

CRAY INC  
Form 10-K/A  
June 20, 2007

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

**FORM 10-K/A  
Amendment No. 1**

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

**o For the Fiscal Year Ended December 31, 2006  
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number: 0-26820**

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

**Washington  
(State or Other Jurisdiction of  
Incorporation or Organization)**

**93-0962605  
(I.R.S. Employer  
Identification No.)**

**411 First Avenue South, Suite 600  
Seattle, Washington  
(Address of Principal Executive Office)**

**98104-2860  
(Zip Code)**

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

**Securities Registered Pursuant to Section 12(b) of the Exchange Act: NONE**

**Securities Registered Pursuant to Section 12(g) of the Exchange Act:  
Common Stock, \$.01 par value**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act: Yes  No

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Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act: Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

The aggregate market value of the Common Stock held by non-affiliates of the Registrant as of June 30, 2006, was approximately \$224,200,000, based upon the closing price of \$9.95 per share reported for such date on the Nasdaq Global Market System.

As of March 2, 2007, there were 32,397,023 shares of Common Stock issued and outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement to be delivered to shareholders in connection with the Registrant's Annual Meeting of Shareholders to be held on May 16, 2007, are incorporated by reference into Part III.

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**EXPLANATORY NOTE**

We are filing this Amendment No. 1 to our Annual Report on Form 10-K for the year ended December 31, 2006 (the 2006 10-K ), filed on March 9, 2007, solely to amend the Deloitte & Touche LLP Report of Independent Registered Public Accounting Firm that appeared on page F-30 of our 2006 10-K.

The report of Deloitte & Touche LLP in our 2006 10-K referred to the accompanying consolidated balance sheet of us and our subsidiaries as of December 31, 2004 and our financial position at that date; under applicable SEC rules, our 2006 10-K did not contain our consolidated balance sheet as of December 31, 2004. The Deloitte & Touche LLP report contained in this Amendment No. 1 to our 2006 10-K does not refer to our consolidated balance sheet as of December 31, 2004, or our financial position at that date.

Although the sole change effected by this Amendment No. 1 is to amend the Deloitte & Touche LLP report as described above, we have included in this Amendment No. 1 all of Item 8, a revised consent of Deloitte & Touche LLP and updated officer certifications, as required by Rule 12b-15 under the Securities Exchange Act of 1934.

By this Amendment No. 1 we have not amended, except as described above, or updated any information contained in our 2006 10-K as originally filed, and this Amendment No. 1 to our 2006 10-K should be read in conjunction with our filings made with the SEC subsequent to the filing of our 2006 10-K.

**Item 8. *Financial Statements and Supplementary Data***

**INDEX TO FINANCIAL STATEMENTS\***

<u>Consolidated Balance Sheets at December 31, 2005 and December 31, 2006</u>	F- 1
<u>Consolidated Statements of Operations for the years ended December 31, 2004, 2005 and 2006</u>	F- 2
<u>Consolidated Statements of Shareholders' Equity and Comprehensive Income (Loss) for the years ended December 31, 2004, 2005 and 2006</u>	F- 3
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006</u>	F- 4
<u>Notes to Consolidated Financial Statements</u>	F- 5
<u>Reports of Independent Registered Public Accounting Firms</u>	F-29

\* The Financial Statements are located following page 7.

**QUARTERLY FINANCIAL DATA**  
**(Unaudited, in thousands, except per share data)**

The following table presents unaudited quarterly financial information for the two years ended December 31, 2006. In the opinion of management, this information contains all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation thereof. Certain 2005 quarterly reclassifications have been made to conform to the 2006 presentation. The operating results are not necessarily indicative of results for any future periods. Quarter-to-quarter comparisons should not be relied upon as indicators of future performance.

The following data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K and consolidated financial statements and related notes thereto.

For the Quarter Ended	2005				2006			
	3/31	6/30	9/30	12/31	3/31	6/30	9/30	12/31
Revenue	\$ 37,634	\$ 53,419	\$ 44,741	\$ 65,257	\$ 48,515	\$ 38,513	\$ 32,565	\$ 101,424
Cost of revenue	33,927	48,741	36,551	49,331	34,370	26,000	21,169	75,655
Gross margin	3,707	4,678	8,190	15,926	14,145	12,513	11,396	25,769
Research and development, net	13,032	13,427	6,472	8,780	7,215	6,371	9,692	5,764
Sales and marketing	6,599	7,574	5,778	5,857	4,985	5,682	4,924	6,386
General and administrative	4,267	4,607	3,617	3,654	5,594	4,600	4,134	4,457
Restructuring, severance and impairment	(215)	1,947	1,201	6,817	738	549	3	(39)
Net income (loss)	(21,035)	(23,796)	(10,250)	(9,227)	(5,305)	(7,173)	(8,324)	8,732
Net income (loss) per common share, basic	\$ (0.95)	\$ (1.08)	\$ (0.46)	\$ (0.42)	\$ (0.24)	\$ (0.32)	\$ (0.37)	\$ 0.36
Net income (loss) per common share, diluted	\$ (0.95)	\$ (1.08)	\$ (0.46)	\$ (0.42)	\$ (0.24)	\$ (0.32)	\$ (0.37)	\$ 0.33

Since the second half of 2004, we have reviewed our workforce requirements in light of our operating results and engaged in workforce reductions, particularly in second and fourth quarters of 2005. The 2005 fourth quarter also reflects a \$4.9 million charge related to impairment of a core technology intangible asset.

Diluted net income per common share for the fourth quarter of 2006 includes approximately 5 million equivalent shares for outstanding employee stock options, warrants, unvested restricted stock grants and shares issuable if the Notes were converted. These items are antidilutive in any period with an overall net loss. Additionally, the Notes fourth quarter 2006 interest expense and issuance fee amortization of \$770,000 has been added back to net income to determine diluted net income per common share under the if-converted method.

Our operating results are subject to quarterly fluctuations as a result of a number of factors. See Item 1A. Risk Factors above.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Amendment No. 1 to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Seattle, State of Washington, on June 19, 2007.

CRAY INC.

By /s/ Peter J. Ungaro  
Peter J. Ungaro  
*Chief Executive Officer and President*

Pursuant to the requirements of the Securities Exchange Act of 1934, this Amendment No. 1 has been signed below by the following persons on behalf of the Company and in the capacities indicated on June 19, 2007.

<b>Signature</b>	<b>Title</b>
By /s/ Peter J. Ungaro Peter J. Ungaro	Chief Executive Officer, President and Director
By /s/ Brian C. Henry Brian C. Henry	Principal Financial Officer
By /s/ Kenneth D. Roselli Kenneth D. Roselli	Principal Accounting Officer
By /s/ William C. Blake* William C. Blake	Director
By /s/ John B. Jones, Jr.* John B. Jones, Jr.	Director
By /s/ Stephen C. Kiely* Stephen C. Kiely*	Director

Stephen C. Kiely

By  
/s/ Frank L. Lederman\*

Director

Frank L. Lederman



<b>Signature</b>	<b>Title</b>
By /s/ Sally G. Narodick*	Director
Sally G. Narodick	
By /s/ Daniel C. Regis*	Director
Daniel C. Regis	
By /s/ Stephen C. Richards*	Director
Stephen C. Richards	
* By /s/ Kenneth W. Johnson	
Kenneth W. Johnson Attorney-in-fact	

**EXHIBIT INDEX**

**Exhibit  
Number**

**Description**

7

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**CRAY INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

	<b>December 31, 2005</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 46,026	\$ 115,328
Restricted cash		25,000
Accounts receivable, net	55,064	44,790
Inventory	67,712	58,798
Prepaid expenses and other current assets	2,909	2,156
Total current assets	171,711	246,072
Property and equipment, net	31,292	21,564
Service inventory, net	3,285	4,292
Goodwill	56,839	57,138
Deferred tax asset	575	722
Intangible assets, net	1,113	1,404
Other non-current assets	8,190	6,311
<b>TOTAL ASSETS</b>	<b>\$ 273,005</b>	<b>\$ 337,503</b>

**LIABILITIES AND SHAREHOLDERS EQUITY**

Current liabilities:		
Accounts payable	\$ 14,911	\$ 22,450
Accrued payroll and related expenses	12,145	17,411
Advance research and development payments	1,538	21,518
Other accrued liabilities	9,164	5,121
Deferred revenue	81,749	43,248
Total current liabilities	119,507	109,748
Long-term deferred revenue	5,234	2,475
Other non-current liabilities	2,317	3,906
Convertible notes payable	80,000	80,000
<b>TOTAL LIABILITIES</b>	<b>207,058</b>	<b>196,129</b>

Commitments and Contingencies (Note 12)

Shareholders equity:

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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, 22,743,377 and 32,236,888 shares, respectively	422,691	507,356
Exchangeable shares, no par value	Unlimited shares authorized; 19,710 and no shares outstanding, respectively	576	
Deferred compensation		(2,811)	
Accumulated other comprehensive income		6,258	6,855
Accumulated deficit		(360,767)	(372,837)
<b>TOTAL SHAREHOLDERS EQUITY</b>		<b>65,947</b>	<b>141,374</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>		<b>\$ 273,005</b>	<b>\$ 337,503</b>

*See accompanying notes*

F-1

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**CRAY INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except share data)

	<b>Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Revenue:			
Product	\$ 95,901	\$ 152,098	\$ 162,795
Service	49,948	48,953	58,222
Total revenue	145,849	201,051	221,017
Operating expenses:			
Cost of product revenue	104,196	139,518	124,728
Cost of service revenue	30,338	29,032	32,466
Research and development, net	53,266	41,711	29,042
Sales and marketing	34,948	25,808	21,977
General and administrative	19,451	16,145	18,785
Restructuring, severance and impairment	8,182	9,750	1,251
In-process research and development charge	43,400		
Total operating expenses	293,781	261,964	228,249
Loss from operations	(147,932)	(60,913)	(7,232)
Other expense, net	(699)	(1,421)	(2,141)
Interest income (expense), net	365	(3,462)	(2,095)
Loss before income taxes	(148,266)	(65,796)	(11,468)
Income tax expense (benefit)	59,092	(1,488)	602
Net loss	\$ (207,358)	\$ (64,308)	\$ (12,070)
Basic and diluted net loss per common share	\$ (9.95)	\$ (2.91)	\$ (0.53)
Basic and diluted weighted average shares outstanding	20,847	22,125	22,849

*See accompanying notes*

## CRAY INC. AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY  
AND COMPREHENSIVE INCOME (LOSS)**  
(In thousands)

	Common Stock and Additional Paid In Capital		Exchangeable Shares		Deferred	Accumulated Other Comprehensive Income	Accumulated	Total	Comprehen
	Number of Shares	Amount	Number of Shares	Amount	Compensation	(Loss)	Deficit		Income
									(Loss)
BLANCE, ember 31, 03	18,203	\$ 312,646		\$	\$ (105)	\$ (807)	\$ (89,101)	\$ 222,633	
Common stock ed in quisition of igaBay	1,846	56,756						56,756	\$
changeable res issued in quisition of igaBay			790	24,207				24,207	
ferred mpensation ted to quisition of igaBay	45	1,190	421	11,185	(14,599)			(2,224)	
changeable res converted o common res	1,067	31,219	(1,067)	(31,219)					
quisition-related ck-based mpensation ense						11,134		11,134	
r value of igaBay options quired		2,579						2,579	
ance of shares ler Employee ck Purchase n	101	1,796						1,796	
ercise of stock ions	219	2,841						2,841	
ance of shares ler Company	23	645						645	

(k) Plan match									
exercise of									
warrants, less									
advance costs of									
2011	320	3,634						3,634	
common stock									
issued for bonus	13	374						374	
compensation									
expense on									
restricted stock					105			105	
compensation									
expense on									
modification of									
stock options		196						196	
compensation									
expense on stock									
options issued to									
contractors		35						35	
under									
comprehensive									
income:									
realized loss on									
available-for-sale									
investments						(33)		(33)	(33)
currency									
translation									
investment					(755)	5,400		4,645	5,400
loss							(207,358)	(207,358)	(207,358)
BALANCE,									
December 31,									
2014	21,837	413,911	144	4,173	(4,220)	4,560	(296,459)	121,965	\$ (201,999)
exchangeable									
shares converted									
to common									
shares	124	3,597	(124)	(3,597)					\$
advance of shares									
under Employee									
Stock Purchase									
plan	200	1,211						1,211	
exercise of stock									
options	22	138						138	
advance of shares									
under Company									
(k) Plan match	52	770						770	
warrants issued in									
connection with									
financing		219						219	
restricted shares	491	2,881			(2,881)				
issued for									

Compensation									
Amortization of									
Deferred									
Compensation					4,106			4,106	
Reversal of									
Deferred									
Compensation for									
Stock options due									
to employee									
terminations		(116)			116				
Common shares									
issued in exchange									
of lease									
amendment	17	80						80	
Other									
Comprehensive									
income:									
Classification									
Adjustment for									
available-for-sale									
realized losses									
included in net									
income						24		24	24
Currency									
translation									
Adjustment					68	1,674		1,742	1,674
loss							(64,308)	(64,308)	(64,308)
<b>BALANCE,</b>									
<b>December 31,</b>									
<b>2015</b>	22,743	422,691	20	576	(2,811)	6,258	(360,767)	65,947	\$ (62,611)
Common stock									
outstanding, less									
treasury costs	8,625	81,250						81,250	\$
Non-convertible									
shares converted									
to common									
shares	20	576	(20)	(576)					
Issuance of shares									
under Employee									
Stock Purchase									
Plan	64	532						532	
Exercise of stock									
options	382	2,625						2,625	
Issuance of shares									
under Company									
(k) Plan match	48	394						394	
Restricted shares									
issued for									
compensation	355								



Classification of									
Deferred									
Compensation to									
Additional paid in									
Capital upon									
Exemption of									
Section 123R	(2,811)			2,811					
Amortization of									
Deferred									
Compensation	2,099							2,099	
Other									
Comprehensive									
Income:									
Currency									
Translation									
Adjustment						597		597	597
Loss							(12,070)	(12,070)	(12,070)
BALANCE,									
December 31,									
2006	32,237	\$ 507,356	\$	\$	\$ 6,855	\$ (372,837)	\$	141,374	\$ (11,470)

*See accompanying notes*

## CRAY INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	<b>Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Operating activities:			
Net loss	\$ (207,358)	\$ (64,308)	\$ (12,070)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	17,179	19,578	16,181
Share-based compensation expense	11,844	4,106	2,099
In-process research and development charge	43,400		
Inventory write-down	8,513	5,751	1,644
Impairment of core technology intangible asset		4,912	
Amortization of issuance costs, convertible notes payable and line of credit		1,008	1,644
Deferred income taxes	59,188	(2,260)	(124)
Other		80	
Cash provided by (used in) changes in operating assets and liabilities, net of the effects of the OctigaBay acquisition:			
Accounts receivable	15,471	(21,623)	10,305
Inventory	(47,443)	(10,628)	2,410
Prepaid expenses and other assets	11,555	3,908	337
Service inventory	(58)	141	
Accounts payable	9,609	(8,422)	7,562
Accrued payroll and related expenses, other accrued liabilities and advance research and development payments	1,061	833	23,720
Other non-current liabilities		473	36
Deferred revenue	24,383	29,746	(41,136)
Net cash provided by (used in) operating activities	(52,656)	(36,705)	12,608
Investing activities:			
Sales/maturities of short-term investments	68,635	44,437	
Purchases of short-term investments	(68,318)	(10,161)	
Acquisition of OctigaBay, net of cash acquired	(6,270)		
Proceeds from sale of investment			239
(Increase) decrease in restricted cash	(11,437)	11,437	(25,000)
Purchases of property and equipment	(12,518)	(3,982)	(2,611)
Net cash provided by (used in) investing activities	(29,908)	41,731	(27,372)
Financing activities:			
Sale of common stock, net of issuance costs			81,250
Proceeds from issuance of common stock through employee stock purchase plan	1,796	1,211	532
Proceeds from exercise of options	2,841	138	2,625
Proceeds from exercise of warrants	3,634		

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Proceeds from issuance of convertible notes payable	80,000		
Convertible notes payable and line of credit issuance costs	(3,376)	(755)	(375)
Principal payments on capital leases	(742)	(731)	(123)
Net cash provided by (used in) financing activities	84,153	(137)	83,909
Effect of foreign exchange rate changes on cash and cash equivalents	370	(595)	157
Net increase in cash and cash equivalents	1,959	4,294	69,302
Cash and cash equivalents			
Beginning of period	39,773	41,732	46,026
End of period	\$ 41,732	\$ 46,026	\$ 115,328
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 153	\$ 2,972	\$ 3,329
Cash paid for income taxes	590	312	279
Non-cash investing and financing activities:			
Inventory transfers to fixed assets and service inventory	\$ 11,281	\$ 8,703	\$ 4,860
Shares issued in acquisition	83,542		
Warrants issued in connection with line of credit arrangement		219	

*See accompanying notes*

F-4

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**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 DESCRIPTION OF BUSINESS**

Cray Inc. (Cray or the Company) designs, develops, manufactures, markets and services high performance computer systems, commonly known as supercomputers. These systems provide capability and capacity far beyond typical server-based computer systems and address challenging scientific and engineering computing problems.

In 2006, the Company incurred a net loss of \$12.1 million but generated \$12.6 million in cash from operating activities. Management's plans project that the Company's current cash resources and cash to be generated from operations in 2007 will be adequate to meet the Company's liquidity needs for at least the next twelve months. These plans assume sales, shipment, acceptance and subsequent collections from several large customers, as well as cash receipts on new bookings.

**NOTE 2 REVERSE STOCK SPLIT**

On June 6, 2006, the Company's shareholders approved an amendment to the Company's articles of incorporation to increase the number of authorized shares of common stock from 150 million to 300 million and also approved a one-for-four reverse stock split of the Company's authorized and outstanding common stock. These concurrent approvals resulted in 75 million authorized shares of the Company's common stock with a par value of \$0.01 per share. The reverse stock split was effective with respect to shareholders of record at the opening of trading on June 8, 2006, and the Company's common stock began trading as adjusted for the reverse stock split on that same day. As a result of the reverse stock split, each four shares of common stock were combined into one share of common stock and the total number of shares outstanding was reduced from approximately 92 million shares to approximately 23 million shares. The Company has retroactively adjusted all share and per share information to reflect the reverse stock split in the consolidated financial statements and notes thereto, as well as throughout the rest of this Form 10-K Report for all periods presented.

**NOTE 3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Accounting Principles*

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America.

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated.

*Reclassifications*

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

*Use of Estimates*

Preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates are based on management's best knowledge of current events and actions the Company may undertake in the future. Estimates are used in accounting for, among other items, fair value determination used in revenue recognition, percentage of completion accounting, estimates of proportional performance on co-funded engineering contracts, determination of inventory at the lower of cost or market, useful lives for depreciation and amortization, determination of future cash flows associated with impairment testing for goodwill and long-lived assets, determination of the fair value of stock options and

F-5

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## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

assessments of fair value, estimation of restructuring costs, calculation of deferred income tax assets, potential income tax assessments and other contingencies. The Company bases its estimates on historical experience, current conditions and on other assumptions that it believes to be reasonable under the circumstances. Actual results could differ from those estimates.

#### *Cash, Cash Equivalents and Restricted Cash*

Cash and cash equivalents consist of highly liquid financial instruments that are readily convertible to cash and have original maturities of three months or less at the time of acquisition. The Company maintains cash and cash equivalent balances with financial institutions that exceed federally insured limits. The Company has not experienced any losses related to these balances, and management believes its credit risk to be minimal. The Company has pledged cash, cash equivalents and other securities valued at \$25 million as required by its line of credit agreement, as described in *Note 14 Convertible Notes Payable and Lines of Credit*.

#### *Foreign Currency Derivatives*

From time to time the Company may utilize forward foreign currency exchange contracts to reduce the impact of foreign currency exchange rate risks. Forward contracts are cash flow hedges of the Company's foreign currency exposures and are recorded at the contract's fair value. The effective portion of the forward contract is initially reported in Accumulated other comprehensive income, a component of shareholders' equity, and when the hedged transaction is recorded, the amount is reclassified into results of operations in the same period. Any ineffectiveness is recorded to operations in the current period. The Company measures hedge effectiveness by comparing changes in fair values of the forward contract and expected cash flows based on changes in the spot prices of the underlying currencies. Cash flows from forward contracts accounted for as cash flow hedges are classified in the same category as the cash flows from the items being hedged.

#### *Concentration of Credit Risk*

The Company currently derives a significant portion of its revenue from sales of products and services to different agencies of the U.S. government or commercial customers primarily serving various agencies of the U.S. government. See *Note 17 Segment Information* for additional information. Given the type of customers, the Company does not believe its accounts receivable represent significant credit risk.

#### *Accounts Receivable*

Accounts receivable are stated at principal amounts and are primarily comprised of amounts contractually due from customers for products and services and amounts due from government reimbursed research and development contracts. The Company provides an allowance for doubtful accounts based on an evaluation of customer account balances past due ninety days from the date of invoicing. In determining whether to record an allowance for a specific customer, the Company considers a number of factors, including prior payment history and financial information for the customer. The Company had no pledges nor any restrictions on its accounts receivable balances at December 31, 2006.

#### *Fair Values of Financial Instruments*

The Company generally has the following financial instruments: cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and convertible notes payable. The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate their fair value based on the short-term nature of these financial instruments. The fair value of convertible notes payable is based on quoted market prices. The Company's convertible notes payable are traded in a market with low liquidity and are therefore subject to price volatility. As of December 31, 2006 and 2005, the fair value of these convertible notes payable was approximately \$77 million and \$44 million, respectively, compared to their carrying value of \$80 million.

**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Inventories*

Inventories are valued at cost (on a first-in, first-out basis) which is not in excess of estimated current market prices. The Company regularly evaluates the technological usefulness and anticipated future demand for various inventory components and the expected use of the inventory. When it is determined that these components do not function as intended, or quantities on hand are in excess of estimated requirements, the costs associated with these components are charged to expense. The Company had no pledges nor any restrictions on any inventory balances at December 31, 2006.

In connection with certain of its sales agreements, the Company may receive used equipment from a customer. This inventory generally will be recorded at no value based on the expectation that the Company will not be able to resell or otherwise use the equipment. In the event that the Company has a specific contractual plan for resale at the date the inventory is acquired, the inventory is recorded at its estimated fair value.

*Property and Equipment, net*

Property and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation is calculated on a straight-line basis over the estimated useful lives of the related assets, ranging from 18 months to seven years for furniture, fixtures and computer equipment, and eight to 25 years for buildings and land improvements. Equipment under capital lease is amortized over the lesser of the lease term or its estimated useful life. Leasehold improvements are amortized over the lesser of their estimated useful lives or the term of the lease. The cost of software obtained or inventory transferred for internal use is capitalized and depreciated over their estimated useful lives, generally four years. The Company had no pledges nor any restrictions on any of its net property and equipment balance at December 31, 2006.

In accordance with American Institute of Certified Public Accountants ( AICPA ) Statement of Position ( SOP ) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Company may capitalize certain costs associated with the implementation of software developed for internal use. Costs capitalized primarily consist of employee salaries and benefits allocated to the implementation project. The Company capitalized no such costs in 2006 or 2005.

*Service Inventory*

Service inventory is valued at the lower of cost or estimated market and represents inventory used to support service and maintenance agreements with customers. As inventory is utilized, replaced items are returned and are either repaired or scrapped. Costs incurred to repair inventory to a usable state are charged to expense as incurred. Service inventory is recorded at cost and is amortized over the estimated service life of the related product platform (generally four years). The Company had no pledges nor any restrictions on any service inventory balances at December 31, 2006.

*Goodwill and Other Intangible Assets*

In accordance with Statement of Financial Accounting Standards ( FAS ) No. 142, *Goodwill and Other Intangible Assets*, the Company tests goodwill for impairment on an annual basis as of January 1, or if indicators of potential



impairment exist, using a fair-value based approach. The Company currently has one operating segment and reporting unit. As such, the Company evaluates impairment based on certain external factors, such as its market capitalization. No impairment of goodwill has been identified during any of the periods presented.

The Company capitalizes certain external legal costs incurred for patent filings. The Company begins amortization of these costs as each patent is awarded. Patents are amortized over their estimated useful lives (generally five years). The Company performs periodic review of its capitalized patent costs to ensure that the patents have continuing value to the Company.

## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### *Impairment of Long-Lived Assets*

In accordance with FAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, management tests long-lived assets to be held and used for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. No impairment of intangible assets was recorded during 2006. As part of the 2004 OctigaBay Systems Corporation ( OctigaBay ) acquisition, the Company assigned \$6.7 million of value to core technology. In December 2005 the Company announced plans to further integrate its technology platforms, and combine the Cray XD1 and the Cray XT3 products into a unified product offering. The expected undiscounted cash flows from the product using the core technology were not sufficient to recover the carrying value of the asset. The Company performed a fair value assessment similar to the original valuation and determined the asset had no continuing value. The Company wrote off the unamortized balance of its core technology intangible asset of \$4.9 million which is included in Restructuring, Severance and Impairment in the accompanying 2005 Consolidated Statements of Operations. No impairment of intangible assets was recorded during 2006 or 2004.

#### *Revenue Recognition*

The Company recognizes revenue when it is realized or realizable and earned. In accordance with the Securities and Exchange Commission Staff Accounting Bulletin ( SAB ) No. 104, *Revenue Recognition in Financial Statements*, the Company considers revenue realized or realizable and earned when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable, no significant unfulfilled Company obligations exist, and collectibility is reasonably assured. The Company records revenue in its Statements of Operations net of 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 specific revenue recognition policies for each major category of revenue and for multiple-element arrangements.

*Products.* The Company recognizes revenue from its product lines as follows:

*Cray X1/X1E and Cray XT3/XT4 Product Lines:* The Company recognizes revenue from product sales upon customer acceptance of the system, when there are no significant unfulfilled Company obligations stipulated by the contract that affect the customer's final acceptance, the price is fixed or determinable and collection is reasonably assured. A customer-signed notice of acceptance or similar document is required from the customer prior to revenue recognition.

*Cray XD1 Product Line:* The Company recognizes revenue from product sales of Cray XD1 systems upon shipment to, or delivery to, the customer, depending upon contract terms, when there are no significant unfulfilled Company obligations stipulated by the contract, the price is fixed or determinable and collection is reasonably assured. If there is a contractual requirement for customer acceptance, revenue is recognized upon receipt of the notice of acceptance and when there are no unfulfilled obligations.

Revenue from contracts that require the Company to design, develop, manufacture or modify complex information technology systems to a customer's specifications is recognized using the percentage of completion method for long-term development projects under AICPA SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Percentage of completion is measured based on the ratio of costs incurred to date

compared to the total estimated costs. Total estimated costs are based on several factors, including estimated labor hours to complete certain tasks and the estimated cost of purchased components or services. Estimates may need to be adjusted from quarter to quarter, which would impact revenue and margins on a cumulative basis. To the extent the estimate of total costs to complete the contract indicates a loss, such amount is recognized in full in the period that the determination is made.

In 2004, the Company concluded that its Red Storm contract would result in an estimated loss of \$7.6 million. This amount was charged to cost of product revenue. During 2005, the Company increased the estimate of the loss

F-8

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## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

on the contract by \$7.7 million (cumulative loss of \$15.3 million) due to additional hardware to be delivered to satisfy contractual and performance issues. This amount was also charged to cost of product revenue. As of December 31, 2006 and 2005, the balance in the Red Storm loss contract accrual was \$157,000 and \$5.7 million, respectively, and is included in Other Accrued Liabilities on the accompanying Consolidated Balance Sheets.

*Services.* Maintenance services are provided under separate maintenance contracts with the Company's 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 installation and acceptance of the product, which may include a warranty period. The Company allocates a portion of the sales price to maintenance service revenue based on estimates of fair value. Revenue for the maintenance of computers is recognized ratably over the term of the maintenance contract. Maintenance contracts that are paid in advance are recorded as deferred revenue. The Company considers fiscal funding clauses as contingencies for the recognition of revenue until the funding is virtually assured. Revenue from Cray Technical Services is recognized as the services are rendered.

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

The element could be sold separately;

The fair value of the undelivered element is established; and

In cases with any general right of return, the Company's performance with respect to any undelivered element is within the Company's control and probable.

If all of the criteria are not met, revenue is deferred until delivery of the last element as the elements would not be considered a separate unit of accounting and revenue would be recognized as described above under the Company's product line or service revenue recognition policies. The Company considers the maintenance period to commence upon installation and acceptance of the product, which may include a warranty period and accordingly allocates a portion of the sales price as a separate deliverable which is recognized as service revenue over the entire service period.

#### *Foreign Currency Translation*

The functional currency of the Company's foreign subsidiaries is the local currency. Assets and liabilities of foreign subsidiaries are translated into U.S. dollars at year-end exchange rates, and revenue and expenses are translated at average rates prevailing during the year. Translation adjustments are included in accumulated other comprehensive income (loss), a separate component of shareholders' equity. Transaction gains and losses arising from transactions denominated in a currency other than the functional currency of the entity involved are included in the Consolidated Statements of Operations. Aggregate transaction losses included in net loss in 2006, 2005 and 2004 were \$1.8 million, \$1.4 million, and \$361,000, respectively.

*Research and Development*

Research and development costs include costs incurred in the development and production of the Company's high performance computing systems, costs incurred to enhance and support existing software features and expenses related to future product development. Research and development costs are expensed as incurred, and may be offset by co-funding from the U.S. government.

Amounts to be received under co-funding arrangements with the U.S. government are based on either contractual milestones or costs incurred. These co-funding milestone payments are recognized as an offset to

F-9

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## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

research and development expenses as performance is estimated to be completed and is measured as milestone achievements or as costs are incurred. As of December 31, 2006 and 2005, the Company had advance payment liabilities (milestones billed in advance of amounts recognized) under co-funded research and development arrangements of \$21.5 million and \$1.5 million, respectively.

The Company does 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 as such, there may be periods in which research and development costs are expensed as incurred for which no reimbursement is recorded, as milestones have not been completed or the U.S. government has not funded an agreement.

The Company classifies 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.

#### *Income Taxes*

The Company accounts for income taxes under FAS No. 109, *Accounting for Income Taxes* ( *FAS 109* ). Deferred tax assets and liabilities are determined based on temporary differences between financial reporting and tax bases of assets and liabilities, operating loss and tax credit carryforwards, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to be recovered or settled. Realization of certain deferred tax assets is dependent upon generating sufficient taxable income in the appropriate jurisdiction. The Company records a valuation allowance to reduce deferred tax assets to amounts that are more likely than not to be realized. The initial recording and any subsequent changes to valuation allowances are based on a number of factors (positive and negative evidence), as required by FAS 109. The Company considers its actual historical results to have stronger weight than other more subjective indicators when considering whether to establish or reduce a valuation allowance.

#### *Stock-Based Compensation*

On January 1, 2006, the Company adopted the fair value recognition provisions of FAS No. 123(R), *Share-Based Payment*, ( *FAS 123R* ). Prior to January 1, 2006, the Company accounted for stock-based payments under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( *APB 25* ), and related Interpretations, as permitted by FAS No. 123, *Accounting for Stock-Based Compensation* ( *FAS 123* ). In accordance with APB 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company adopted FAS 123R using the modified-prospective transition method. Under that transition method, compensation cost recognized for the year ended December 31, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of FAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. The financial results for the prior periods have not been restated. The Company typically issues stock options with a four-year vesting period (defined by FAS 123R as the requisite service period), and no

performance or service conditions, other than continued employment. The Company amortizes stock compensation cost ratably over the requisite service period.

F-10

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**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The fair value of unvested stock grants is based on the price of a share of the Company's common stock on the date of grant. In determining the fair value of stock options, the Company uses the Black-Scholes option pricing model that employs the following key weighted average assumptions:

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Risk-free interest rate	4.2%	4.1%	4.5%
Expected dividend yield	0%	0%	0%
Volatility	82%	85%	73%
Expected life	6.9 years	4.6 years	4.0 years
Weighted average Black-Scholes value of options granted	\$15.00	\$5.44	\$6.00

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. For the year ended December 31, 2006, the expected term of an option was based on the assumption that options will be exercised, on average, about two years after vesting occurs, which approximates historical exercise practices; for most options, 25% vest after one year with the balance vesting monthly over the subsequent three years. FAS 123R also requires that the Company recognize 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 applied for the year ended December 31, 2006 is 10%. 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, all of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

The Company also has an employee stock purchase plan ( ESPP ) which allows employees to purchase shares of the Company's common stock at 95% of the closing market price 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 provisions of FAS 123R.

For 2006, the Company recognized \$123,000 of additional non-cash, share-based compensation expense due to the adoption of FAS 123R, which increased the loss from operations and net loss by such amount. This expense increased the Company's net loss per share for the year ended December 31, 2006, by \$.01, from \$(0.52) to \$(0.53).

If compensation cost for the Company's stock option plans and its ESPP had been determined based on the fair value at the grant dates for awards under those plans in accordance with a fair value based method of FAS 123, the Company's net loss and net loss per common share for the years ended December 31, 2005 and 2004 would have been the pro forma amounts indicated below (in thousands). For purposes of this pro forma disclosure, the value of the options is amortized ratably to expense over the options' vesting periods. Because the estimated value is determined as of the date of grant, the actual value ultimately realized by the employee may be significantly different.





## CRAY INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	2004	2005
Net loss, as reported	\$ (207,358)	\$ (64,308)
Add:		
Stock-based employee compensation included in reported net loss, net of related tax effects	11,844	4,106
Less:		
Amortized stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(19,423)	(30,524)
Pro forma net loss	\$ (214,937)	\$ (90,726)

Amortization of pro forma stock-based employee compensation expense increased significantly in 2005 due to the actions taken to accelerate vesting, as described in *Note 15 Shareholders Equity Stock Option Plans*.

Pro forma basic and diluted net loss per common share for the years ended December 31, 2005 and 2004 are as follows:

	2004	2005
Basic and diluted net loss per common share:		
As reported	\$ (9.95)	\$ (2.91)
Pro forma	\$ (10.31)	\$ (4.10)

*Shipping and Handling Costs*

Costs related to shipping and handling are included in *Cost of Product Revenue* and *Cost of Service Revenue* on the accompanying Consolidated Statements of Operations.

*Advertising Costs*

Marketing and sales expenses in the accompanying Consolidated Statements of Operations include advertising expenses of \$871,000, \$697,000, and \$683,000 in 2006, 2005 and 2004, respectively. The Company incurs advertising costs for representation at certain trade shows, promotional events, sales lead generation, as well as design and printing costs for promotional materials. The Company expenses all advertising costs as incurred.

*Earnings (Loss) Per Share ( EPS )*

Basic EPS is computed by dividing net income available to common shareholders by the weighted average number of common shares, including exchangeable shares but excluding unvested restricted stock, outstanding during the period. Diluted EPS is computed by dividing net income available to common shareholders by the weighted average number of common and potential common shares outstanding during the period, which includes the additional dilution related

to conversion of stock options, unvested restricted stock and common stock purchase warrants as computed under the treasury stock method and the common shares issuable upon conversion of the outstanding convertible notes. For the years ended December 31, 2006, 2005 and 2004, outstanding stock options, unvested restricted stock, warrants, and shares issuable upon conversion of the convertible notes are antidilutive because of net losses, and as such, their effect has not been included in the calculation of diluted net loss per share. Potentially dilutive securities of 11.7 million, 12.1 million and 9.1 million, respectively, have been excluded from the denominator in the computation of diluted EPS for the years ended December 31, 2006, 2005 and 2004, respectively, because they are antidilutive.

F-12

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**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Accumulated Other Comprehensive Income*

Accumulated other comprehensive income, a component of shareholders' equity, consisted of the following at December 31 (in thousands):

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Accumulated unrealized loss on available-for-sale investments	\$ (24)	\$	\$
Accumulated currency translation adjustment	4,584	6,258	6,855
Accumulated other comprehensive income	\$ 4,560	\$ 6,258	\$ 6,855

*Recent Accounting Pronouncements*

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not expect the adoption of FIN 48 to be significant except to provide additional disclosures about tax uncertainties.

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements* ( FAS 157 ). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements but does not require any new fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of FAS 157 to have a significant impact on its financial statements.

In September 2006, the FASB issued FAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, ( FAS 158 ). FAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Company adopted FAS 158 as of December 31, 2006, and this adoption did not have a material impact on its financial position.

In February 2007, the FASB issued FAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, ( FAS 159 ). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. FAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company has not yet determined the impact of adopting FAS 159 on the Company's financial statements.



**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 4 ACCOUNTS RECEIVABLE, NET**

Net accounts receivable consisted of the following at December 31 (in thousands):

	<b>2005</b>	<b>2006</b>
Trade accounts receivable	\$ 23,023	\$ 39,766
Unbilled receivables	12,340	4,045
Advance billings	19,894	1,078
	55,257	44,889
Allowance for doubtful accounts	(193)	(99)
Accounts receivable, net	\$ 55,064	\$ 44,790

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 no revenue has yet been recognized.

As of December 31, 2006 and 2005, accounts receivable included \$34.7 million and \$41.6 million, respectively, due from U.S. government agencies and customers primarily serving the U.S. government. Of this amount, \$4.0 million and \$12.0 million, respectively, were unbilled, based upon contractual billing arrangements with these customers.

**NOTE 5 INVENTORY**

A summary of inventory is as follows (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Components and subassemblies	\$ 10,706	\$ 22,536
Work in process	8,314	15,310
Finished goods	48,692	20,952
	\$ 67,712	\$ 58,798

As of December 31, 2006 and 2005, \$17.7 million and \$48.7 million, respectively, of finished goods inventory was located at customer sites pending acceptance. At December 31, 2006 and 2005, \$16.4 million and \$33.2 million, respectively, was related to a single customer in each year. Revenue for 2006, 2005, and 2004 includes \$256,000,

\$2.1 million, and \$498,000, respectively, from the sale of refurbished inventory recorded at a zero cost basis. In 2005, the amount consisted mainly of the sale of a refurbished Cray T3E supercomputer, one of the Company's legacy systems.

During 2006, the Company wrote off \$1.6 million of inventory, primarily related to inventory on the Cray XT3 product line. During 2005, the Company wrote off \$5.8 million of inventory, primarily related to the Cray X1E and Cray XD1 product lines. During 2004, the Company wrote off \$8.5 million of inventory, primarily related to the Cray X1 product line.

**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 6 PROPERTY AND EQUIPMENT, NET**

A summary of property and equipment is as follows (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Land	\$ 131	\$ 131
Buildings	9,638	9,965
Furniture and equipment	14,161	14,753
Computer equipment	70,704	73,825
Leasehold improvements	3,046	3,060
	97,680	101,734
Accumulated depreciation and amortization	(66,388)	(80,170)
Property and equipment, net	\$ 31,292	\$ 21,564

Depreciation expense for 2006, 2005 and 2004 was \$16.1 million, \$17.9 million and \$15.7 million, respectively.

**NOTE 7 SERVICE INVENTORY, NET**

A summary of service inventory is as follows (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Service inventory	\$ 26,201	\$ 28,797
Accumulated depreciation	(22,916)	(24,505)
Service inventory, net	\$ 3,285	\$ 4,292

**NOTE 8 GOODWILL AND INTANGIBLE ASSETS**

The following table provides information about activity in goodwill for the years ended December 31, 2006 and 2005, respectively (in thousands):

2005	2006
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Goodwill, at January 1	\$ 55,644	\$ 56,839
Foreign currency translation adjustments and other	1,195	299
Goodwill, at December 31	\$ 56,839	\$ 57,138

In April 2004, the Company completed the acquisition of OctigaBay, a privately-held development stage company located in Burnaby, British Columbia, for \$99.5 million and accounted for the transaction under the purchase method of accounting. Goodwill of approximately \$39 million was recorded. Additionally, in-process research and development of \$43.4 million was expensed in 2004.

Intangible assets as of December 31, 2006 and 2005 consisted of net capitalized patent costs of \$1.4 million and \$1.1 million, respectively.

Amortization expense for 2006, 2005 and 2004 was \$101,000, \$1.6 million, and \$1.5 million, respectively. Amortization decreased significantly for the year ended December 31, 2006 as a result of the Company's write off of its core technology intangible asset in December 2005.

**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 9 DEFERRED REVENUE**

Deferred revenue consisted of the following (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
Deferred product revenue	\$ 58,593	\$ 26,993
Deferred service revenue	28,390	18,730
Total deferred revenue	86,983	45,723
Less long-term deferred revenue	(5,234)	(2,475)
Deferred revenue in current liabilities	\$ 81,749	\$ 43,248

At December 31, 2006 and 2005, deferred revenue included \$19.0 million and \$43.5 million, respectively, related to a single customer in each year.

**NOTE 10 RESTRUCTURING AND SEVERANCE CHARGES**

During 2006, the Company recognized net restructuring charges of \$1.3 million, which is included in Restructuring, Severance and Impairment on the accompanying Consolidated Statements of Operations, all of which originated from actions arising during 2005. There were no new actions taken during 2006.

During 2005, the Company recognized restructuring charges of \$4.8 million, which is included in Restructuring, Severance and Impairment on the accompanying Consolidated Statements of Operations, net of adjustments for previously accrued amounts. These restructuring charges were the result of two actions taken during 2005, one of which was a worldwide reduction in work force which was announced on June 27, 2005, and affected employees in operations, sales and marketing. The other action was a plan announced on December 12, 2005 to reduce nearly 65 full-time staff, principally based in the Company's Burnaby, British Columbia, Canada facility, based upon Company plans to increase research and development efficiencies, lower costs and integrate technology platforms, and mainly affected employees in research and development.

During 2004, the Company recognized restructuring costs of \$8.2 million in Restructuring, Severance and Impairment on the accompanying Consolidated Statements of Operations, including a \$196,000 compensation charge related to the modification of stock options for certain individuals affected by the restructuring. The \$196,000 charge was recorded directly to common stock. Substantially all of the restructuring costs represent severance expenses for 131 terminated employees.

Activity related to the Company's restructuring liability, included in Accrued Payroll and Related Expenses on the accompanying Consolidated Balance Sheets, during the years ended December 31 is as follows (in thousands):

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Balance, January 1	\$ 3,069	\$ 4,690	\$ 3,582
Additional restructuring charge	8,077	5,092	1,284
Payments	(6,420)	(5,724)	(3,849)
Adjustments to previously accrued amounts	(91)	(255)	(33)
Foreign currency translation adjustment	55	(221)	79
Total restructuring and severance liability, December 31	4,690	3,582	1,063
Less long-term restructuring and severance liability		(362)	
Current restructuring and severance liability	\$ 4,690	\$ 3,220	\$ 1,063

F-16

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**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****NOTE 11 FOREIGN CURRENCY DERIVATIVE**

In order to reduce the impact of foreign currency exchange rate risk related to a sales contract denominated in British pound sterling, the Company entered into a forward contract on February 6, 2006 with an original notional amount of £15 million to hedge anticipated cash receipts on the specific sales contract. During December 2006, the final cash receipts were received and the hedge contract was settled. The amount reclassified from Other Comprehensive Income (Loss) was a \$192,000 reduction to revenue. Prior to its designation as an effective hedge on June 30, 2006, the Company recorded losses of approximately \$1.3 million in 2006, which are included in Other expense in the accompanying Consolidated Statement of Operations.

In January and February 2007, the Company entered into additional forward contracts with notional amounts totaling £37.8 million to hedge anticipated cash receipts on another specific sales contract. These forward contracts were designated as hedges in February 2007. These hedge contracts are expected to be settled as cash receipts are received, with the final cash receipts expected in late 2009.

**NOTE 12 COMMITMENTS AND CONTINGENCIES**

The Company leases certain property and equipment under capital leases pursuant to master equipment lease agreements and has non-cancelable operating leases for facilities. Under the master equipment lease agreements, the Company had fixed asset balances of \$7.7 million and \$7.5 million as of December 31, 2006 and 2005, respectively, net of accumulated amortization of \$6.7 million and \$5.4 million, respectively.

The Company has recorded rent expense under leases for buildings or office space accounted for as operating leases in 2006, 2005 and 2004 of \$3.5 million, \$4.1 million and \$4.2 million, respectively.

As of December 31, 2006, the Company had no commitments past 2012, except for principal and interest due on its convertible notes payable described in Note 14 *Convertible Notes Payable and Lines of Credit*. Minimum contractual commitments as of December 31, 2006, were as follows (in thousands):

	<b>Capital Leases</b>	<b>Operating Leases</b>	<b>Development Agreements</b>
2007	\$ 32	\$ 3,215	\$ 12,922
2008		2,576	43
2009		793	
2010		205	
2011		205	
Thereafter		22	
Minimum contractual commitments	32	\$ 7,016	\$ 12,965
Less amount representing interest	(1)		

Recorded capital lease obligations \$ 31

In its normal course of operations, the Company engages in development arrangements under which it hires outside engineering resources to augment its existing internal staff in order to complete research and development projects, or parts thereof. For the years ended December 31, 2006, 2005 and 2004, the Company incurred \$23.9 million, \$20.3 million and \$16.8 million, respectively, for such arrangements.

In October 2005, the Company renegotiated one of its facility leases to consolidate its floor space in its headquarters in Seattle, Washington. The Company issued 17,500 shares of common stock to the landlord, Merrill Place, LLC, for release from certain of its operating lease obligations. The Company charged \$80,000, representing the fair value of the shares issued, to Restructuring, Severance and Impairment on the accompanying Consolidated Statements of Operations for this issuance and related release from future obligations

F-17

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**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Litigation*

As of December 31, 2006, the Company had no material pending litigation.

In 2005 the Company and certain of its current and former officers and directors were named as defendants in class actions filed in the U.S. District Court for the Western District of Washington alleging certain federal securities laws violations in connection with certain of the Company's public statements and filings. The Court consolidated the actions. On September 8, 2006, the Court entered judgment in favor of the defendants dismissing the consolidated action with prejudice.

In 2005 two derivative actions were filed, and later consolidated, in the same Court against certain of the Company's current and former officers and directors, asserting breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. On September 8, 2006, the Court entered judgment in favor of the defendants in the consolidated case, dismissing with prejudice claims based on alleged insider trading and dismissing without prejudice the remaining claims.

In December 2005, two derivative actions were filed in the Superior Court of the State of Washington for King County against certain of the Company's current and former officers and directors, and were later consolidated. The state court derivative plaintiff asserted allegations substantially similar to those asserted in the dismissed federal derivative action. On July 28, 2006, the Company and the defendants filed motions to dismiss the amended complaint. On November 1, 2006, the Superior Court approved plaintiff's dismissal of this litigation without prejudice.

*Other*

From time to time the Company is subject to various other legal proceedings that arise in the ordinary course of business or are not material to the Company's business. Additionally, the Company is subject to income taxes in the U.S. and several foreign jurisdictions and, in the ordinary course of business, there are transactions and calculations where the ultimate tax determination is uncertain. Although the Company cannot predict the outcomes of these matters with certainty, the Company's management does not believe that the disposition of these matters will have a material adverse effect on the Company's financial position, results of operations or cash flows.

**NOTE 13 INCOME TAXES**

Under FAS 109, *Accounting for Income Taxes*, income taxes are recognized for the amount of taxes payable for the current year and for the impact of deferred tax assets and liabilities, which represent consequences of events that have been recognized differently in the financial statements under GAAP than for tax purposes. As of December 31, 2006, the Company had federal net operating loss carryforwards of approximately \$290 million and gross federal research and experimentation tax credit carryforwards of approximately \$12.6 million. The net operating loss carryforwards, if not utilized, will expire from 2010 through 2026, and research and development tax credits will expire from 2007 through 2026, if not utilized.

Loss before provision for income taxes consists of the following (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
United States	\$ (92,654)	\$ (63,304)	\$ (10,550)
International	(55,612)	(2,492)	(918)
Total	\$ (148,266)	\$ (65,796)	\$ (11,468)

F-18

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**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The provision (benefit) for income taxes related to operations consists of the following (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Current provision:			
Federal	\$	\$	\$
State		128	109
Foreign	581	644	617
Total current provision	581	772	726
Deferred provision (benefit):			
Federal	61,906		
State	(3,466)		
Foreign	71	(2,260)	(124)
Total deferred provision (benefit)	58,511	(2,260)	(124)
Total provision (benefit) for income taxes	\$ 59,092	\$ (1,488)	\$ 602

The following table reconciles the federal statutory income tax rate to the Company's effective tax rate:

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Federal statutory income tax rate	(35.0)%	(35.0)%	(35.0)%
State taxes, net of federal effect	(2.4)	(3.1)	(3.6)
Foreign income taxes at other than U.S. rates	(0.3)	1.0	5.0
In-process research and development write-off	10.6		
Permanent differences	3.9	1.5	8.2
Foreign tax credit	(0.3)		
Research and development tax credit	(1.0)	(2.1)	(7.6)
Other	(0.1)	(0.4)	(4.5)
Effect of change in valuation allowance on deferred tax assets	64.5	35.8	42.7
Effective income tax rate	39.9%	(2.3)%	5.2%



**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Deferred income taxes reflect the net tax effects of temporary differences between the tax bases of assets and liabilities and the corresponding financial statement amounts, operating loss, and tax credit carryforwards. Significant components of the Company's deferred income tax assets and liabilities are as follows (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>Assets</b>		
<b>Current:</b>		
Inventory	\$ 2,840	\$ 2,610
Accrued compensation	1,876	4,292
Deferred service revenue	684	815
Gross current deferred tax assets	5,400	7,717
Valuation allowance	(5,377)	(7,717)
Net current deferred tax assets	23	0
<b>Long-Term:</b>		
Property and equipment	709	455
Research and experimentation	12,447	12,587
Net operating loss carryforwards	115,110	117,454
Accrued restructuring charge	764	240
Other	576	518
Gross long-term deferred tax assets	129,606	131,254
Valuation allowance	(129,031)	(130,532)
Net long-term deferred tax assets	575	722
Total net deferred tax assets	\$ 598	\$ 722

The net current deferred tax assets as of December 31, 2005 of \$23,000 are included in Prepaid Expenses and Other Current Assets on the accompanying Consolidated Balance Sheets.

A summary of the changes to the valuation allowance on deferred tax assets for the years ended December 31, 2006, 2005 and 2004 was increases of \$3.8 million, \$29.6 million and \$96.7 million, respectively. In September 2004, as a result of substantial losses during the year and based on revised projections indicating continued challenging operating results, the Company established a valuation allowance of \$58.9 million. During 2003, the Company had reduced its valuation allowance by \$58.0 million.

Undistributed earnings of the Company's foreign subsidiaries are considered to be permanently reinvested; accordingly, no provision for U.S. federal and state income taxes has been provided thereon. Upon repatriation of those earnings, in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable due to the complexities associated with this hypothetical calculation.

**NOTE 14 CONVERTIBLE NOTES PAYABLE AND LINES OF CREDIT**

In December 2004 the Company issued \$80 million aggregate principal amount of 3.0% Convertible Senior Subordinated Notes due 2024 ( Notes ) in a private placement pursuant to Rule 144A under the Securities Act of 1933, as amended. These unsecured Notes bear interest at an annual rate of 3.0%, payable semiannually on June 1 and December 1 of each year through the maturity date of December 1, 2024.

F-20

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## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Notes are convertible, under certain circumstances, into the Company's common stock at an initial conversion rate of 51.8001 shares of common stock per \$1,000 principal amount of Notes, which is equivalent to an initial conversion price of approximately \$19.31 per share of common stock (subject to adjustment in certain events). Upon conversion of the Notes, in lieu of delivering common stock, the Company may, at its discretion, deliver cash or a combination of cash and common stock.

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

Holder may convert the Notes during a conversion period beginning with the mid-point date in a fiscal quarter to, but not including, the mid-point date (or, if that day is not a trading day, then the next trading day) in the immediately following fiscal quarter, if on each of at least 20 trading days in the period of 30 consecutive trading days ending on the first trading day of the conversion period, the closing sale price of the Company's common stock exceeds 120% of the conversion price in effect on that 30th trading day of such period. The mid-point dates for the fiscal quarters are February 15, May 15, August 15 and November 15. Holders may also convert the Notes if the Company has called the Notes for redemption or, during prescribed periods, upon the occurrence of specified corporate transactions or a fundamental change, in each case as described in the indenture governing the Notes. As of December 31, 2006, 2005 and 2004, none of the conditions for conversion of the Notes were satisfied.

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

In connection with the issuance of the Notes, the Company incurred \$3.4 million of issuance costs, which primarily consisted of investment banker fees, legal and other professional fees. These costs are being amortized using the effective interest method to interest expense over the five-year period from December 2004 through November 2009. A total of \$683,000 and \$676,000, respectively, was amortized into interest expense during 2006 and 2005. The unamortized balance of these costs was \$2.0 million and \$2.7 million, respectively, as of December 31, 2006 and 2005, and is included in Other non-current assets on the accompanying Consolidated Balance Sheets.

#### *Lines of Credit*

On December 29, 2006, the Company entered into a Credit Agreement with Wells Fargo Bank, N.A., providing for a line of credit for up to \$25.0 million. The credit line replaces the Company's previous line of credit with Wells Fargo Foothill, Inc. entered into in May 2005. The Credit Agreement provides for a line of credit up to \$25.0 million until December 1, 2008. The Company is required to maintain a pledged collateral account containing cash, cash equivalents and other securities valued at not less than the maximum amount allowed under the line of credit, currently \$25.0 million. The Company receives all interest and other earnings on the collateral account until the

F-21

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## CRAY INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Bank otherwise notifies the account holder and the Company. In addition, the Company has covenants to maintain liquid assets with an aggregate fair market value of not less than \$25.0 million. The Company designated \$25.0 million of its cash as restricted at December 31, 2006. The Credit Agreement provides support for the Company's existing letters of credit, the balance of which was \$190,000 as of December 31, 2006. The available borrowing base under the Credit Agreement is reduced by the amount of outstanding letters of credit at that date. Therefore, the Company was eligible to use \$24.8 million of the line of credit as of December 31, 2006.

On May 31, 2005, the Company entered into a \$30.0 million, two-year revolving line of credit agreement with Wells Fargo Foothill, Inc. The Company capitalized \$1.3 million in fees, including the fair value of a four-year warrant issued to the lender to purchase 50,000 shares of its common stock with an exercise price of \$6.60 per share, which was exercised on February 27, 2007. That line of credit was collateralized by all of the Company's assets and pledges of the stock of its subsidiaries. The agreement was replaced in December 2006 and the remaining unamortized fee balance of \$286,000 was charged to interest expense on the accompanying Consolidated Statement of Operations.

#### NOTE 15 SHAREHOLDERS' EQUITY

**Preferred Stock:** The Company has 5,000,000 shares of undesignated preferred stock authorized, and no shares of preferred stock outstanding.

**Common Stock:** On December 19, 2006, the Company completed a public offering of 8,625,000 shares of newly issued common stock at a public offering price of \$10.00 per share. The Company received net proceeds of \$81.3 million from the offering, after underwriting discount and selling expenses. The Company expects to use the net proceeds for general corporate purposes.

In 2004, the Company issued 1,890,221 shares of its common stock and 1,210,105 exchangeable shares in connection with the acquisition of OctigaBay.

**Exchangeable Shares:** Shares of exchangeable stock were issued by one of the Company's Nova Scotia subsidiaries in connection with the April 2004 acquisition of OctigaBay. No exchangeable shares were outstanding as of December 31, 2006.

**Shareholder Warrants:** At December 31, 2006, the Company had outstanding and exercisable warrants to purchase an aggregate of 1,334,852 shares of common stock, as follows:

Shares of Common Stock	Exercise Price per Share	Expiration Date of Warrants
50,000	\$ 6.60	June 3, 2009
1,284,852	\$ 10.12	June 21, 2009
1,334,852		

On February 27, 2007, the warrant for 50,000 shares of common stock was exercised, and the Company issued 25,194 shares in the net exercise transaction.

**Restricted Stock:** During 2006, the Company issued an aggregate of 354,993 shares of restricted stock to certain directors, executives and managers. The Company will record approximately \$3.6 million in stock compensation expense for these issuances ratably over the vesting period, which is generally two years for non-employee directors and four years for officers and employees of the Company. In the fourth quarter of 2005, the Company issued an aggregate of 491,250 shares of restricted stock to certain executives and managers. These shares will become fully vested on June 30, 2007. The Company recorded a deferred compensation charge of \$2.9 million for the issuance of these shares, and will recognize compensation expense ratably over the 18-month vesting period. As of December 31, 2006, \$2.1 million of expense has been recorded for these restricted stock issuances, and an aggregate of \$4.4 million remains to be expensed over the respective vesting periods of the grants.

**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Stock Option Plans:** As of December 31, 2006, the Company had five active stock option plans that provide shares available for option grants to employees, directors and others. Options granted to employees under the Company's option plans generally vest over four years or as otherwise determined by the plan administrator; however, options granted during 2005 were generally granted with full vesting on or before December 31, 2005, in order to avoid additional expense related to the options under the implementation of FAS 123R and to enhance short-term retention. Options to purchase shares expire no later than ten years after the date of grant.

On December 20, 2005, the Company announced a stock option repricing for certain outstanding options as of that date, the purpose of which was to reduce the number of new options needed for grant at the same time, since the Company had a limited number of shares available for such grant. A total of 318,565 options with original exercise prices from \$14.52 to \$34.12 per share were repriced to an exercise price of \$5.96 per share, all of which were fully vested at the time of repricing. Per the requirements of FIN No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, the stock option modification resulted in variable stock option accounting from the date of repricing until the end of the year; however, because the closing price of the Company's common stock on December 31, 2005, was less than the re-grant price, no compensation expense was recorded.

Twice during 2005, the Board of Directors approved the acceleration of the vesting of all unvested outstanding stock options previously granted to employees and executive officers under the Company's stock option plans which exceeded certain exercise price thresholds. In March 2005 the threshold for accelerated vesting was all options with a per share exercise price of \$9.44 or higher (the market price of the Company's common stock on the date of the change), while in May 2005 the threshold was all options with a per share exercise price of \$5.88 or greater (the market price of the Company's common stock on the date of the change). This acceleration resulted in options to acquire approximately 1.2 million shares of the Company's common stock becoming immediately exercisable. Options granted to consultants and to non-employee directors were not accelerated. All other terms and conditions applicable to outstanding stock option grants, including the exercise prices and numbers of shares subject to the accelerated options, were unchanged. The acceleration resulted in a charge to income of approximately \$1.1 million related to the deferred compensation of previously unvested options granted as part of the OctigaBay acquisition in April 2004. The acceleration eliminated future compensation expense that the Company would have recognized in its Consolidated Statements of Operations with respect to these options upon the adoption of FAS 123R, on January 1, 2006.

In connection with a restructuring plan announced in June 2005, the Company amended the stock option grants for certain terminated employees to extend the exercise period of vested stock options, which is normally three months from the date of termination. No compensation expense was recorded as the fair market value of the Company's stock (the closing market price of the Company's stock on the date of the change) was less than the respective stock option exercise prices.

## CRAY INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the Company's stock option activity and related information follows:

	Options	Weighted Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2004	3,035,033	\$ 20.92		
Granted	1,004,958	18.36		
Exercised	(218,964)	12.92		
Canceled	(249,929)	21.64		
Outstanding at December 31, 2004	3,571,098	20.64		
Granted	1,278,567	8.56		
Exercised	(22,295)	6.24		
Canceled	(327,225)	16.60		
Outstanding at December 31, 2005(a)	4,500,145	16.56		
Granted	725,430	10.44		
Exercised	(381,890)	6.87		
Canceled	(976,270)	23.25		
Outstanding at December 31, 2006	3,867,415	14.68	7.0 years	\$ 7.2 million
Exercisable at December 31, 2006	3,144,887	15.64	6.4 years	\$ 6.2 million
Available for grant at December 31, 2006	2,319,928			

(a) The weighted average exercise price of outstanding options at December 31, 2005 includes the impact of the 2005 repricing of 318,565 options, as described above.

The aggregate intrinsic value in the table above 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 2006 and the exercise price, multiplied by the number of shares) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount changes, based on the fair market value of the Company's stock. Total intrinsic value of options exercised was \$1.6 million for the year ended December 31, 2006. Weighted average fair value of options granted during the year ended December 31, 2006 was \$6.00 per share.



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A summary of the Company's unvested restricted stock grants and changes during the years ended December 31 is as follows:

	<b>Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Outstanding at December 31, 2004		\$
Granted during 2005	491,250	5.87
Outstanding at December 31, 2005	491,250	5.87
Granted during 2006	354,993	10.08
Outstanding at December 31, 2006	846,243	7.63

F-24

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**CRAY INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of December 31, 2006, the Company had \$8.7 million of total unrecognized compensation cost related to unvested stock options and unvested restricted stock grants, which is expected to be recognized over a weighted average period of 2.8 years.

Outstanding and exercisable options by price range as of December 31, 2006, are as follows:

Range of Exercise Prices per Share	Number Outstanding	Outstanding Options		Exercisable Options	
		Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.00 \$ 4.00	87,111	8.6	\$ 3.77	87,111	\$ 3.77
\$ 4.01 \$ 8.00	789,160	6.9	\$ 6.25	780,863	\$ 6.24
\$ 8.01 \$10.00	292,921	7.1	\$ 9.32	270,046	\$ 9.38
\$10.01 \$12.00	1,092,908	8.5	\$ 10.67	403,008	\$ 10.87
\$12.01 \$14.00	208,181	7.7	\$ 13.70	208,181	\$ 13.70
\$14.01 \$16.00	534,145	6.6	\$ 15.15	534,145	\$ 15.15
\$16.01 \$32.00	542,743	4.8	\$ 24.99	541,337	\$ 24.98
\$32.01 \$54.75	320,246	5.9	\$ 39.37	320,196	\$ 39.37
\$0.00 \$54.75	3,867,415	7.0	\$ 14.68	3,144,887	\$ 15.64

The following table (in thousands) sets forth the share-based compensation cost resulting from stock options and unvested stock grants recorded in the Company's Consolidated Statements of Operations for the years ended December 30, 2006, 2005 and 2004. The 2006 expense represents expense as a result of the adoption of FAS 123R. The 2005 and 2004 expense represents acquisition-related, share-based compensation expense arising from the acquisition of OctigaBay in 2004.

	2004	2005	2006
Cost of product revenue	\$	\$	\$ 60
Cost of service revenue			101
Research and development	5,068	3,444	386
Sales and marketing	2,837	579	334
General and administrative	3,229	13	1,218
Total share-based compensation expense	\$ 11,134	\$ 4,036	\$ 2,099

**Employee Stock Purchase Plan:** In 2001, the Company established an ESPP, which received shareholder approval in May 2002. The maximum number of shares of the Company's common stock that employees could acquire under the ESPP is 1,000,000 shares. Eligible employees are permitted to acquire shares of the Company's common stock through payroll deductions not exceeding 15% of base wages. The purchase price per share under the ESPP is 95% of the closing market price on the fourth business day after the end of each offering period. As of December 31, 2006 and 2005, 526,710 and 462,533 shares, respectively, had been issued under the ESPP.

## **NOTE 16 BENEFIT PLANS**

### *401(k) Plan*

The Company has a retirement plan covering substantially all U.S. employees that provides for voluntary salary deferral contributions on a pre-tax basis in accordance with Section 401(k) of the Internal Revenue Code of 1986, as amended. Prior to 2005, the Company matched 25% of employee contributions each calendar year, comprised of a 12.5% match of employee contributions in cash 45 days after each quarter and a 12.5% match determined annually by the Board of Directors and payable in cash or common stock of the Company. The Company eliminated its matching obligation as of June 30, 2005. However, the Company reinstated its match for

**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

2006 at 6.25% of total employee contributions, which was satisfied in 2007 through issuance of common stock. The Company's 2006, 2005 and 2004 matching contribution expenses were \$347,000, \$795,000 and \$1.6 million, respectively.

*Pension Plan*

The Company's German subsidiary maintains a defined benefit plan. At December 31, 2006 and 2005, the Company recorded a liability of \$1.9 million and \$1.7 million, respectively, which approximates the excess of the projected benefit obligation over plan assets of \$671,000 and \$599,000, respectively. Plan assets are invested in insurance policies payable to employees. Net pension expense was not material for any period. Contributions to the plan are not expected to be significant to the financial position of the Company. The Company's adoption of FAS 158, effective December 31, 2006, did not have a material impact on the financial position of the Company.

**NOTE 17 SEGMENT INFORMATION**

FAS No. 131, *Disclosure about Segments of an Enterprise and Related Information* ( FAS 131 ), establishes standards for reporting information about operating segments and for related disclosures about products, services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision-maker, or decision-making group, in making decisions regarding allocation of resources and assessing performance. Cray's chief decision-maker, as defined under FAS 131, is the Chief Executive Officer. During 2006, 2005 and 2004, Cray had one operating segment.

Product and service revenue and long-lived assets classified by significant country are as follows (in thousands):

	<b>United States</b>	<b>All Other Countries</b>	<b>Total</b>
<i>For the year ended December 31, 2004:</i>			
Product revenue	\$ 86,067	\$ 9,834	\$ 95,901
Service revenue	\$ 34,800	\$ 15,148	\$ 49,948
<i>For the year ended December 31, 2005:</i>			
Product revenue	\$ 104,274	\$ 47,824	\$ 152,098
Service revenue	\$ 33,377	\$ 15,576	\$ 48,953
Long-lived assets	\$ 50,464	\$ 50,255	\$ 100,719

*For the year ended December 31, 2006:*

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Product revenue	\$ 76,370	\$ 86,425	\$ 162,795
Service revenue	\$ 37,979	\$ 20,243	\$ 58,222
Long-lived assets	\$ 41,554	\$ 49,155	\$ 90,709

Revenue attributed to foreign countries are derived from sales to external customers. Revenue derived from U.S. government agencies or commercial customers primarily serving the U.S. government, and therefore under its control, totaled approximately \$105.4 million, \$111.2 million and \$107.8 million in 2006, 2005 and 2004, respectively. In 2006, two customers accounted for an aggregate of approximately 33% of total revenue. In 2005, one customer contributed approximately 18% of total revenue; in 2004, one customer accounted for approximately 27% of total revenue. In 2006, revenue in Korea accounted for 20% of total revenue, and revenue in the United

**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Kingdom accounted for 15% of total revenue. No single foreign country accounted for more than 10% of the Company's revenue in either of the other years presented.

Goodwill makes up a significant portion of the long-lived asset balances of the Company's foreign subsidiaries. At December 31, 2006 and 2005, goodwill comprised \$45.4 million and \$45.1 million, respectively, or 92% and 90%, respectively, of foreign long-lived asset balances.

**NOTE 18 RESEARCH AND DEVELOPMENT**

The details for the Company's net research and development costs for the years ended December 31 are as follows (in thousands):

	<b>2004</b>	<b>December 31, 2005</b>	<b>2006</b>
Gross research and development expenses	\$ 98,843	\$ 96,257	\$ 99,061
Less: Amounts reimbursed or included in cost of product revenue	(45,577)	(54,546)	(70,019)
Net research and development expenses	\$ 53,266	\$ 41,711	\$ 29,042

**NOTE 19 INTEREST INCOME (EXPENSE)**

The detail of interest income (expense) for the years ended December 31 is as follows (in thousands):

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Interest income	\$ 666	\$ 741	\$ 2,525
Interest expense	(301)	(4,203)	(4,620)
Net interest income (expense)	\$ 365	\$ (3,462)	\$ (2,095)

Interest income is earned by the Company on cash and cash equivalent balances, which are invested in highly liquid money market funds.

Interest expense in both 2006 and 2005 consisted of \$2.4 million on the Notes in each year, \$1.6 million and \$1.0 million, respectively, of amortization of capitalized issuance costs, and \$390,000 and \$765,000, respectively, of interest and fees on the line of credit with Wells Fargo Foothill, Inc. Amortization of fees capitalized for the line of credit increased in 2006 as the Company wrote off all remaining capitalized costs when it changed lines of credit, see *Note 14 Convertible Notes Payable and Lines of Credit*.

**NOTE 20 RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS**

Subsequent to the issuance of the December 31, 2004 consolidated financial statements, the Company determined that certain research and development costs were incorrectly charged to one of its product development contracts in 2004. The contract was accounted for under the percentage of completion method of accounting. The error resulted in revenue being recognized prematurely on the contract. Accordingly, the accompanying 2004 consolidated financial statements have been restated from the amounts previously reported to correct this error. Additionally, the Company has reclassified the cash flow impact of changes in restricted cash from financing activities to investing activities.

F-27

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**CRAY INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of the significant effects of the restatement is as follows (in thousands, except per share data):

	<b>Consolidated Statement of Operations</b>		
	<b>As</b>		
	<b>Previously Reported</b>	<b>As Restated</b>	<b>Change</b>
Year Ended December 31, 2004:			
Product revenue	\$ 99,236	\$ 95,901	\$ (3,335)
Total revenue	\$ 149,184	\$ 145,849	\$ (3,335)
Cost of product revenue	\$ 107,264	\$ 104,196	\$ (3,068)
Research and development (a)	\$ 50,198	\$ 53,266	\$ 3,068
Net loss	\$ (204,023)	\$ (207,358)	\$ (3,335)
Basic and diluted net loss per common share	\$ (9.79)	\$ (9.95)	\$ (0.16)

Notes:

- (a) Previously reported amount was increased by \$5,068 to conform to 2005 financial statement presentation. Amount was reclassified from Acquisition-related Compensation Expense.



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders  
of Cray Inc.

We have audited the accompanying consolidated balance sheets of Cray Inc. and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows for the years then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cray Inc. and Subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the 2006 and 2005 basic consolidated financial statements taken as a whole. The financial statement schedule listed in the index at Item 15(a)(2) is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule, for the years ended December 31, 2006 and 2005, has been subjected to the auditing procedures applied in the audits of the 2006 and 2005 basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the 2006 and 2005 basic consolidated financial statements taken as a whole.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Cray Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 5, 2007, expressed an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

As discussed in Note 3 to the consolidated financial statements, Cray, Inc. and Subsidiaries adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, effective January 1, 2006.

/s/ PETERSON SULLIVAN PLLC

Seattle, Washington  
March 5, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of Cray Inc.  
Seattle, Washington

We have audited the accompanying consolidated statements of operations, shareholders' equity and comprehensive income (loss), and cash flows of Cray Inc. and subsidiaries (the Company) for the year ended December 31, 2004. Our audit also included the financial statement schedule for the year ended December 31, 2004, listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the results of operations and cash flows of the Company for the year ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 20, the accompanying financial statements as of and for the year ended December 31, 2004, have been restated.

/s/ DELOITTE & TOUCHE LLP

Seattle, Washington  
March 31, 2005

(April 20, 2006 as to the effects of the restatement discussed in Note 20)

**Schedule II Valuation and Qualifying Accounts  
December 31, 2006**

<b>Description</b>	<b>Balance at Beginning of Period</b>	<b>Charge/(Benefit) to Expense</b>	<b>Deductions</b>	<b>Balance at End of Period</b>
<i>Year ended December 31, 2004:</i>				
Allowance for doubtful accounts	\$ 1,125	\$ 373	\$ (59)(1)	\$ 1,439
Warranty accrual	\$ 655	\$	\$ (655)	\$
<i>Year ended December 31, 2005:</i>				
Allowance for doubtful accounts	\$ 1,439	\$ 165	\$ (1,411)(1)	\$ 193
Warranty accrual	\$	\$	\$	\$
<i>Year ended December 31, 2006:</i>				
Allowance for doubtful accounts	\$ 193	\$ (17)	\$ (77)(1)	\$ 99
Warranty accrual	\$	\$	\$	\$

(1) Represents uncollectible accounts written off, net of recoveries.