the impact of inventory fair value

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adjustments and intangible amortization related to our acquisition of Appro. Service gross profit margin increased from 38% for the six months ended June 30, 2012 to 52% for the same period in 2013. The increase in service gross profit margin was due to maintenance services on a larger base of installed systems.

Operating expenses. Our operating expenses are driven largely by headcount, contracted third-party research and development services, and incentive compensation expense. During 2012 and in the three and six month period ended June 30, 2013, we significantly grew our sales organization to enable us to better pursue growth opportunities. We have also significantly increased our investment in Big Data in the three and six month periods ended June 30, 2013 as compared to the prior year periods. As part of our ongoing expense control efforts, we continue to monitor headcount levels in specific geographic and operational areas.

Liquidity and cash flows. Due to the variability in product revenue, new contracts, and payment terms, our cash position also varies significantly from quarter-to-quarter and within a quarter. We 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. The net proceeds from the sale of our interconnect hardware development program to Intel of $139.2 million in the second quarter of 2012 substantially increased our liquidity position.

Results of Operations

Our revenue, results of operations and cash balances are likely to fluctuate significantly from quarter-to-quarter. These fluctuations are due to such factors as the high average sales prices and limited number of sales of our products with variable gross margin levels, the timing of purchase orders and product deliveries, the revenue recognition accounting policy of generally not recognizing product revenue until customer acceptance and other contractual provisions have been fulfilled, the timing of payments for product sales, maintenance services, government research and development funding, the impact of the timing of new products on customer orders, and purchases of inventory during periods of inventory build-up. As a result of these factors, revenue, gross margin, expenses, cash and inventory are expected to vary significantly from quarter-to-quarter and year-to-year.

Revenue and Gross Profit Margins

Our revenue, cost of revenue and gross profit margin for the three and six months ended June 30, 2013 and 2012, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2013		2012		2013		2012	
Product revenue	$62,353		$68,516		$122,221		$164,493	
Less: Cost of product revenue	47,477		39,521		93,047		97,071	
Product gross profit	$14,876		$28,995		$29,174		$67,422	
Product gross profit margin	24	%	42	%	24	%	41	%
Service revenue	$22,114		$15,667		$41,793		$31,997	
Less: Cost of service revenue	10,189		10,167		20,017		19,768	
Service gross profit	$11,925		$5,500		$21,776		$12,229	
Service gross profit margin	54	%	35	%	52	%	38	%
Total revenue	$84,467		$84,183		$164,014		$196,490	
Less: Total cost of revenue	57,666		49,688		113,064		116,839	
Total gross profit	$26,801		$34,495		$50,950		$79,651	
Total gross profit margin	32	%	41	%	31	%	41	%

Product Revenue

Product revenue for the three and six months ended June 30, 2013 of $62.4 million and $122.2 million, respectively, was primarily from sales of the Cray XC30, Cray XK7, CCS systems and Sonexion storage systems. Product revenue for the three and six months ended June 30, 2012 of $68.5 million and $164.5 million, respectively, was primarily from sales of Cray XE6 and Cray XK6 systems. Product revenue for the six months ended June 30, 2013 was lower than the prior year period primarily due to the acceptance of the first phase of the upgrade at ORNL which accounted for approximately $65 million of revenue in the first half of 2012. This was partially offset by higher revenue for storage products and revenue from our new CCS products in the first half of 2013.

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Service Revenue

Service revenue for the three months ended June 30, 2013 was $22.1 million compared to $15.7 million for the same period in 2012. Service revenue for six months ended June 30, 2013 was $41.8 million compared to $32.0 million for the same period in the 2012. The increase in service revenue was primarily due to higher maintenance revenue from our larger installed system base.

Cost of Product Revenue and Product Gross Profit

Cost of product revenue increased by $8.0 million and decreased by $4.0 million, for the three and six months ended June 30, 2013, respectively. For the three months ended June 30, 2013, product gross profit margin decreased 18% percentage points to 24% from the same period in 2012. The decrease in product gross profit margin for the three months ended June 30, 2013 was due in part to higher than anticipated costs on the second phase of the supercomputer upgrade at Oak Ridge National Laboratory (ORNL). The additional costs associated with the ORNL upgrade decreased the product gross profit margin for the three months ended June 30, 2013 by eight percentage points. Product gross profit margins in any one period may not be indicative of future results as product gross profit margins can vary significantly between contracts for many reasons.

Cost of Service Revenue and Service Gross Profit

Cost of service revenue was unchanged and service gross profit increased by 19% percentage points to 54% during the three months ended June 30, 2013 compared to the same period in 2012 due to higher service revenue. For the six months ended June 30, 2013, cost of service revenue increased $0.2 million and service gross profit margin increased by 14% percentage points to 52% compared to the same period in 2012. The increases in service gross profit margin percentage were due to higher service revenue on a stable base of fixed expenses and lower incentive compensation expense during the six months ended June 30, 2013.

Research and Development Expenses

Research and development expenses for the three and six months ended June 30, 2013 and 2012, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Gross research and development expenses	$21,531	$22,015	$42,511	$46,037
Less: Amounts included in cost of revenue	(974)	(122)	(1,728)	(232)
Less: Reimbursed research and development (excludes amounts in cost of revenue)	(589)	(15,000)	(589)	(15,162)
Net research and development expenses	$19,968	$6,893	$40,194	$30,643
Percentage of total revenue	24%	8%	25%	16%

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

For the three and six months ended June 30, 2013, gross research and development expenses decreased $0.5 million and $3.5 million, respectively, due to the sale of our interconnect hardware development program to Intel in the second quarter of 2012 and higher incentive compensation expense in the first half of 2012. The decrease in our gross research and development expense was partially offset by increased research and development spending for our new products and the acquisition of Appro in the fourth quarter of 2012.

Net research and development expenses increased by $13.1 million and $9.6 million for the three and six months ended June 30, 2013, respectively, compared to the same periods in 2012. The increase was primarily due to lower research and development reimbursements due to the end of our DARPA contract in 2012. We recognized $15 million in research and development reimbursements from DARPA in the second quarter of 2012.

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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, 2013 and 2012, respectively, were (in thousands, except for percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Sales and marketing	$11,550	$10,233	$22,693	$18,106
Percentage of total revenue	14%	12%	14%	9%
General and administrative	$5,085	$4,971	$10,570	$10,101
Percentage of total revenue	6%	6%	6%	5%

Sales and Marketing. Sales and marketing expense for the three and six months ended June 30, 2013 increased $1.3 million and $4.6 million, respectively, from the same periods in 2012, primarily due to an increase in salaries and employee-related expenses in connection with the expansion of our sales force and as result of our acquisition of Appro. These added expenses were partially offset by lower incentive compensation expense.

General and Administrative. General and administrative expense for the three and six months ended June 30, 2013 increased $0.1 million and $0.5 million, respectively, from the same periods in 2012, and was generally consistent with general and administrative expense from the same period in 2012 as additional recurring expenses from the Appro acquisition were offset by lower incentive compensation expense.

Other Income (Expense), net

For the three months ended June 30, 2013, we recognized net other income of $0.1 million compared to net other income of $0.2 million for the same period in 2012. For the six months ended June 30, 2013, we recognized net other expense of $0.2 million compared to net other income of $0.5 million for the same period in 2012. Net other income and expense for the three and six months ended June 30, 2013 and 2012 was principally the result of foreign currency transaction gains and losses.

Interest Income, net

Our interest income and interest expense for the three and six months ended June 30, 2013 and 2012, respectively, were (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest income	$214	$79	$599	$110
Interest expense	(10)	(42)	(19)	(74)
Interest income, net	$204	$37	$580	$36

Interest income, net for the three and six months ended June 30, 2013 increased as compared to the same periods in 2012 due to higher average invested balances.

Taxes

Our effective tax rates were approximately 98% and 65% for the three and six months ended June 30, 2013 compared to 3% and 5% for the three and six months ended June 30, 2012. The primary reason for the difference between the expected statutory tax rate of 35% and the actual tax rates of 98% and 65% for the three and six months ended June 30, 2013 was the result of an improved business outlook with respect to the current year which reduced our forecasted tax rate and our decision to reduce the valuation allowance held against our U.S. deferred tax assets by $8.3 million as a result of an improved business outlook with respect to future years. The assessment of our ability to utilize our deferred tax assets included an assessment of all known business risks and industry trends as well as forecasted domestic and international earnings over a number of years. As a result of an improved business forecast, we concluded that it was more likely than not that additional deferred tax assets would be realized.

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

Liquidity and Capital Resources

We generate cash from operations predominantly from the sale of HPC systems and related services. We typically have a small number of significant contracts that make up the majority of total revenue. The material changes in certain of our balance sheet accounts were due to the timing of product deliveries, customer acceptances, contractually determined billings and cash collections. Working capital requirements, including inventory purchases and normal capital expenditures, are generally funded with cash from operations.

Cash and cash equivalents decreased by $103.9 million from December 31, 2012 to June 30, 2013. The decrease was in part attributable to an increase in accounts and other receivables from $13.4 million at December 31, 2012 to $25.1 million at June 30, 2013, an increase in inventory of $36.4 million and payment of the 2012 accrued incentive compensation expense, which resulted in a decrease in accrued payroll and related expenses from $25.9 million at December 31, 2012 to $9.2 million at June 30, 2013. Partially offsetting these items was an increase in accounts payable from $34.7 million at December 31, 2012 to $62.3 million at June 30, 2013.

As of June 30, 2013, we had working capital of $285.2 million compared to $283.4 million as of December 31, 2012. During the six months ended June 30, 2013, we invested $34.0 million in debt securities and had a total of $104.0 million in debt securities as of June 30, 2013.

Cash flow information included the following (in thousands):

	Six Months Ended June 30, 2013	2012
Cash provided by (used in):		
Operating Activities	$(65,761)	$25,705
Investing Activities	$(38,405)	$137,186
Financing Activities	$572	$6,089

Operating Activities. Net cash used in operating activities for the six months ended June 30, 2013 was $65.8 million compared to $25.7 million net cash provided by operating activities for the same period in 2012. For the six months ended June 30, 2013, net cash used in operating activities was due in part to an increase in inventory and the payment of the 2012 accrued incentive compensation expense. For the six months ended June 30, 2012, cash provided by operating activities was principally the result of high cash collections from customers partially offset by an increase in inventory.

Investing Activities. Net cash used in investing activities was $38.4 million for the six months ended June 30, 2013, compared to $137.2 million net cash provided by investing activities for the same 2012 period. Net cash used in investing activities for the six months ended June 30, 2013 was due principally to purchases of debt securities of $34.0 million. For the six months ended June 30, 2012, net cash provided by investing activities was due principally to the sale of our interconnect hardware development program to Intel for $139.2 million, net of direct transaction costs.

Financing Activities. Net cash provided by financing activities for the six months ended June 30, 2013 was $0.6 million compared to $6.1 million provided by financing activities for the same period in 2012. Net cash provided by financing activities for the six months ended June 30, 2013 resulted primarily from cash received from the issuance of common stock from the exercise of options and from the issuance of stock through our employee stock purchase plan, partially offset by payments for shares remitted to the Company for statutory withholding. Net cash provided by financing activities for the six months ended June 30, 2012 resulted primarily from cash received from the issuance of common stock from the exercise of options and from the issuance of stock through our employee stock purchase plan. In addition, we lease certain equipment and facilities used in our operations under operating leases in the normal course of business and have contractual commitments under certain development arrangements. The following table summarizes our contractual obligations as of June 30, 2013 (in thousands):

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Contractual Obligations	Amounts Committed by Year				
	Total	2013 (Less than 1 Year)	2014-2015	2016-2017	Thereafter
Development agreements	$5,059	$4,540	$494	$25	$—
Operating leases	20,469	2,464	7,677	6,833	3,495
Total contractual cash obligations	$25,528	$7,004	$8,171	$6,858	$3,495

As of June 30, 2013, we had a $10.0 million unsecured line of credit with Wells Fargo Bank, National Association. This facility has a maturity date of October 15, 2013. As of June 30, 2013, we also had a $10.0 million letter of credit facility with Silicon Valley Bank. The Silicon Valley Bank facility is unsecured and may be used only to support the issuance of letters of credit. This facility has a maturity date of October 17, 2013. We have made no draws and had no outstanding borrowings on any credit facilities as of June 30, 2013.

In our normal course of operations, we have development arrangements under which we engage outside engineering resources to work on our research and development projects. For the three and six months ended June 30, 2013, we incurred $2.5 million and $4.0 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. We expect our cash resources to be adequate for at least the next twelve months.

Critical Accounting Policies and Estimates

This discussion, as well as disclosures included elsewhere in this quarterly report on Form 10-Q, are based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingencies. In preparing our financial statements in accordance with GAAP, there are certain accounting policies that are particularly important. These include revenue recognition, inventory valuation, accounting for income taxes, research and development expenses and share-based compensation. Our significant accounting policies are set forth in Note 2 to the Consolidated Financial Statements included in our 2012 Annual Report on Form 10-K and should be reviewed in conjunction with the accompanying Condensed Consolidated Financial Statements and notes thereto as of June 30, 2013 in this quarterly report on Form 10-Q, as they are integral to understanding our results of operations and financial condition in this interim period. In some cases, these policies represent required accounting. In other cases, they may represent a choice between acceptable accounting methods or may require substantial judgment or estimation.

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

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

Revenue Recognition

We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when we have persuasive evidence of an arrangement, delivery has occurred, the sales price is fixed or determinable, and collectibility is reasonably assured. Delivery does not occur until the products have been shipped or services provided to the customer, risk of loss has transferred to the customer, and, where applicable, a customer acceptance has been obtained, where applicable. The sales price is not considered to be fixed or determinable until all material contingencies related to the sales have

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been resolved. We record revenue in the Condensed Consolidated Statements of Operations net of any sales, use, value added or certain excise taxes imposed by governmental authorities on specific sales transactions. In addition to the aforementioned general policy, the following are our statements of policy with regard to multiple-element arrangements and specific revenue recognition policies for each major category of revenue.

Multiple-Element Arrangements. We commonly enter into revenue arrangements that include multiple deliverables of our product and service offerings due to the needs of our customers. Product may be delivered in phases over time periods which can be as long as five years. Maintenance services generally begin upon acceptance of the first equipment delivery and future deliveries of equipment generally have an associated maintenance period. We consider the maintenance period to commence upon acceptance of the product or installation in situations where a formal acceptance is not required, which may include a warranty period and accordingly allocate a portion of the arrangement consideration as a separate deliverable which is recognized as service revenue over the entire service period. Other services such as training and engineering services can be delivered as a discrete delivery or over the term of the contract. A multiple-element arrangement is separated into more than one unit of accounting if the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis; and
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in our control.

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized ratably over the contract term or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered. If these criteria are met for each element, the arrangement consideration is allocated to the separate units of accounting based on each unit’s relative selling price.

We follow a selling price hierarchy in determining the best estimate of the selling price of each deliverable. Certain products and services are sold separately in standalone arrangements for which we are sometimes able to determine vendor specific objective evidence, or VSOE. We determine VSOE based on normal pricing and discounting practices for the product or service when sold separately.

When we are not able to establish VSOE for all deliverables in an arrangement with multiple elements, we attempt to establish the selling price of each remaining element based on third-party evidence, or TPE. Our inability to establish VSOE is often due to a relatively small sample of customer contracts that differ in system size and contract terms which can be due to infrequently selling each element separately, not pricing products within a narrow range, or only having a limited sales history, such as in the case of certain advanced and emerging technologies. TPE is determined based on our prices or competitor prices for similar deliverables when sold separately. However, we are often unable to determine TPE, as our offerings contain a significant level of customization and differentiation from those of competitors and we are often unable to reliably determine what similar competitor products’ selling prices are on a standalone basis.

When we are unable to establish selling price using VSOE or TPE, we use estimated selling price, or ESP, in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a standalone basis. In determining ESP, we use either the list price of the deliverable less a discount, the cost to provide the product or service plus a margin, or consider other factors. When using list price less a discount, we use discounts from list price for previous transactions. This approach incorporates several factors, including the size of the transaction and any changes to list prices. The data is collected from prior sales, and although the data may not have the sample size or consistency to establish VSOE, it is sufficiently objective to estimate the selling price. When using cost plus a margin, we consider the total cost of the product or service, including customer-specific and geographic factors. We also consider the historical margins of the product or service on previous contracts and several factors including any changes to pricing methodologies, competitiveness of products and services and cost drivers that would cause future margins to differ from historical margins.

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

Services. Maintenance services are provided under separate maintenance contracts with customers. These contracts generally provide for maintenance services for one year, although some are for multi-year periods, often with prepayments for the term of the contract. We consider the maintenance period to commence upon acceptance of the product or installation in situations where a formal acceptance is not required, which may include a warranty period. When service is part of a multiple element arrangement, we allocate a portion of the arrangement consideration to maintenance service revenue based on

estimates of selling price. Maintenance contracts that are billed in advance of revenue recognition are recorded as deferred revenue. Maintenance revenue is recognized ratably over the term of the maintenance contract.
Revenue from engineering services is recognized as services are performed.
Project Revenue. Revenue from design and build contracts is recognized under the percentage-of-completion (or POC method). Under the POC method, revenue is recognized based on the costs incurred to date as a percentage of the total estimated costs to fulfill the contract. If circumstances arise that change the original estimates of revenues, costs, or extent of progress toward completion, revisions to the estimates are made. These revisions may result in increases or decreases in estimated revenues or costs, and such revisions are recorded in income in the period in which the circumstances that gave rise to the revision become known by management. We perform ongoing profitability analyses of our contracts accounted for under the POC method in order to determine whether the latest estimates of revenue, costs and extent of progress require updating. If at any time these estimates indicate that the contract will be unprofitable, the entire estimated loss for the remainder of the contract is recorded immediately.
We record revenue from certain research and development contracts which include milestones using the milestone method if the milestones are determined to be substantive. A milestone is considered to be substantive if management believes there is substantive uncertainty that it will be achieved and the milestone consideration meets all of the following criteria:

- It is commensurate with either of the following:
  - Our performance to achieve the milestone; or
  - The enhancement of value of the delivered item or items as a result of a specific outcome resulting from our performance to achieve the milestone.
- It relates solely to past performance.
- It is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

The individual milestones are determined to be substantive or non-substantive in their entirety and milestone consideration is not bifurcated.
Revenue from projects is classified as Product Revenue or Service Revenue, based on the nature of the work performed.
Nonmonetary Transactions. We value and record nonmonetary transactions at the fair value of the asset surrendered unless the fair value of the asset received is more clearly evident, in which case the fair value of the asset received is used.
Inventory Valuation
We record our inventory at the lower of cost or market. We regularly evaluate the technological usefulness and anticipated future demand for our inventory components. Due to rapid changes in technology and the increasing demands of our customers, we are continually developing new products. Additionally, during periods of product or inventory component upgrades or transitions, we may acquire significant quantities of inventory to support estimated current and future production and service requirements. As a result, it is possible that older inventory items we have purchased may become obsolete, be sold below cost or be deemed in excess of quantities required for production or service requirements. When we determine it is not likely we will recover the cost of inventory items through future sales, we write-down the related inventory to our estimate of its market value.
Because the products we sell have high average sales prices and because a high number of our prospective customers receive funding from U.S. or foreign governments, it is difficult to estimate future sales of our products and the timing of such sales. It also is difficult to determine whether the cost of our inventories will ultimately be recovered through future sales. While we believe our inventory is stated at the lower of cost or market and that our estimates and assumptions to determine any adjustments to the cost of our inventories are reasonable, our estimates may prove to be inaccurate. We have sold inventory previously reduced in part or in whole to zero, and we may have future sales of previously written-down inventory. We also may have additional expense to write-down inventory to its estimated market value. Adjustments to these estimates in the future may materially impact our operating results.
Accounting for Income Taxes

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

As of June 30, 2013, we had approximately $100.1 million of net deferred tax assets, against which we provided a $74.0 million valuation allowance, resulting in a net deferred tax asset of $26.1 million. We continue to provide a partial valuation allowance against our U.S. deferred tax assets and a full valuation allowance against our deferred tax assets in a limited number of foreign jurisdictions as the realization of such assets is not considered to be more likely than not. Our conclusion about the realizability of our deferred tax assets, and therefore the appropriateness of a valuation allowance, is reviewed quarterly. If our conclusion about the realizability of our deferred tax assets changes in a future period, we could record a substantial tax provision or benefit in our Condensed Consolidated Statements of Operations when that occurs.

Estimated interest and penalties are recorded as components of interest expense and other expenses, respectively.

Research and Development Expenses

Research and development expenses include costs incurred in the development and production of our hardware and software, costs incurred to enhance and support existing product features, costs incurred to support and improve our development processes, and costs related to future product development. Research and development costs are expensed as incurred, and may be offset by co-funding from third parties. We may also enter into arrangements whereby we make advance, non-refundable payments to a vendor to perform certain research and development services. These payments are deferred and recognized over the vendor’s estimated performance period.

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

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

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

Share-based Compensation

We measure compensation cost for share-based payment awards at fair value and recognize it as compensation expense over the service period for awards expected to vest. We recognize share-based compensation expense for all share-based payment awards, net of an estimated forfeiture rate. We recognize compensation cost for only those shares expected to vest on a straight-line basis over the requisite service period of the award.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. We utilize the Black-Scholes options pricing model to value the stock options granted under our options plans. In this model, we utilize assumptions related to stock price volatility, stock option term and forfeiture rates that are based upon both historical factors as well as management’s judgment.

The fair value of restricted stock and restricted stock units is determined based on the number of shares or units granted and the quoted price of our common stock at the date of grant.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk
We are exposed to financial market risks, including changes in interest rates and foreign currency fluctuations.
Interest Rate Risk: We invest our available cash principally in highly liquid investment-grade debt instruments of corporate issuers and in debt instruments of the U.S. government and its agencies. We do not have any derivative instruments in our investment portfolio. We protect and preserve invested funds by limiting default, liquidity, market and reinvestment risk.
Foreign Currency Risk: We sell our products primarily in North America, Asia and Europe. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our products are generally priced in U.S. dollars, and a strengthening of the dollar could make our products less competitive in foreign markets. While we commonly sell products with payments in U.S. dollars, our product sales contracts may call for payment in foreign currencies and to the extent we do so, or engage with our foreign subsidiaries in transactions deemed to be short-term in nature, we are subject to foreign currency exchange risks. As of June 30, 2013, we were a party to forward exchange contracts that hedged approximately $140.4 million of anticipated cash receipts on specific foreign currency denominated sales contracts. These forward contracts hedge the risk of foreign exchange rate changes between the time that the related contract was signed and when the cash receipts are expected to be received. Our foreign maintenance contracts are typically paid in local currencies and provide a natural hedge against foreign exchange exposure. To the extent that we wish to repatriate any of these funds to the United States, however, we are subject to foreign exchange risks. As of June 30, 2013, a 10% change in foreign exchange rates could impact our annual earnings and cash flows by approximately $0.4 million.
Item 4. Controls and Procedures
Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this quarterly report. Based on this evaluation, our chief executive officer and chief financial officer concluded as of June 30, 2013 that our disclosure controls and procedures were effective such that the information required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.
Changes in internal control over financial reporting. There have been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2013 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.
Limitations on effectiveness of control. Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected.

Part II. OTHER INFORMATION

Item 1A. Risk Factors
You should carefully consider the risks described below together with all of the other information in this quarterly report on Form 10-Q and in our 2012 annual report on Form 10-K. If any of these risks actually occur, our business, financial condition or operating results could be materially adversely affected and the trading price of our common stock could decline.
Our operating results fluctuate significantly and we may not achieve profitability in any given period. Our operating results are subject to significant fluctuations which make predicting revenue and operating results for any specific

period very difficult, particularly because a material portion of product revenue recognized in any given quarter or year

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typically depends on a very limited number of system sales expected for that quarter or year and the product revenue generally depends on the timing of product acceptances by customers and contractual provisions affecting revenue recognition. For example, a system sale to the University of Illinois' National Center for Supercomputing Applications accounted for approximately $143 million of our revenue in fiscal 2012. Delays in achieving customer acceptances of installed systems and recognizing revenue from a product transaction or transactions due to development or product delivery delays, not receiving needed components timely or with anticipated quality and performance, inability of a system to meet performance requirements or targets, contractual provisions or for other reasons, could have a material adverse effect on our operating results in any specific quarter or year, and could shift associated revenue, gross profit and cash receipts from one quarter to another, or even from one year to another in the case of revenue expected to be realized in the fourth quarter of any year. The amount and timing of research and development co-funding can also materially affect our expenses for any given quarter or year. In addition, because our revenue is often concentrated in particular quarters rather than evenly spread throughout a year, we generally do not expect to sustain profitability over successive quarters even if we are profitable for the year.

Although we recorded positive net income in 2010, 2011 and 2012, we have experienced net losses in earlier periods and, prior to 2010, had last recorded positive annual net income in 2003. For example, we recorded a net loss of $10.6 million in 2007, a net loss of $40.7 million in 2008, which included a non-cash goodwill impairment charge of approximately $54.5 million and a net loss of $0.6 million in 2009. Net income in 2011 benefited from the partial reduction of the valuation allowance held against our U.S. deferred tax assets of $13.9 million and a complete reduction of the valuation allowance held against the deferred tax assets of our German subsidiary of $0.8 million.

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

- our ability to secure sufficient orders for our Cray XC30 systems as well as upgrades and successor systems;
- successfully delivering and obtaining customer acceptances of our Cray XC30 systems;
- our ability to successfully generate revenue and profitability from opportunities developed from our YarcData, storage and data management and Cluster Solutions businesses;
- our ability to scale our internal processes effectively to enable growth;
- the level of revenue recognized in any given period, which is affected by the very high average sales prices and limited number of significant system sales and resulting potential acceptances in any quarter, the timing of product acceptances by customers and contractual provisions affecting the timing and amount of revenue recognition;
- revenue delays or losses due to customers postponing purchases to wait for future upgraded or new systems, delays in delivery of upgraded or new systems, longer than expected customer acceptance cycles or penalties resulting from system acceptance issues;
- our expense levels, including research and development expense net of government funding;
- our ability to successfully and timely design, integrate and secure competitive processors for our Cray XC30 systems and upgrades and successors systems;
- our ability to secure additional government funding for future development projects such as funding targeted for "exascale" and other computing initiatives as our DARPA HPCS program has been completed;
- the level of product gross profit contribution in any given period due to volume or product mix, particularly with the introduction of flexible commodity-based supercomputers, competitive factors, strategic transactions, product life cycle, currency fluctuations, acceptance penalties and component costs;
- the competitiveness of our products and prices;
- maintaining our product development projects on schedule and within budgetary limitations;
- the level and timing of maintenance contract renewals with existing customers; and
- the terms and conditions of sale or lease for our products and services.

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

- the timely availability of acceptable components, including, but not limited to, processors, in sufficient quantities to meet customer delivery schedules at a competitive cost;
-

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

- the introduction or announcement of competitive or key industry supplier products;
- competitor pricing strategies;
- price fluctuations in the commodity electronics, processor and memory markets;
- general economic trends, including changes in levels of customer capital spending;
- the availability of adequate customer facilities to install and operate new Cray systems;

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- currency fluctuations, international conflicts or economic crises, including the ongoing macroeconomic challenges in the United States and the debt crisis in certain countries in the European Union; and
- the receipt and timing of necessary export licenses.

Because of the numerous factors affecting our revenue and results of operations, we may not achieve profitability on a quarterly or annual basis in the future. We anticipate that our quarterly results will fluctuate significantly, and include losses, even in years where we expect or achieve positive annual net income. Delays in component availability, product development, receipt of orders, level and timing of approved government fiscal budgets, product acceptances, reductions in outside funding for our research and development efforts and achieving contractual development milestones have had a substantial adverse effect on our past results and could continue to have such an effect on our results in 2013 and in future years.

If we are unable to successfully develop, sell and deliver our Cray XC30 systems and successor systems, and recognize revenue for these systems, our operating results will be adversely affected. We expect that a substantial portion of our revenue in the foreseeable future will come from acceptances of delivered Cray XC30 systems and successor systems, including systems integrating future processors and accelerators. The development effort related to these systems are lengthy and technically challenging processes, and require a significant investment of capital, engineering and other resources often years ahead of the time when we can be assured that they will result in competitive products. We may invest significant resources in alternatives that prove ultimately unfruitful. Unanticipated performance and/or development issues may require more engineers, time or testing resources than are currently available. Given the breadth of our engineering challenges and our limited engineering and technical personnel resources, we periodically review the anticipated contributions and expense of our product programs to determine their long-term viability, and we may substantially modify or terminate one or more development programs. We may not be successful in meeting our development schedules for technical reasons and/or because of insufficient engineering resources, which could result in an uncompetitive product or cause a lack of confidence in our capabilities among our key customers. To the extent that we incur delays in completing the design, development and production of hardware components, delays in development of requisite system software, cancellation of programs due to technical or economic infeasibility or investment in unproductive development efforts, our revenue, results of operations and cash flows, and the reputation of such systems in the market, could be adversely affected.

In addition, many factors affect our ability to successfully sell and recognize revenue for these systems, including the following:

- the level of product differentiation in our Cray XC30 systems and successor systems. We need to compete successfully against HPC systems from both, large established companies and smaller companies and demonstrate the value of our balanced high bandwidth systems;
- our ability to meet all customer requirements for acceptance. Even once a system has been delivered, we sometimes do not meet all of the contract requirements for customer acceptance and ongoing reliability of our systems within the provided-for acceptance period, which has resulted in contract penalties and delays in our ability to recognize revenue from system deliveries. Most often these penalties have adversely affected gross profit through the provision of additional equipment and services and/or service credits to satisfy delivery delays and performance shortfalls. The risk of contract penalties is increased when we bid for new business prior to completing development of new products when we must estimate future system performance, such as has been required with our Cray XC30, Cray XE6 and Cray XK6 systems and will be required for subsequent systems;
- our ability to source competitive, key components in appropriate quantities, in a timely fashion and on acceptable terms and conditions. If we underestimated our needs, we could limit the number of possible sales of these products and reduce potential revenue, or if we overestimated, we could incur inventory obsolescence charges and reduce our gross profit, as has happened in the past; and
- whether potential customers delay purchases of our products because they decide to wait for successor systems or upgrades that we have announced or they believe will be available in the future.

Failure to successfully develop and sell our Cray XC30 systems and successor systems into the high-end of the HPC market and recognize revenue for such systems will adversely affect our operating results.

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If our current and future growth initiatives targeting markets outside of our traditional markets, primarily our Big Data analytics and storage and data management opportunities, are not successful, our ability to grow our revenues and achieve and sustain profitability will be adversely affected. Our ability to materially grow our revenues and achieve and sustain profitability will be adversely affected if we are unable to generate sufficient revenue from growth initiatives targeting markets outside of our traditional market, particularly if those market segments do not grow significantly. We are currently focusing on Big Data analytics and storage and data management opportunities. To grow our revenue from new opportunities outside our primary market, we must compete successfully with many established companies and new entrants in these markets, continue to win awards for new contracts, timely perform on existing contracts, develop our capability for broader market sales and business development and successfully develop and introduce new solution-oriented offerings, notwithstanding that these are relatively new businesses for us and we do not have significant experience targeting these markets. These Big Data analytics and storage and data management opportunities require significant monetary investments ahead of revenue, including product development efforts, adding experienced personnel and initiating new marketing and sales efforts and therefore may reduce net income in the short term even if successful.

If our Cray Cluster Solutions business is not successful, our operating results will be adversely affected. Our Cray Cluster Solutions business is the result of our acquisition of Appro International, Inc., or Appro, in the fourth quarter of 2012. We have had a very limited experience selling a cluster-based solution into the same markets we sell our core HPC systems, and for this business to be successful we must successfully do so without impairing our ability to sell tightly-integrated solutions, such as our Cray XC products. We must also successfully complete the integration of the Appro business into our business. If we are unable to successfully integrate and grow our Cluster Solutions business, our operating results will be adversely affected.

We have recently completed the acquisition of Appro, and may make acquisitions in the future, which could require significant management attention, disrupt our business, result in dilution to our stockholders, deplete our cash reserves and adversely affect our financial results. Acquisitions involve numerous risks, including the following:

- difficulties in successfully integrating the operations, systems, technologies, products, offerings and personnel of the acquired company or companies;
- insufficient revenue to offset increased expenses associated with acquisitions;
- diversion of management's attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions;
- potential difficulties in completing projects associated with in-process research and development intangibles;
- difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;
- initial dependence on unfamiliar supply chains or relatively small supply partners; and
- the potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans.

Acquisitions may also cause us to:

- use a substantial portion of our cash reserves or incur debt;
- issue equity securities or grant equity incentives to acquired employees that would dilute our current shareholders' percentage ownership;
- assume liabilities, including potentially unknown liabilities;
- record goodwill and nonamortizable intangible assets that are subject to impairment testing on a regular basis and potential periodic impairment charges;
- incur amortization expenses related to certain intangible assets;
- incur large and immediate write-offs and restructuring and other related expenses; or
- become subject to intellectual property or other litigation.

Acquisitions of high-technology companies and assets are inherently risky and subject to many factors outside of our control, and no assurance can be given that our recently completed or future acquisitions will be successful and will not materially adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results.

If the U.S. government and other governments purchase, or fund the purchase of, fewer supercomputers or delay such purchases, our revenue would be reduced and our operating results would be adversely affected. Historically, sales to the U.S. government and customers primarily serving the U.S. government have represented the largest single market segment for supercomputer sales worldwide, including our products and services. In 2010, 2011, 2012 and the first six months of 2013, approximately 62%, 54%, 68% and 59%, respectively, of our revenue was derived from such sales. Our plans for the foreseeable future contemplate significant sales to U.S. government agencies and customers primarily serving the U.S. government. Sales to government agencies and customers primarily serving the U.S. government, including further sales pursuant to existing contracts, may be adversely affected by factors outside our control, such as by "sequestration" or other

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Congressional failures or successes in addressing budget concerns, current economic uncertainty, the downgrading of U.S. government debt, the political climate in the U.S. focusing on cutting or limiting budgets and their effect on government budgets, the limits on federal borrowing capacity, changes in procurement policies, budgetary considerations including Congressional delays in completing appropriation bills as occurred in 2011 and 2012, domestic crises, and international political developments, such as the downgrading of European debt. If agencies and departments of the United States or other governments were to stop, reduce or delay their use and purchases of supercomputers, our revenue and operating results would be adversely affected.

Our reliance on third-party suppliers poses significant risks to our operating results, business and prospects. We rely upon third-party vendors to supply processors for our systems, storage solutions, subsystems and use service providers to co-develop key technologies. We subcontract the manufacture of a majority of the hardware components for our high-end products, including integrated circuits, printed circuit boards, connectors, cables, power supplies and memory parts, on a sole or limited source basis to third-party suppliers. We use contract manufacturers to assemble certain important components for all of our systems. We also rely on third parties to supply key software and hardware capabilities, such as file systems, solution-specific servers and storage subsystems, and in the case of the Cray Sonexion products, we rely on third-party original equipment manufacturers to supply complete storage systems. Because specific components must be designed into our systems well in advance of initial deliveries of those systems, we are particularly reliant on our processor vendors to deliver on the capabilities and pricing expected at the time we design key elements of the system. We are subject to substantial risks because of our reliance on these and other limited or sole source suppliers, including the following risks:

- if a supplier does not provide components or systems that meet our specifications in sufficient quantities and with acceptable quality on time or deliver when required, then production, delivery, acceptance and revenue from our systems could be delayed and we could be subject to costly penalties even once delivered and accepted, which happened during 2011 and 2012 and adversely affected our efforts to complete the acceptance processes on the upgrades at Oak Ridge National Laboratory, which in turn significantly lowered our total revenue for fiscal year 2011 and, to a lesser extent for fiscal year 2012;
- if a supplier cannot provide a competitive key component (for example, due to inadequate performance or a prohibitive price) or eliminates key features from components, such as with the processors we design into our systems, our systems may be less competitive than systems using components with greater capabilities;
- if an interruption of supply of our components, services or capabilities occurs because a supplier changes its technology roadmap, decides to no longer provide those products or services, increases the price of those products or services significantly or imposes reduced delivery allocations on its customers, it could take us a considerable period of time to identify and qualify alternative suppliers, to redesign our products as necessary and to begin to manufacture the redesigned components or otherwise obtain those services or capabilities. In some cases, such as with key integrated circuits and memory parts or processors, we may not be able to redesign such components or find alternate sources that we could use in any realistic timeframe;
- if a supplier of a component is subject to a claim that the component infringes a third-party's intellectual property rights, as has happened with one of our suppliers, our ability to obtain necessary components could be adversely affected or our cost to obtain such components could increase significantly;
- if a supplier providing us with key research and development and design services or core technology components with respect to integrated circuit design, network communication capabilities or software is late, fails to provide us with effective functionality or loses key internal talent, our development programs may be delayed or prove to be impossible to complete;
- if a supplier provides us with hardware or software that contains bugs or other errors or is different from what we expected, as is occurring with a key component, our development projects and production systems may be adversely affected through reduced performance or capabilities, additional design testing and verification efforts, re-spins of integrated circuits and/or development of replacement components, and the production and sales of our systems could be delayed and systems installed at customer sites could require significant, expensive field component replacements or result in penalties;
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- some of our key component and service suppliers are small companies with limited financial and other resources, and consequently may be more likely to experience financial and operational difficulties than larger, well-established companies, which increases the risk that they will be unable to deliver products as needed; and
- if a key supplier is acquired or has a significant business change, such as the acquisition of our file system software provider by our competitor Sun Microsystems and the subsequent acquisition of Sun by Oracle, the production and sales of our systems and services may be delayed or adversely affected, or our development programs may be delayed or may be impossible to complete.

For example, our DARPA HPCS project was adversely affected by changes by a major microprocessor supplier in its high performance technology roadmap that affected our ability to complete that program successfully and resulted in a reduction in the amount of funding we could receive from DARPA by $60 million. Certain delays in the availability of

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acceptable components, including processors and memory parts, and increases in order lead times for certain components, adversely affected our revenue and operating results in prior periods, including in 2011 and 2012, and could adversely affect future results.

If we are unable to compete successfully in the highly competitive HPC market, our business will not be successful. The market for HPC systems is very competitive. An increase in competitive pressures in our market or our failure to compete effectively may result in pricing reductions, reduced gross margins and loss of market share and revenue. Many of our competitors are established companies well known in the HPC market, including IBM, NEC, Hewlett-Packard, Fujitsu, Hitachi, Silicon Graphics International, and Bull S.A. Most of these competitors have substantially greater research, engineering, manufacturing, marketing and financial resources than we do. We also compete with systems builders and resellers of systems that are constructed from commodity components using processors manufactured by Intel, AMD and others. These competitors include the companies named above and Dell, with IBM using both third-party processors and its own proprietary processors, as well as smaller companies that benefit from the low research and development costs needed to assemble systems from commercially available commodity products. Such companies, because they can offer high peak performance per dollar, can put pricing pressure on us in certain competitive procurements. In addition, to the extent that Intel, IBM and other processor suppliers develop processors with greater capabilities or at a lower cost than the processors we currently use, our Cray XC systems may be at a competitive disadvantage to systems utilizing such other processors until we can design in, integrate and secure competitive processors, if at all. Our growth initiatives in the Big Data analytics and storage and data management markets must also compete successfully with many established companies and new entrants, many of whom have significantly greater resources and brand recognition in these markets than we do.

Periodic announcements by our competitors of new HPC systems or plans for future systems and price adjustments may reduce customer demand for our products. Many of our potential customers already own or lease high performance computer systems. Some of our competitors may offer substantial discounts to potential customers. We have in the past and may again be required to provide substantial discounts to make strategic sales, which may reduce or eliminate any gross profit on such transactions, or to provide lease financing for our products, which could result in a deferral of our receipt of cash and revenue for these systems. These developments limit our revenue and resources and reduce our ability to be profitable.

The continuing commoditization of HPC hardware and software has resulted in pricing pressure and may adversely affect our operating results. The continuing commoditization of HPC hardware, particularly processors and interconnect systems, and the growing commoditization of software, including plentiful building blocks and more capable open source software, as well as the potential for integration of differentiated technology into already-commoditized components, has resulted in, and may result in pricing pressure that may cause us to reduce our pricing in order to remain competitive, which can negatively impact our gross margins and adversely affect our operating results.

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

- harm to our ability to compete in relevant markets or in customer perception of our products;
- unanticipated costs or adverse tax consequences;
- exposure to potential liabilities to third parties or Intel, or claims for indemnification by Intel, including with respect to third-party litigation matters;
- failure to successfully further develop our current products or disruption to our current or future product roadmaps and ongoing business;
- delays and difficulties in receiving key components for our products from suppliers, including Intel;

- loss of customers, vendors or alliances; and
- failure to create shareholder value with the additional cash resources.

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

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

Customers and other third parties may make statements speculating about or announcing an intention to complete purchases or acceptances of our products before such purchases or acceptances are substantially certain, and these proposed purchases or acceptances may not be completed when or as expected, if at all. From time to time, customers and other third parties may make statements speculating about or announcing a potential purchase of our products before we have obtained an order for such purchases or completed negotiations and signed a contract for the purchase of such products. In some instances, government and government-funded customers may announce possible purchases even before they have obtained the necessary budget to procure the products. As a result, these statements or announcements do not mean that we will ultimately be able to secure the sale when or as expected or at all as it is not certain that the contract or order negotiations will be completed successfully or as expected or that the customer will be able to obtain the budget they hope for or expect. In addition, from time to time, customers and other third parties may make statements speculating about or announcing the completion of an acceptance process of a delivery system before such acceptance is completed or certain. As a result, these statements or announcements do not mean that we will ultimately be able to obtain the acceptance when or as expected.

We are subject to increasing government regulations and other requirements due to the nature of our business, which may adversely affect our business operations. In 2010, 2011, 2012 and the first six months of 2013, approximately 62%, 54%, 68% and 59%, respectively, of our revenue was derived from the U.S. government or customers primarily serving the U.S. government. In addition to normal business risks, our contracts with the U.S. government are subject to unique risks, some of which are beyond our control. Our contracts with the U.S. government are subject to particular risks, including:

The funding of U.S. government programs is subject to congressional appropriations. Many of the U.S. government programs in which we participate may extend for several years; however, these programs are normally funded annually. Changes in U.S. strategy and priorities may affect our future procurement opportunities and existing programs. Long-term government contracts and related orders are subject to cancellation, or delay, if appropriations for subsequent performance periods are not made. The termination of funding for existing or new U.S. government programs could result in a material adverse effect on our results of operations and financial condition.

The U.S. government may modify, curtail or terminate its contracts with us. The U.S. government may modify, curtail or terminate its contracts and subcontracts with us, without prior notice at its convenience upon payment for work done and commitments made at the time of termination. Modification, curtailment or termination of our major programs or contracts could have a material adverse effect on our results of operations and financial condition.

Our U.S. government contract costs are subject to audits by U.S. government agencies. U.S. government representatives may audit the costs we incur on our U.S. government contracts, including allocated indirect costs. Such audits could result in adjustments to our contract costs. Any costs found to be improperly allocated to a specific contract will not be reimbursed, and such costs already reimbursed must be refunded. If any audit uncovers improper or illegal activities or non-compliance with the terms of a specific contract, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government.

Our business is subject to potential U.S. government inquiries and investigations. We may be subject to U.S. government inquiries and investigations of our business practices due to our participation in government contracts.

Any such inquiry or investigation could potentially result in a material adverse effect on our results of operations and financial condition.

Our U.S. government business is also subject to specific procurement regulations and other requirements. These requirements, although customary in U.S. government contracts, increase our performance and compliance costs. These costs might increase in the future, reducing our margins, which could have a negative effect on our financial condition. Failure to comply with these regulations and requirements could lead to suspension or debarment, for cause, from U.S. government contracting or subcontracting for a period of time and could have a negative effect on our reputation and ability to secure future U.S. government contracts.

U.S. export controls could hinder our ability to make sales to foreign customers and our future prospects. The U.S. government regulates the export of HPC systems such as our products. Occasionally we have experienced delays for up to several months in receiving appropriate approvals necessary for certain sales, which have delayed the shipment of our products. Delay or denial in the granting of any required licenses could make it more difficult to make sales to certain foreign customers, eliminating an important source of potential revenue. Our ability to have certain components manufactured in certain foreign countries for a lower cost has also been adversely affected by export restrictions covering information necessary to allow such foreign manufacturers to manufacture components for us.

Our stock price is volatile. The trading price of our common stock is subject to significant fluctuations in response to many factors, including our quarterly operating results, changes in analysts' estimates or our outlook, our capital raising activities, announcements of technological innovations and customer contracts by us or our competitors, a significant aggressive seller or buyer, general economic conditions and conditions in our industry.

We may infringe or be subject to claims that we infringe the intellectual property rights of others. Third parties in the past have asserted, and may in the future assert intellectual property infringement claims against us. As a result of such intellectual property infringement claims, we could be required or otherwise decide that it is appropriate to:

- pay third-party infringement claims;
- discontinue manufacturing, using, or selling particular products subject to infringement claims;
- discontinue using the technology or processes subject to infringement claims;
- develop other technology not subject to infringement claims, which could be time-consuming and costly or may not be possible; or
- license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms.

Regardless of the merits, any intellectual property infringement claim would require management attention and could be expensive to defend.

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

We also incorporate proprietary incidental software from third parties, such as for file systems, job scheduling and storage subsystems. We have experienced some functional issues in the past with implementing such software with our supercomputer systems. In addition, we may not be able to secure needed software systems on acceptable terms, which may make our systems less attractive to potential customers. These issues may result in lost revenue, additional expense by us and/or loss of customer confidence.

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

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requirements, a loss of market confidence in our publicly available information, delisting from the NASDAQ Global Market, an inability to complete a financing, loss of other financing sources such as our line of credit, and litigation based on the events themselves or their consequences.

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

We maintain confidential and proprietary information on our computer networks and employ security measures designed to protect this information from unauthorized access. If our security measures are breached, we could lose proprietary data and may suffer economic losses. We maintain confidential information on our computer networks, including information and data that are proprietary to our customers and third parties, as well as to us. Although we have designed and employed and continue to enhance a multitude of security measures to protect this information from unauthorized access, security breaches may occur as a result of third-party action, including computer hackers, employee error, malfeasance or otherwise, that could result in someone obtaining unauthorized access to our customers' data or our data, including our intellectual property and other confidential business information. Because the techniques employed by hackers to obtain unauthorized access or to sabotage systems change frequently, we may be unable to anticipate these techniques or to implement adequate preventative measures. Any security breach could result in disclosure of our trade secrets or disclosure of confidential customer, supplier or employee data. If this should happen, we could be exposed to potentially significant legal liability, remediation expense, harm to our reputation and other harm to our business.

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

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

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

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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
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema Document*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document*
*	Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

	CRAY INC.
Date: July 31, 2013	/S/ PETER J. UNGARO Peter J. Ungaro President and Chief Executive Officer
Date: July 31, 2013	/S/ BRIAN C. HENRY Brian C. Henry Executive Vice President and Chief Financial Officer
Date: July 31, 2013	/S/ CHARLES D. FAIRCHILD Charles D. Fairchild Vice President, Corporate Controller and Chief Accounting Officer